

# New Central Bank Act

*A new Central Bank Act went into effect on May 23, 2001, replacing legislation from 1986. Major reforms are included in the new legislation. It simplifies and clarifies the Bank's objectives, ensures it full independence to apply its instruments, and increases its financial independence. The act also contains clearer provisions on transparency and accountability towards the government and general public.*

## 1. Introduction

Towards the end of 2000 the Prime Minister of Iceland appointed a committee to review the Central Bank Act. Among the points made in the committee's letter of appointment were: "The core of the current Central Bank Act dates from 1986. Since then, great changes have taken place in the Icelandic and international financial markets. Legislation on the Central Bank needs to be adapted to these changed conditions. The review will need to extend to all aspects of the Bank's activities and administration." The committee comprised Ólafur Davíðsson, secretary general, who was its chairman; members of parliament Sighvatur Björgvinsson, Steingrímur J. Sigfússon and Vilhjálmur Egilsson; and Jón Sigurðsson, executive. Secretary to the committee was Skarphédinn Steinarsson from the Office of the Prime Minister. Ingimundur Fridriksson, Assistant Governor of the Central Bank, acted as consultant to the committee.

The committee completed its work on March 23, 2001 and was in consensus on all points of the draft bill. In a report delivering its findings, the committee said that "while discussions within the committee revealed a wide range of viewpoints on the main issues, the committee is unanimous on the proposals made in the accompanying draft bill." The bill was presented to parliament in the form in which it was delivered by the committee and passed as law, virtually unchanged, in May. The Act entered into effect on May 23 as Act no. 36/2001. It is printed in its entirety as an appendix to this article.

The report accompanying the draft bill on the Central Bank of Iceland alluded to reforms of central bank legislation in other countries in recent years and outlined their main aims as the simplification of central banks' objectives, greater independence for them to apply their monetary instruments, and more stringent requirements for transparency of monetary policy and central banking activities, and for accountability towards the government and general public. Treasury access to central bank funding has also been addressed in cases where this was authorised. Last but not least, major reforms have been made to these banks' executive management, in some cases including the establishment of separate monetary policy committees which were authorised to make monetary decisions and were made closely accountable for them in the public arena. Simplification of central bank objectives had generally included specification of a single main objective, i.e. to contribute to price stability in the sense of a low rate of measured inflation, for example in the range 1-3% in industrialised countries. Some central banks were assigned the task of defining their own main objectives, while elsewhere these were set by the government or jointly by the government and central bank. Another common central objective was contributing to the stability of the financial system, including that of payments systems. In many cases the scope of this central banking task has been steadily expanding in recent years, as a necessary complement to deregulation of international capital movements. At international level, a growing focus has been active monitoring of financial activities and an active overview of various

financial and macroeconomic risk factors, in an effort to prevent serious shocks.

The main changes represented by Iceland's Central Bank Act are to set clear targets for ensuring price stability. Subject to the approval of the Prime Minister, these targets may be defined more specifically, with a numerical inflation target. However, the Bank enjoys full independence in decisions about how to attain this target by applying the instruments at its disposal. The government will continue to decide foreign exchange rate policy, but in accordance with the act's main objective of price stability. The act stipulates that monetary decisions will be in the hands of the three Governors who comprise the Central Bank Board of Governors. The Bank will be solely responsible for decisions regarding the use of its instruments, instead of doing so in consultation with the minister. The Governors' term of appointment is extended from five years to seven, but a limit is imposed on the number of terms. The minister appoints the Governors and Chairman of the Board of Governors separately. Other provisions are that more members are appointed to the Supervisory Board, and they now elect their chairman from their own ranks. Its role is strengthened somewhat under the new law. The treasury is no longer authorised to borrow from the Bank. Furthermore, the Board of Governors is obliged to set procedures concerning the preparation of, arguments for and presentation of its monetary decisions, and to explain publicly such decisions and the assumptions underlying them. The aim is to promote professionalism and greater monetary policy transparency. The need to strengthen the Bank's capital position was identified and this is enabled under the new act.

## 2. Main content of the new act

The following is a summary of various major aspects of the new act and the main changes entailed from earlier legislation.

