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, as well as the capital flow management measure currently in effect. It also elaborates on financial stability policies and the Central Bank's role in promoting an efficient and stable financial system.The chapter concludes with a box that reviwes the imposition and liberalisation of the capital controls.

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, no. 36/2001, entered into force in May 2001 and included substantial amendments from the previous Act. In the 2001 Act, 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 on 27 March 2001, the price stability goal was further defined as an annual inflation rate of about 2½%, measured in terms of the twelve-month rate of change in the consumer price index (CPI). If inflation deviates from the target by more than 1½ percentage points in either direction, the Central Bank shall bring it inside that range as quickly as possible. In such circumstances, the Bank is obliged to submit a report to the Government, explaining the reasons for the deviations from the target, how the Bank intends to react, and how long it will take to reach the inflation target again, in the Bank's assessment. The report shall be made public.

Since the financial crisis in 2008, the Central Bank has used a wider range of monetary policy instruments than it did before the crisis (see Table 5.1). Until mid-2017, the Central Bank was an active buyer in the foreign exchange market, but it has reduced its intervention since then, as the foreign exchange reserves had become large enough and the exchange rate appeared to reflect underlying fundamentals. However, the Bank has stated that it will intervene in the market in order to mitigate volatility when it considers such intervention warranted. Furthermore, a capital flow management measure entailing a special reserve requirement (SRR) on a portion of new inflows of foreign currency to Iceland was introduced in June 2016.

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 2009 amendment 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, a senior Central

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 their share in merchandise trade, 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 in 2008-2011, 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.

Bank official in the field of monetary policy, and two outside experts in the field of economic and monetary policy, who are appointed by the Prime Minister.

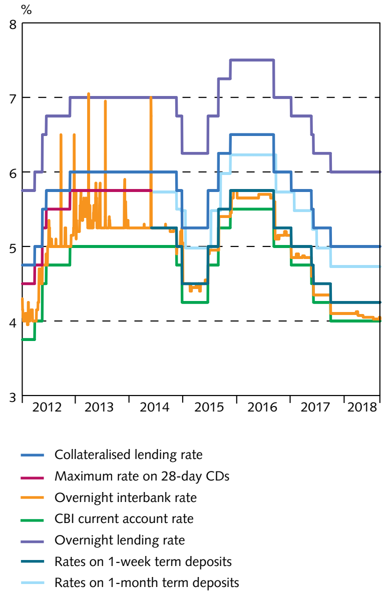
According to the amended Act, decisions by the MPC must be based on the Bank's objectives and a thorough assessment of the current situation and the outlook for the economy, monetary developments, and financial stability. In implementing monetary policy, the MPC bases its decisions in part on an appraisal 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 principal monetary policy instrument is its interest rates on transactions with credit institutions. Other policy instruments include open market operations, decisions on minimum reserve requirements, intervention in the foreign exchange market, and special reserve require-

Chart 5.1
Central Bank of Iceland interest rates and short-term market rates
Daily data 1 January 2012 - 31 August 2018



Source: Central Bank of Iceland.

ments on capital inflows. Financial institutions subject to reserve requirements – commercial banks, savings banks, and credit institutions – are eligible for access to 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: seven-day 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. As of this writing, the key rate is the rate on seven-day term deposits, owing to abundant financial system liquidity. 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. As of June 2018, the minimum reserve requirement is divided into two parts, a fixed non-remunerated 1% reserve requirement and a 1% requirement currently bearing an interest rate of 4%.

Special reserve requirement on 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 a new Temporary Provision of the Foreign Exchange Act, no. 87/1992.[1] The Temporary Provision provides

1. A list of frequently asked questions and answers on the Rules can be found on the Central Bank website: https://www.cb.is/foreign-exch/capital-flow-measures/.

the Central Bank with a policy instrument, generally referred to as a capital flow management measure (CFM), which entails a special reserve requirement (SRR) on new inflows of foreign currency to Iceland in connection with specified types of capital, including new investment in registered bonds and bills and high-yielding deposits. The objectives of introducing the SRR were to mitigate the risk that can accompany large-scale capital inflows and to promote more effective monetary policy transmission by attempting to temper cross-border inflows and affect their composition. The SRR therefore serves as a macroprudential tool that can impede the build-up of systemic risks, supporting other aspects of domestic economic policy, and contributing to overall macroeconomic and financial stability. The use of the SRR is not intended to be a substitute for appropriate implementation of conventional macroeconomic policy and micro- and macroprudential tools but rather to complement and support it as a third line of defence.

