5 Monetary and financial stability policies

This chapter describes the frameworks for monetary policy and financial stability in Iceland. It explains the objectives and the role of the Central Bank's Monetary Policy Committee and describes the Bank's main monetary policy instruments. It also elaborates on financial stability policies and the Central Bank's role in promoting an efficient and safe financial system.

The objective of monetary policy

The Central Bank of Iceland was established as a separate institution in 1961. The current Act on the Central Bank of Iceland entered into force in May 2001 and included substantial changes from the previous Act. In the 2001 Act, maintaining price stability was defined as the Bank's single main objective. The Bank was also granted financial and instrument independence, and any direct access by the Government to Central Bank financing was prohibited.

In a joint declaration issued by the Government and the Central Bank of Iceland on 27 March 2001, the price stability goal was further defined as an inflation target of 2½%, measured in terms of the twelve-month rate of change in the consumer price index (CPI). The declaration requires the Central Bank to keep inflation as close to the target as possible, on average. If inflation deviates from the target by more than 1½ percentage points in either direction, the Bank is obliged to submit a report to the Government, explaining the causes for the deviation, how the Bank intends to respond, and when it expects the inflation target to be reached again. The report is to be made public.

Since the financial crisis in 2008, monetary policy has used a wider range of policy instruments than it did before the crisis. The Central Bank has been active on both sides of the foreign exchange market (see Table 5.1). Furthermore, a new policy instrument to temper and affect the composition of capital inflows was introduced in June 2016 (see Box 5.1).

The Monetary Policy Committee

Amendments made to the Central Bank Act in 2009 included changes to the governance structure of the Bank, replacing the previous three-member Board of Governors with a single Governor and a Deputy Governor. The amended 2009 Act also provided for the establishment of a five-member Monetary Policy Committee (MPC) that takes decisions on the application of monetary policy instruments. The MPC consists of the Governor, the Deputy Governor, one Central Bank executive responsible for formulating monetary policy, and two outside experts in the field of economic and monetary policy appointed by the Minister of Finance and Economic Affairs.

According to the amended Act, decisions by the MPC must be based on the Bank's objectives and a thorough assessment of the current situation and the outlook for the economy, monetary developments, and financial stability. In implementing monetary policy, the MPC bases its deci-

Table 5.1 Monetary policy arrangements in Iceland since 1970

1970-1973	After the collapse of the Bretton Woods system, the Icelandic króna followed an adjustable peg to the US dollar.
1974-1983	Implementation of exchange rate policy became increasingly flexible and can be described as a managed float. The króna was first linked to the US dollar and then to various baskets of trading partner countries' currencies.
1984-1989	Exchange rate policy became more restrictive, with increasing emphasis on exchange rate stability. In 1989, however, the króna was devalued ten times in small increments.
1990-1995	More emphasis was placed on exchange rate stability as the anchor of monetary policy. Until 1992, the currency peg was specified vis-à-vis a basket of 17 currencies, weighted according to merchandise trading shares, with ±2¼% fluctuation bands. The basket was redefined in 1992, with the ECU given a weight of 76%, the US dollar 18%, and the Japanese yen 6%. The króna was devalued twice in this period, by 6% in November 1992 and by 7½% in June 1993. In September 1995, the fluctuation band was widened to ±6%, in response to the abolition of capital controls. The currency basket was also changed. The new basket contained 16 currencies, weighted by their share in Iceland's trade in goods and non-factor services.
1996-2000	Fluctuation of the króna within the bands increased as the foreign exchange market deepened and emphasis on price stability relative to exchange rate stability increased. Reflecting this, the exchange rate band was widened to ±9% in February 2000.
2001-2008	The exchange rate target was abolished in March 2001 and a formal 2½% inflation target adopted. The Central Bank was granted full independence in the application of its monetary policy instruments. The currency was allowed to move freely, with limited intervention in the foreign exchange market.
2008-	Following the financial crisis, and as a part of Iceland's IMF programme, monetary policy emphasised exchange rate stability together with the inflation target as a key ingredient in re-establishing nominal stability and securing low and stable inflation. Active use of foreign exchange intervention to lean against excessive exchange rate fluctuations has become an important part of the post-crisis monetary policy framework, dubbed "inflation targeting plus", which also emphasises the use of additional policy instruments such as macroprudential tools and capital flow management measures.[1] Decisions on the application of the Central Bank's monetary policy instruments are taken by the Monetary Policy Committee, which was established by law in 2009.

