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## Foreign exchange market, exchange rate developments, and international reserves 2022

*The króna depreciated by 2.1% in 2022, and turnover in the interbank foreign currency market increased by 6% year-on-year. The Central Bank traded in the market to mitigate exchange rate volatility as it deemed warranted. Although the Bank both bought and sold currency in 2022, its net foreign currency purchases for the year totalled 13.2 b.kr. Public health restrictions due to the COVID-19 pandemic were lifted at the end of February, which had a positive impact on the tourism sector. Tourism-generated export revenues increased over the course of the year and were back to the pre-pandemic level by early summer. Russia's invasion of Ukraine and the ensuing uncertainty in global markets strongly affected developments in the domestic foreign exchange market in 2022. The pension funds continued buying significant amounts of foreign currency, and there were several large capital transactions by domestic and foreign entities during the year. At the year-end, the Bank's international reserves totalled 837 b.kr., or 24% of GDP.*

### **Exchange rate developments**

The króna depreciated by 2.1% in trade-weighted terms, by 2.6% against the euro, and by 8.2% against the US dollar in 2022. It strengthened in H1/2022 but then weakened in H2. The exchange rate was more volatile in 2022 than in 2021. Pandemic-related public health measures within Iceland were significantly relaxed in January, and all measures were abolished in February, both within Iceland and at the border. There was considerable optimism about turnover in key export sectors, as analysts forecast a busy summer tourist season and the capelin quota was increased markedly. The króna depreciated abruptly following Russia's invasion of Ukraine, and exchange rate volatility increased somewhat, but the depreciation quickly reversed. Forward foreign currency transactions grew over the first half of the year. The increase suggests more speculation with the króna, but it also indicates that exports sold a portion of their foreign exchange revenues via forward contracts. Authorisations for derivatives trading were expanded in 2021, perhaps causing expectations about the exchange rate of the

króna to have a stronger impact than before. Forward currency sales peaked in June, and the position then declined in H2. The króna was at its strongest at the end of May, when it was up 7.4% year-on-year.

Even though revenues in key export sectors grew markedly over the year, the króna depreciated. From the beginning of June through the year-end, it weakened by 8.3%, bottoming out in December. Changed expectations stemmed from various factors, including the deteriorating outlook for global markets in the wake of the war in Ukraine, growing imports, and a current account deficit. Furthermore, the pension funds bought twice as much foreign currency as in 2021, with net purchases totalling 104 b.kr. This was offset in part by inflows of foreign capital for investment in domestic assets. The second offering of share capital in Íslandsbanki was held in March, and foreign investors bought shares in the bank. Foreign investors also bought Treasury bonds during the year, in particular the new nominal Treasury series maturing in 2042 (RIKB 42). The Icelandic equity market was reclassified from frontier to secondary emerging market status by index provider FTSE Russell. The upgrade was divided into three phases, the first two of which were completed in September and December 2022. Foreign investment funds invested in Icelandic equities thereafter. In H2/2022, two listed companies sold their shares in domestic subsidiaries to foreign investors for substantial amounts. Foreign investment funds' holdings in Icelandic shares therefore increased during the year, and inflows for investment in unlisted shares were significant as well.

### **Foreign exchange market**

The Central Bank's foreign exchange market transactions during the year aimed at mitigating volatility as conditions warranted. The Bank's net foreign currency sales in the market totalled 13.2 b.kr. during the year. In all, the Bank bought currency for 33.9 b.kr. (240 million euros) and sold currency for 20.7 b.kr. (143 million euros). Purchases peaked at 18 b.kr. in April, in connection with foreign investment in Icelandic Treasury bonds. The Bank's purchases took place over the first five months of the year, although in February and March the Bank both bought and sold currency. Russia's invasion of Ukraine created temporary unrest in the foreign exchange market, and the Central Bank sold currency. The market appeared relatively well balanced over the summer months, and the Bank conducted no transactions. In September

and November, the Bank sold currency for a total of 10.8 b.kr., but it did not trade in the market in October and December.

