



Annual Report 2007

ANNUAL REPORT 2007

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Board of Governors.

Left to right: Ingimundur Friðriksson, Davíð Oddsson (Chairman), Eiríkur Guðnason.

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I Objectives and policy

The main objective of monetary policy is price stability. The Central Bank of Iceland Act, no. 36/2001, stipulates that the Bank's main objective is to promote price stability. By agreement with the Prime Minister, the Bank is authorised to declare a numerical inflation target. In the joint declaration issued by the Government of Iceland and the Central Bank of Iceland on March 27, 2001, an inflation target was set for the Bank; that is, a rate of inflation, measured as the twelve-month increase in the CPI, of as close to 2½% as possible.¹ Furthermore, the Act states that the Central Bank shall promote the implementation of the economic policy of the government as long as it does not regard that policy to be inconsistent with its main objective of price stability. The Bank shall also undertake such tasks as are consistent with its role as a central bank, such as to maintain external reserves and promote an efficient and secure financial system, including payment systems domestically and with foreign countries. In other words, the Bank shall address tasks concerning financial stability. The Central Bank Act furthermore clarifies provisions on accountability, transparency of monetary policy, and the Bank's activities in general.

Monetary policy

Monetary policy implementation is based on the Central Bank's inflation forecast, made over a horizon of three years and presented in *Monetary Bulletin*, which is published three times a year. The Bank also publishes its own macroeconomic forecast and an in-depth analysis of economic and monetary developments and prospects, in addition to presenting its inflation forecast.

Until the end of 2005, the Central Bank did not follow a prearranged schedule for interest rate decisions, apart from publishing a detailed explanation of its monetary policy decisions – whether or not these involved a change in the policy interest rate – in *Monetary Bulletin*, which was then published four times a year. At the beginning of 2006, the Bank adopted a formal calendar for its interest rate decisions. Initially it announced that there would be six scheduled dates, three of them coinciding with the publication of *Monetary Bulletin*, and that the Board of Governors may change the policy interest rate between the scheduled dates if it considers that there are grounds for doing so. Two interest rate decision dates were added in 2006, making a total of eight during the year. Each of the two additional interest rate decision dates was announced on the preceding decision date. Late in 2006, the Board of Governors announced six interest rate decision dates for 2007; however, the Board of Governors was still authorised to add decision dates if it deemed it necessary. In 2007 one extra interest rate decision date – December 20 – was announced on the decision date immediately preceding, bringing the total for the year to seven. Late in 2007 the Board of Governors announced six decision

1. The declaration was published in *Monetary Bulletin* 2001/2 and on the Bank's website. Minor amendments were made to it in November 2005.

dates in 2008; however, the Board of Governors retains the authority to declare additional decision dates if required. In accordance with the provisions of the Central Bank Act, the Board of Governors has laid down internal rules on the preparation of, arguments for and presentation of its monetary policy decisions.²

The Bank's main instrument is its policy interest rate; that is, the rate of interest on the liquidity facilities that it provides to credit undertakings through collateral loans. Auctions of collateral loans with a maturity of one week are held on a weekly basis.

The Central Bank sets a minimum reserve requirement for credit undertakings. This requirement is equivalent to 2% of specified liabilities with a maturity of two years or less.

Financial stability

The Central Bank seeks to have a constant, clear overview of the position of credit institutions and financial markets. It publishes a regular analysis of factors affecting financial stability, including an in-depth examination of both macroeconomic and aggregate microprudential indicators. Until 2004 this was published twice a year in *Monetary Bulletin*. In 2005 the Bank launched *Financial Stability* as a separate report that is published once a year.

As authorised by law, the Central Bank has set rules on minimum liquidity of credit undertakings and on their foreign exchange balance. In 2006 the Board of Governors announced a decision defining the Central Bank's financial stability functions.³

In special circumstances, when the Central Bank deems it necessary in order to preserve confidence in the domestic financial system, it is authorised by law to issue guarantees to credit institutions experiencing liquidity difficulties, or to grant them loans other than those classified as regular transactions. In addition, the Central Bank promotes an efficient and secure financial system by evolving Icelandic payment and settlement systems in line with internationally recognised standards. The Central Bank cooperates on financial stability issues with the Financial Supervisory Authority (FME) on the basis of a cooperation agreement made with reference to legislation on the Central Bank and on official supervision of financial operations.⁴ In 2006 a Memorandum of Understanding was also signed by the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, Financial Supervisory Authority, and Central Bank of Iceland, on consultation concerning financial stability and contingency plans.⁵

Other functions

By law, the Central Bank has the sole right to issue banknotes and coin. It maintains and invests Iceland's foreign reserves. The Bank cooperates and conducts business with international institutions in

2. Published on the Central Bank website.

3. The decision is published on the Central Bank website. See also the discussion in Chapter IV.

4. The agreement is published on the websites of both institutions.

5. The Memorandum of Understanding is published on the Central Bank website. For further discussion, see Chapter IV.

its field of activities, including serving as a financial agent with the International Monetary Fund on behalf of the State.

Accountability and transparency

The Central Bank is obliged by law to give a public account of its monetary policy at least four times a year. This account must include monetary, exchange rate and foreign exchange developments, and the Bank's measures in these areas. The Central Bank also issues an annual report in which it explains its activities in detail.⁶ The Central Bank strives to explain its activities to the fullest possible extent. This includes the assumptions underlying its monetary policy decisions, its assessment of financial stability, and many other aspects of its activities. Transparency and accountability are also safeguarded through defined tolerance limits for the inflation target. This means that, if inflation deviates by more than 1½ percentage points from the target, the Central 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. This report must be made public.

6. A list of Central Bank of Iceland publications in 2007 can be found in the Appendix.

II Monetary policy and economic developments

As in recent years, the primary task of monetary policy in 2007 was to combat inflation, which has been considerably above target since 2004.¹ The real policy interest rate was near its historical high, and in November the Central Bank raised the policy rate by 0.45 percentage points to 13.75%.² Underlying inflation was approximately 7½% during the year, but due to the effects of a reduction in consumption taxes, headline inflation measured only 5.9% for the year as a whole. Inflation is a clear sign of continuing imbalances in the economy. It is estimated that production far exceeded potential output,³ and pressure in the labour market mounted during the year. The current account deficit narrowed year-on-year but remained substantial. After a slowdown during the latter half of 2006 and early in 2007, which followed the depreciation of the króna earlier in 2006, demand gained pace again, and inflation followed suit. In addition, financial conditions deteriorated markedly in the latter half of the year, due to developments in the global financial markets and more effective transmission of monetary policy measures to longer bond maturities as well as lending rates. Most likely, the Central Bank's decision to increase transparency in monetary policy conduct by publishing its own policy rate path also played a significant role in enhancing the effectiveness of the policy rate.

Rising inflation largely explained by increase in housing prices

The year-on-year increase in inflation averaged 5% in 2007; however, excluding the effects of tax cuts and other temporary measures that should be de-emphasised in monetary policy decision-making, inflation was almost 7% on average. Inflation slowed down in the first half of the year, largely due to lower consumption taxes, and had dropped to 3.4% by August. It gained pace later in the year, however, as demand growth accelerated and exerted pressure on wage costs and housing prices, and measured 5.9% for the year. The surge in housing prices largely explains the increase in inflation.

Cooling real estate market towards year-end

One reason inflation has been difficult to contain in recent years is that the Central Bank's policy rate increases have not been reflected sufficiently in the mortgage market, as the Housing Financing Fund's (HFF) mortgage rates lagged behind market rates for an extended period of time. Moreover, in April HFF raised its loan-to-value ratio and mortgage ceilings. Both of these factors probably contributed to rapid increases in real estate prices from the spring through the fall. Furthermore, households managed, to some extent, to circumvent

1. A detailed account of economic developments and monetary policy conduct can be found in *Monetary Bulletin*, which is published by the Central Bank three times a year.
2. As of June 2007, the Central Bank's policy rate is presented as a nominal discounted rate, instead of annual yield.
3. Potential output is the production level that is consistent with long-term price stability.

Chart II-1

Central Bank policy rate

Daily data January 1, 1998 - December 27, 2007

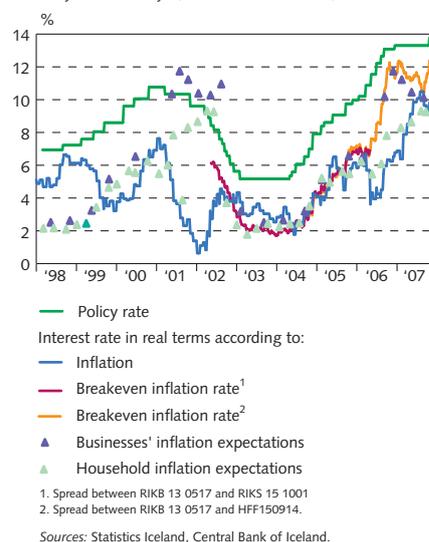


Chart II-2

Components of CPI inflation

Contribution to inflation 2004-2007

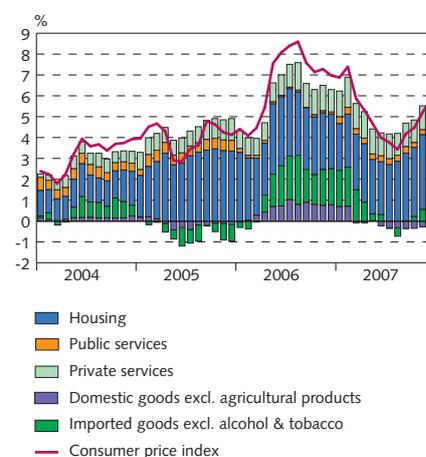


Chart II-3

Interest rates on indexed housing loans

Housing loans - lowest interest rates

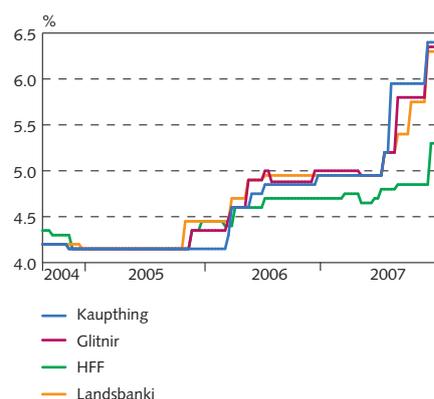
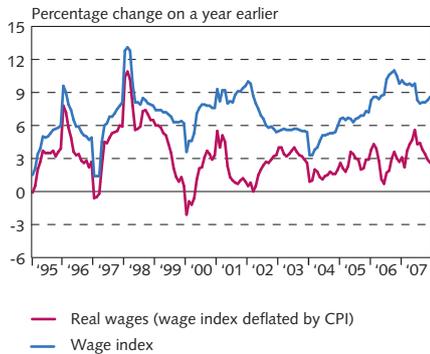
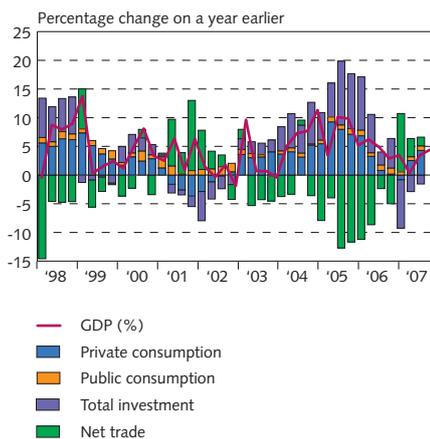


Chart II-4
Nominal and real wages 1995-2007
Statistics Iceland wage index



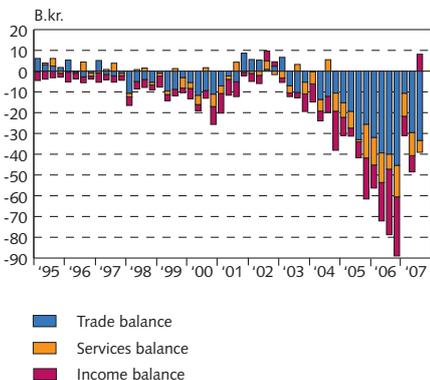
Source: Statistics Iceland.

Chart II-5
Contributions to GDP growth
Quarterly data



Source: Statistics Iceland.

Chart II-6
Components of current account
Net current transfer is included in factor income



Source: Central Bank of Iceland.

higher interest rates by taking foreign currency-denominated loans. Towards the end of the year, however, higher rates triggered a slow-down in the real estate market, and housing prices levelled off.

Rapid growth in disposable income fuelled demand growth

Following several years of excess demand, labour shortage and wage drift escalated still further in 2007, despite the fact that the demand for workers had increasingly been met with migrant labour. Tax cuts and rapidly rising wages combined to trigger an unusually sharp increase in disposable income, which in turn spurred demand growth in 2007. After a listless period early on, private consumption accelerated as the year progressed, reaching staggering levels in the latter half of the year. Although investments in the aluminium and power sectors slowed, other investments filled the gap to a large degree. Overall business investment was strong during the year, particularly in the construction of commercial and retail properties.

Wide current account deficit

Although the current account deficit narrowed noticeably from 2006 to 2007, the change is less radical than it first appeared. The bulk of the contraction was due to developments in irregular items – such as purchases and sales of ships and aircraft, and volatile returns on foreign shareholdings – which exaggerated the results for 2006 but reduced the calculated deficit in 2007. Although the current account deficit is estimated to have been much smaller in 2007 than in 2006, it was nonetheless far from sustainable. As before, turbulence in the global capital markets strongly affected the exchange rate of the króna, which fluctuated considerably during the year. At year-end, however, the weighted exchange rate of the króna was broadly unchanged since the beginning of the year.

Publication of policy rate path affected expectations

In order to enhance monetary policy communication, the Central Bank began in March 2007 to publish the policy rate path that the Bank's staff consider most conducive to the attainment of the inflation target within an acceptable horizon. The policy rate path does not entail a declaration or commitment by the Board of Governors as regards policy rate developments, but it is regarded as an important indicator of the policy rate required, based on available information, to ensure that the inflation target is attained within the forecast horizon. The publication of the policy rate path appears to have enhanced monetary policy transmission across the yield curve. Since the Bank began publishing the policy rate path, the expectations of market agents and others as regards policy rate developments have been more in line with the Central Bank's message than they were previously.

Monetary policy transmitted more readily

After the sharp increase in the policy rate in 2006, the real policy rate was extremely high at the beginning of 2007. Lower inflation in early 2007 resulted in a considerable rise in the real policy rate as measured by past inflation; however, that trend reversed when inflation mount-

ed again in the latter half of the year. Measured by the breakeven inflation rate, the real policy rate at year-end was similar to that at the beginning of the year. Therefore, as has been noted previously, the Central Bank's publication of its own policy rate path seems to have made monetary policy transmission much more effective across the yield curve. Yields on long-term indexed bonds, which had been resistant to tighter monetary policy, rose sharply in the latter half of the year; however, deteriorating global market conditions also played a part in this development.

Interbank rates in line with Central Bank rates

In 2007, interbank rates were closer to the Central Bank's base rate than often before. From the latter half of 2006 until February 2007 there had been problems in monetary policy transmission at the shortest end of the yield curve, but following the increase in the types of securities eligible as collateral for Central Bank facilities, the market began to function normally. Interest rates rose somewhat in August, when the turmoil in the global financial markets was at its peak, but never exceeded the Central Bank's overnight lending rate.

Glacier bond issuance in the international market has resulted in substantially increased trading volumes and stronger price formation in the domestic markets. Trading volumes on the domestic currency market rose by over 20% year-on-year in 2007. Turnover in the króna market rose by nearly 13% and has increased fourfold since 2004.

Financial conditions worsened in the latter half of the year

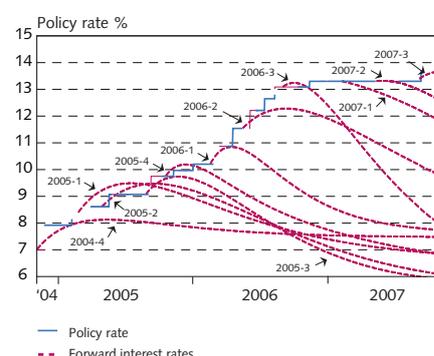
The turbulence in the global capital markets during the second half of the year did not bypass Iceland. The króna depreciated, and domestic financial institutions' credit terms in foreign markets deteriorated. These factors, together with the policy rate hike in November, made a substantial impact, pushing domestic interest rates upward and curtailing the supply of credit. Falling equity prices during the autumn also increased companies' cost of capital. Therefore, toward the end of the year the Central Bank was faced with the difficult task of assessing its response to increasing demand and rising inflation, on one hand, and rapidly deteriorating financial conditions, on the other, which will curtail growth and inflation if the króna does not depreciate more than forecasts indicate.

Table II-I. Changes in the Central Bank's policy rate in 2007

Decision date	Change
February 8	Unchanged
March 29	Unchanged
May 16	Unchanged
July 5	Unchanged
September 6	Unchanged
November 1	+ 0.45 percentage points
December 20	Unchanged

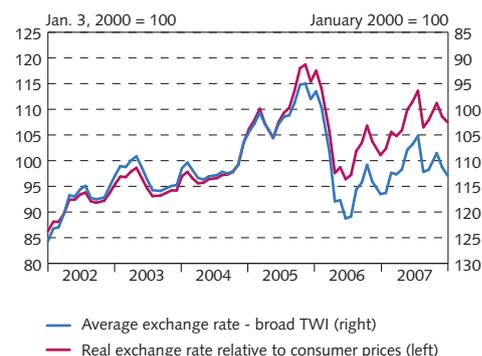
Source: Central Bank of Iceland.

Chart II-7
Policy rate and forward interest rates



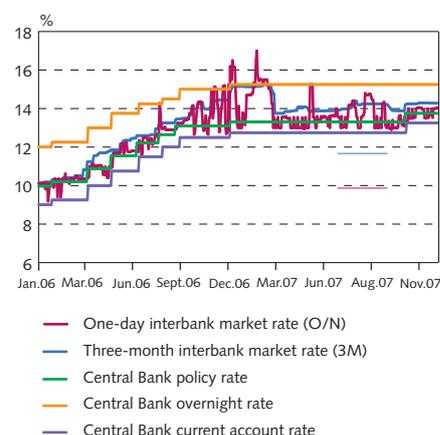
Source: Central Bank of Iceland.

Chart II-8
Nominal and real effective exchange rate of the króna 2002-2007
Monthly averages



Source: Central Bank of Iceland.

Chart II-9
Interest rates in the interbank market and Central Bank policy rate
Daily data January 3, 2006 - December 31, 2007



Source: Central Bank of Iceland.

III The financial system

Financial companies

Promoting an efficient and safe financial system

In performing its mandatory role of promoting an efficient and safe financial system, including payment systems domestically and with foreign countries, the Central Bank of Iceland focuses on assessing the risk of illiquidity among financial companies and problems in payment and securities settlement systems that could be systemically important. It also promotes the efficiency and positive development of the financial system. In its work, the Central Bank has taken into account international agreements and other standards for best practice, as well as considering the work of leading central banks in this field. The Central Bank cooperates closely with the Financial Supervisory Authority (FME) on financial stability tasks, on the basis of an agreement between the two institutions.¹ In light of the increasing prevalence of Nordic banks with cross-border establishments, the central banks of the five Nordic countries have signed a Memorandum of Understanding (MoU) on financial crisis management.

Financial stability broadly hinges upon the stability of the key institutions and markets that make up the financial system. This requires (1) that the key institutions in the financial system be stable, in that there is a high degree of confidence that they can continue to meet their contractual obligations without interruption or outside assistance; and (2) that the key markets be stable, in that participants can confidently transact in them at prices that reflect the fundamental forces and do not vary substantially over short periods when there have been no changes in the fundamentals.