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 Bank focuses on assessing risks among systemically important financial institutions, identifying 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 Market 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.

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 promote a healthy financial system. The agreement also strengthens cooperation and exchange of information between the two institutions and coordinates their responses to systemic risks or crises.

A Financial Stability Council (FSC) was established 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. Members of the Council are the Minister of Finance and Economic Affairs (chair), the Governor of the Central Bank, 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 appointed for a term of five years by the Prime Minister.

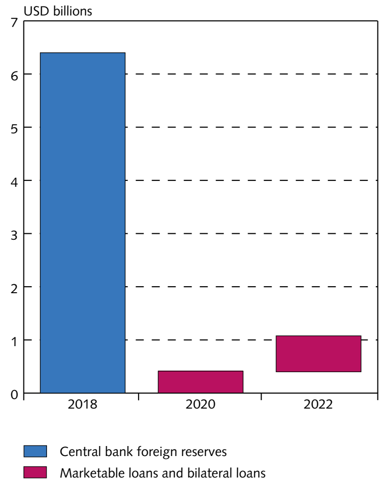
International reserves

One of the Central Bank of Iceland's legally mandated functions is to manage Iceland's international reserves. The Central Bank's international reserves enable it to achieve its goals and fulfil its duties according to the Central Bank Act. The 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 volatility.

The size of the reserves is generally 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 size of the reserves is also determined by the balance of payments outlook.

The international reserves have grown in recent years, mainly due to Central Bank purchases of foreign currency through market intervention, which was part of the Bank's policy of mitigating excess short-term exchange rate volatility and building up the reserves during the run-up to capital account liberalisation. The size of the reserves peaked in early 2017, when important steps towards capital account liberalisation were taken and the Bank purchased offshore króna assets. Following these steps, the need to continue building up the international reserves receded. Since June 2017, the size of the reserves has been steady at around 6.5 billion US dollars, and close to 150% of the IMF's reserve adequacy metric (RAM). At the end of June 2018, the reserves amounted to the equivalent of 27% of GDP and 38% of M3, and covered eight months of goods and services imports.

Chart 5.2
Central Bank foreign reserves and repayment profile of Treasury foreign debt
Position 30 June 2018



Source: Central Bank of Iceland.

Box 5.1

Imposition and liberalisation of capital controls 2008-2017

The policy response and objectives of the capital controls

In October 2008, Iceland suffered a systemic currency and banking crisis of major proportions. The passage of the so-called Emergency Act (the Act on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances, etc., no. 125/2008) provided, among other things, for immediate intervention in the operations of the collapsing banks. Capital controls were introduced in late November 2008, following the formal adoption of the IMF Stand-By Arrangement with Iceland.

The objective of the capital controls was to place temporary restrictions on certain types of cross-border capital transfers and foreign exchange transactions that could cause monetary and exchange rate instability while the resurrection of the Icelandic economy and financial system was underway. The capital controls played an important role in achieving and safeguarding the objectives of the policy response developed by the domestic authorities with the support of the IMF.

The capital controls prevented further depreciation of the currency by limiting disorderly outflows. They also supported asset prices by limiting fire sales by financially distressed financial institutions, firms, and households. In addition, they allowed monetary policy to be more accommodative than would otherwise have been possible, thereby reducing the Government's cost of financing, supporting asset prices, limiting the depth of the recession, and expediting economic recovery. They provided shelter for necessary private sector balance sheet restructuring and gave the authorities time to strengthen the policy framework in order to reinstate and safeguard macroeconomic and financial stability. The country's exposure to global financial conditions diminished, as the capital controls weakened the financial channel through which external shocks could affect the domestic financial system and economy. Finally, the capital controls eventually served as an instrument to affect the resolution of the failed banks' estates and prevent a disorderly resolution involving undue risk to macroeconomic and financial stability.