Turnover in the interbank foreign exchange market totalled 385 b.kr. (2.7 billion euros) in 2022, an increase of 6% relative to 2021. The Bank's share in market turnover was 14%, down from 21% in 2021.

### **International reserves**

At the end of 2022, the Central Bank's international reserves amounted to 837.1 b.kr., some 86 b.kr. less in krónur terms than at year-end 2021. In US dollar terms, the reserves shrank by 1.2 billion dollars, to a total of 5.9 billion dollars at the year-end. At that time, the reserves totalled 24% of GDP and 33% of broad money holdings (M3), and they covered eight months' worth of goods and services imports. Two foreign-denominated Treasury bonds matured during the year in the combined amount of 88.5 b.kr., which for the most part explains the reduction in the reserves.

Market interventions and other foreign exchange transactions reduced the reserves by 5.4 b.kr. Interest income net of interest expense on the Central Bank's external assets and liabilities totalled 4 b.kr. Price changes in the markets reduced the international reserves by 33 b.kr., and exchange rate movements led to an increase of 36.8 b.kr. At the end of 2022, the international reserves net of the Central Bank and the Treasury's foreign-denominated debt amounted to 602 b.kr., as compared with 579 b.kr. at the end of 2021.

The Central Bank's foreign exchange balance – i.e., the difference between the Bank's foreign-denominated assets and liabilities – was positive by approximately 526 b.kr. at year-end 2022, compared to 529 b.kr. at the end of 2021.

**Table 1. Foreign exchange market, exchange rate, and international reserves**

		2020	2021	2022
ISK exchange rate (+appreciation/-depreciation)	%	-10.4%	2.5%	-2.1%
Exchange rate volatility <sup>1</sup>	%	8.5%	7.0%	7.6%
FX market turnover	b.kr.	426	363	385
Central Bank share	%	36.6%	21.1%	14.2%
FX market purchases, Central Bank	b.kr.	11.7	26.9	33.9
FX market sales, Central Bank	b.kr.	144.4	49.6	20.7
Net purchases, Central Bank	b.kr.	-132.7	-22.7	13.2
Reserves in USD	USD millions	6,420	7,080	5,894
Reserves in b.kr.	b.kr.	817	923	837
Reserves financed domestically <sup>2</sup>	b.kr.	566	579	602
Central Bank foreign exchange balance <sup>3</sup>	b.kr.	572	529	526
Foreign exchange reserves, as % of GDP <sup>4</sup>	%	30%	30%	24%
Foreign exchange reserves, equivalent months of imports <sup>5</sup>		9	10	8