Financial stability report

Once a year, the Central Bank publishes *Financial Stability*. The purpose of the report is to promote informed dialogue, strengthen risk management, and explain how the Bank carries out its mandatory tasks in this field. In the 2007 issue of *Financial Stability*, published in April, the Central Bank specified the chief risk factors in the financial system and the system's resistance to those risks. Among the factors mentioned were macroeconomic imbalance, the current account deficit, foreign debt accumulation, and the possible depreciation of the króna. The report also discussed the risks related to rising interest rates and interest rate premia abroad, pointing out that such developments could make a profound impact. On the other hand, by the spring of 2007 the uncertainty concerning the banks' access to capital had subsided considerably since the year before, and the banks had built up ample liquidity. Thus particular attention was drawn to the quality of their assets. The factors that supported the financial system's resist-

1. Published on the Central Bank of Iceland website.

ance to shock centred particularly on the strength of the banks, which showed primarily in their generous liquidity position and high equity ratios. Furthermore, the Icelandic banks performed very well on the stress tests carried out by FME and the Central Bank. On the whole, it was the Central Bank's conclusion that the Icelandic financial system was fundamentally sound and that it was able to withstand potential shocks to the economy and the financial markets, mediate credit and payments, and redistribute risks appropriately. In other words, the financial system was deemed able to carry out its role effectively and efficiently.

Commercial banks performed well

Profitability was strong at the three largest commercial banks in 2007. Their interest income continued to grow due to strong lending growth, and income from commissions and fees was robust, but gains on equity portfolios diminished substantially from 2006. Operating expenses increased somewhat, but customer delinquency remained very low. Over half the banks' income for 2007 was generated outside Iceland.

Assets of the three largest commercial banks grew by 34%, or 3,000 b.kr., totalling 11,354 b.kr. at year-end. The banks' largest asset item is lending, with lending to customers outside Iceland accounting for 59% of total lending at the end of the year. The year 2007 saw a considerable increase in deposit business. By year-end, roughly half of the largest commercial banks' lending was funded with deposits. The banks' equity ratios fell year-on-year to an average of 11.6% at year-end 2007; however, these levels are considered quite satisfactory.

Table III-1. Moody's ratings of Icelandic commercial banks

	<i>Announced</i>	<i>Long-term</i>	<i>Short-term</i>	<i>Financial strength</i>
Kaupthing Bank	February 2008	A1	P-1	C-
Glitnir	February 2008	A2	P-1	C-
Landsbanki	February 2008	A2	P-1	C-

Table III-2. Fitch's ratings of Icelandic commercial banks and Straumur-Burdaras Investment Bank at year-end 2007

	<i>Announced</i>	<i>Long-term</i>	<i>Short-term</i>	<i>Individual</i>	<i>Support</i>
Kaupthing Bank	August 2006	A	F1	B/C	2
Glitnir	August 2006	A	F1	B/C	2
Landsbanki	February 2006	A	F1	B/C	2
Straumur-Burdaras Investment Bank	January 2006	BBB-	F3	C/D	3

Table III-3. Standard & Poor's ratings at year-end 2007

	<i>Announced</i>	<i>Long-term</i>	<i>Short-term</i>
Glitnir	June 2006	A-	A2

Illiquidity in global financial markets

Rapid expansion in recent years has resulted in an increase in foreign funding for Iceland's commercial banks and made them more dependent than before on ready access to international capital markets. In 2007, in the wake of escalating defaults on US housing loans, liquidity problems began to emerge in the global financial markets. The Icelandic banks felt the effects of a tightening credit supply, and their CDS spreads rose. Because of market turbulence, the banks were inactive in the markets in the latter half of the year and strengthened their deposit business. At year-end 2007 their liquidity position was satisfactory according to Central Bank rules, as well as meeting the banks' own internal requirements.

International agencies assess the credit ratings of Iceland's three large commercial banks – that is, Kaupthing Bank, Glitnir and Landsbanki – as well as Straumur-Burdaras Investment Bank. The Republic of Iceland, the Housing Financing Fund, the power company Landsvirkjun, and Orkuveita Reykjavíkur (Reykjavik Energy) also have international credit ratings. Ratings become increasingly important for the banks as their market funding increases.

Brisk activity in foreign lending and deposits

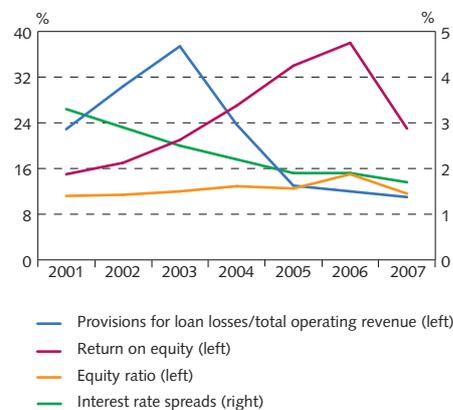
Lending by deposit money banks (DMBs) continued to increase in 2007. Domestic lending rose by 31% over the year, and foreign lending by even more, or 143%. Deposit business continued to expand throughout the year. Deposits by non-residents in Icelandic banks, including their overseas branches, nearly trebled. Deposits by residents also increased markedly, or by 57%. At year-end 2007, nearly half of lending by deposit money banks (DMBs) was funded with deposits from the banks' customers. Despite the increase in deposit activity, however, bond issuance remains an important element in DMB funding. Most of the banks' bond issuance takes place in foreign markets and is denominated in foreign currency.

Outstanding credit at other credit institutions increased by just over 1% in 2007.² Lending by the Housing Financing Fund (HFF), which accounted for 62% of total outstanding lending by other credit institutions at the end of 2007, rose by 14% over the year. Securities issues by other credit institutions grew by 6% during the year, the bulk in the form of HFF bonds.

Depositors' and Investors' Guarantee Fund

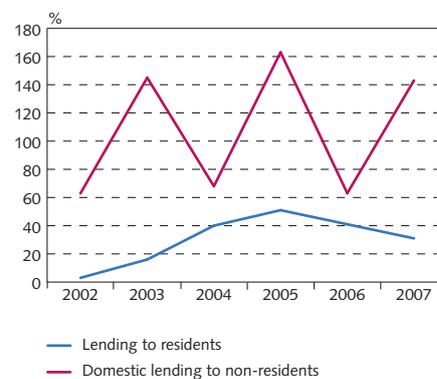
The Depositors' and Investors' Guarantee Fund operates in two divisions as provided for by the Act on Guarantees for Depositors and Investors, no. 98/1999; Regulation no. 120/2000 on the same subject; and the articles of association approved at the Fund's founding meeting on December 28, 1999. By law, the total assets of the Fund's deposit division must amount to a minimum of 1% of the average

Chart III-1
Largest commercial banks 2001-2007¹



1. Kaupthing Bank, Glitnir Bank and Landsbanki. Consolidated figures.
Sources: The banks' annual reports, Central Bank of Iceland.

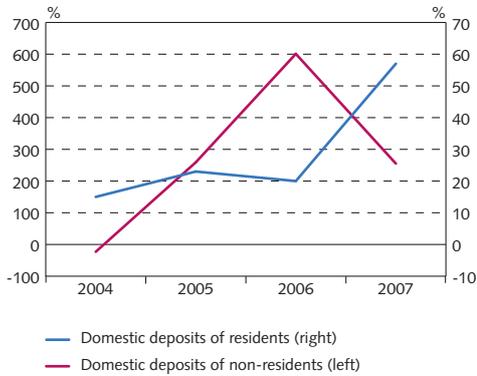
Chart III-2
Lending activity of DMBs 2002-2007¹
12-month changes



1. Parent companies.
Source: Central Bank of Iceland.

2. Other credit institutions comprise the Housing Financing Fund, investment banks, leasing companies, payment card companies, and investment credit funds. It is necessary to take account of the fact that Straumur-Burdaras Investment Bank was granted a commercial banking licence in August 2007 and is therefore no longer listed here.

Chart III-3
Deposit activity of DMBs 2004-2007¹
12-month changes



1. Parent companies.
Source: Central Bank of Iceland.

amount of guaranteed deposits in commercial banks and savings banks during the preceding year. Guaranteed deposits have grown rapidly in recent years, with a corresponding increase in required collections. The deposit division has not yet needed to draw on its assets on account of difficulties faced by member companies in meeting their obligations. By law, total minimum assets of the Fund's securities division shall be 100 m.kr. The winding-up proceedings of the bankruptcy estate of Burnham International in Iceland concluded in February 2007. The Fund's securities division remitted a total of 38.5 m.kr. due to the company's insolvency. A slightly higher amount had been assumed in calculating the equity of the securities division. This transaction concluded the Depositors' and Investors' Guarantee Fund's involvement in the case of Burnham International in Iceland.

Payment and settlement systems

Payment systems are fundamental to the functioning of the economy. Three systemically important payment systems are in operation in Iceland: the Central Bank's real-time gross settlement system (RTGS), the netting system managed by Fjölgreiðslumiðlun hf. (FGM), and the securities settlement system managed by the Icelandic Securities Depository (ISD). Direct participants in these systems, apart from the Central Bank, include financial institutions that have applied for membership and meet the required conditions. The Icelandic Banks' Data Centre (RB) provides software services and hosts the systems, and the Central Bank acts as a settlement provider, manages the RTGS system, and oversees the payment systems in Iceland.

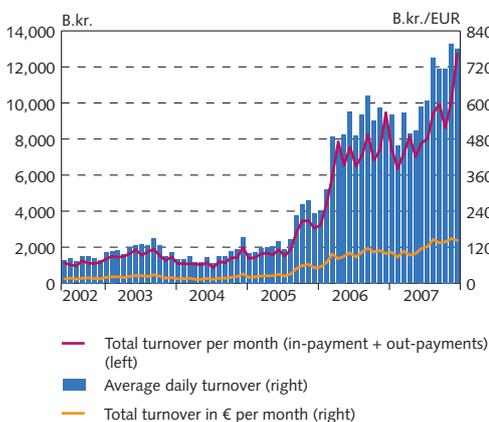
RTGS system

The RTGS system, which is used for high-value transactions in the interbank market, handles payment orders of 10 m.kr. and above. The system is open from 9 a.m. to 5 p.m. on banking days. The final settlement of payment systems is based on a netting arrangement that takes place either just before opening or after the close of business. The Central Bank of Iceland is responsible for the operation of the RTGS system and oversees its activities. The system is expected to withstand comparison with high-value payment systems in other countries and to comply with the Bank for International Settlements' (BIS) 10 Core Principles for Systemically Important Payment Systems.

Turnover in the RTGS system has been on the rise. The chart shows monthly turnover in the RTGS system from 2002 to the end of 2007. Monthly turnover (both deposits and withdrawals) grew from 9,076 b.kr. in December 2006 to 12,987 b.kr. in December 2007. Daily average turnover per month, calculated in the same manner, increased correspondingly over the same period, from just under 567 b.kr. to nearly 764 b.kr. The average monthly turnover for 2007 (deposits and withdrawals) was just under 10,475 b.kr. Average daily turnover was slightly more than 511 b.kr. for the year, which is significantly higher than the 2006 daily average of 404 b.kr.

The number of participants in the RTGS system has remained unchanged since its inception in 2000. At year-end 2007, however, three financial institutions applied for membership to the system and

Chart III-4
RTGS system turnover



Source: Central Bank of Iceland.

were approved by the Board of Governors. These new participants are expected to begin using the system by mid-2008, bringing the total number of participants in the RTGS system to nine, including the Central Bank.

User fees in the RTGS system were reviewed in December 2007, and a new tariff entered into force at the beginning of 2008. No changes were made to entry charges or to transaction fees during the year. The arrangement for the fixed annual fee, however, was changed, and the number of fee categories increased from two to four so as to coordinate the tariff system with participants' actual use of the system. Annual fees now range from 1.5 to 6 m.kr., as opposed to 3 to 4 m.kr. previously. Furthermore, a special fee has been introduced for settlement of other payment systems in the RTGS system. The fee ranges from 2 to 2.5 m.kr. per year for either system, with the actual amount determined by the number of settlements per day, among other factors. Beginning in 2008, users of the RTGS system will defray all expenses for the operation of the system, as well as for any necessary changes to it.

The RTGS system is subject to the provisions of Central Bank Rules no. 312/2007, which were revised and reissued in April 2007.

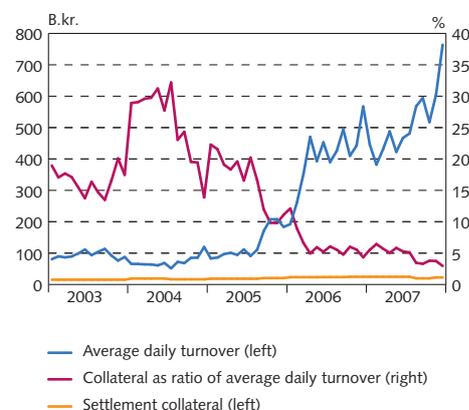
Netting system

The Central Bank has taken part in the development of the FGM netting system ever since its establishment. The technological separation of the netting system from the RTGS system has been an ongoing process, and each year FGM has assumed greater responsibility for the operation of the netting system. In January 2007, the user fees for the netting system were reviewed and the transaction charge raised from 2.45 kr. to 2.65 kr. Furthermore, agreements on system operation were renewed in 2007, and new agreements were made between participants and FGM as the system owner and operator. Automatic locks comparable to those in the Central Bank's RTGS system were activated in the netting system during the year. Settlement of participants' netted positions has been carried out at 5 p.m. on banking days since the system began operation, but in 2007 the number of daily settlements was increased, and now a morning settlement takes place at 8:30 a.m. on banking days. The collection and processing of data from the netting system has also been enhanced. The netting system is subject to the provisions of Central Bank Rules no. 313/2007, which were revised at the beginning of 2007.

Securities settlement system

The Icelandic securities settlement system is operated on the basis of a cooperation agreement between the Central Bank, ISD, and the OMX Nordic Exchange. It includes all institutional arrangements for confirmation, determination of rights and obligations, clearance and settlement of securities trades, and safekeeping of securities. A T+1 settlement cycle is used, whereby bond trades are settled at 8 a.m. the following day, before the RTGS system opens for daily business at 9 a.m. In 2007 a new arrangement for settlement of equity transactions was adopted in order to coordinate with the customs in neighbour-

Chart III-5
Average daily turnover in the RTGS system
and settlement collateral
January 2003 - December 2007



Source: Central Bank of Iceland.

ing countries. Equity transactions are now settled according to a T+3 cycle; that is, settlement and delivery take place three days following the purchase or sale, at 8 a.m.

Registration and settlement of securities transactions in euros

In 2007 several Icelandic companies listed on the OMX Exchange expressed an interest in registering their share capital in euros instead of the Icelandic króna; therefore, ISD began to examine how the monetary settlement of such transactions could take place. The matter was discussed at meetings of a consultative committee on interactions between securities depositories, stock exchanges, and the Central Bank of Iceland as regards the conclusion of transactions.

Pursuant to Act no. 36/2001, the Central Bank is required to promote an efficient and secure financial system, including the country's payment systems. Act no. 131/1997 assumes that the monetary settlement of securities transactions must take place through the Central Bank of Iceland. As is the case with other central banks, the Central Bank of Iceland only settles transactions in its domestic currency, and the final settlement of all payment instructions takes place through the Bank's RTGS system. As a result, the Central Bank cannot carry out the customary monetary settlement for transactions taking place in currencies other than its own. However, the above-mentioned Act no. 131/1997 stipulates that the Central Bank of Iceland shall carry out such settlement. A possible solution is that another central bank whose domestic currency is the euro could carry out the monetary settlement of trades in euro-denominated shares registered at ISD, provided that the law authorises the involvement of a party other than the Central Bank of Iceland in instances involving transactions in a currency other than the króna.

Toward the end of 2007, the Minister of Commerce decided to appoint a committee to review the current statutory provisions and propose amendments that would enable foreign banks to participate in the monetary settlement of transactions in currencies other than the króna.

Settlement collateral

Adequate collateral for payment system settlement is vital for ensuring the sound and efficient operation of the financial system in the event that a credit institution cannot honour its settlement obligations. At the beginning of 2007, collateral of all credit institutions amounted to 24.6 b.kr. in the RTGS system and 5.9 b.kr. in the FGM netting system, a total of 30.5 b.kr. Collateral amounts were revised during the year and totalled 23.1 b.kr. at the end of 2007. Of that amount, RTGS system collateral was set at 18.6 b.kr. and netting system collateral at 4.5 b.kr. Authorisations in both payment systems are fully secured, and both systems are equipped with technical locks that prevent uncollateralised overdraft. It was possible to reduce the collateral amounts in 2007 due to changes in the netting system and the introduction of new RTGS system equipment that facilitates methodical steering of intraday payment flow. With the addition of new system participants at the beginning of 2008, settlement collat-

eral will increase again to 25.4 b.kr. in the RTGS system and 5.0 b.kr. in the netting system, a total of 30.4 b.kr.

Payment instruments

Cash in circulation

At the end of 2007, notes and coin in circulation outside the Central Bank amounted to 15.7 b.kr., an increase of 1.2 b.kr. from the previous year. This large increase is noteworthy given the growing use of other payment instruments. In May 2006, the Central Bank announced that banknotes with a denomination of 10, 50 and 100 krónur would be withdrawn from circulation. The Central Bank is required to redeem these banknotes for at least 24 months following the publication of the announcement. At year-end 2007, the Central Bank's debt due to these banknotes was balanced with an income entry in the amount of 118 m.kr.

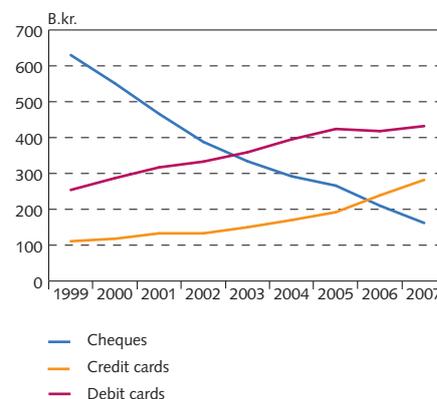
The Central Bank gives high priority to maintaining the credibility of Icelandic banknotes, with security features in notes and by regular banknote processing, among other things. Note processing includes counting, identification of forgeries, and sorting of notes into fit and unfit. Fit notes are recirculated and unfit destroyed. In 2007 the note processing department received 13.3 million notes from commercial banks and savings banks. 5.8 million notes were destroyed.

Payment card turnover still on the increase

Credit and debit card turnover is still growing year-on-year and cheque turnover decreasing correspondingly. Credit card turnover increased by 43 b.kr. (17.9%) in 2007, to 282 b.kr. The increase was divided between 36 b.kr. in domestic transactions and just over 7 b.kr. outside Iceland. Debit card transaction volume increased by 3.2% year-on-year, from 418 b.kr. to 432 b.kr. Cheque transaction volume was down by almost 22.7% year-on-year, to 162 b.kr. at the end of 2007.

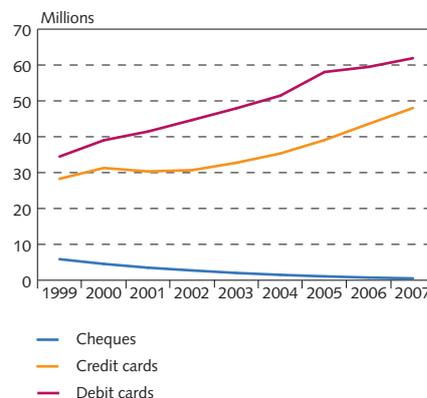
The number of domestic transactions with debit cards increased marginally between years, or by 2.5 million, while credit card transactions rose by 3.5 million, or 8.8%. The number of cheque transactions diminished by 30.2% during the year.

