



23 August 2017

Governor's explanatory remarks at the presentation of the 23 August 2017 interest rate decision, concerning the Central Bank's foreign exchange market activity and the special reserve requirement on capital flows into the bond market and high-yielding deposits (the capital flow management measure)

Foreign exchange transactions by the Central Bank

Earlier this year, the Central Bank announced that it was no longer necessary to purchase foreign currency to build up the foreign exchange reserves. After most of the capital controls were lifted in mid-March without affecting economic and financial stability, the need to lean against possible excess appreciation of the króna caused by unrestricted inflows and restricted outflows was reduced. Therefore, the Bank significantly reduced its activity in the foreign exchange market after capital controls were mostly lifted. Since the Monetary Policy Committee's June meeting, the Bank has intervened in the market only on four occasions, in all instances for the purpose of halting spirals – three downward ones and one on the upside. When intervention took place, the intraday depreciation or appreciation lay in the 1.9-3% range. From the beginning of June through 21 August, the Bank's net foreign exchange sales totalled only 2.9 b.kr.

This policy has met with criticism from both sides. Some observers have criticised the fact that any intervention took place at all, and others have asserted that the Bank allowed more exchange rate volatility than it should have. It is difficult to take the former of these points of view seriously, as such intervention is consistent with the Bank's oft-stated policy and with common practise in small markets.

As regards the latter criticism, it should be borne in mind that in the past few months it has been unusually difficult to distinguish between volatility in the exchange rate and movements that are driven more by

underlying factors, in part because opposing forces are pulling against one another and the market is seeking a new equilibrium in the post-capital controls environment. It would probably not be advisable for the Central Bank to interfere too much in this process, as it could prove difficult to accomplish. However, in this context, it should be pointed out that the formulation of an intervention policy under a managed float is still under discussion, and there is less experience and research that can be relied upon in this area than in the case of interest rate policy. The Monetary Policy Committee will continue to discuss the intervention policy at its upcoming meetings.

Capital flow management measure

There has been some misunderstanding about the special reserve requirement imposed on capital flows into the bond market and into high-yielding deposits, generally referred to as the capital flow management measure (CFM). From the outset, it has been the Bank's official policy to bring the special reserve ratio to zero when conditions warrant it. However, it has been considered likely that the special reserve ratio would be lowered in conditions-based increments, taking particular account of developments in the long-term interest rate differential with abroad. Furthermore, consideration must be given to the fact that the final step towards full liberalisation of the capital controls has yet to be taken – a step that will involve, among other things, the remaining offshore krónur. Alongside this, it is necessary to review the statutory and technical foundations for the CFM. This work is currently underway. The long-term interest rate differential has narrowed considerably since the CFM was introduced, in part because of lower Central Bank interest rates but also because of rate increases abroad and reduced risk premia on Icelandic obligations. If current forecasts materialise, this trend should continue in the coming term, and the conditions for scaling down the CFM should improve still further. That said, it is important to consider both timing and order of events when taking decisions on such matters. The Central Bank's interest rates have not been, and will not be, lowered expressly to unwind the CFM. Those decisions will be taken based on the interest rate that is considered necessary to keep inflation and inflation expectations at target. This could then, together with other factors, affect the fine-tuning of the CFM. In closing, it should be emphasised that the Bank's declared long-term objective is that, under normal conditions, the CFM will not be activated but will be a third line of

defence to supplement conventional macroeconomic economic policy and macroprudential tools if needed.