### *Monetary policy objectives*

Under the previous act, the Central Bank had a number of roles and objectives which were not necessarily consistent with each other in some respects. The new act makes the Bank's objectives much simpler. It states that the Bank's main objective is to con-

tribute to price stability and that, with the approval of the Prime Minister, it may state a numerical target for the inflation rate. The Central Bank shall promote implementation of the government's economic policy as long as it does not regard this as inconsistent with its main objective of price stability. This provision, made under Article 3, in effect gives legal sanction to the substance of the joint declaration made by the government and Central Bank on March 27, 2001 on the introduction of inflation targeting and the abolition of the exchange rate fluctuation band. According to this Article it is the Prime Minister who actually sets the inflation target which the Central Bank is then assigned to achieve through the use of its instruments. In other words, the Bank is granted independence to use its instruments but not to set the target itself. When the bill was being drafted, it was considered more natural for this to be in the hands of the minister.

The report accompanying the draft bill stated that price stability had been selected as the main monetary policy objective since inflation is primarily a monetary phenomenon. While temporary inflation may have many causes, persistent inflation is a consequence of slack monetary stance. In the long run, monetary policy therefore exerts an impact on prices, no less than on growth and employment. Since the Central Bank had in principle a single instrument at its disposal, i.e. interest rates, and could therefore only attain one long-term macroeconomic objective, it would be normal for the main monetary objective to be price stability. This does not imply that price stability is a more important objective than, for example, full employment, but simply that monetary policy instruments are intrinsically better suited to impacting prices. There would be little point in setting targets for monetary policy which it was incapable of achieving. Experience also suggests that setting of such targets could diminish the success of monetary policy implementation. Through price stability, a forward-orientated monetary strategy could contribute to the stable economic environment which is the foundation of long-term economic growth.

Similarly, there has been a growing realisation of the need to give legal sanction to the policy of price stability. Doing so makes it much more difficult to abandon a monetary policy of stability in favour of short-term interests. What is generally regarded as

the most successful course for achieving this objective is the formal granting to the central bank of full and unrestricted power to apply its instruments in order to achieve its main price stability objective. Central banks then do not need to comply with government or ministerial instructions to take monetary measures that are inconsistent with such an aim (see article by Thórarinn G. Pétursson, 2000).

As underlined above, this does not entail that the Central Bank decides exclusively on the ultimate objective of monetary policy. The report accompanying the draft bill pointed out that such a decision is better entrusted to democratically elected representatives, provided that the elected government sets objectives for the Central Bank which it is capable of achieving through its monetary instruments, and makes these publicly known.

Article 4 of the act states that the Central Bank shall undertake such tasks as are consistent with its role as a central bank, such as maintaining external reserves and promoting an efficient and safe financial system, including payment systems domestically and with foreign countries. In its report the committee said that, instead of listing the Bank's various duties, it had opted to state them in general terms and underline that they should be consistent with its role. Nonetheless, there were grounds for specifying the maintenance of external reserves and promotion of an efficient and safe financial system, including domestic and international payment systems, which were singled out because they are a particularly important aspect of central banking. Most central banks are entrusted with maintaining their countries' external reserves and external financial security. Particular mention was made of an efficient and safe financial system, in accordance with the growing focus by most countries' central banks on promoting financial security, i.e. ensuring financial stability. Since this is a growing task at the Central Bank of Iceland, this point was felt to merit special mention in the act.

#### *Issue of notes and coins*

The section of the act dealing with the issue of notes and coins is unchanged from previous legislation. It states the Central Bank's sole right to issue bank notes and mint and issue coins.