Chart III-6
Turnover: payment cards and cheques



Source: Central Bank of Iceland.

Chart III-7
Number of transactions



Source: Central Bank of Iceland.

IV Various Central Bank activities

Foreign reserves

The Act on the Central Bank of Iceland stipulates that one of the Bank's functions is to maintain Iceland's foreign reserves. Accordingly, the Board of Governors lays down rules on management of the reserves, and the rules are approved by the Supervisory Board. Foreign reserves comprise the Central Bank's holdings of foreign securities, deposits in foreign banks and money market funds, gold, Special Drawing Rights (SDRs), and the reserve position at the International Monetary Fund (IMF). SDRs refer to the Bank's position in its SDR account at the IMF.

The Board of Governors sets rules for the investment of the reserves. Funds may be deposited in international financial institutions and invested in money market funds and listed securities issued by entities in member countries of the OECD. Issuers can be sovereigns, local governments, state enterprises, international organisations and financial institutions. A minimum rating of A+/A1/A1 from recognised rating agencies (Moody's/S&P/Fitch) is required for long-term securities. Short-term securities require minimum ratings of A-1/P-1/F-1, respectively, from the same agencies. The same demands are made towards deposit-taking institutions. Under the rules set by the Board of Governors, the bulk of the reserves are invested in securities with a lifetime of more than one year, but a share of the reserves must be held in sight accounts. The average duration of securities and deposits in foreign reserves may not exceed five years. The Bank's gold reserves amounted to just over 63,700 ounces at the end of 2007. The gold is held in the Bank of England and may be lent against gold interest rates.

The Central Bank has made agreements for short-term credit facilities (secondary reserves) with foreign banks, in order to strengthen its foreign reserves when necessary. At the end of 2007, committed credit facilities were available for the equivalent of 4.7 b.kr.

The Bank's foreign reserves dropped by roughly 5 b.kr. and amounted to 163 b.kr. at the end of 2007, due to the appreciation of the króna. Together with available credit facilities, primary and secondary reserves therefore totalled 169.4 b.kr. In addition, the Central Bank has non-committed access to credit lines with a number of international financial institutions.

The Central Bank's net foreign balance is its foreign-denominated assets net of foreign-denominated liabilities. The currency composition of the net foreign balance is adjusted with the aim of minimising risk. Currency composition of the Central Bank's foreign reserves is regularly reviewed and confirmed in the Board of Governors' rules of procedure. The weight of currencies is determined using a model that minimises volatility in the foreign value of the reserves. According to the Board of Governors' rules of procedure, the weight of currencies in the foreign reserves for the year 2007 was as follows: US dollars 35%, euros 45%, pounds sterling 15%, and yen 5%.

Table IV-1. Returns on investment of Central Bank foreign reserves

<i>US dollar</i>	2003	2004	2005	2006	2007
Interest income (%)	3.89%	3.74%	3.84%	4.06%	4.34%
Price gain/loss (%)	-0.62%	-1.99%	-2.35%	0.01%	2.74%
Total return on securities (%)	3.27%	1.75%	1.49%	4.07%	7.08%
Average maturity at year-end	2.88	2.64	2.33	2.09	2.40
MSCI 1-3-year index ¹	1.90%	0.91%	1.66%	3.95%	7.34%
Average maturity at year-end	1.80	1.65	1.69	1.70	1.66
MSCI 3-5-year index ¹	2.50%	2.12%	0.86%	3.50%	9.83%
Average maturity at year-end	3.80	3.66	3.52	3.52	3.62
Time deposits	1.07%	1.37%	3.16%	4.93%	5.09%
LIBOR (annual average)	1.20%	1.48%	3.30%	4.98%	5.64%
<i>Euro</i> ²	2003	2004	2005	2006	2007
Interest income (%)	3.95%	3.59%	3.33%	3.67%	4.27%
Price gain/loss (%)	-0.19%	1.75%	-0.46%	-2.55%	-1.84%
Total return on securities (%)	3.76%	5.34%	2.87%	1.12%	2.42%
Average maturity at year-end	3.26	3.31	2.80	3.52	2.96
MSCI 1-3-year index ¹	3.19%	3.21%	2.16%	1.80%	3.83%
Average maturity at year-end	1.63	1.61	1.73	1.81	1.70
MSCI 3-5-year index ¹	3.68%	5.62%	2.91%	0.62%	3.37%
Average maturity at year-end	3.42	3.47	3.50	3.56	3.56
Time deposits	2.35%	2.02%	2.08%	2.82%	3.86%
LIBOR (annual average)	2.36%	2.07%	2.12%	2.83%	3.89%
<i>Sterling</i>	2003	2004	2005	2006	2007
Interest income (%)	5.76%	5.58%	5.50%	5.01%	5.51%
Price gain/loss (%)	-1.79%	0.09%	0.15%	-2.86%	0.68%
Total return on securities (%)	3.97%	5.67%	5.65%	2.15%	6.18%
Average maturity at year-end	2.78	3.31	2.95	2.22	2.23
MSCI 1-3-year index ¹	3.35%	4.66%	4.90%	3.07%	7.48%
Average maturity at year-end	1.10	2.05	1.51	1.79	1.75
MSCI 3-5-year index ¹	2.83%	5.15%	5.62%	1.48%	7.54%
Average maturity at year-end	3.47	3.53	3.36	3.38	3.42
Time deposits	3.52%	4.31%	4.66%	4.70%	5.58%
LIBOR (annual average)	3.63%	4.42%	4.71%	4.65%	5.16%

1. For the year 2007, returns according to indices reflect the Bloomberg/EFFAS Government Bond Index, which is comparable to the MSCI. The MSCI Index has not been updated since summer 2007.

2. Euro reserves 1 and 2 are weighted together.

Currency-by-currency investment of the foreign reserves

Until 2005 the Central Bank used the MSCI Sovereign Bond Index as a benchmark for the yields of securities in the foreign reserves. The MSCI indices include government bonds with various maturities. With the Board of Governors' Decision no. 1019/2004, an investment policy was approved, which assumes that the Central Bank's securities portfolio will contain not only foreign government bonds but also bonds issued by municipalities, multinational organisations, government agencies, and financial institutions; therefore, the MSCI indices were hardly useful as benchmarks for the yield and risk of the securities in the Bank's foreign reserves. The investment bank Lehman Brothers was engaged to design indices for the Central Bank's bond funds in accordance with Decision no. 1019. Table IV-1 gives a comparison between the Bank's bond portfolio and the MSCI indices, and Table IV-2 compares the portfolio with the Lehman Brothers indices.

The augmentation of the Bank's foreign reserves at year-end 2006 due to Treasury bond issuance was invested with the aim of eliminating exchange rate risk, minimising interest rate risk, and limiting re-financing risk insofar as is possible. Another consideration was to minimise the cost of the issue; that is, an attempt was made to build up a fund that would, at a minimum, yield no less than Treasury bonds. In order to achieve these objectives, it proved necessary to increase the weight of instruments from issuers other than foreign sovereigns.

The year 2007 was a time of great turbulence in the global capital markets. From 2002 until the beginning of 2007, there hardly appeared a single news item that had a negative impact on world financial markets; however, this changed early in 2007, when bad news began to spread about the US housing loan market, particularly the sub-prime mortgage market. Developments in the US housing loan market led to a drastic increase in write-downs of loans and assets by many of the world's largest banking institutions. Market conduct and expectations changed swiftly from risk-seeking to risk-averse, and the demand for government securities surged, while other bonds dropped in price.

In comparison with the Lehman indices, the Central Bank's bond funds were underweighted as regards government bonds at the beginning of 2007, while international and government agency bonds, municipals, and bonds issued by financial institutions weighed more heavily. Returns on the Bank's foreign reserves were marginally below the Lehman indices in 2007.

Treasury domestic borrowing

Changes were made in the Icelandic government's debt management affairs in 2007, when the Minister of Finance and the Central Bank agreed that the Bank would take over the issuance of the Treasury's domestic marketable securities, as well as various other tasks previously carried out by the National Debt Management Agency. With this change, which took effect on October 1, 2007, the National Debt Management Agency discontinued operation, and domestic Treasury debt management was added to foreign debt management, which the Central Bank has carried out for a number of years.

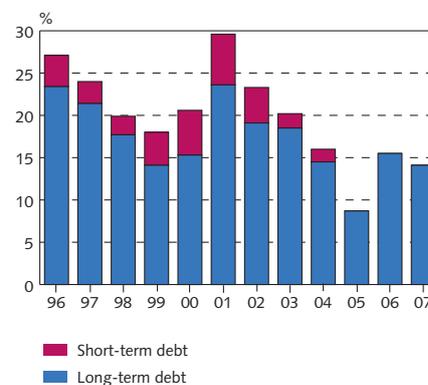
The agreement with the Minister of Finance assigned the Central Bank the task of administering and overseeing auctions, buybacks, and redemption of government securities, as well as agreements with primary dealers and the administration of securities loans to primary dealers. The Bank also handles regular information disclosure on government debt affairs to the market and the Ministry of Finance, and maintains the website www.bonds.is. The aim of merging domestic

Table IV-2. Comparison between portfolio returns and Lehman benchmark indices

	Returns 2007
US dollar	7.08%
Lehman Brothers benchmark	7.47%
<i>Difference</i>	-0.399%
Euro 1*	2.22%
Treasury issue Dec. 1, 2006	2.44%
<i>Difference</i>	-0.225%
Euro 2*	3.25%
Lehman Brothers benchmark	3.26%
<i>Difference</i>	-0.008%
Sterling	6.18%
Lehman Brothers benchmark	6.57%
<i>Difference</i>	-0.385%

* The euro reserves are divided into two parts. Euro 1 indicates the reserves that offset the obligations related to the December 1, 2006 issue. Euro 2 represents the euro reserves that are compared with the Lehman Brothers benchmark.

Chart IV-1
Treasury foreign debt as % of GDP
at end of year



Sources: Statistics Iceland, Central Bank of Iceland.

Table IV-3. Treasury long-term foreign debt maturing during the year retired

	Annual (millions)		Date of issue	Maturity date	Payment date
	Currency	ISK			
<i>Loan/bond maturing</i>					
Loan	124.5 EUR	11,085	03.14.2000	03.14.2007	03.14.2007



and foreign debt management affairs was to gain a better overview and achieve more efficient management of matters related to debt, foreign currency, and liquidity. A further objective with the agreement was to streamline operations and make more efficient use of personnel.

According to the agreement, the Central Bank has also taken over the NDMA's tasks related to government guarantees and relending. The Bank handles the administration of government guarantees and assesses the Treasury's risk due to such guarantees. It also submits statements to the Ministry concerning government guarantees, handles the processing of guarantees, and collects the pertinent fees. The Bank also issues bonds for relending.

The agreement provides for the division of tasks and the ultimate decision-making authority of the Ministry of Finance with respect to debt affairs. The aim is to prevent potential conflicts of interest in the event that the Central Bank's monetary policy does not conform to the Treasury's policy on debt management.

Treasury foreign borrowing

By agreement with the Minister of Finance, the Central Bank is assigned the implementation of Treasury foreign borrowing and other specific tasks as authorised under the Act on the National Debt Management Agency, no. 43/1990. Under this agreement, the Central Bank implements the Minister of Finance's decisions on foreign borrowing, interest rate swaps and currency swaps outside Iceland, and management of short-term borrowing facilities, along with management of other foreign loans taken by the Treasury. The agreement also assigns to the Central Bank a consultative role on borrowing and debt management policies and on relations with international rating agencies. Furthermore, the Bank supervises the credit terms of entities that enjoy Treasury guarantees and intend to borrow in the international market. The Bank oversees the Treasury's foreign loan accounts and provides related services. In managing the Treasury's foreign borrowing, the Central Bank aims to secure the reputation of the Republic of Iceland in international markets and procure foreign credit on the best available terms.

Foreign borrowing

Long-term credit is procured with issues under a European Medium-Term Note (EMTN) Program. Short-term credit is issued through two commercial paper programmes: a European-Commercial Paper Program (ECP) and a United States Commercial Paper Program (US-CPP). The Treasury also has a multi-currency revolving credit facility.

Table IV-4. Sovereign credit ratings at the end of 2007

	Foreign currency		Domestic currency		Outlook	Most recent
	Long-term	Short-term	Long-term	Short-term		
Moody's	Aaa	P-1	Aaa	P-1	Stable	August 2007
Standard & Poor's	A+	A-1	AA	A-1+	Negative	November 2007
Fitch Ratings	A+	F1	AA+		Stable	March 2007
R&I Rating of Japan	AA+				Stable	June 2007

EMTN Program

The agreement establishing the Euro Medium-Term Note Program (EMTN Program) was first signed in 2001. It was most recently renewed in 2006, and the ceiling now amounts to 2 billion US dollars. The agreement grants the Treasury access to credit in various currencies and also offers greater flexibility in issuance.

ECPP and US-CPP

The agreement concerning the issuance of commercial paper in Europe – the European Commercial Paper Program (ECPP) – has been in effect since 1985 and was last renewed in 1995. The agreement authorises the issuance and sale of commercial paper through Citibank International, SEB, and Deutsche Bank at current market terms. The maximum outstanding balance is 500 million US dollars, with a multi-currency option allowing for issuance in other major currencies. The agreement establishing the United States Commercial Paper Program (US-CPP) was signed in 2001. The total outstanding balance in the US market may not exceed 1 billion US dollars. The ECPP and the US-CPP are linked so that the combined total amount of the two issues may not exceed 1 billion US dollars. Dealers are Citibank and J.P. Morgan of New York. No issuance was made in the US market in 2007.

Repayment and borrowings

The only foreign loan that matured in 2007 was in the amount of 124.5 million euros. The loan, which matured in March, was funded in part with a three-month bill of exchange issued on the European market, in the amount of 49 million euros. This was the only bill of exchange sold during the year. The Central Bank purchased foreign currency in the domestic interbank market in an amount equivalent to 312 million US dollars in order to service foreign Treasury debt. Interest payments on foreign loans totalled 6.7 b.kr. during the year.

Debt management and risk analysis

The Central Bank's strategy for Treasury foreign debt management aims both to spread debt service as evenly as possible over coming years and to optimise the composition of the loan portfolio, with particular regard to interest rates, maturity, and currency denomination. Five forward currency agreements were made during the year, with the objective of adapting the intended currency composition. At year-end, two of the agreements had not been settled. The Treasury's foreign liabilities totalled approximately 153.9 b.kr. at year-end 2007. The weighted average maturity of foreign long-term borrowing was 3.78 years and the average duration 3.28 years.

Sovereign credit rating of the Republic of Iceland

Rating agencies are an important determinant of credit terms in global financial markets. The best-known rating agencies are Moody's Investors Service and Standard & Poor's from the US and Fitch Ratings of Europe. Ratings help to provide an indication of the terms a borrower will enjoy. The Republic of Iceland enjoys confidence as a borrower in international markets, and all main markets are open to





the Treasury because of its strong ratings and prompt repayment of debt.

Moody's rating is now Aaa for long-term foreign and domestic obligations, Aaa for country ceiling, and P-1 for short-term obligations. These are the highest ratings the agency issues.

In mid-March 2007, Fitch Ratings downgraded Iceland's foreign and local currency issuer default ratings (IDRs) to A+ and AA+ from AA- (AA minus) and AAA, respectively. The outlook on both ratings was stable. The short-term foreign currency rating was also downgraded to F1 from F1+, and the country ceiling was lowered to AA- from AA. The primary rationale for the downgrade was that Iceland's position with respect to foreign countries had deteriorated substantially as regards the balance of payments and the net external position of the economy. Fitch's opinion also stated that, in certain areas, Iceland has strengths that clearly distinguish it from other countries with a sovereign rating of A. These include its high per capita income, its very high standards of governance, and its strong, transparent institutions.

In November Standard & Poor's downgraded its outlook for the Republic of Iceland's sovereign rating from stable to negative due to macroeconomic imbalances. At that time, S&P affirmed its foreign currency sovereign credit ratings of A+ for long-term obligations and A-1 for short-term obligations. The local currency sovereign ratings are AA for long-term obligations and A-1+ for short-term obligations. Standard & Poor's opinion stated that the outlook reflected growing and persistent macroeconomic imbalances and a lack of restraint in fiscal policy. The agency also cited a growing risk of a hard landing in the Icelandic economy. S&P stated, however, that if macroeconomic imbalances unwind without palpable difficulty and risks are contained, the outlook should change back to stable.

In June 2007, the Japanese rating agency R&I Rating published its first sovereign credit rating for the Republic of Iceland, assigning a rating of AA+ for foreign currency obligations. The outlook was stable. The assessment took place in connection with the company's credit rating of Kaupthing Bank hf. R&I Ratings decided independently to give the Republic of Iceland a rating, even though the government had not requested it.

International cooperation

The Central Bank of Iceland has extensive responsibilities and obligations in the field of international finance. The Bank cooperates closely with other central banks and international economic and monetary organisations.

Nordic central banks' MoU on financial crisis management

At a meeting in Stykkishólmur, Iceland, in June 2003, the Governors of the central banks of Denmark, Finland, Iceland, Norway and Sweden signed a Memorandum of Understanding (MoU) on financial crisis management. The MoU has been published in its entirety on the websites of all the signatory banks. Nordic central banks cooperate

closely on financial stability tasks and contingencies for meeting challenges to the financial system, especially illiquidity.

The International Monetary Fund (IMF)

The Central Bank represents Iceland at the International Monetary Fund. Davíð Oddsson, Chairman of the Board of Governors of the Central Bank, represented Iceland on the IMF Board of Governors. Bolli Þór Bollason, Secretary General at the Office of the Prime Minister, was Iceland's alternate on the IMF Board. Iceland cooperates with the Nordic and Baltic countries through a Constituency at the IMF, and they jointly elect an Executive Director as one of the Fund's 24 Executive Board members. At the spring meeting, the Nordic and Baltic countries' representative to the Fund's International Monetary and Financial Committee (IMFC) was Finland's Minister of Finance, Eero Heinäluoma; however, Mr. Heinäluoma was replaced at the autumn meeting by the new Finnish Minister of Finance, Jyrki Katainen, who took over from his predecessor in late April 2007. Martti Hetemäki, Permanent Under-Secretary of State in the Finnish Ministry for Finance, was chairman of the Nordic-Baltic Monetary and Financial Committee (NBMFC), whose role is to coordinate and manage cooperation within the Constituency. Anders Svor, Assistant Director of the International Department of Norges Bank, the Central Bank of Norway, was the chair of the NBMFC Alternates, which addresses various common Constituency issues and reports to the NBMFC, as well as preparing its meetings.

The Constituency's permanent representative on the IMF Executive Board in Washington during the year was Tuomas Saarenheimo from Finland, and his alternate was Jón Sigurgeirsson from Iceland.

Both the spring meeting and the annual meeting of the International Monetary and Financial Committee were held at the IMF headquarters in Washington, D.C. In connection with the meetings, the Central Bank of Iceland published on its website the Nordic and Baltic Constituency Office's reports to the IMF on the main activities of the Fund and its Executive Board. Nordic-Baltic speeches that were presented to the IMFC and the IMF Annual Meeting were also published.

An IMF staff mission visited Iceland in early June 2007, and its concluding statement was published on the Central Bank of Iceland website. After being discussed in the Executive Board of the IMF, the Staff Report for the Article IV Consultation was published on the IMF and Central Bank websites in late August 2007.

The Bank for International Settlements (BIS)

The Central Bank is a shareholder in the Bank for International Settlements (BIS) in Basel. BIS is an important forum for consultation among central banks as well as being an information and research centre in economics, especially in the monetary field. BIS also addresses financial stability and monitors the operations and financial soundness of financial institutions. Central Bank representatives participate in a number of BIS meetings.