1. For further discussion, see the Central Bank report "Monetary policy in Iceland after capital controls", *Special Report* no. 4, 2010.
Source: Central Bank of Iceland.

sions, among other things, on an appraisal of economic developments and the outlook for the domestic economy as presented in the Bank's quarterly *Monetary Bulletin*.

In order to enhance transparency, the 2009 Act also stipulated that the minutes of MPC meetings are to be made public and an account given of the Committee's decisions and the premises upon which they are based. Furthermore, the MPC is required to submit a written report on its activities to Parliament twice a year. The contents of the report are to be discussed in the parliamentary committee of the Speaker's choosing.

Monetary policy instruments

The Bank's monetary policy instruments are its interest rates on transactions with credit institutions, open market operations, decisions on minimum reserve requirements, and intervention in the foreign exchange market. Financial institutions subject to reserve requirements – commercial banks, savings banks, and credit institutions – are eligible for Central Bank facilities. Icelandic branches of foreign financial institutions are eligible as well. According to the Rules on Central Bank Facilities for Financial Undertakings, securities issued in Icelandic krónur by the Republic of Iceland are the primary instruments eligible as collateral for Central Bank facilities.

Financial institutions' regular transactions with the Central Bank can be divided into two categories: standing facilities and open market operations. Financial institutions may avail themselves of standing facilities at any time and on their own initiative. The facilities offered by the Central Bank are deposits and overnight loans against acceptable collateral. Interest on overnight loans forms the ceiling of the Central Bank's interest rate corridor, while the current account deposit rate determines the floor.

The Central Bank's open market operations take place once a week on Wednesdays. Since 2009, the Bank's counterparties have had abundant liquidity. From autumn 2009 through May 2014, the Bank offered 28-day certificates of deposit (CD) for sale; however, in May 2014 the Bank made modifications to its monetary policy conduct without changing the monetary stance. Instead of issuing CDs, the Bank now offers two types of term deposits: one-week term deposits and one-month term deposits issued at the beginning of each month. The objective of these changes was to enhance the effectiveness of liquidity management and to increase efficiency from the standpoint of the Bank's balance sheet.

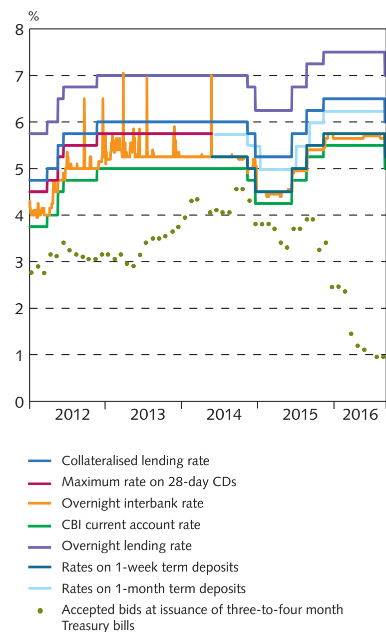
The key Central Bank interest rate – i.e., the rate that is most important in determining short-term market rates – may vary from time to time. Owing to abundant financial system liquidity, the key rate is the rate on one-week term deposits, as of this writing. As a general rule, the Bank does not offer its counterparties deposits and loan facilities at the same time. Thus counterparties do not currently have access to collateralised loans, except for emergency overnight loans.