#### *Domestic activities*

Several important innovations are found in Chapter III, which deals with the Central Bank's domestic activities. Article 7 provides for it to act as lender of last resort; there was no provision of this kind in earlier legislation. The commentary appended to the bill pointed out that, under special circumstances deemed necessary by the Bank in order to maintain confidence in the domestic financial system, it may issue guarantees to credit institutions which are in liquidity difficulties or grant loans to them outside its regular business framework, and against other collateral than is customary or other conditions it may impose. This means that, when the Bank regards its assistance as necessary in order to prevent fears about the safety of the financial system or the possibility that difficulties on the part of a single institution would lead to a run on the banks, it can intervene to carry that institution temporarily through the troubles it may have encountered. Particular mention was made that this applied to liquidity problems of individual institutions. This means that the Central Bank will not provide assistance in the form of special facilities to boost the capital position of institutions which run into difficulties. In other words, it will not provide facilities to institutions which are bankrupt or have capital adequacy ratios below the legally stipulated limits, in order to prevent them from going bankrupt or to enable them to fulfil these requirements. In such cases, new capital must be brought in.

Thus the Central Bank may only provide assistance if it seems clear that the problem faced by the institution in question involves liquidity and not capital. As mentioned above, Central Bank assistance may take the form either of guaranteeing the liabilities of the respective institution, or lending on special terms and conceivably against other collateral than it customarily insists on in its regular business transactions. It will be left to the Central Bank's discretion to assess the collateral in question, which could include securities from the institution's portfolio which fall outside its conditions for regular business, or other assets. The Bank could also feasibly insist on reforms to the institution's activities, for example a change of executive management, as a condition for granting such assistance. It can prove difficult to distinguish between a liquidity problem and wider-reaching ones when an institution experiences diffi-

culties of the kind addressed by this article. The Central Bank will naturally engage in close cooperation and consultation with the Financial Supervision Authority on solving any such problems which may arise.

It should be pointed out that analogous provisions are very widely found in central bank legislation and are considered necessary as a safety net for the financial system. The main argument against including a provision to this effect in central bank legislation is that it invites a moral hazard by making credit institutions more willing to take risks than otherwise, in the faith that the central bank will come to their rescue if anything goes amiss. However, this is felt to be outweighed by the fact that central banks hereby have the possibility to prevent liquidity problems at one institution from jeopardising the financial system as a whole. In this context it should also be pointed out that international credit rating agencies take account of provisions of this kind. Thus the problem of moral hazard must be assessed in different terms. Here a strong financial supervisory authority has a role to play, along with the message that although financial institutions may be rescued from trouble, the same does not apply to their executive management and owners. If this message is clear and credible, it will encourage management of financial institutions to take a safe approach in their operations, notwithstanding the central bank's legal authorisation to act as a lender of last resort.

Article 16 contains an important innovation, namely that the Central Bank may not grant credit to the treasury, municipalities or government institutions other than credit institutions. No restrictions were made in earlier legislation concerning treasury access to short-term credit from the Central Bank. In 1992 the Minister of Finance and Central Bank made an agreement whereby the treasury ceased to use its overdraft facility with the Central Bank and would thenceforth meet its borrowing requirement by market auctions of government securities. During reviews of central bank legislation in many parts of the world in recent years, one major change has involved the closure of treasury access to central bank credit where this has been at hand in the first place. This has been seen as a necessary aspect of ensuring the central banks' financial independence and promoting normal interest rate formation, as well

as preventing expansionary treasury funding. The new clause confirmed in law the important milestone reached in the agreement between the Minister of Finance and Central Bank in 1992.

Notwithstanding this provision, the Act authorises the Central Bank to buy market securities issued by the treasury, municipal authorities and government institutions in order to achieve its monetary objectives. Such securities are not classified as credit according to the stipulations described above.

#### *Exchange rate issues*

Provisions on exchange rate issues were simplified from earlier legislation. Article 18 states that the Central Bank, with the consent of the Prime Minister, decides the policy for determining the value of the Icelandic króna against foreign currencies. One point made in the report accompanying the draft bill was that, while this is consistent with earlier Central Bank legislation, it should also be understood in the context of the Bank's main objective of promoting price stability. In other words, no exchange rate policy can be adopted that is not consistent with the main monetary policy objective.