Other central banks

The Nordic central banks engage in extensive cooperation in a number of areas. The governors of the Nordic central banks hold an annual meeting to discuss monetary issues, financial stability, and other relevant topics of joint interest. Their experts in various areas cooperate and share information on issues including reserve management, market operations, legal matters, economic research, general monetary matters, financial stability, administration, human resources, information disclosure, etc. The Central Bank of Iceland also cooperates with various other central banks, including the European Central Bank (ECB). The Chairman of the Board of Governors meets regularly with the President of the ECB. Other Central Bank representatives have met with ECB experts to discuss payment systems and various aspects of monetary policy formulation and implementation.

The Organisation for Economic Cooperation and Development (OECD)

Central Bank representatives participate on a regular basis in the work of various OECD committees and groups, including the Economic Policy Committee, Working Party 1, the Committee on Financial Markets, and an expert committee on government debt management. OECD experts visit Iceland regularly to discuss economic developments with the authorities. Similar discussions are held with all the member countries. Following the visits, the OECD publishes its assessment of economic conditions. An OECD mission visited Iceland in the first half of 2006 and subsequently published its Country Survey in August.

Other financial institutions and rating agencies

In connection with the management of international reserves, the Treasury's foreign borrowing, and other tasks, the Central Bank is engaged in business relations with a number of financial institutions. It also handles regular communication with international credit rating agencies.

Agreement with the Ministry of Finance on current accounts and interest rates

The Central Bank Act, which was approved by Parliament in May 2001, removed Treasury access to credit with the Central Bank. Under an agreement between the Ministry of Finance and the Central Bank on current accounts and interest rates, which was renewed most recently in 2005, the rate of interest paid on average deposits is the same for the Treasury's current accounts and those held by credit institutions, as of the beginning of 2006.

Internal rules on the preparation of, arguments for and presentation of monetary policy decisions

Article 24 of the Central Bank Act, no. 36/2001, states that "the Board of Governors lays down internal rules to be approved by the Supervisory Board on the preparation of, arguments for and presentation of its monetary policy decisions." These rules have been applied since they were formally set in the beginning of 2002. The main principles on which the rules are based concern utilisation of information and

expertise, professionalism, transparency, and documentation of the rationale behind monetary policy decisions. Their provisions cover the production of inflation forecasts; procedures for evaluating economic and monetary developments and outlook; procedures for appraising monetary policy; and the Board of Governors' decision-making process and the announcement of such decisions. The rules were reviewed in 2006 and are published on the Central Bank website.

Financial stability functions

The Central Bank's financial stability functions were defined more fully with a decision by the Board of Governors in 2006. The decision makes reference to the legal foundation on which the Central Bank's operations are based and explains the main underlying principles used to define those functions. It also specifies how the Central Bank of Iceland carries out its tasks relating to framework and oversight, collection and communication of data, research, analysis and communication, cooperation, and contingencies. Furthermore, the decision provides for cooperation and division of tasks among Bank departments as regards financial stability and specifies arrangements for regular in-house meetings concerning financial stability. The decision is published on the Central Bank website.

Cooperation with the Financial Supervisory Authority

Legislation on the Central Bank and Official Supervision of Financial Activities states that the Central Bank and the Financial Supervisory Authority (FME) shall conclude a special agreement further stipulating the cooperation between them. An agreement outlining such cooperation was first made in 1999 and renewed most recently in 2006. The agreement is published on the websites of both institutions. The Central Bank Act states that the Bank shall provide FME all the information that it holds and may be utilised for the latter's activities. The two institutions regularly exchange statistics and other information, and the Board of Governors of the Central Bank and the Director of FME hold regular consultative meetings. The Central Bank and FME have conducted joint contingency exercises, the first in 2004 and another early in 2006. In 2007 the Central Bank, FME, and the Ministry of Finance participated in a Nordic contingency exercise together with their sister institutions in the Nordic and Baltic countries.

Central Bank participation on the boards of institutions and companies

The Central Bank has an equity interest in the Icelandic Banks' Data Centre (RB). According to a collaboration agreement concluded in 1994, the Bank contributed one-fifth of RB's initial capital. In 2007 Tryggvi Pálsson, Director of the Bank's Financial Stability Department, replaced Governor Eiríkur Guðnason on the RB board. Alternate board member was Ingvar A. Sigfússon, Director of Operations. The Bank's representative on the RB auditing committee was Chief Auditor Stefán Svavarsson. Árni Þórðarson, Assistant Chief Accountant, served as the Bank's representative on the RB advisory committee, and Pálína





Kristinsdóttir of the Statistics and IT Department was alternate. The advisory committee was discontinued during the year.

The Financial Supervisory Authority is governed by a three-person board appointed by the Minister of Commerce. One member is nominated by the Central Bank. For the year 2007, the Bank's representative on the board was Governor Ingimundur Friðriksson. Sigríður Logadóttir, Chief Attorney, served as alternate.

The Central Bank owns an 8% equity interest in Fjölgreiðslumiðlun hf. (FGM). Guðmundur Kr. Tómasson, Assistant Director of the Financial Stability Department, was the Bank's representative on the board of FGM during 2007. Alternate board member was Tryggvi Pálsson, Director of the Financial Stability Department.

Jónas Þórðarson of the Financial Stability Department was Executive Manager of the Depositors' and Investors' Guarantee Fund for the year 2007.

Employees of the Central Bank are members of the Bank Employees' Pension Fund. In 2007, the Bank's representative on the board of the Fund was Ingvar A. Sigfússon, Director of Operations. Alternate board member was Kristiana Baldursdóttir, Director of the Statistics and IT Department.

Risk analysis and risk management

Broadly speaking, the Central Bank's risk may be divided into four areas: management risk, reputational risk, financial risk, and operational risk. Management risk involves decisions in connection with monetary policy implementation and the Bank's other mandatory responsibilities. Although difficult to define precisely, it is determined by factors including management competence, working procedures, and internal controls. Reputational risk concerns the Central Bank's credibility and may be crucial for the Bank itself and even the financial system as a whole. Financial risk mainly lies in credit risk, interest rate risk, liquidity risk, and exchange rate risk, in connection with the maintenance of foreign reserves and monetary policy implementation. In effect are internal rules on the maintenance and investment of foreign reserves. These rules are reviewed by the Board of Governors at regular intervals and confirmed by the Supervisory Board. Rules address investment strategy, investment options, eligibility, duration of securities, and the share of liquid assets in foreign reserves. Operational risk is divided into several subcategories. These include employee risk, accounting risk, technical risk, and the general operational risk posed to the Central Bank's activities.

Efforts are made to minimise risk in the work and responsibilities of all the Bank's departments, by such means as internal rules, work procedures, job descriptions, and internal audit.

Data collection

The Central Bank collects information on a regular basis about the domestic credit market, balance of payments, and external position of the economy. Most institutions and companies operating in the domestic credit market report monthly on balance sheet items. They are also obliged to provide the Central Bank with information about

interest rate changes immediately. The balance of payments and external position are calculated on a quarterly basis. These data form the basis for the Bank's assessment of important aspects of monetary developments, as well as for regular dissemination of statistical information, both in the Bank's publications and on the Statistics pages of its website. The Statistics pages provide links to relevant resources and are published simultaneously in English.

In cooperation with the Ministry of Finance, the Central Bank operates a FAME time-series database management system that contains a range of databases with hundreds of thousands of time series, including data from corporate accounts with restricted access. Similar systems are used by most of the largest central banks and many international institutions. The Central Bank of Iceland has subscribed to the IMF's Special Data Dissemination Standard (SDDS) since 1996 and publishes an advance release calendar on its website in accordance with the standard.

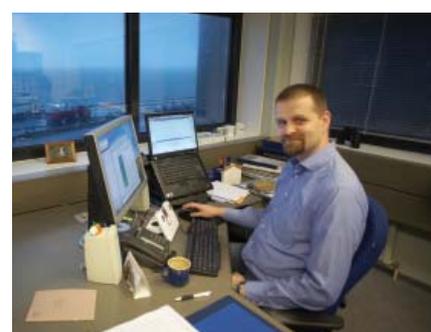
Publications and information

Strict requirements are made of central banks to explain clearly their monetary policy objectives and implementation and other activities. In Iceland, the Central Bank is obliged by law to publish reports on its monetary policy; its monetary, exchange rate and foreign exchange developments; and its measures in these areas. The forum it uses is *Peningamál*, which is published simultaneously in English translation as *Monetary Bulletin*. This publication also presents research findings by Bank employees who are connected with monetary policy, financial stability, and the Bank's general activities. Three editions of *Monetary Bulletin* were published in 2007.

Also published during the year was the Central Bank's *Financial Stability* report, which discusses the position and strength of the Icelandic financial system and financial stability in a macroeconomic context. *Financial Stability* is published once a year.

In its *Annual Report*, the Bank outlines various aspects of its operations. The Chairman of the Board of Governors gives an account of the Bank's policy at its annual meeting. *Hagvísar*, which is issued eleven times a year, is published simultaneously in English under the title *Economic Indicators*. In addition, regular statistical data appear in Icelandic and English on the Statistics pages of the Central Bank's website.

Another regular publication (in Icelandic), *Fjármálatíðindi*, has been a platform for academic articles on economics. It has been published since 1954. Publication of *Fjármálatíðindi* was discontinued after the 2007 issue. A series in English, *Central Bank of Iceland Working Papers*, publishes economic research conducted within the Bank and outside it. *Economy of Iceland*, which has been published for many years and now appears annually, contains information on Iceland's system of government and its economic structure and developments. Central Bank publications in 2007 are listed in the appendix to the present *Annual Report*. The Central Bank publishes regular announcements of decisions by the Board of Governors and various other aspects of its activities. Other news is posted on the Bank's website without the issue of an official press release.





Electronic versions of the Bank's publications are available on its website. Press releases, news, statistics, and information on the Bank's activities can also be found on the website in Icelandic and English, as can information on the contents of the Bank's various seminars and presentations, which are described further in the following section. The Bank also makes a point of promoting its activities to the public through various means, including arranging visits by students and other groups.

Research

A wide range of research is conducted within the Central Bank in connection with its functions. Most is centred in the Economics Department, but other departments are active in carrying out research as well. Furthermore, the Central Bank occasionally commissions or backs outside research.

To pursue a forward-looking monetary policy, a central bank needs models for assessing the economic outlook, especially inflation. A considerable share of research at the Central Bank of Iceland is devoted to this task. A quarterly macroeconomic model (QMM), which has been under design for some years, was introduced in the beginning of 2006 and has substantially enhanced the Bank's forecasting and analysis. Development of the model is still underway, and analysis of its long-term properties is well advanced. Also in progress is the development of a new DSGE model, which is more suitable for economic policy simulations and will be used alongside QMM.

Other extensive projects in 2007 included developmental work on a Bayesian forecasting model for inflation in Iceland, assessment of the yield curve for domestic interest rates, a VAR model for high-frequency indicators, assessment of the Central Bank's macroeconomic forecasts, preparation of a simulation model of the Icelandic financial system, assessment of expected and unexpected loan losses among the commercial banks, and the development of stress tests for the domestic financial system.

Furthermore, a number of smaller research projects are ongoing, including the design of short-term forecasting models for key subcomponents of the CPI; an assessment of the impact of foreign labour on the Icelandic economy; a study of automatic fiscal stabilisers; the design of indicators for the housing market and residential investment; and studies of the relationship between income and consumption, of the origin, composition and funding of the current account deficit, and of the informational value of preliminary national accounts estimates.

Work also commenced on a number of new research projects during the year. Among these are a study of corporate pricing decisions, a study of drivers and consequences of Icelanders' direct outward investment, a study of the role of money supply in monetary policy formation, a study of domestic equilibrium interest rates and the use of the Taylor rule in monetary policy implementation, and an assessment of the assets and liabilities of domestic households and the Icelandic economy as a whole.



The Bank carried out a wide variety of research on financial stability in 2007, including a survey of the correlation between equity indices and the exchange rate index. Stress tests to determine banks' credit risk were developed further, unexpected loan losses were estimated alongside an assessment of market risk, and a survey of system risk in the interbank market was carried out. These studies are discussed in detail in *Financial Stability 2007*. Among new studies and analyses are the development of stress tests to determine liquidity risk, an analysis of the framework of the financial system, and a re-evaluation of the methodology used to assess liquidity risk and systemically important financial institutions.

Various long-term projects are also in progress, several in cooperation with academics in Iceland and abroad. These include an extensive research project on specific monetary policy tasks in very small, open economies with an independent, floating currency; the development of methods for estimating the output gap; a study of domestic real interest rates; and changes in the pass-through from the exchange rate of the króna to inflation.

In order to create a framework for the Bank's research activities and communicate its findings to professionals and the general public alike, regular presentations are organised, at which researchers inside and outside the Bank report their findings and discuss them with other Bank employees and researchers. Central Bank staff also presented their research findings at seminars outside the Central Bank, both in Iceland and abroad. They also attended local and international conferences to present their own findings and hear those of other researchers, and lectured at public, specialist and academic venues.

The Central Bank underlines the importance of publishing research by its experts in internationally recognised academic journals. A number of such papers were published during the year.

National Festival Fund

The National Festival Fund operated for its 30th year in 2007. Its initial capital was the proceeds from the Central Bank's commemorative coin issue for the National Festival of 1974, and its revenue base has been the Bank's proceeds from other commemorative coins since then. The board of the Fund comprises five members, three appointed by Parliament and one by the Central Bank. The fifth board member, who serves as chairman, is appointed by the Prime Minister. The board was appointed for a four-year term in 2006. The chairman is Margrét Bóasdóttir, and the Central Bank's representative is Governor Eiríkur Guðnason. The secretary of the Fund board is Central Bank attorney Sigfús Gauti Þórðarson. The Fund made two allocations during the year. The prior allocation took place on May 24, when the board decided to award 20.6 m.kr. to 46 applicants for the year 2007. The latter allocation was made on December 1, when the board awarded 25.4 m.kr. to 55 applicants for 2008. On both occasions, an award ceremony was held in the Reykjavík Culture House. The Fund's capital amounted to just over 103 m.kr. at the end of the year. It is intended that its entire capital be allocated no later than in 2010, for the year 2011.

Central Bank premises – library and archive

The Central Bank's premises at Kalkofnsvegur in Reykjavík also housed the Banks' Data Centre (RB) at the end of 2007. Most of the Central Bank library and archive is housed at Einholt 4 in Reykjavík. In 2006 the joint Central Bank and National Museum numismatic collection was moved from Einholt 4 to exhibition space on the ground floor of Kalkofnsvegur. A library of periodicals and journals is also located on the Bank's premises at Kalkofnsvegur. The Central Bank's extensive library on Iceland's economy and industry has been incorporated into the National and University Library of Iceland computerised card catalogue.



V Accounts and organisation

Central Bank accounting principles

According to Article 32 of the Central Bank of Iceland Act, no. 36/2001, the preparation of the Bank's annual accounts "shall be in accordance with the law and with generally accepted accounting principles. The Prime Minister shall lay down further rules on the accounting principles and preparation of the annual accounts." The current rules were set in 2005. The financial statements for 2007 are based on the same principles as in 2006; however, minor changes have been made in the presentation of individual items. These changes are explained in the notes to the financial statements, which appear in this Annual Report.

Operating results and balance sheet

According to its profit and loss account, the Central Bank of Iceland recorded a net loss of 1,224 m.kr. in 2007, compared with a profit of 11,857 m.kr. in the previous year. The substantial change between years is due primarily to exchange rate valuation differences. In 2007 there was an exchange rate loss amounting to 5,899 m.kr., as compared with an exchange rate gain of 11,825 m.kr. the year before. Excluding exchange rate valuation differences, the Central Bank earned a profit of 4,675 m.kr. in 2007, compared with a profit of 32 m.kr. in 2006. The transfer to the Treasury totalled 2,338 m.kr. in 2007, as opposed to 16 m.kr. in 2006. Interest income increased on both domestic and foreign assets during the year. The Bank's total interest income for 2007 amounted to 31,281 m.kr., as opposed to 15,444 m.kr. in 2006. The rise in interest income is explained by increased average lending and higher interest rates. Interest expense also increased substantially in 2007, amounting to 25,234 m.kr., as compared with 13,743 m.kr. for 2006. Net interest income totalled 6,047 m.kr. in 2007, as opposed to 1,701 m.kr. the year before. Other operating revenue increased from 348 m.kr. to 2,531 m.kr. between years. Operating expenses amounted to 1,565 m.kr. in 2007, as compared with 2,002 m.kr. the previous year. The drop is due primarily to the supplemental pension contribution paid in 2006 and the reduction in expenses for banknotes and coin in 2007.

In 2007, the Central Bank's balance sheet total increased by 155 b.kr. to 477 b.kr. at the end of the year. The considerable growth in assets is due almost entirely to increases in the Bank's claims on deposit money banks and other financial institutions in the form of collateralised loans, which rose from 147 b.kr. at year-end 2006 to 303 b.kr. at the end of 2007. On the liability side, notes and coin grew by 8.4% to 15,735 m.kr. at year-end. The Central Bank's liabilities towards deposit money banks, in particular their current account deposits, rose from 43,210 m.kr. at year-end 2006 to 152,112 m.kr. at the end of 2007.

At year-end 2007, liabilities of the Central government amounted to 211 b.kr., which is virtually unchanged from 2006 despite the payment of an equity capital contribution, mentioned later in this chapter.



Other government claims against the Central Bank at year-end 2007 included time deposits amounting to 26,815 m.kr. As is discussed in the Central Bank's Annual Reports for 2005 and 2006, this amount is part of the proceeds deposited when Iceland Telecom was privatised. Also among the government's claims against the Central Bank is a foreign-denominated bond which represents the value of a foreign loan that was taken in late 2006 and was discussed in the Bank's Annual Report for that year. The amount of the bond totalled 88,990 m.kr. at year-end 2007.

At the end of 2007, foreign assets accounted for 34% of the Central Bank's total assets, as against 52% at the end of the previous year. Foreign and foreign currency-denominated liabilities represented 19% of the Central Bank's total liabilities and equity at the end of 2007, as compared with 31% at year-end 2006.

The Bank's equity totalled 91,003 m.kr. at year-end 2007, as opposed to 48,227 m.kr. at the end of 2006. The increase is primarily a result of a 44 b.kr. equity capital contribution paid to the Bank by the Treasury in May 2007. At year-end 2007, the Bank's equity corresponded to 18% of the balance sheet total excluding revaluation of fixed assets, as compared with 13.4% for the prior year.

The Central Bank pays the same rate of interest on government current accounts as on credit institutions' current accounts. On the time accounts in which the proceeds from the privatisation of Iceland Telecom were deposited, the interest rate corresponds to the average of Central Bank current account rates and its policy rate.

Returns on foreign investments in 2007 were satisfactory under the circumstances, as is discussed in Chapter IV. In the global markets, interest rates were low but volatile, and this volatility was mirrored by fluctuations in the market value of the bond portfolio. Investment of the foreign reserves is explained in detail in Chapter IV and is covered in the notes to the financial statements.

Maintaining foreign reserves exposes the Central Bank to currency risk from changes in the exchange rate of the króna against which it is unable to hedge – and increasingly so, the larger the reserves. On the other hand, changes in the exchange rate of the króna have no effect on the value of the reserves denominated in foreign currency. They serve their purpose irrespective of changes in the exchange rate of the domestic currency. The Central Bank's foreign assets and liabilities are entered in the accounts at market price, translated into domestic currency at the end of the year. Changes in the exchange rate have a direct impact on the Bank's calculated profit. Foreign exchange rate loss and gain are expensed or credited in full in the profit and loss account, directly affecting the Bank's result.

The Central Bank's accounts are presented later in this report, together with detailed explanatory notes for individual items.