Financial stability and the Central Bank

In performing its role of promoting financial stability and a sound and efficient financial system, including domestic and cross-border payment systems, as is stipulated in the Central Bank Act, the Central Bank of Iceland focuses on assessing risks among systemically important financial institutions, identifying external imbalances, and securing safe and sound operation of payment and securities settlement systems. The Bank regularly analyses the risks and threats to the stability of the Icelandic financial system in order to detect changes and vulnerabilities that could lead to a serious crisis, and it communicates its overall assessment to markets and decision-makers through the publication of its semi-annual *Financial Stability* report. The bank also publishes an annual report entitled *Financial Infrastructure*.

To promote financial stability, the Central Bank sets prudential rules on credit institutions' liquidity, funding and foreign exchange balance. In its work on financial stability, the Central Bank takes into account international agreements and standards for best practice.

Chart 5.1
Central Bank of Iceland interest rates and short-term market rates
Daily data 1 January 2012 - 31 August 2016



Source: Central Bank of Iceland.

Prudential framework

Iceland's European Economic Area (EEA) membership entails that financial regulation is based on EU regulations and directives. Also, technical standards and guidelines are provided by the three European supervisory authorities, EBA, EIOPA, and ESMA.

The Financial Supervisory Authority (FME) supervises financial undertakings and entities operating in the financial and insurance sectors, while the Central Bank issues liquidity regulations and carries out liquidity supervision. The FME and Central Bank of Iceland have a cooperation agreement whose main aim is to strengthen cooperation and exchange of information between the two institutions.

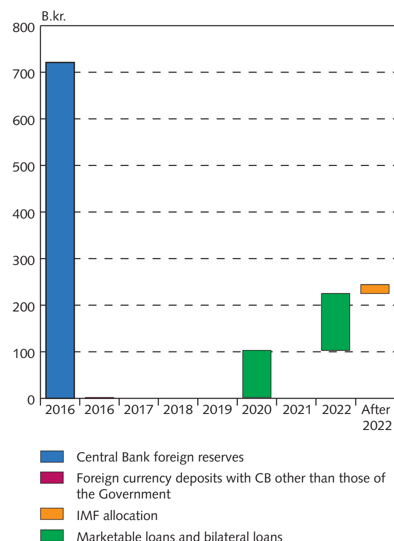
A new Act on a Financial Stability Council (FSC) entered into force in 2014. The Council serves as a forum for cooperation, information sharing, and policy-making regarding financial stability, and it coordinates Government responses in the event of a financial crisis. The Council makes recommendations concerning macroprudential policy to the appropriate authorities, which are legally bound to comply or explain. Members of the Council are the Minister of Finance and Economic Affairs (chair), the Governor of the Central Bank of Iceland, and the Director General of the FME.

A Systemic Risk Committee (SRC) works for the FSC. The SRC evaluates the current situation and outlook for the financial system, systemic risk, and financial stability. It examines the interaction of the application of the FSC member institutions' policy instruments that affect financial stability (with the exception of the Central Bank of Iceland's monetary policy instruments) and presents proposals to the FSC. The SRC comprises five members: the Governor of the Central Bank (Chair); the Director General of the FME (Vice-Chair); the Deputy Governor of the Central Bank; the Deputy Director General of the FME; and one expert who is appointed for a term of five years by the Minister of Economic Affairs.

Foreign exchange reserves

One of the Central Bank of Iceland's legally mandated functions is to manage Iceland's foreign exchange reserves. The Central Bank's foreign exchange reserves enable it to achieve its goals and fulfil its duties according to the Central Bank Act. The foreign reserves mitigate the effects of external risks related to changes in access to foreign credit and fluctuations in capital flows to and from Iceland. They enable the Bank to help the Treasury meet its need for foreign currency and fulfil its foreign debt obligations. Adequate reserves also facilitate market confidence by ensuring that Iceland is able to service its foreign debt. They can also be used to support monetary policy and lean against excessive exchange rate fluctuations.

Chart 5.2
Repayment profile of Central Bank and Treasury foreign debt
Position 31 July 2016



Source: Central Bank of Iceland.

