Monetary policy and instruments

The objective and implementation of monetary policy

The objective of monetary policy is price stability. On March 27, 2001, a formal inflation target was adopted, as follows:

- The Central Bank aims for an annual rate of inflation, measured as the twelve-month increase in the CPI, which in general will be as close as possible to 2½%.
- If inflation deviates by more than 1½% from the target, the Central Bank shall be obliged to submit a report to the government explaining the reason for the deviation, how it intends to respond, and when it expects the inflation target to be reached again. This report shall be made public.
- The Central Bank shall publish inflation forecasts, projecting inflation at least two years into the future. Forecasts shall be published in the Bank's *Monetary Bulletin*. This shall also contain the Bank's assessment of the main uncertainties pertaining to the inflation forecast. The Bank shall also publish its assessment of the current economic situation and outlook.

Since monetary policy aims at maintaining price stability, it will not be applied in order to achieve other economic targets, such as a balance on the current account or a high level of employment, except insofar as this is consistent with the Bank's inflation target.

Macroeconomic and inflation forecasts perform an important function in monetary policy conduct. As of *Monetary Bulletin* 2007/1, the Bank's forecasts are based on the policy rate path that its staff consider as appropriate for attaining the inflation target. The policy rate path is chosen with the aim of bringing inflation to 2½% within an acceptable horizon and stabilising it close to that target afterwards. Confidence limits are presented for the policy rate to underline the uncertainties surrounding the forecast, emphasising that the policy rate path is liable to change over time as new data become available.

The Central Bank announces interest rate decisions on scheduled,

Overview of Central Bank interest rates October 18, 2007

Traditional instruments	*Current rate (%)*	*Last change* *Date*	*Last change* *Percentage points*	*Rate one year ago (%)*
Current accounts	12.75	Dec. 21, 2006	0.25	12.50
Overnight loans	15.25	Dec. 21, 2006	0.25	15.00
Required reserves	13.00	Dec. 21, 2006	0.25	12.75
Collateral loans – policy rate	13.30	Dec. 27, 2006	0.25	13.09
Certificates of deposit, 7 days	13.20	Dec. 27, 2006	0.25	13.85

1. Joint declaration of the Government of Iceland and the Central Bank of Iceland. Published on the Central Bank of Iceland website, sedlabanki.is.

prearranged dates. Before an interest rate decision is made, the Board of Governors convenes monetary policy meetings, as detailed in the Bank's Internal rules on the preparation, rationale and presentation of monetary policy decisions, which are set pursuant to the provisions of the Central Bank Act. The Internal rules are published on the Central Bank website, www.sedlabanki.is.

Main monetary policy instruments

In particular, the Central Bank implements its monetary policy by managing money market interest rates, primarily through interest rate decisions for its collateral loan agreements with credit institutions. Yields in the money market have a strong impact on currency flows and thereby on the exchange rate, and in the long run on domestic demand. Broadly speaking, transactions with credit institutions can be classified into fixed trading instruments and market actions.

Fixed trading instruments:

- Current accounts are deposits of the credit institutions' undisposed assets. These are settlement accounts for netting between deposit institutions and for interbank market trading, including transactions with the Central Bank. Interest rates on these accounts set the floor for overnight interest rates in the interbank market.
- Overnight loans are provided at the request of credit institutions and secured with the same securities that are eligible for collateral loan transactions (see below). Overnight interest rates form the ceiling for overnight interest rates in the interbank market.
- Certificates of deposit are issued with a maturity of 90 days, at the request of credit institutions. Although they are unlisted, they are eligible for collateral loan transactions. Their role is to establish the floor for three-month yields in the money market.
- Required reserves apply to credit institutions that are not dependent on Treasury budget allocations for their operations. The required reserve base comprises deposits, issued securities and money market instruments. The required reserve ratio is 2% for the part of the required reserve base, which is tied for two years or less. The maintenance period is based on the 21st day of each month until the 20th of the following month, and the two-month average reserve is required to reach the stipulated ratio during the period.

Market operations:

- Collateral loans are the Central Bank's main instrument. Auctions of 7-day agreements are held every week. Credit institutions need to put up securities that are eligible as collateral, as specified in the Central Bank's Rules No. 541 of June 18, 2007. Auctions can be fixed-price or auctions where total amount is announced. Fixed-price auctions have been used so far. The interest rate on collateral loans constitutes the Central Bank's policy rate.
- Certificates of deposit with a maturity of 7 days are auctioned weekly. Their function is to counteract temporary surplus liquidity in the banking system. The auction format is fixed-price.
- Securities market trading is limited to Treasury-guaranteed paper.

Central Bank of Iceland interest rate decisions

Date	*Interest on collateral loans (%)*		
Policy rate interest decision dates in 2007	*Nominal rate[1] (policy rate)*	*Yield*	*Change*
November 1, 2007	13.75		0.45
September 6, 2007	13.30		0
July 5, 2007	13.30		0
May 17, 2007	(13.30)	14.25	0
Previous decisions			
March 29, 2007	(13.30)	14.25	0
February 8, 2007	(13.30)	14.25	0
December 21, 2006	(13.30)	14.25	0.25
November 2, 2006	(13.09)	14.00	0
September 14, 2006	(13.09)	14.00	0.50
August 16, 2006	(12.65)	13.50	0.50
July 6, 2006	(12.21)	13.00	0.75
May 18, 2006	(11.54)	12.25	0.75
March 30, 2006	(10.87)	11.50	0.75
January 26, 2006	(10.20)	10.75	0.25
December 2, 2005	(9.97)	10.50	0.25
September 29, 2005	(9.75)	10.25	0.75
June 3, 2005	(9.07)	9.50	0.50
March 22, 2005	(8.61)	9.00	0.25
February 18. 2005	(8.38)	8.75	0.50
December 2, 2004	(7.92)	8.25	1.00
October 29, 2004	(6.99)	7.25	0.50
September 17, 2004	(6.53)	6.75	0.50
July 1, 2004	(6.06)	6.25	0.50
June 1, 2004	(5.59)	5.75	0.25
May 6, 2004	(5.35)	5.50	0.20
February 10, 2003	(5.16)	5.30	-0.50
December 12, 2002	(5.63)	5.80	-0.50
November 6, 2002	(6.10)	6.30	-0.50
October 15, 2002	(6.57)	6.80	-0.50
September 18, 2002	(6.85)	7.10	-0.50
August 30, 2002	(7.31)	7.60	-0.30
August 1, 2002	(7.59)	7.90	-0.60
June 18, 2002	(8.15)	8.50	-0.30
May 16, 2002	(8.42)	8.80	-0.50
April 30, 2002	(8.88)	9.30	-0.30
March 26, 2002	(9.15)	9.60	-0.50
November 8, 2001	(9.60)	10.10	-0.80
March 27, 2001	(10.33)	10.90	-0.50

1. The policy rate as quoted until May 2007, is presented as a nominal discounted rate.

- Foreign exchange market intervention, in keeping with the declaration on the inflation target from 2001, is employed only if the Central Bank considers this necessary in order to promote its inflation target or sees exchange rate fluctuations as a potential threat to financial stability.