Supervisory Board

The Central Bank Act, no. 36/2001, stipulates that there shall be seven members of the Supervisory Board, which is to be elected following parliamentary elections. The last election of the Supervisory Board took place in June 2007. The Supervisory Board selects a chair-

man and deputy chairman from among its members. Members of the Supervisory Board at year-end 2007 were Halldór Blöndal (Chairman), Jón Sigurðsson (Deputy Chairman), Erna Gísladóttir, Hannes Hólmsteinn Gissurarson, Jónas Hallgrímsson, Ragnar Arnalds, and Sigríður Ingibjörg Ingadóttir (elected on October 3, 2007, to replace Jón Þór Sturluson, who resigned from the Board). The Supervisory Board held 20 meetings in the course of 2007.

Board of Governors

The Board of Governors of the Central Bank of Iceland comprised Davíð Oddsson (Chairman), Eiríkur Guðnason, and Ingimundur Friðriksson. Eiríkur Guðnason's term of appointment as Governor expires at the end of April 2012 and Davíð Oddsson's in October 2012. Ingimundur Friðriksson's term expires in August 2013.

Central Bank organisation

The Bank's activities take place in six main departments, plus the Internal Audit Department. The Governors' Office is separate from the Bank's main departments. It provides general office and administrative service to the Governors, oversees public relations and information disclosure for the Bank, and supervises the publication of the Bank's Annual Report and website. The Legal Services staff prepare a wide range of contractual agreements for the Bank, as well as preparing legal documents and debt instruments and participating in the preparation of laws, regulations, and legal opinions. The Library and Collection Department is a part of the Governors' Office. It carries out library operations, as well as overseeing the Central Bank and National Museum numismatic collection.

The International and Market Operations Department oversees domestic money markets and currency markets and handles transactions with domestic financial institutions. It also manages the Bank's foreign reserves and oversees government debt affairs, as well as Treasury guarantees and relending. Furthermore, the Department handles the Bank's regular relations with foreign financial institutions, international credit rating agencies, and the International Monetary Fund.

The Accounting Department keeps the Central Bank's main accounts, as well as those of the Greenland Fund and the Depositors' and Investors' Guarantee Fund, which are under the Bank's custodianship. The Department also handles accounting relative to Treasury bond redemption and the government's foreign borrowing. Furthermore, it administers the Bank's SWIFT system, as well as overseeing payments for the Bank, the Treasury, and State enterprises.

The Financial Stability Department's activities centre on the stability and effectiveness of financial institutions and markets. The Department's operations are divided into three units related to financial stability: Financial Systems, Payment Systems, and Contingency. The Cashier's Unit also belongs to the Financial Stability Department. Financial Systems carries out analysis of financial institutions and the structure of the financial system. Payment Systems oversees the most important payment and settlement systems. Contingency handles the development and preparation of stress tests and contingency-related

Table V-1. Employees

	No.	Man-years
Secretariat	10	9.3
Governors' Office	3	3.0
Legal Services	2	2.0
Library and Collection	5	4.3
International and Market		
Operations Department	12	12.0
Accounting Department	10	10.0
Financial Stability Department	14	13.9
Financial Stability	8	7.9
Cashier's Unit	6	6.0
Economics Department	16	15.9
Operations Department	34	26.8
Statistics and Information	17	16.4
Internal Auditing Department	2	2.0
Total	115	106.3



projects. The Cashier's Unit oversees the issuance and handling of notes and coin. The Financial Stability Department is a leading contributor to the Bank's annual report entitled *Financial Stability*.

The Economics Department carries out economic and monetary research, prepares macroeconomic and inflation forecasts, participates in formulating policy in currency and monetary matters, and analyses developments in domestic and foreign economic and monetary matters – for example, the macroeconomic elements of financial stability. The Department also oversees or participates in the issuance of various Bank publications, including *Hagvísar/Economic Indicators*, *Peningamál/Monetary Bulletin*, *Working Papers*, *Financial Stability*, *Fjármálatíðindi*, and *Economy of Iceland*. The Department comprises two units: the Analysis and Publications Unit and the Research and Forecasting Unit.

The Operations Department has the largest staff among the Bank's departments. It carries out the operation and administration of the Bank's real estate and equipment, as well as overseeing security, procurement, budgeting, and expenditure control. The Department also handles human resources and payroll affairs and provides a variety of in-house services. Operations is also responsible for the Bank's archives. Since 2001 telephone reception has been handled by a company in Raufarhöfn.

The Statistics and IT Department handles the gathering, entry, and processing of statistical data that the Central Bank compiles for its work. It also operates the Bank's computer systems and databases. The Department comprises four units: Information Technology, operation and maintenance of the Bank's FAME database, data gathering and entry, and data processing and communication.

The Chief Auditor is appointed by the Supervisory Board and not by the Board of Governors. The Internal Auditing Department carries out internal auditing and monitoring of the Bank's operations in a broad sense, as well as administering the funds under the Bank's management.

Human resources

Considerable changes took place in Central Bank staffing during 2007. Eleven employees left or retired from the Bank, and sixteen were hired. Four of the new employees began in October 2007, when the National Debt Management Agency was closed and its activities, as well as four members of staff, were transferred to the Bank's International and Market Operations Department. The number of summer employees was similar to previous years. Bernard John Scudder passed away on October 15, 2007. Born on August 29, 1954, Bernard began work as the Bank's translator on May 19, 2003, after having worked for a number of years as a self-employed translator. Three employees retired during the year: Guðmundur Guðmundsson, Economics Department, retired after 35 years of service; Hannes Haraldsson, Cash Unit, retired after 40 years of service; and María Jenný Jónasdóttir, Operations Department, retired after 42 years of service.

The number of staff members in the International and Market Operations Department increased by four, while the Financial Stabili-

ity Department and the Statistics and IT Department added one staff member each. The Operations Department staff decreased by one.

At year-end 2007, the Bank's staff totalled 115 – 60 males and 55 females – four more than at year-end 2006. The number of full-time equivalent positions was 106.3. Seven employees were in part-time posts equivalent to 5.3 positions, and the Banks' Data Centre was responsible for seven of the 14 positions in the joint cafeteria, security, and maintenance and janitorial services it shares with the Central Bank. Average man-years were 111, a decrease of 1.6 from 2006.

Wage agreements

Most Central Bank employees are members of the Federation of Bank Employees and are paid salaries according to its wage agreements. The current wage settlement is in force until September 2008. It provides for a pay rise of 2.25% on January 1, 2008.

Equal opportunities policy

The Board of Governors confirmed the Bank's equal opportunities strategy in 1996, and an equal opportunities committee has been active since then. The equal opportunities strategy has been reviewed regularly, most recently in 2007. The Bank's equal opportunities policy was confirmed at that time.

Central Bank of Iceland December 31, 2007

Supervisory Board

Principal members

Halldór Blöndal, Chairman
 Jón Sigurðsson, Deputy Chairman
 Erna Gísladóttir
 Ragnar Arnalds
 Hannes Hólmsteinn Gissurarson
 Jónas Hallgrímsson
 Sigríður Ingibjörg Ingadóttir

Alternates

Halla Tómasdóttir
 Birgir Þór Runólfsson
 Tryggvi Friðjónsson
 Sigríður Finsen
 Guðný Hrund Karlsdóttir
 Ingibjörg Ingvadóttir
 Valgerður Bjarnadóttir

Board of Governors

Davíð Oddsson, Governor and Chairman
 Eiríkur Guðnason, Governor
 Ingimundur Friðriksson, Governor

Principal Officers

Sigurður Sturla Pálsson, Director of International and Market Operations Department
 Erla Árnadóttir, Chief Accountant
 Stefán Svavarsson, Chief Auditor
 Tryggvi Pálsson, Director of Financial Stability Department
 Arnór Sighvatsson, Chief Economist
 Sigríður Logadóttir, Chief Attorney
 Ingvar A. Sigfússon, Director of Operations
 Tómas Örn Kristinsson, Director of Statistics and IT



Meeting of the Supervisory Board in early 2008. From left: Arnór Sighvatsson, Davíð Oddsson, Jónas Hallgrímsson, Sigríður Ingibjörg Ingadóttir, Jón Sigurðsson, Halldór Blöndal, Hannes Hólmsteinn Gissurarson, Erna Gísladóttir, Ragnar Arnalds, Eiríkur Guðnason, Ingimundur Friðriksson and Tómas Örn Kristinsson.

Employees

SECRETARIAT

Governors' Office

Ágústa Johnson
Ellen Hrefna Haraldsdóttir
Stefán Jóhann Stefánsson

Legal Services

Sigfús Gauti Þórðarson
Sigríður Logadóttir

Library and Collection

Anton Holt
Magný Gyða Ellertsdóttir
Sigurbjörg Sigurðsson
Unnur Björk Lárusdóttir
Valborg Stefánsdóttir

INTERNATIONAL AND MARKET OPERATIONS DEPARTMENT

Bergur Barðason
Björgvin Sighvatsson
Björn G. Ólafsson
Gerður Ísberg
Guðrún Sóley Gunnarsdóttir
Hallgrímur Ólafsson
Jóna Guðrún Ísaksdóttir
Lilja D. Alfreðsdóttir
Oddgeir Gunnarsson
Sigurður G. Thoroddsen
Sigurður Sturla Pálsson
Viðar Rúnar Geirsson

ACCOUNTING DEPARTMENT

Alf H. Pedersen
Anna S. Árnadóttir
Arndís Leifsdóttir
Árni Þórðarson
Erla Árnadóttir
Guðrún E. Herberdsdóttir
Halldóra Konráðsdóttir
Ísólfulf Sigurðsson
Jónína Guðbjartsdóttir
Ólöf Jónsdóttir

INTERNAL AUDITING DEPARTMENT

Guðmundur Björnsson
Stefán Svavarsson

FINANCIAL STABILITY DEPARTMENT

Bryndís Ásbjarnardóttir
Elín Kristjana Sighvattdóttir
Guðmundur Kr. Tómasson
Guðrún Ögmundsdóttir
Jónas Þórðarson
Perla Ösp Ásgeirsdóttir
Sylvía Kristín Ólafsdóttir
Tryggvi Pálsson

Cashier's Unit

Auður Gísladóttir
Ingveldur S. Kristjánadóttir
Jóhanna Pétursdóttir
Kolbrún Jóhannsdóttir
Kristján Guðmundsson
Stefán Arnarson

ECONOMICS DEPARTMENT

Arnór Sighvatsson
Ásgeir Danielsson
Daniel Svavarsson
Guðrún Yrsa Richter
Helga Guðmundsdóttir
Karen Á. Vignisdóttir
Magnús Fjalar Guðmundsson
Markús Möller
Ólafur Örn Klemensson
Rannveig S. Sigurðardóttir
Regína Bjarnadóttir
René Kallestrup
Rósa Björk Sveinsdóttir
Svava Jóhanna Haraldsdóttir
Þorvarður Tjörvi Ólafsson
Þórarinn G. Pétursson

OPERATIONS DEPARTMENT

Birna K. Jónsdóttir
Hólmfríður M. Ingibergsdóttir
Ingvar A. Sigfússon
Kristjón Kolbeins
Þórður Gautason

Maintenance and Janitorial Services

Berglind Þorsteinsdóttir
Bogey R. Hreiðarsdóttir
Guðný Harpa Hallgrímsdóttir
Hildur Hrönn Hreiðarsdóttir
Kristinn Unnarsson
Marteinn Jóhannesson
Olga A. Björnsdóttir
Ólafía Egilsdóttir
Ragnheiður E. Rúnarsdóttir
Rita Sigurðardóttir
Sigurlaug Jósepsdóttir
Sólveig Kristinsdóttir
Stefanía Hrönn Guðnadóttir
Svala Sigurðardóttir

Cafeteria

Bergþóra Óskarsdóttir
Guðlaug Erla Ingólfssdóttir
Halla Kristín Björnsdóttir
Sigríður Laufey Guðmundsdóttir
Sigurberg Jónsson

Design and Printing

Sigríður María Jónsdóttir
Sigurbjörg Steingrimsdóttir
Sveinn A. Blöndal

Secretaries

Hrafnhildur Georgsdóttir
Klara Jóhannsdóttir
Sigríður Bogadóttir
Þórey Þórarinsdóttir

Archives

Eva Sóley Sigurðardóttir
Guðrún Sigmarsdóttir
Hilmar Gunnþór Garðarsson
Sigurbjörg Ólafsdóttir
Sveinbjörg Rut Helgadóttir

Transport

Garðar Halldórsson
Karl G. Smith

Security

Guðleifur Svanbergsson
Gunnlaugur Magnússon
Hannes Ólafsson
Hólmgeir H. Hákonarson
Jóhann Gunnar Friðjónsson
Sigurður Sigurðsson
Sveinbjörn Kristjánsson
Þorsteinn Þorvaldsson

STATISTICS AND IT DEPARTMENT

Arnar Freyr Guðmundsson
Bryndís Pétursdóttir
Einar Örn Ólafsson
Eva Hjördís Bjarnadóttir
Fjóla Agnarsdóttir
Guðmundur Harðarson
Gylfi Vilberg Árnason
Hrönn Helgadóttir
Jakob Gunnarsson
Kristjana Baldursdóttir
Lárus Jóhannesson
Pálína Kristinsdóttir
Pétur Örn Sigurðsson
Ríkarður B. Ríkarðsson
Tómas Örn Kristinsson
Tryggvi Eyvindsson
Örn Jónasson



ANNUAL ACCOUNTS 2007

Confirmation by the Supervisory Board and the Board of Governors

The Supervisory Board and the Board of Governors of the Central Bank of Iceland hereby confirm the annual accounts for the year 2007.

Reykjavík, March 13, 2008

Supervisory Board

Halldór Blöndal
Chairman

Jón Sigurðsson
Hannes Hólmsteinn Gissurarson
Ragnar Arnalds

Erna Gísladóttir
Jónas Hallgrímsson
Sigríður I. Ingadóttir

Board of Governors

Davíð Oddsson
Chairman

Eiríkur Guðnason

Ingimundur Friðriksson

Auditor's Report

To the Supervisory Board and the Board of Governors of the Central Bank of Iceland:

We have audited the annual accounts of the Central Bank of Iceland for the year 2007. These annual accounts comprise a report from the Supervisory Board and the Board of Governors, a profit and loss account, balance sheet, statement of cash flows, information on important accounting policies, and other explanatory notes.

Management's responsibility for the annual accounts

Management is responsible for the preparation and fair presentation of these annual accounts in accordance with the Annual Accounts Act. This responsibility includes designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of annual accounts that are free of material misstatement; selecting and applying appropriate accounting principles; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to render an opinion on the annual accounts based on our audit. We carried out our audit in accordance with generally accepted auditing standards and the provisions of the Act on the National Audit Bureau. Those standards and provisions require that we follow a set code of conduct and that we plan and perform the audit so as to obtain reasonable assurance that the annual accounts are free of material misstatement.

The audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the accounts. The procedures selected depend on the auditor's judgment, including the assessment of the risk of material misstatement in the accounts. The audit also includes evaluating the appropriateness of the accounting principles used and the reasonableness of the accounting estimates made by management, as well as evaluating the overall presentation of the accounts.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

It is our opinion that the annual accounts give a true and fair view of the results of operations of the Central Bank of Iceland for the year 2007, the financial position as at December 31, 2007, and cash flows for the year then ended, in accordance with the Annual Accounts Act.

National Audit Bureau, March 13, 2008

Sigurður Þórðarson
Auditor General

Confirmation by the Prime Minister of Iceland

With reference to the statements of the auditor, the Supervisory Board and Board of Governors, the annual accounts are hereby ratified.

Reykjavík, March 28, 2008

Geir H. Haarde
Prime Minister

Profit and Loss Account for 2007

	Notes	2007	2006
Interest income			
On domestic loans		25,346,076	12,631,734
On foreign deposits and securities	1	5,935,188	2,812,105
		<u>31,281,264</u>	<u>15,443,839</u>
Interest expense			
On domestic deposits		21,778,592	13,658,417
On foreign liabilities		3,455,811	84,112
		<u>25,234,403</u>	<u>13,742,529</u>
Net interest income	13	6,046,861	1,701,310
Other income and (expenditure)			
Income from services		232,651	220,664
Expenditure on services		(107,654)	(83,016)
Notes retired		118,220	0
Share investment income		320,290	452,341
Valuation changes on foreign securities	1	(640,509)	(839,611)
Valuation change on foreign long-term debt	1	1,801,665	0
Price increase on gold		797,228	525,927
Exchange rate gain on foreign currency transactions, net		9,260	72,144
		<u>2,531,151</u>	<u>348,449</u>
Net operating income		8,578,012	2,049,759
Other expenses			
Salaries and payroll expenses	15	921,195	890,257
Other operating expenses		413,095	384,192
Expenses relating to new note/coin issues		143,355	251,446
Depreciation	4	87,710	90,246
Supplementary pension fund contribution		0	385,662
		<u>1,565,355</u>	<u>2,001,803</u>
Profit before transfer to Treasury		7,012,657	47,956
Transfer to Treasury	8	2,337,552	15,985
Profit excluding exchange rate gain (loss)		4,675,105	31,971
Exchange rate gain (loss)	14	(5,898,662)	11,825,022
Net profit (loss) for the year	11	<u>(1,223,557)</u>	<u>11,856,993</u>

All amounts in thousand kr.