Although the controls were instrumental in preserving financial stability and safeguarding Iceland's medium-term balance of payments in the wake of the crisis, the longer they remained in effect, the more the costs began to catch up with the benefits, ultimately necessitating liberalisation.

The capital account liberalisation strategy

Icelandic economic factors, as well as relevant external factors that could affect capital outflows, were relatively favourable when the revised liberalisation strategy was presented in June 2015 (for a more detailed discussion, see Chapter 8 in *Economy of Iceland* 2016). It proposed a phased lifting of the controls, with the first phase focusing on the failed banks' estates, the second on offshore krónur, and the third on households and businesses. The strategy involved reducing the size of outflows through the foreign currency market in connection with the resolution of the failed banks' estates, while reducing the externalities associated with outflows from offshore króna owners through an auction and effecting a secure segregation of the onshore and offshore markets during the liberalisation process.

The total scope of the risk addressed by the strategy amounted to as much as 56% of GDP. The assets concerned consisted of krona-denominated assets held by the insolvent estates of the failed commercial banks and savings banks (23% of GDP), foreign-denominated claims held by these estates against domestic parties (18% of GDP), and offshore krónur owned by non-residents (15% of GDP). The actions comprising the authorities' liberalisation strategy prevented the sales proceeds of these assets from flooding the foreign exchange market and thereby undermining economic, monetary, and financial stability.

The failed banks' estates and offshore krónur

The failed banks' estates were presented with two options: conclude composition agreements in accordance with specific stability conditions before year-end 2015 (later extended to 15 March 2016), or face a one-off stability tax of 39% on their total assets. The stability conditions aimed to reduce the size of potential capital outflows in connection with the distribution of the estates' domestic assets and thereby neutralise, to the extent possible, their effects on Iceland's balance of payments. The estates opted for the composition agreements.

The balance of payments effect of distributions from the estates was mitigated when króna-denominated assets were reduced. The stability contribution amounted to 17.2% of year-2015 GDP, thus reducing the estates' domestic assets and limiting outflows. The settlement of the estates through composition agreements based on stability conditions was more or less finalised between June 2015 and May 2016. With the composition agreements, the estates' liabilities were written off with reference to their assets. The NIIP improved markedly because of the estates' stability contributions, as well as a revaluation of the estates' liabilities.

The revised liberalisation strategy also addressed offshore krónur. The stock of offshore krónur had shrunk markedly during the years prior to the presentation of the revised strategy in June 2015, mainly due to Central Bank auctions. However, uncertainty still remained concerning the extent to which offshore króna owners would choose to reduce their exposure once controls were lifted. Therefore, in June 2016, the Central Bank offered to use part of its foreign exchange reserves to buy offshore krónur in a single-price auction, the last auction of this type before removal of capital controls on domestic firms and households. The auction helped to facilitate the exit of offshore krónur without negative effects on the foreign exchange market.

In August 2016 the Central Bank temporarily authorised withdrawal of part or all of the funds from accounts subject to special restrictions so that the account owners could use the funds for foreign exchange transactions with the Bank. The authorisation remained in effect until 1 November 2016. Some 70.5 million euros (15.5 b.kr.) were exchanged in this manner. Furthermore, the Bank bought offshore króna assets in two stages, between March and June 2017, for a total of 817.5 million euros (112.4 b.kr.). The stock of offshore króna assets was estimated at about 770 million euros (88 b.kr.) following the trades.

With the passage of Act no. 27/2017 on 27 May 2017, as a part of the liberalisation strategy, the authorisation to make withdrawals from accounts subject to special restrictions was changed. As a result of this, individuals were authorised to withdraw up to 0.9 million euros (100 m.kr.) per calendar year from accounts subject to special restrictions if they could demonstrate continuous ownership of the offshore króna assets since 28 November 2008.