1. Standard deviation of daily exchange rate movements, annualised

2. Foreign exchange reserves net of Central Bank and Treasury foreign debt

3. Difference between assets and liabilities in foreign currency

4. Based on Central Bank of Iceland year-2022 GDP forecast

Chart 1

### Exchange rate of the Icelandic króna 2022

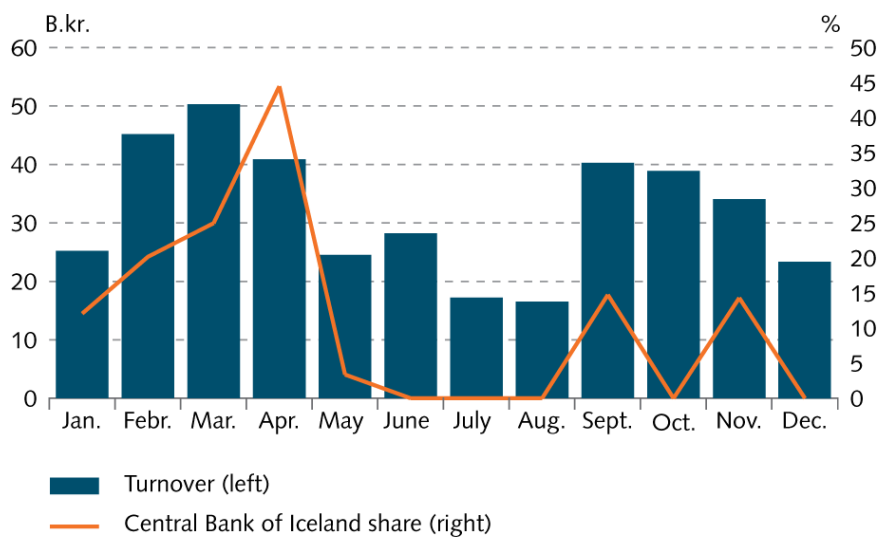


Narrow trade basket. An increase in the series indicates a depreciation of the króna and a decline indicates an appreciation.

Source: Central Bank of Iceland.

Chart 2

### Turnover in the interbank foreign exchange market 2022

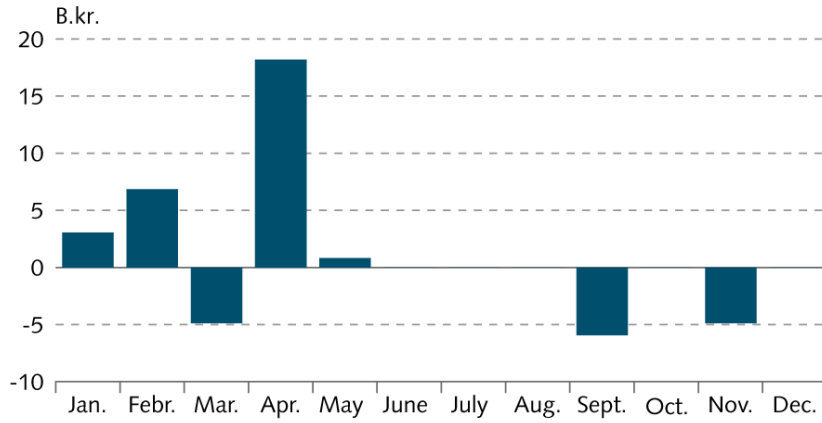


■ Turnover (left)  
— Central Bank of Iceland share (right)

Source: Central Bank of Iceland.

Chart 3

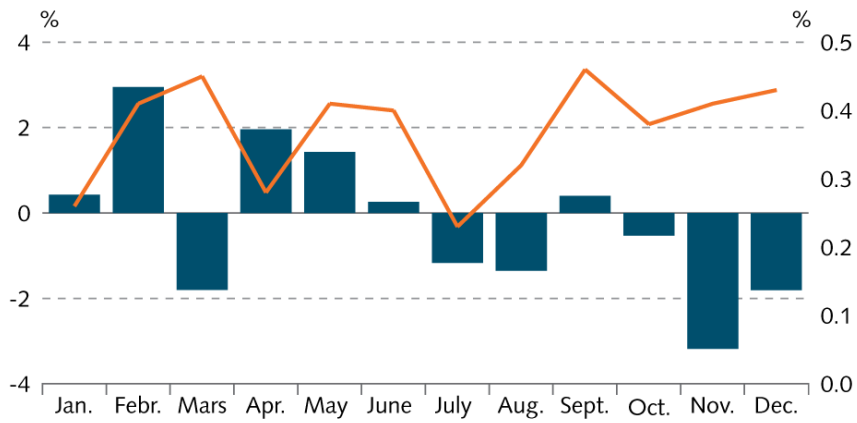
### Net Central Bank of Iceland foreign exchange transactions 2022



Source: Central Bank of Iceland.

Chart 4

### Short term changes in exchange rate 2022



■ Monthly changes in exchange rate (left)  
— Monthly average of daily changes in exchange rate, absolute values (right)

Source: Central Bank of Iceland.