Balance Sheet at December 31, 2007

ASSETS	Notes	2007	2006
Foreign assets			
Cash balances with other banks		19,348,284	41,649,443
Gold	3	3,305,189	2,934,064
Securities	3	138,322,338	121,246,719
Reserve tranche with the IMF	5	1,822,996	2,019,865
Assets not included in foreign reserves	2	786,675	522,496
		<u>163,585,482</u>	<u>168,372,587</u>
Domestic assets			
<i>Deposit money banks</i>			
Collateral loans	6	258,164,548	119,862,706
<i>Other financial institutions</i>			
Listed securities		1,446,568	1,472,558
Collateral loans	6	44,553,548	27,073,964
Overnight loans		4,101,698	0
		<u>50,101,814</u>	<u>28,546,522</u>
<i>Other</i>			
Miscellaneous accounts		55,070	47,206
Securities		75,859	95,313
		<u>130,929</u>	<u>142,519</u>
<i>Fixed assets</i>			
Property and equipment	4	4,875,730	4,859,244
		<u>313,273,021</u>	<u>153,410,991</u>
		<u>476,858,503</u>	<u>321,783,578</u>
Total assets			
Assets off-balance sheet	12		

Balance Sheet at December 31, 2007

LIABILITIES AND EQUITY

	Notes	2007	2006
Foreign liabilities			
Foreign demand deposits		99,541	94,644
SDR allocation with the IMF	5	1,612,593	1,779,605
		<hr/>	<hr/>
Foreign liabilities		1,712,134	1,874,249
Domestic liabilities			
Notes and coin		15,735,426	14,512,501
<i>Deposit money banks</i>			
Sight deposits, including required deposits	6	152,111,529	43,210,188
Certificates of deposit		0	1,777,253
		<hr/>	<hr/>
		152,111,529	44,987,441
<i>Other financial institutions</i>			
Sight deposits, including required deposits		1,425,239	129,825
<i>Central government</i>			
Government deposits		93,970,973	80,114,201
Time deposits		26,814,835	33,085,333
Deposits denominated in foreign currency		864,722	3,459,663
Foreign-denominated long-term debt	8	88,990,036	93,775,409
Government institutions, deposits		536,006	567,120
		<hr/>	<hr/>
		211,176,572	211,001,726
<i>Other liabilities</i>			
Unpaid transfer to Treasury	8	2,337,552	15,985
Miscellaneous		1,036,091	677,513
Pension fund obligations	7	320,719	357,541
		<hr/>	<hr/>
		3,694,362	1,051,039
		<hr/>	<hr/>
Domestic liabilities		384,143,128	271,682,532
Equity			
Contributed capital		57,501,000	13,501,000
Revaluation account		4,990,681	4,990,681
Other reserves		28,511,560	29,735,116
		<hr/>	<hr/>
Equity	11	91,003,241	48,226,797
		<hr/>	<hr/>
Liabilities and equity		476,858,503	321,783,578
		<hr/>	<hr/>
Off-balance sheet commitments	12		

Statement of Changes in Cash Flows

OPERATING ACTIVITIES:	Notes	2007	2006
Net profit (loss) for the year		(1,223,557)	11,856,993
<i>Operating items not involving cash:</i>			
Depreciation	4	87,710	90,246
Exchange rate differences on assets and liabilities	1	4,321,437	(5,302,678)
Exchange rate difference on cash		1,577,225	(6,522,344)
Unrealized holding (gain) on long-term debt	1	(1,801,665)	0
Various valuation changes on assets and liabilities		(1,263,634)	(169,074)
<i>Change in operating assets and liabilities, net</i>		<u>2,837,936</u>	<u>(1,900,761)</u>
		<u>4,535,452</u>	<u>(1,947,618)</u>
INVESTING ACTIVITIES:			
Collateral loans, (increase)		(155,781,425)	(59,094,674)
Overnight loans, (increase)		(4,101,698)	0
Acquisition of fixed assets		(100,617)	(24,634)
Securities, amortization		234,209	506,205
Investment in bonds in foreign reserves		(47,419,630)	(82,116,280)
Bonds in foreign reserves sold		22,910,830	16,366,439
		<u>(184,258,331)</u>	<u>(124,362,944)</u>
FINANCING ACTIVITIES:			
Increase in contributed capital	11	44,000,000	0
Notes and coin in circulation, increase		1,341,145	1,310,592
Time deposit, (decrease)		(6,100,000)	0
Certificates of deposit, (decrease)		(1,777,253)	(516,885)
Long-term foreign-denominated debt, increase		0	89,034,459
Increase in demand deposits, money banks		110,196,756	11,239,049
Increase in demand deposits, central government		11,338,297	39,321,739
		<u>158,998,945</u>	<u>140,388,954</u>
CHANGE IN CASH POSITION:			
Foreign cash balance, increase (decrease)		(20,723,934)	14,078,392
Exchange rate (losses) gains on cash position		(1,577,225)	6,522,344
Foreign cash balance at beginning of year		<u>41,649,443</u>	<u>21,048,707</u>
Foreign cash balance at end of year		<u><u>19,348,284</u></u>	<u><u>41,649,443</u></u>

Notes to the Annual Accounts for 2007

1. The annual accounts have been prepared in accordance with the Annual Accounts Act, no. 3/2006; the provisions of the Act on Financial Undertakings, no. 161/2002; and the Rules on Central Bank Accounting and Annual Accounts, no. 1088/2005.
 - Assets and liabilities denominated in foreign currencies are translated into Icelandic krónur (kr.) using the buying exchange rate at the end of 2007. Income and expenses in foreign currency are converted using the exchange rate on the date of transaction. Exchange rate gains/losses are posted to the Profit and Loss Account.
 - Assets and liabilities linked to price indices are shown in the Balance Sheet with accrued indexation at year-end, stated in terms of the relevant index figures for January 2008 reflecting price levels at year-end 2007. Indexation is entered in the Profit and Loss Account under *Interest income/on domestic loans*.
 - Debt securities in foreign reserves are recorded at market value, and valuation changes are entered in the Profit and Loss Account. The valuation changes reflect the difference between market value and book value based on amortized cost, with unamortized discounts and premiums recorded based on the relevant effective interest rates. Correspondingly, the foreign-denominated long-term debt with the Central Government, used to finance the increase in foreign reserves, is recorded at fair value reflecting the market yield at year-end and the valuation change being posted to the Profit and Loss Account.
 - Income is entered when earned, whether or not it has been collected. Likewise, expenses are entered when incurred, whether or not they have been paid. Changes in the valuation of debt securities are also entered in the Profit and Loss Account regardless of whether they are realized or unrealized.
 - In the Statement of Cash Flows, the conventional classification of activities is used, but with a change in the definition of the fund balance, which now reflects only the foreign bank balances. Previously, the fund was defined as a liquid position representing investment in foreign debt securities as well as foreign bank balances less the demand deposits with financial institutions and the Central Government. By segregating these items from the fund balance, changes in investments in debt securities and in demand deposits with financial institutions and the Central Government are now shown under *Investing Activities* and *Financing Activities* in the Cash Flow Statement.
 - The presentation of interest income has been altered from earlier financial statements. Interest income on debt securities now reflects the effective rate of interest, whereas previously the interest posted as income was the nominal rate of interest. Valuation changes on debt securities change correspondingly. Thus the change in presentation is only a matter of reclassification of items

Summary of accounting policies

within the Profit and Loss Account. Comparative figures have been restated to reflect this change.

- Share investments have been stated at historical cost since the shares owned by the Bank have not been listed. At the end of 2006, the Bank received shares in the OMX Nordic Exchange in exchange for shares in Eignarhaldsfélag Verðbréfaþings hf. Since the shares received are listed on the securities markets, the share investment in OMX is recorded at market value at year-end, with valuation changes posted to the Profit and Loss Account. Other share investments are valued at original cost.
- The cost of printing notes and minting coins is expensed as incurred.
- Fixed assets at the end of 2005 were revalued to fair value, with subsequent depreciation based on that fair value. Fixed assets purchased in 2006 and later are recorded at cost less accumulated depreciation, with annual depreciation based on cost less the expected salvage value.
- In other respects, accounting is conducted according to the same principles as in the past.

Shareholdings

2. The Bank's holding in the Bank for International Settlements (BIS) is entered at cost price. At the end of 2007, the Bank held 1,070 shares at nominal value of 5,000 SDR. This holding is entered under the item *Foreign Assets/Assets not included in foreign reserves*. The book value at year-end 2007 amounted to 184.5 m.kr., and the nominal value 130.7 m.kr. (1.3 m. SDR). The Bank has paid 25% of the nominal value of each share, or 1,250 SDR; thus the remainder, or 75%, is unpaid, and the Bank is obliged to pay the outstanding shares if they are called. Based on financial statements for BIS at the end of March 2007, the Bank's interest in the book value of equity amounts to 2.3 b.kr.

Foreign assets/Assets not included in foreign reserves includes the Bank's share in OMX, with a market value of 578.6 m.kr. at the end of 2007. The total number of shares is 228,259, and their market value was 262.5 at year-end 2007. A favorable valuation change in 2007 amounted to 279 m.kr. and was posted to the Profit and Loss Account. The item *Other/Miscellaneous accounts* includes the Bank's 8% equity in Fjölgreiðslumiðlun hf., a netting service provider. The book value of this holding is 1.2 m.kr., which is also the nominal value.

Foreign assets and gold

3. The Bank's foreign assets amounted to 163.6 b.kr. at the end of 2007 but were 168.4 b.kr. at the end of the previous year. The figure includes the gold reserves of the Central Bank, which amounted to 63,883.8 troy ounces. The gold is valued at its year-end 2007 market value of 836.5 dollars per troy ounce, which is equivalent to 51,737 kr. At the end of 2007, the Bank's gold reserves therefore amounted to 3.3 b.kr.

Returns on bonds and bank balances in foreign reserves during the year were as follows, by currency:

	<i>Bonds</i>	<i>Deposits</i>
US dollars	7.08%	4.70%
Euros	2.42%	2.30%
Pounds sterling	6.18%	3.70%

- Bond investment at the end of 2007 is specified as follows, and the book value is at market value:

<i>(amounts in thous. of foreign currency)</i>	<i>Par value</i>	<i>Un- amortized prem- ium, Amortized net cost</i>		<i>Market value</i>	<i>Un- realized valu- ation chg.</i>
Euro bonds EUR	1,216,500	6,416	1,222,916	1,204,060	(18,856)
Dollar bonds USD	237,000	2,226	239,226	239,917	691
Sterling bonds GBP	65,000	322	65,322	64,932	(390)

- The Central Bank has entered into a securities lending program with JPMorgan Chase Bank, which lends out securities in the Bank's possession. At year-end 2007 the outstanding balance of securities loaned amounts to the equivalent of 509 million US dollars, and the fees received for lending amounted to 550,000 US dollars during the year.

4. Fixed assets were revalued at year-end 2005. Property and equipment acquired after that date are recorded at historical cost less accumulated depreciation, which takes into account the expected salvage value at the end of useful life.

Fixed assets

Fixed assets at the end of 2007 are specified as follows (in m.kr.):

	<i>Land</i>	<i>Real estate</i>	<i>Equip./ furnish.</i>	<i>Collec- tions</i>	<i>Total</i>
<i>Assets:</i>					
Balance Jan. 1, 2007	24.0	4,575.3	215.4	238.3	5,053.0
Purchased in 2007		91.0	15.2	1.4	107.6
Sold in 2007			(6.9)		(6.9)
	<u>24.0</u>	<u>4,666.3</u>	<u>223.7</u>	<u>239.7</u>	<u>5,153.7</u>
<i>Accumulated depreciation:</i>					
Balance Jan. 1, 2007		96.5	97.3		193.8
Depreciation in 2007		49.8	37.9		87.7
Accum. depr. on assets sold in 2007			(3.5)		(3.5)
	<u>0.0</u>	<u>146.3</u>	<u>131.7</u>	<u>0.0</u>	<u>278.0</u>
Book value at end-2007	<u>24.0</u>	<u>4,520.0</u>	<u>92.0</u>	<u>239.7</u>	<u>4,875.7</u>
Depreciation ratio	0%	1.25-3%	10-33%	20%	
Land Registry valuation 2007	0.5	4,444.2			4,444.7
Insurance valuation 2007		4,344.7	341.9	252.2	4,938.8

International Monetary Fund

5. Iceland's quota with the International Monetary Fund (IMF) amounted to 117.6 m. SDR at the end of 2007. One-quarter of the quota was originally paid with a gold contribution and the remainder in Icelandic currency. The Bank's reserve tranche position with IMF was 18.6 m. SDR, which is the difference between the quota and IMF's total currency holdings from the Bank (see table). The Bank's borrowing in the form of SDR allocation from the IMF amounted to 16.4 m. SDR. Figures are in millions.

Assets:

	<i>M.SDR</i>	<i>M.kr.</i>
Central Bank of Iceland's quota	117.6	11,488.3
Total currency holdings	(99.0)	(9,672.5)
Reserve tranche position	18.6	1,815.9
Accrued interest on tranche	0.1	7.1
SDR deposit with IMF	0.1	10.7
	<u>18.8</u>	<u>1,833.7</u>

Liabilities:

	<i>M.SDR</i>	<i>M.kr.</i>
SDR allocation with IMF	16.4	1,603.0
Currency holding, Account no. 2	0.0	0.1
Accrued interest on allocation	0.1	9.5
	<u>16.5</u>	<u>1,612.6</u>

Financial institutions

6. Credit institutions that are participants in the Central Bank's Real-Time Gross Settlement (RTGS) system pledge collateral for payment in the system. Collateral is in the form of securities. The amount corresponds to the intraday overdraft for participants to meet fluctuations on their RTGS accounts.
- At the end of 2007, the market value of collateral securities in the RTGS system was 22.6 b.kr.
 - Credit institutions pledge collateral to the custody of the Central Bank for their collateral loans in accordance with Rules no. 997/2004.
 - The net position of financial institutions towards the Bank increased by 51.5 b.kr. during the year, as explained by the following:

Increase in net position:

Collateral loans at end of 2007.....	306.9	
Deposits at end of 2007	(153.5)	153.4
Collateral loans at beginning of 2007	147.0	
Deposits at beginning of 2007.....	(45.1)	101.9
Net increase		<u>51.5</u>

Pension obligations

7. According to actuarial valuations, the Bank's total pension obligations towards former Governors of the Bank and their spouses, as well as towards the directors of the National Economics Institute,

for which the Bank was responsible for half the costs, amounted to 320.7 m.kr. at the end of 2007. Payments during the year towards this obligation, in the amount of 43.8 m.kr., reduce previously recorded debt. The increase in the pension obligation, after taking into account payments for the year, totalled to 6.9 m.kr., which was expensed.

8. The Central Bank's transfer to the Treasury, according to Article 34 of the Central Bank Act, no. 36/2001, is equal to two-thirds of its net profit (excluding exchange rate loss or gain) in the year, provided that its equity (excluding revaluation of fixed assets) exceeds 2.25% of the outstanding lending and domestic securities stock of the credit system at the end of the year, but otherwise one-third. The Bank's equity was below this limit at the end of 2007. One-third of the net profit before the transfer was transferred to the Treasury, amounting to 2.3 b.kr.

- At the end of 2006, the Bank issued a long-term debt security in order to finance an increase in foreign reserves. The Treasury sold bonds on foreign markets and lent the proceeds to the Bank in the amount of 1 million euros. The nominal interest rate is 3.75%, but the bonds sold at the effective rate of 3.88%. The market rate of interest was 4.54% at year-end 2007, and the corresponding valuation change on the debt in the amount of 1.8 billion kr. was credited to the Profit and Loss Account. Thus the fair value of the debt amounted to 88.7 b.kr. at year-end 2007, with accrued interest totalling 0.3 b.kr. The maturity date of the bond is December 1, 2011.

9. Total remuneration and fees to the Board of Governors and Supervisory Board amounted to 68.6 m.kr. in 2007. Governors are not remunerated for sitting on boards and committees that are established jointly by financial market institutions and companies, or to which the Central Bank appoints representatives by law. Total emoluments of the Board of Governors and Supervisory Board in 2007 were as follows:

<i>Board of Governors</i>	<i>M.kr.</i>
Davíð Oddsson	21.6
Eiríkur Guðnason	18.6
Ingimundur Friðriksson	17.8
Jón Sigurðsson	0.4
<i>Supervisory Board</i>	
Halldór Blöndal, Chairman from June 12	1.6
Helgi S. Guðmundsson, Chairman before June 12	1.3
Other members, including alternates (13)	7.3
	<u>68.6</u>

10. The fee paid by the Central Bank to the National Audit Office for auditing the accounts and providing other audit services for 2007 amounted to 1 m.kr.

Transfer to the Treasury

Emoluments of the Supervisory Board and Board of Governors

Auditor's fee

Equity and net profit

11. Over the past five years, the Bank's equity has developed as follows (in m.kr.):

<i>Equity</i>	2007	2006	2005	2004	2003
Equity at beginning of year (excl. revaluation of assets)	43,236	31,379	34,198	40,217	40,254
Capital contribution	44,000				
Net profit before transfer and exch. differences	7,013	48	(186)	487	1,898
Transfer to Treasury	(2,338)	(16)			
Exchange rate differences, gain (loss)	(5,899)	11,825	(2,633)	(6,506)	(1,935)
Equity at end of year (excl. revaluation)	86,012	43,236	31,379	34,198	40,217
Revaluation of assets	4,991	4,991			
Equity at end of year	<u>91,003</u>	<u>48,227</u>	<u>31,379</u>	<u>34,198</u>	<u>40,217</u>
<i>Position at end of year in b.kr.</i>					
Total assets	476.8	321.8	162.3	106.6	87.3
Equity - excl. revaluation of assets	86.0	43.2	31.4	34.2	40.2
Domestic lending and securities	5,386.0	4,298.2	3,234.8	2,658.1	2,208.3
Equity / total assets	18.0%	13.4%	19.3%	32.1%	46.0%
Equity / domestic lending and securities	1.6%	1.0%	1.0%	1.3%	1.8%

Guarantees and off-balance sheet commitments

12. The Central Bank is obliged to pay on call 75% of its share of the share issue of BIS. That obligation totalled 392 m.kr. at year-end 2007.

- The Central Bank's equity interest in the Banks' Data Centre (RB) is not reflected in the accounts. In formal terms, this is a joint operation under the auspices of all banks and savings banks in Iceland, in accordance with an agreement to that effect. The partnership agreement states that the Central Bank's contribution was one-fifth of the Banks' Data Centre's initial capital. The book value of owners' equity in Banks' Data Centre was 1.5 b.kr. at the end of 2007.
- At the end of 2007 the Central Bank had access to committed credit facilities with foreign financial institutions in the amount of 75 million US dollars, which was equivalent to 4.7 b.kr.

Net interest income

13. Net interest income amounted to 6 b.kr. in 2007, as compared with 1.7 b.kr. in the previous year. The main explanation for the increase is higher net interest from monetary policy instruments, which increased by 10 b.kr. from 2006 to 2007. This increase was counteracted in part by an increase in interest expense on the Central Government's deposits in the amount of 4.8 b.kr. Net interest income is specified as follows (in thous.kr.):

	2007	2006
<i>Net interest income on monetary policy instruments</i>		
Interest income on collateral loans.....	25,170,987	12,412,600
Interest expense on required deposits with credit institutions.....	(5,459,201)	(2,772,772)
	<u>19,711,786</u>	<u>9,639,828</u>
<i>Net interest income on foreign reserves</i>		
Interest income on foreign bank balances	644,594	843,319
Interest income on foreign debt securities	5,290,594	1,968,785
Interest expense on Central Government's financing loan	(3,013,878)	(311,699)
	<u>2,921,310</u>	<u>2,500,405</u>
<i>Other interest income (expense):</i>		
Interest expense on Central Government's deposits:		
Time deposits	(3,980,385)	(3,791,778)
Demand deposits	(10,322,960)	(5,695,435)
	<u>(14,303,345)</u>	<u>(9,487,213)</u>
Interest income on other assets.....	175,088	219,135
Other interest expense to credit institutions.....	(2,016,047)	(749,840)
Interest expense on foreign debt and deposits	(441,932)	(421,005)
	<u>(16,586,236)</u>	<u>(10,438,923)</u>
Net interest income	<u>6,046,860</u>	<u>1,701,310</u>

14. The net exchange rate loss amounted to 5.9 b.kr. in 2007, as compared with a net exchange rate gain of 11.8 b.kr. in 2006. The exchange rate differences (loss)/gain are calculated on the following foreign assets and liabilities (in thous.kr.):

Exchange rate differences

	2007	2006
Gold	(404,157)	320,922
IMF accounts	(21,854)	38,811
Foreign bank balances	(1,577,224)	6,522,344
Foreign securities.....	(7,393,857)	11,594,613
Foreign short-term debt	(9,149)	(148,188)
Domestic deposits/debt denominated in foreign currency	<u>3,507,580</u>	<u>(6,503,481)</u>
Net exchange rate differences	<u>(5,898,661)</u>	<u>11,825,021</u>

- Assets and liabilities specified by currency were as follows at the end of 2007 (in m.kr.):

	ISK	EUR	USD	GBP	Other	Total
Assets	313,273	122,604	26,490	9,356	5,136	476,859
Liabilities	294,288	89,448	299	25	1,796	385,856
Net equity at year-end 2007						<u>91,003</u>

Salaries and payroll costs

15. Salaries and payroll costs are specified as follows (in thous.kr.):

	2007	2006
Salaries	761,395	686,802
Payroll costs	152,855	138,257
Pension fund contributions, retired Governors	6,945	65,199
	<u>921,195</u>	<u>890,258</u>
Supplementary contribution to Bank Employees' Pension Fund	0	385,662
	<u>921,195</u>	<u>1,275,920</u>

- An agreement was reached in 2006 between the Bank Employees' Pension Fund and its contributing employers on a final settlement with respect to the Fund's commitments. The Central Bank was party to this agreement, and its share of the settlement was 385.7 m.kr. The agreement entails that no further payments will be made on account of the Fund's pension commitments.