Households and businesses

In accordance with the revised liberalisation strategy of June 2015, Parliament passed an amendment to the Foreign Exchange Act, no. 87/1992, in October 2016. The amendment gave businesses and individuals considerably greater freedom to transfer capital to and from Iceland and engage in foreign exchange transactions. This represented an important step towards general liberalisation of the capital controls. The amendment removed certain restrictions on foreign exchange transactions and cross-border movement of capital and expanded specified authorisations under the Act.

According to the amended Act, general liberalisation was sequenced as follows: Outward foreign direct investment was permitted and restrictions on long- and short-term portfolio investment eased up to a limit of 226 thousand euros (30 m.kr.) immediately upon passage of the amendment. Effective 1 January 2017, the limit was raised to 754 thousand euros (100 m.kr.) per party and expanded to include cross-border deposit transfers. The Central Bank was authorised to ease these limits until they are abolished, along with limitations on derivatives, other instruments, and other remaining restrictions. This phase of liberalisation excluded both offshore króna holdings and pension funds (in excess of the limits stated above); however, due to their size, pension funds continued to invest abroad on an exemption basis. From mid-2015 through end-2016, pension funds were granted exemptions for foreign investment in the amount of about 797 million euros (95 b.kr.), or 3.9% of GDP. These exemptions met some of their pent-up need for foreign investment.

Upon the adoption of the measures provided for in the amended Act, the capital controls placed only minor restrictions on most individuals, and by year-end 2016, very few individuals were affected. The amendment did not have any impact on offshore króna holders' authorisations.

After the second step was taken to ease restrictions on households and businesses, the Central Bank reassessed conditions for further liberalisation of the capital controls. The risk of balance of payments disequilibrium that could cause monetary, exchange rate, or financial instability had diminished significantly. First of all, restrictions on capital transfers in excess of specified maximum amounts had been lifted without discernible impact on the foreign exchange market or on cross-border movement of capital. When the ceiling on such transfers was raised at the turn of the year, the vast majority of individuals and companies were effectively unrestricted by the Foreign Exchange Act. Second, the Central Bank's international reserves had increased markedly during the preceding twelve months, to a total of about 7 billion euros (800 b.kr.), or 33% of GDP, as of end-February 2017. The expansion of the reserves stemmed from a current account surplus in the amount of 7.5% of GDP in 2016, well in excess of forecasts. The risk of instability was further reduced by the outlook for a continuing current account surplus, reduced foreign liabilities, and a positive net international investment position for the first time in the history of measurements. In addition, conditions in the global economy were favourable for liberalisation of the capital controls. Third, it was foreseeable that the Bank's purchase of offshore krónur from the largest holders would reduce risk in the long run and facilitate full liberalisation of the capital controls.

New Rules on Foreign Exchange, No. 200/2017, were published 14 March 2017. The new Rules granted general exemptions from nearly all of the restrictions in the Foreign Exchange Act and abolished the repatriation requirement for foreign currency. With the introduction of the Rules, households and businesses were, for the most part, no longer subject to the restrictions that the Foreign Exchange Act places on foreign exchange transactions, foreign investment, hedging, and lending activity, among other things. The new Rules also authorised unrestricted foreign investment by pension funds, funds for collective investment (UCITS), and other investors in excess of the maximum amounts provided for in the Foreign Exchange Act. Until then, such foreign investment had been subject to explicit exemptions by the Central Bank.

The remaining restrictions

During the liberalisation process described above most of the capital controls that were imposed during and in the wake of the financial crisis have been lifted. For households and businesses virtually all controls are gone. Overall, what remains of capital controls are two kinds of restrictions. First, those that cannot be lifted without changes in legislation. That applies to the release of the remaining offshore krónur amounting to 703 million euros (87 b.kr.), or 3.2% of GDP. Second, those restrictions that are needed to ensure the continued effectiveness of the SRR on capital flows into the bond market and high yielding deposits. That includes mainly derivative trading for other purposes than hedging and certain specific cross-border capital transfers and foreign exchange transactions that are restricted in order to reduce the risk of carry trade associated with investments outside the scope of the SRR.