As a rule, the size of the reserves is determined with reference to the scope of external trade, the monetary and exchange rate regime, regulatory provisions on capital movements and foreign exchange transactions, and Iceland's foreign liabilities. At any given time, the necessary size of the reserves is also determined by the balance of payments outlook. The Governor issues instructions on the desirable size of the reserves, based on the above-mentioned factors.

In preparation for the general liberalisation of capital controls, the Central Bank has purchased foreign currency through foreign exchange interventions in order to build up the foreign exchange reserves in advance of upcoming steps in the capital liberalisation process. At the end of July 2016, the reserves amounted to the equivalent of 32% of GDP and 43% of M3, and covered nine months of goods and service imports. Furthermore, at that time, the size of the reserves compared favourably to the IMF's reserve adequacy metric (RAM): the current ratio equals 160%, thus exceeding the 150% ratio that the Central Bank and the IMF considered necessary in the run-up to capital account liberalisation.

Box 5.1

New policy instrument to temper and affect the composition of capital inflows

On 4 June 2016, the Central Bank of Iceland published new Rules on Special Reserve Requirements for New Foreign Currency Inflows, no. 490/2016, in accordance with the new Temporary Provision of the Foreign Exchange Act, no. 87/1992.[1] The main purpose of the Temporary Provision is to provide the Central Bank with a policy instrument, generally referred to as a capital flow management measure (CFM), which is designed to temper inflows of foreign currency and to affect the composition of such inflows. It is therefore intended to reduce the risk that could accompany excessive capital inflows under the current foreign exchange regulatory framework, support other aspects of domestic economic policy, and contribute to overall macroeconomic and financial stability. The CFM is intended to support monetary policy and reduce systemic risk so as to safeguard financial stability. It is also designed to mitigate implementation risks associated with the final steps of capital account liberalisation.

The Central Bank's CFM is based on the application of special reserve requirements for new inflows of foreign currency. The Rules contain provisions concerning special reserve requirements for specified new foreign currency inflows; they specify the special reserve base, holding period, special reserve ratio, settlement currency, and interest rates on deposit institutions' capital flow accounts with the Central Bank of Iceland. The special reserve base is defined as new inflows of foreign currency in connection with specified types of capital, including new investment in registered bonds and bills and certain types of deposits. In addition, new inflows related to loans taken for investment in such instruments can create the special reserve base. Deposit institutions are required to deposit the special reserve amount that they hold in special reserve accounts to a capital flow account with the Central Bank. The amount deposited shall equal 100% of the special reserve amount. The Foreign Exchange Act states that the holding period may be as long as five years and that the special reserve ratio may be as high as 75% of total inflows; however, the Rules set the holding period at one year and the special reserve ratio at 40%. The Rules also

1. The bill of legislation was passed on 2 June, and the Rules were published on 4 June and amended on 16 June. A list of frequently asked questions and answers on the rules can be found on the Central Bank's website: http://www.cb.is/foreign-exch/questions-answers/faq-on-rules-no.-490-2016/

specify the Icelandic króna as the settlement currency and set the interest rate on the capital flow accounts at 0%, although it is stated explicitly in the Foreign Exchange Act that the interest rate could be negative.

The use of the CFM is not intended to replace or be a substitute for appropriate implementation of conventional fiscal and monetary policy but rather to complement and support it. The reserve requirements are directed first and foremost towards the portion of inflows that obstruct monetary policy transmission and are conducive to financial and economic instability. Profits on long-term investments will be affected to a limited degree, and equity investments are exempted. Furthermore, the temporary aspect of the CFM and its incorporation into the current legal framework on foreign exchange allow it to mitigate the risk of excessive inflows within the current regime and thereby facilitate the complete removal of capital controls. Nevertheless, the Central Bank has stated on a number of occasions that a policy instrument of this sort will also be needed during the post-liberalisation phase. Work on the development of such an instrument is currently underway.