APPENDICES

Press releases 2007

No. 1	February 8, 2007	The Central Bank of Iceland leaves its policy rate unchanged
- 2	February 8, 2007	Policy interest rate unchanged
- 3	March 6, 2007	Balance of payments in the fourth quarter of 2006 and the external position
- 4	March 15, 2007	Fitch Downgrades Iceland to 'A+'/'AA+; Outlook stable
- 5	March 29, 2007	The Central Bank of Iceland leaves its policy rate unchanged
- 6	May 16, 2007	The Central Bank of Iceland leaves its policy rate unchanged
- 7	May 16, 2007	<i>Policy announcement by the Board of Governors of the Central Bank of Iceland: Policy interest rate unchanged</i>
- 8	May 16, 2007	Amendments to Rules on Transactions by Financial Companies with the Central Bank of Iceland
- 9	June 5, 2007	Balance of payments in the first quarter of 2007 and the external position
- 10	June 6, 2007	R&I Rating assigns the Republic of Iceland AA+; Outlook stable
- 11	June 11, 2007	Concluding Statement by the IMF mission to Iceland 2007
- 12	June 18, 2007	New rules on Central Bank of Iceland facilities for financial undertakings and changed presentation of the policy rate
- 13	July 5, 2007	The Central Bank of Iceland leaves its policy rate unchanged
- 14	August 30, 2007	IMF Concludes 2007 Article IV Consultation with Iceland
- 15	September 4, 2007	Balance of payments in the second quarter of 2007 and the external position
- 16	September 6, 2007	The Central Bank of Iceland leaves its policy rate unchanged
- 17	September 6, 2007	<i>Policy announcement by the Board of Governors of the Central Bank of Iceland: Policy interest rate unchanged</i>
- 18	September 18, 2007	Inflation beyond the tolerance limit
- 19	November, 1, 2007	The Central Bank of Iceland raises its policy rate
- 20	November 20, 2007	Republic of Iceland Outlook To Negative On Macroeconomic Imbalances; Ratings Affirmed
- 21	December 4, 2007	Balance of payments in the third quarter of 2007 and the external position
- 22	December 20, 2007	The Central Bank of Iceland leaves its policy rate unchanged
- 23	December 20, 2007	<i>Policy announcement by the Board of Governors of the Central Bank of Iceland: Policy interest rate unchanged</i>

Publications by the Central Bank of Iceland in 2007

In English:

Annual Report 2006

Monetary Bulletin 2007, three issues

Financial Stability 2007

The Economy of Iceland 2007

Central Bank of Iceland Working Papers No. 33: Predicting recessions with leading indicators: An application on the Icelandic economy, by Bruno Eklund.

Central Bank of Iceland Working Papers No. 34: An Embarrassment of Riches: Forecasting using Large Panels, by Jana Eklund and Sune Karlsson.

Central Bank of Iceland Working Papers No. 35: Computational Efficiency in Bayesian Model and Variable Selection, by Jana Eklund and Sune Karlsson.

Central Bank of Iceland Working Papers No. 36: Forecasting the Icelandic business cycle using vector autoregressive models, by Bruno Eklund.

Central Bank of Iceland Working Papers No. 37: Asymmetric Labor Market Institutions in the EMU: positive and normative implications, by Mirko Abbritti and Andreas Mueller.

Economic Indicators, eleven issues

In Icelandic:

Ársskýrsla 2006

Fjármálatíðindi 2007

Fjármálastöðugleiki 2007

Peningamál 2007, three issues

Hagvísar Seðlabanka Íslands, eleven issues

All of these publications are also posted on the Central Bank of Iceland website.

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Table 1 Survey

<i>Main economic indicators</i>		1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Gross domestic product ¹	% change year-on-year	6.4	4.1	4.3	3.9	0.1	2.5	7.7	7.1	4.3	0.9
National expenditure ¹	% change year-on-year	13.8	4.2	5.9	-2.1	-2.3	5.8	9.9	15.4	9.2	-3.4
Exports ¹	% change year-on-year	2.6	4.0	4.2	7.4	3.7	1.6	8.5	7.2	-5.1	4.2
Imports ¹	% change year-on-year	23.4	4.4	8.6	-9.1	-2.5	10.8	14.4	29.4	10.1	-8.6
Current account balance ¹	% of GDP	-7.0	-6.8	-10.1	-4.7	1.5	-4.8	-9.8	-16.1	-25.3	-18.0
Terms of trade ¹	% change year-on-year	5.1	-0.6	-2.4	0.3	0.5	-4.0	-1.3	1.0	3.5	-0.3
International investment position	% of GDP	57.6	67.1	94.0	102.0	89.8	93.3	113.5	152.4	204.2	226.3
Employment (man-years)	% change year-on-year	3.4	2.7	2.2	1.6	2.2	0.8	0.9	3.0	5.0	4.5
Unemployment	% of labour force	2.8	1.9	1.3	1.4	2.5	3.4	3.1	2.1	1.3	1.0
<i>Prices and wages</i>		<i>% change</i>									
Consumer price index	year-on-year	1.7	3.4	5.0	6.7	4.8	2.2	3.2	4.0	6.8	5.0
Wage index	year-on-year	9.4	6.8	6.6	8.8	7.2	5.6	4.7	6.8	9.5	9.0
Real wages (deflated by CPI)	year-on-year	7.6	3.3	1.6	2.0	2.3	3.4	1.4	2.6	2.6	3.8
<i>Asset prices</i>		<i>% change</i>									
Residential housing	Q4-on-Q4	7.8	22.2	13.3	3.1	7.5	9.1	23.3	31.0	5.0	15.0
Share prices	within year	9.8	47.4	-19.3	-11.2	16.7	56.4	58.9	64.7	15.8	-1.4
<i>Money supply and credit</i>		<i>% change</i>									
M1	within year	20.2	19.3	4.4	-2.3	23.8	22.6	30.1	23.5	22.5	94.1
M3	within year	15.1	17.1	11.2	14.9	15.3	17.5	15.0	23.2	19.4	56.6
Credit system lending and market securities	within year	15.1	17.3	17.2	19.2	3.2	11.4	19.9	31.1	33.6	21.9
DMB lending	within year	30.3	23.0	50.0	12.6	15.0	16.0	42.1	51.5	41.4	30.7
<i>Exchange rate and real exchange rate</i>		<i>% change</i>									
Nominal effective exchange rate	year-on-year	-1.6	-0.2	0.1	20.1	-3.0	-6.0	-2.0	-10.3	11.7	-2.5
Icelandic króna vis-à-vis US dollar	year-on-year	-0.2	-1.8	-8.2	-19.3	6.8	19.2	9.5	11.6	-9.9	9.0
Icelandic króna vis-à-vis euro (ECU '98)	year-on-year	0.4	0.0	6.3	-17.0	1.5	-0.6	-0.5	11.5	-10.9	0.1
Real exchange rate: relative prices	year-on-year	1.8	2.6	3.9	-12.7	5.1	4.7	2.2	13.5	-6.4	4.2
Real exchange rate: relative ULC	year-on-year	2.9	4.8	3.8	-13.3	4.3	6.0	-2.4	13.6	-1.6	12.8
<i>Central Bank rates</i>		<i>average</i>									
Banks' current accounts	% p.a.	3.0	3.8	5.9	6.7	5.4	2.9	3.7	7.7	10.9	12.8
Collateral loans	% p.a.	7.3	8.3	10.4	10.9	8.3	5.4	6.1	9.4	12.4	11.5
Overnight loans	% p.a.	8.5	9.3	11.5	12.3	10.6	7.8	8.3	11.0	13.7	12.4
<i>Yields in the money and bond market (OMXI)</i>		<i>average</i>									
OMXI-5Y-I	% p.a.	.	.	.	.	.	.	.	.	4.6	6.0
OMXI-3M-NI	% p.a.	.	.	.	.	.	.	.	.	12.1	13.9
OMXI-5Y-NI	% p.a.	.	.	.	.	.	.	.	.	8.5	9.4
5-year Treasury notes (non-indexed)	% p.a.	7.7	8.4	11.1	9.6	7.8	7.6	7.6	7.6	9.3	10.5
<i>Commercial banks' interest rates</i>		<i>% p.a.</i>									
Non-indexed secured loans	% p.a.	12.8	13.6	16.7	18.0	15.4	12.0	12.2	14.8	17.1	19.2
Indexed securities	% p.a.	8.8	8.6	9.5	10.2	10.1	9.1	8.0	7.2	6.9	8.0
Yield on new standard loans ²	% p.a.	13.5	14.2	17.5	.	.	.	.	.	.	.
Penalty interest ³	% p.a.	16.5	17.3	21.9	23.7	21.3	17.3	17.3	20.3	22.5	25.0
<i>International comparison</i>		<i>% p.a.</i>									
Economic growth in OECD countries	% p.a.	2.6	3.3	4.0	1.1	1.6	1.9	3.1	2.6	3.1	...
Inflation in OECD countries	% p.a.	3.8	3.3	3.7	3.4	2.6	2.4	2.3	2.6	2.6	2.4
<i>General government finances⁴</i>		<i>% of GDP</i>									
Treasury fiscal balance	% of GDP	0.4	1.4	1.8	-0.5	-1.3	-1.8	1.0	4.5	5.3	4.1
Treasury net borrowing requirement	% of GDP	-0.9	2.2	0.3	-2.8	-1.3	1.6	2.6	8.4	-2.7	-0.2
General government revenue	% of GDP	40.8	43.1	43.5	41.8	41.6	42.7	44.2	47.5	48.8	50.3
General government expenditure	% of GDP	41.2	41.9	41.8	42.5	44.1	45.5	44.0	42.3	41.8	44.7
General government fiscal balance	% of GDP	-0.4	1.1	1.7	-0.7	-2.6	-2.8	0.2	5.2	7.0	4.9
General government gross debt	% of GDP	47.6	42.3	40.2	44.1	41.8	40.3	33.8	24.9	29.4	28.8
General government net debt	% of GDP	28.5	20.9	20.9	21.5	19.3	20.2	17.2	3.5	-1.1	-1.0

1. Central Bank of Iceland forecast for the year 2007 (November 2007). 2. Cf. Art. 10 of Act no. 25/1987. 3. Cf. Art. 10 of Act no. 25/1987 and (from July 2001) Art. 10 of Act no. 38/2001. 4. Data for 2007 based on estimates of the Central Bank of Iceland.

Sources: Directorate of Labour, OMX Nordic Exchange in Iceland (OMXI), Land Registry of Iceland, OECD, Statistics Iceland, Central Bank of Iceland.

Table 2 Exchange rate indices

	Official exchange rate ¹ Dec. 31, 1991 = 100	Average exchange rate index ² Dec. 31, 1994 = 100			Real exchange rate ³ 2000 = 100			
		Average	Based on import weights	Based on export weights	Based on relative prices		Based on unit labour cost	
					Index	% change ⁴	Index	% change ⁴
1997	114.7	97.7	98.3	97.2	92.2	1.0	89.2	1.6
1998	112.8	96.2	96.7	95.7	93.8	1.8	92.2	2.9
1999	112.6	96.0	96.5	95.6	96.3	2.6	96.8	4.8
2000	112.7	96.1	96.3	95.7	100.0	3.9	100.0	3.5
2001	135.4	115.4	115.1	115.3	87.3	-12.7	87.1	-13.1
2002	131.4	112.0	111.7	112.0	91.7	5.1	91.7	5.0
2003	123.5	105.3	104.8	105.4	96.0	4.7	97.0	5.8
2004	121.0	103.1	102.4	103.5	98.1	2.2	94.5	-2.5
2005	108.6	92.6	91.9	93.0	111.4	13.5	105.9	13.5
2006	121.3	103.4	102.6	104.0	104.2	-6.4	106.0	-1.8
2007	118.3	100.9	99.9	101.5	108.6	4.2	117.9	12.8

1. The index shows the average exchange rate of foreign currencies against the Icelandic króna for each period. From September 6, 1995, the trade-weighted basket (goods and services) of 16 currencies replaced the former basket of US dollar (18%), ECU (76%) and Japanese yen (6%). 2. The index shows the average exchange rate of foreign currencies against the Icelandic króna for each period. Since 1995, country weights are based on trade in goods and services; before that, they are based on trade in goods only. 3. Based on quarterly information on prices (consumer prices), wages, employment and output in main trading partner countries. 4. Year-on-year.

Table 3 Sales of government securities¹

M.kr.	Treasury bonds			Treasury bills, net	Treasury notes, net	Total
	Sales	Redemptions	Net sales			
1988	4,867	3,413	1,454	-219	-	1,235
1989	5,049	4,170	879	5,171	-	6,050
1990	8,275	1,825	6,450	2,166	75	8,691
1991	5,584	4,433	1,151	298	1,158	2,607
1992	3,661	1,495	2,166	4,645	1,244	8,055
1993	8,200	3,706	4,494	742	3,444	8,680
1994	9,447	6,189	3,258	894	-355	3,797
1995	9,252	9,859	-607	830	1,004	1,227
1996	20,051	27,410	-7,359	391	3,772	-3,197
1997	18,454	15,449	3,005	-7,294	2,932	-1,357
1998	8,957	16,855	-7,898	2,912	-6,320	-11,306
1999	2,975	12,302	-9,327	-5,310	-6,231	-20,868
2000	3,531	13,299	-9,768	-3,928	1,015	-12,681
2001	146	5,690	-5,544	6,033	11,285	11,774
2002	0	18,546	-18,546	1	12,790	-5,755
2003	0	9,453	-9,453	8,500	8,202	7,249
2004	0	11,100	-11,100	-6,000	13,010	-4,090
2005	0	21,963	-21,963	-500	10,099	-12,364
2006	0	92,541	-92,541	-7,750	21,866	-78,425
2007	0	323,485	-323,485	7,300	5,497	-310,688

1. Sales and redemption of Treasury bonds include accrued interest and indexation, but Treasury bills and Treasury notes, net, are at face value.

Table 4 Notes and coin in circulation by denomination

	2003		2004		2005		2006		2007	
	Thous. kr.	%	Thous. kr.	%	Thous. kr.	%	Thous. kr.	%	Thous. kr.	%
<i>Notes:</i>										
5,000 kr.	6,105,500	66.9	6,755,000	67.1	7,932,500	69.3	8,787,500	69.5	9,597,500	70.3
2,000 kr.	233,000	2.6	277,000	2.7	279,000	2.4	350,000	2.8	398,000	2.9
1,000 kr.	1,928,500	21.1	2,113,500	21.0	2,264,000	19.8	2,475,000	19.6	2,669,000	19.5
500 kr.	735,500	8.1	810,000	8.0	846,750	7.4	905,000	7.2	989,500	7.2
100 kr.	95,800	1.1	95,600	0.9	95,700	0.8	95,550	0.8	.	.
50 kr.	11,475	0.1	11,625	0.1	11,800	0.1	11,825	0.1	.	.
10 kr.	11,010	0.1	11,055	0.1	11,055	0.1	11,050	0.1	.	.
Total	9,120,785	100.0	10,073,780	100.0	11,440,805	100.0	12,635,925	100.0	13,654,000	100.0
<i>Coin:</i>										
100 kr.	747,100	51.4	799,300	51.3	924,500	52.5	1,006,180	53.6	1,188,600	57.1
50 kr.	322,040	22.2	353,440	22.7	388,740	22.1	392,590	20.9	374,890	18.0
10 kr.	245,750	16.9	261,330	16.8	292,130	16.6	314,080	16.8	342,370	16.5
5 kr.	68,780	4.7	72,240	4.6	78,240	4.4	82,480	4.4	89,434	4.3
1 kr.	69,100	4.8	72,218	4.6	77,494	4.4	81,247	4.3	86,132	4.1
Total	1,452,770	100.0	1,558,528	100.0	1,761,104	100.0	1,876,576	100.0	2,081,426	100.0

Table 5 Accounts of the Central Bank¹

<i>M.kr. at year-end</i>	2001	2002	2003	2004	2005	2006	2007
Net foreign exchange reserves	21,844	20,879	58,150	65,567	67,356	167,975	161,873
Domestic items, net ²	5,972	11,747	-36,450	-27,009	-19,904	-108,457	-70,565
Claims on Treasury and government institutions, net	-31,099	-20,851	-22,185	-17,782	-75,916	-211,036	-211,177
Claims on other financial institutions	54,053	69,141	24,038	31,771	77,772	119,863	258,165
Claims on deposit money banks	22,774	8,227	4,193	8,993	11,902	28,547	50,102
Other claims	105	65	87	84	189	499	131
Deposits of other financial institutions	-2,126	-1,334	-33	-13,681	-145	-131	-1,425
Other items, net	-37,735	-43,500	-42,549	-36,394	-33,706	-46,199	-166,361
Base money	27,817	32,626	21,700	38,558	47,452	59,518	167,841
Reserves of deposit money banks	20,410	24,960	13,311	29,415	36,952	48,047	155,403
Required reserves ³	17,678	21,874	3,830	0	0	0	0
Certificates of deposit	0	0	4,501	4,404	2,294	1,777	0
Cash and liquid reserves	2,732	3,087	4,980	25,012	34,658	46,269	155,403
Notes and coin in circulation	7,406	7,666	8,390	9,143	10,500	11,471	12,438

1. Further breakdown in Table 12. 2. Deposits are marked as negative (-). 3. Separate reserve accounts were merged with deposit accounts after 2003.

Note: See the Central Bank of Iceland Statistics pages, www.sedlabanki.is/.

Table 6 Summary of the accounts of deposit money banks¹

<i>M.kr. at year-end</i>	2001	2002	2003	2004	2005	2006	2007 ²
<i>Assets:</i>							
Claims on domestic credit institutions	80,324	81,977	59,508	89,757	105,362	196,396	205,849
Domestic credit and marketable securities	790,578	863,986	1,062,053	1,431,579	2,205,912	2,969,617	3,828,064
Lending	675,999	694,524	805,376	1,123,510	1,701,808	2,407,176	3,145,497
Leasing contracts	401	139	16,442	18,739	18,909	28,380	38,126
Marketable bonds	10,591	7,066	14,849	2,440	5,248	2,770	3,401
Debt securities	70,840	118,991	166,669	195,604	256,788	275,620	393,878
Equities and other variable-income securities	32,747	43,266	58,717	91,287	223,158	255,670	247,162
Derivatives	...	...	...	...	...	...	264,625
Shares in associated undertakings	11,577	16,217	8,655	11,159	28,892	21,125	29,232
Shares in affiliated undertakings	5,184	10,436	38,184	44,143	67,996	80,329	131,384
Other assets	...	...	...	...	...	...	305,304
Foreign assets, total	69,398	129,002	307,662	633,492	1,488,256	3,031,477	4,752,566
Foreign credit and equities	33,932	59,239	132,762	237,430	723,831	1,284,133	2,852,029
Foreign lending	28,393	46,296	113,267	190,455	500,953	817,046	1,989,454
Marketable bonds	1,408	2,248	3,098	4,554	71,165	227,456	577,245
Equities and other variable-income securities	4,131	10,695	16,397	42,421	151,713	239,631	285,330
Derivatives	0	0	0	0	0	0	132,240
Shares in associated undertakings	0	0	208	315	1,168	1,714	76,560
Shares in affiliated undertakings	5,501	5,740	24,244	118,088	205,190	329,305	619,730
Other foreign assets	29,965	64,023	150,448	277,659	558,067	1,416,326	1,072,007
<i>Total assets</i>	<i>977,762</i>	<i>1,126,906</i>	<i>1,489,356</i>	<i>2,239,544</i>	<i>3,933,324</i>	<i>6,346,303</i>	<i>9,682,280</i>
<i>Liabilities:</i>							
Domestic liabilities, total	496,219	606,412	640,189	785,108	1,137,043	1,545,990	2,580,247
Central Bank facilities	54,194	69,311	24,062	31,822	77,766	120,388	281,444
Deposits of residents	335,497	387,562	455,923	524,686	647,001	774,714	1,217,200
Deposits from credit institutions	0	0	0	0	0	0	107,923
Bond issues	49,711	72,800	76,372	95,689	146,243	252,498	407,172
Subordinated loans	17,761	24,457	24,304	25,080	30,392	30,668	40,934
Direct borrowing	23,270	19,656	36,446	72,359	130,997	188,684	238,992
Derivatives	...	...	...	...	...	...	76,807
Other liabilities	15,786	32,626	23,081	35,471	104,644	179,038	209,775
Foreign liabilities, total	417,512	440,015	737,097	1,212,415	2,391,125	4,234,096	6,182,487
Dep. from non-resid. other than credit institutions	...	...	18,839	14,501	52,069	364,595	1,293,293
Derivatives	...	...	...	...	...	...	93,063
Bond issues	195,423	196,611	478,829	896,934	1,842,123	2,814,959	2,596,502
Subordinated loans	14,367	11,749	20,641	71,980	151,125	360,588	417,628
Direct borrowing	207,722	231,655	218,788	229,000	345,808	693,954	1,389,581
Other liabilities	0	0	0	0	0	0	392,419
Total equity and minority interest	64,031	80,479	112,070	242,021	405,156	566,217	919,547
<i>Liabilities and equity</i>	<i>977,762</i>	<i>1,126,906</i>	<i>1,489,356</i>	<i>2,239,544</i>	<i>3,933,324</i>	<i>6,346,303</i>	<i>9,682,280</i>

1. Kaupthing was licensed to operate as a commercial bank in January 2002 and was thereby reclassified from an investment bank, then merged with Búnaðarbanki in May 2003. Giltinr leasing company merged with Íslandsbanki in May 2003. 2. Preliminary.

Note: See the Central Bank of Iceland Statistics pages, www.sedlabanki.is/.

Table 7 Summary of the accounts of the banking system¹

<i>M.kr. at year-end</i>	2001	2002	2003	2004	2005	2006	2007 ²
Foreign assets, net	-317,404	-295,953	-350,646	-441,376	-684,319	-686,404	-1,268,337
Foreign credit and equities	33,931	59,239	132,762	237,430	723,831	1,284,133	2,990,351
Foreign assets, short-term, net	51,809	73,074	233,050	461,629	831,781	1,915,338	1,925,524
External liabilities	-195,423	-196,611	-478,829	-896,934	-1,842,123	-2,814,959	-2,596,502
Foreign assets unacc. for elsewhere	-207,721	-231,655	-237,629	-243,501	-397,808	-1,070,916	-3,587,710
Domestic credit	749,804	803,219	976,519	1,327,859	1,914,880	2,523,615	3,405,498
Treasury and government institutions	-2,291	12,976	14,452	-1,779	-52,286	-183,410	-186,038
Municipalities	18,070	19,194	13,762	13,504	10,788	12,327	12,038
Non-bank financial institutions	81,969	89,709	150,567	192,026	208,125	274,438	422,358
Enterprises	472,031	486,905	592,653	808,165	1,191,840	1,704,921	2,313,645
Households	180,025	194,435	187,886	305,840	544,418	707,531	838,197
Other	0	0	17,199	10,103	11,995	7,808	5,298
Other financial institutions (deposits = -)	-2,126	-1,334	-31	-13,681	-145	-131	-1,431
Other items, net	-14,389	-18,248	-48,709	-170,922	-295,673	-599,971	-260,359
Broad money and bonds (M4)	392,615	468,028	540,687	629,521	803,746	1,037,629	1,636,809
Bonds	49,711	72,800	76,372	95,689	146,243	252,498	407,172
Broad money (M3)	342,904	395,228	464,315	533,832	657,503	785,131	1,229,637
Time savings deposits	196,723	235,482	275,184	291,753	353,501	423,084	580,385
Money and demand savings deposits (M2)	146,180	159,746	189,131	242,079	304,002	362,047	649,253
Demand savings deposits	75,311	71,990	81,545	102,125	131,216	150,498	238,533
Money supply (M1)	70,869	87,755	107,586	139,953	172,786	211,549	410,720
Demand deposits	0	0	99,197	130,811	162,286	200,077	398,282
Notes and coin in circulation	7,406	7,666	8,389	9,142	10,500	11,472	12,438
Other domestic borrowing	23,270	19,656	36,446	72,359	130,997	199,480	238,562

1. Lending was reclassified among sectors with the introduction of the ÍSAT 95 standard in September 2003. 2. Preliminary.

Note: See the Central Bank of Iceland Statistics pages, www.sedlabanki.is/.

Table 8 Liquidity and reserve ratios in %¹

<i>Effective as of:</i>	<i>Reserve requirement ratio</i>	<i>Effective as of:</i>	<i>Reserve requirement ratio</i>
June 1, 1979	28.0	January 1, 1992	7.0
April 17, 1985	18.0	November 1, 1992	6.0
March 1, 1987	13.0	December 1, 1992	5.0
August 1, 1988	12.0	November 1, 1993	4.0 (2.5) ²
March 1, 1989	11.0	May 21, 1998	4.0 (1.5) ²
May 1, 1990	10.0	March 21, 2003	3.0 (1.0) ²
June 1, 1990	7.0	December 21, 2003	2.0 (0.0) ³
October 31, 1991	6.0		

1. Percentage of bank total deposits as of June 1, 1979, of domestic disposable funds as of March 1, 1989, and of all disposable funds as of May 21, 1998. 2. Figure in parentheses refers to the reserve ratio for bond issues and time deposits. 3. Figure in parentheses refers to the reserve ratio for deposits and bond issues with an original maturity of more than two years, and securities eligible as collateral for transactions with the Central Bank.

Table 9 Main interest rates announced pursuant to Article 10, Paragraph 2 and temporary provision III of the Act on Interest and Price Indexation, no. 38/2001

<i>General interest rates, rates on damage claims and penalty interest, in % per annum</i>			
	<i>General interest on non-indexed loans</i>	<i>General interest on indexed loans</i>	<i>Interest on damage claims</i>
January 1, 2007	16.0	4.85	10.7
February 1	16.0	4.95	10.7
March 1	16.0	4.95	10.7
April 1	16.0	4.95	10.7
May 1	16.0	4.95	10.7
June 1	16.0	4.95	10.7
July 1	16.0	4.95	10.7
August 1	16.0	5.00	10.7
September 1	16.0	5.40	10.7
October 1	16.0	5.40	10.7
November 1	16.0	5.75	10.7
December 1	16.5	6.30	11.0
Average 2006	13.9	4.6	9.3
Average 2007	16.0	5.2	10.7

Table 10 Selected annual nominal yields of deposit money banks and penalty rates in % per annum

	<i>Non-indexed loans¹</i>		<i>New (long) indexed securities²</i>		<i>Penalty rates</i>		<i>Credit terms index, 12-month change³</i>
	<i>Nominal</i>	<i>Real</i>	<i>Nominal</i>	<i>Real</i>	<i>Nominal</i>	<i>Real</i>	
1990	17.1	9.3	15.7	8.0	26.0	17.6	7.1
1991	18.4	10.0	17.5	9.2	25.0	16.1	7.6
1992	13.5	11.8	11.0	9.3	19.5	17.7	1.6
1993	14.8	11.5	12.4	9.1	17.7	14.3	3.0
1994	10.9	9.5	9.3	7.9	14.2	12.8	1.3
1995	11.9	10.1	10.5	8.7	14.6	12.8	1.6
1996	12.8	10.5	11.1	8.9	15.8	13.5	2.1
1997	13.3	11.1	11.2	9.0	16.3	14.0	2.0
1998	13.2	11.8	10.1	8.8	16.5	15.1	1.3
1999	14.1	8.0	14.7	8.6	17.3	11.1	5.6
2000	17.4	12.7	14.1	9.5	22.0	17.2	4.2
2001	18.8	9.4	19.7	10.2	23.7	13.9	8.6
2002	16.0	13.7	12.3	10.1	21.3	18.9	2.0
2003	12.4	9.4	12.0	9.1	17.3	14.2	2.7
2004	12.6	8.3	10.5	6.3	17.3	12.9	3.9
2005	15.3	10.7	10.3	5.9	20.3	15.5	4.2
2006	18.6	10.9	13.4	6.1	22.5	14.6	6.9
2007	20.2	13.5	12.9	6.6	25.0	18.0	5.9

1. Weighted average of DMBs' interest rates. Based on two due dates per year. 2. Weighted average of DMBs' interest rates. 3. January to January.

Table 11 Selected Central Bank interest rates

	<i>Bank's current accounts</i>	<i>Required deposits, normal terms</i>	<i>O/N loans, discount rates</i>	<i>Yield on collateral loans, auctions</i>	<i>Collateral loans (nominal rate)</i>	<i>Yield on certificates of deposit, 7-day</i>	<i>Certificates of deposit, 7-day (nominal rate)</i>
January 12, 2000	4.50	7.30	10.80	9.00	.	.	.
January 18	4.50	7.30	10.80	9.80	.	.	.
January 21	5.30	8.10	10.80	9.80	.	.	.
February 14	5.30	8.10	11.10	9.80	.	.	.
February 15	5.30	8.10	11.10	10.10	.	.	.
February 21	5.60	8.40	11.10	10.10	.	.	.
June 19	5.60	8.40	11.60	10.60	.	.	.
June 21	6.10	8.90	11.60	10.60	.	.	.
November 1	6.90	9.70	12.40	11.40	.	.	.
March 28, 2001	6.70	9.50	12.40	10.90	.	.	.
November 11	6.70	8.70	12.00	10.10	.	.	.
April 1, 2002	6.20	8.20	12.00	9.60	.	.	.
May 1	5.90	7.90	11.70	9.30	.	.	.
May 21	5.70	7.40	11.20	8.80	.	.	.
June 21	5.70	7.10	10.90	8.50	.	.	.
August 21	5.40	6.70	10.30	7.90	.	.	.
September 1	5.10	6.40	10.00	7.60	.	.	.
September 21	4.60	5.90	9.50	7.10	.	.	.
October 21	4.30	5.60	9.20	6.80	.	.	.
November 11	3.80	5.10	8.70	6.30	.	.	.
December 17	3.30	4.60	8.20	5.80	.	.	.
February 28, 2003	2.80	4.10	7.70	5.30	.	.	.
May 11, 2004	3.00	4.30	7.90	5.50	.	.	.
June 8	3.25	4.50	8.00	5.75	.	.	.
July 6	3.75	5.00	8.25	6.25	.	.	.
September 21	4.25	5.50	8.75	6.75	.	.	.
November 1	5.00	6.00	9.25	7.25	.	.	.
December 10	6.25	7.25	10.25	8.25	.	.	.
February 21, 2005	6.75	7.75	10.75	8.75	.	.	.
March 29	7.25	8.00	10.75	9.00	.	.	.
June 7	8.00	8.75	11.00	9.50	.	9.35	.
October 4	8.75	9.50	11.75	10.25	.	10.10	.
December 11	9.00	9.75	12.00	10.50	.	10.35	.
February 1, 2006	9.25	10.00	12.25	10.75	.	10.60	.
April 1	10.00	10.75	13.00	11.50	.	11.35	.
May 21	10.75	11.50	13.75	12.25	.	12.10	.
June 11	11.50	12.00	14.25	13.00	.	12.85	.
August 21	12.00	12.25	14.50	13.50	.	13.35	.
September 21	12.50	12.75	15.00	14.00	.	13.85	.
December 21	12.75	13.00	15.25	14.25	.	14.10	.
June 20, 2007	12.75	13.00	15.25	14.25	.	14.10	.
June 21	12.75	13.00	15.25	.	13.30	.	13.20
November 1	12.75	13.25	15.25	.	13.75	.	13.65
<i>Time-weighted averages</i>							
1998	3.00	5.50	8.50	7.30	.	.	.
1999	3.80	6.60	9.30	8.30	.	.	.
2000	5.90	8.70	11.40	10.40	.	.	.
2001	6.70	9.40	12.30	10.90	.	.	.
2002	5.50	7.00	10.70	8.40	.	.	.
2003	2.80	4.10	7.70	5.30	.	.	.
2004	3.65	4.88	8.28	6.09	.	.	.
2005	7.69	8.50	11.02	9.35	.	.	.
2006	11.00	11.52	13.77	12.50	.	12.35	.
2007	12.83	13.04	15.25	14.25	.	14.10	.

Table 12 Balance sheet of the Central Bank of Iceland

M.kr.	End of year					
	2001	2002	2003	2004	2005	2006
Assets:						
<i>Foreign assets</i>	36,823	37,378	58,274	65,709	67,506	168,070
Foreign accounts	5,228	9,509	22,740	23,171	21,049	41,650
Gold	1,752	1,727	1,873	1,707	2,074	2,934
Foreign bonds and Treasury bills	27,423	24,093	31,695	39,058	42,702	121,467
IMF reserve position and SDRs	2,420	2,050	1,966	1,773	1,681	2,019
<i>Domestic assets</i>	79,321	79,248	29,033	40,881	94,789	153,772
<i>Deposit money banks</i>	54,053	69,141	24,038	31,771	77,772	119,863
Securities	131	105	0	0	0	0
Collateral loans	50,020	69,035	24,038	31,771	77,772	119,863
Short-term loans	3,902	0	0	0	0	0
<i>Other financial institutions</i>	22,774	8,227	4,193	8,993	11,902	28,547
Listed securities	2,954	3,445	3,223	3,232	1,832	1,473
Collateral loans	18,790	4,782	969	5,762	10,070	27,074
Short-term loans	1,030	0	0	0	0	0
<i>Central government</i>	2,389	1,816	715	32	0	0
Treasury current account	244	0	0	0	0	0
Listed securities	2,144	1,816	715	32	0	0
<i>Other sectors</i>	105	65	87	84	189	499
Sundry accounts	77	25	43	39	151	404
Securities	28	41	44	45	38	95
<i>Real estate and liquid assets</i>	0	0	0	0	4,926	4,864
Real estate	0	0	0	0	4,527	4,479
Other assets	0	0	0	0	399	385
Assets = Liabilities	116,144	116,627	87,307	106,590	162,294	321,842
Liabilities:						
<i>Foreign liabilities</i>	17,108	18,301	1,858	1,703	1,634	1,873
Short-term	14,979	16,499	124	142	150	95
Long-term	0	0	0	0	0	0
IMF SDR allocation	2,130	1,802	1,735	1,561	1,484	1,779
<i>Domestic liabilities</i>	64,709	59,500	45,230	70,689	124,291	271,599
<i>Notes and coin</i>	9,174	9,590	10,583	11,632	13,202	14,513
<i>Deposit money banks</i>	18,643	23,037	11,117	26,926	34,250	45,006
Sight deposits	965	1,163	2,786	22,519	31,956	43,228
Required reserves	17,678	21,874	3,830	0	0	0
Certificates of deposit	0	0	4,501	4,404	2,294	1,777
<i>Other financial institutions</i>	2,126	1,334	31	13,681	145	131
Sight deposits	837	75	31	13,681	145	131
Required reserves	1,288	1,259	0	0	0	0
<i>Central government</i>	33,488	22,667	22,901	17,815	75,916	211,002
Treasury current account	11,232	8,771	9,689	16,257	33,573	80,114
Government institutions	1,575	1,977	1,208	519	371	567
Foreign exchange deposits	4,544	399	487	1,039	9,113	97,235
Tied deposits	16,137	11,520	11,517	0	32,859	33,085
<i>Other liabilities</i>	1,279	2,872	597	636	778	731
Equity	34,327	38,827	40,217	34,198	36,370	48,336

End of month 2007

January	February	March	April	May	June	July	August	Sept.	Oct.	Nov.	Dec.
160,579	160,650	155,165	151,660	145,062	144,178	145,536	152,388	155,426	157,213	163,181	163,586
18,147	18,856	15,129	13,609	14,399	12,341	12,522	14,503	16,829	18,219	19,248	19,348
2,860	2,863	2,791	2,781	2,589	2,578	2,586	2,705	2,928	3,014	3,043	3,305
137,666	137,041	135,389	133,436	126,327	127,493	128,679	133,372	133,871	134,213	139,075	139,109
1,907	1,890	1,856	1,833	1,747	1,766	1,749	1,808	1,798	1,767	1,815	1,823
157,970	163,780	161,287	200,918	175,450	180,608	204,720	204,890	249,345	236,066	252,444	313,273
116,816	131,564	126,239	171,828	147,437	139,913	157,908	186,916	216,606	213,406	220,206	258,165
0	0	0	0	0	0	0	0	0	0	0	0
116,816	125,562	126,239	171,828	147,437	139,913	157,908	186,916	216,606	213,406	220,206	258,165
0	6,002	0	0	0	0	0	0	0	0	0	0
35,778	27,161	29,996	24,018	22,947	35,642	41,757	12,899	27,688	17,610	27,201	50,102
1,432	1,433	1,427	1,393	1,394	1,431	1,405	1,412	1,434	1,418	1,431	1,447
34,346	25,729	28,569	22,625	21,553	34,211	40,351	11,486	26,254	16,192	25,769	44,554
0	0	0	0	0	0	0	0	0	0	0	4,102
0	0	0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0	0	0
0	0	0	0	0	0	0	0	0	0	0	0
518	129	127	147	136	124	121	143	116	115	99	131
422	34	31	52	47	35	32	54	27	25	23	55
95	95	95	95	89	89	89	89	89	90	76	76
4,859	4,925	4,925	4,925	4,930	4,930	4,934	4,932	4,934	4,936	4,938	4,875
4,479	4,545	4,545	4,545	4,550	4,550	4,554	4,552	4,554	4,556	4,558	4,517
380	380	380	380	380	380	380	380	380	380	380	357
318,549	324,431	316,451	352,578	320,513	324,786	350,256	357,278	404,771	393,280	415,625	476,858
4,326	1,947	4,519	1,870	1,783	1,805	2,135	2,035	2,031	3,314	2,047	1,713
2,646	278	2,880	260	245	250	596	439	444	1,762	451	100
0	0	0	0	0	0	0	0	0	0	0	0
1,680	1,669	1,639	1,610	1,538	1,554	1,540	1,596	1,587	1,551	1,597	1,613
270,336	278,383	269,254	309,199	236,652	240,086	264,667	269,160	315,860	302,753	323,752	384,143
13,556	13,615	14,064	14,367	15,001	15,402	15,927	15,615	15,360	14,900	15,132	15,735
29,516	41,275	37,353	72,516	47,343	49,930	61,909	59,155	95,814	75,890	88,641	152,111
27,525	39,161	35,236	70,398	45,229	49,930	61,909	59,155	95,814	75,890	88,641	152,111
0	0	0	0	0	0	0	0	0	0	0	0
1,991	2,114	2,116	2,118	2,115	0	0	0	0	0	0	0
195	176	255	264	484	476	630	679	484	631	709	1,425
195	176	255	264	484	476	630	679	484	631	709	1,425
0	0	0	0	0	0	0	0	0	0	0	0
226,338	222,477	215,910	219,564	172,716	173,126	185,003	192,429	202,844	209,870	217,787	211,177
102,222	97,373	93,210	97,429	54,352	53,427	72,338	76,266	84,578	93,368	97,087	93,971
445	558	819	1,017	1,082	625	640	710	789	588	665	536
91,300	91,839	88,802	88,758	84,550	85,982	85,825	88,951	90,683	89,713	93,532	89,855
32,372	32,708	33,080	32,360	32,732	33,092	26,201	26,502	26,794	26,201	26,503	26,815
731	840	1,672	2,487	1,108	1,151	1,198	1,282	1,358	1,463	1,483	3,694
43,887	44,102	42,677	41,509	82,077	82,896	83,453	86,084	86,881	87,213	89,826	91,003