#### *Board of Governors*

Several changes were made in the chapter on the Bank's administration. As before, the Board of Governors consists of three Governors. Article 23 states that the Board of Governors is responsible for the Bank's operations and is authorised to make decisions in all of its affairs not specifically assigned to others. This means that executive authority in monetary policy is in the exclusive hands of the Board of Governors. Under another provision, the Prime Minister appoints the Governors for a seven-year term at a time, for no more than two terms, or a total of 14 years. He also appoints the Chairman of the Board of Governors. When these posts fall vacant, they do not have to be advertised. Under earlier law, the Minister appointed the Governors after the Supervisory Board had delivered its opinion. Now the Supervisory Board plays no role in appointment of a Governor. Previously the Governors elected the Chairman of the Board of Governors from their own ranks for a term of three years at a time, but now he is appointed separately by the Prime Minister. There is also an authorisation to appoint a Governor tem-

porarily in place of one who becomes unable to perform his duties, so that the Board is always fully represented.

The commentary points out that the committee drafting the bill had discussed whether to change the title of the Chairman of the Board of Governors to Chief Governor. Since there was no material difference in the sense in which these titles are understood, the conclusion was to retain the title of Chairman. Another important consideration is that the Board should always be fully represented, i.e. that appointments are made to vacant posts without any unwarranted delay. Furthermore, the commentary states that the provisions of the Act on the Rights and Obligations of Government Employees will continue to apply to all aspects of the Bank's governorship that are not otherwise specified. The provisions of this act therefore apply to a Governor's dismissal.

It is also pointed out that the post of Chairman of the Board of Governors will be a separate appointment by law, and that his role is to act as spokesman for the Bank, chair Board meetings and undertake other such leadership duties. In other respects the Governors divide the Board duties among themselves, including who shall represent the Chairman in his absence

According to Article 24, the Board of Governors lays down its own rules, which are to be approved by the Supervisory Board, on the preparations of, arguments for and presentation of its monetary policy decisions. Monetary policy decisions by the Board of Governors shall be publicly presented along with the rationale behind them. The commentary points out that legal provisions are felt to be warranted for separate internal rules covering preparations of, arguments for and presentation of the Board of Governors' monetary policy decisions, in order to ensure the most professional approach towards formulating and implementing monetary policy, given the provisions on the Bank's main objectives in Article 3. These rules are to be made public. For example, this refers to the procedures by which decisions are prepared, the information on which they are based and, on a case-by-case basis, the involvement of other Bank officials in this process, although ultimately the decision is formally made by the Governors. It is also important to give a clear account of the Governors' decisions, especially those involv-

ing the use of the Bank's monetary instruments. Decisions are to be made public with an outline of the assumptions on which they are based and what they entail. These provisions seek to ensure the most professional possible basis for the Governors' decisions, transparency of monetary policy and the accountability of the Governors towards the government and general public. It was pointed out that the Article did not oblige the Board of Directors to publish accounts of discussions at meetings when monetary policy decisions are made, nor of the standpoints of individual Governors.

It transpired in the commentary that the committee compiling the bill had discussed whether to stipulate the establishment of a separate monetary policy committee which would comprise more members than the Governors alone and be authorised to make monetary decisions. The conclusion was to assign the decision to the Board of Governors but at the same time oblige it to set rules on the monetary decision-making process.

Article 25 lays down that the Governors and their Chairman are not permitted to serve on the boards of institutions or business firms outside the Bank or otherwise engage in business in other respects. The commentary stated that this provision should be interpreted in a narrow sense, whereby Governors should not serve on the boards of institutions or business firms outside the Bank or engage in business unless this is specifically stipulated by law. The Governors are expected to lay down rules on this same issue for other chief executives of the Bank and its other employees.

#### *Supervisory Board*

Considerable changes were made to provisions governing the Supervisory Board. Its membership was increased from five to seven, which was described in the commentary as being consistent with its supervisory role. This would ensure broader composition of the Board and representation of more viewpoints. Article 26 also states that management or employees of credit institutions or other financial institutions which do business with the Central Bank are automatically disqualified from membership of the Supervisory Board. This provision is new. Other new features are that the mandate of the Supervisory Board lasts until a new one is elected, which is to be

done after a parliamentary election has taken place. Under earlier legislation, the Supervisory Board was elected for a term of four years. Another innovation is that the Supervisory Board elects its Chairman and Vice Chairman from the ranks of its own main members, instead of their being appointed by the minister.

Article 28 describes the role of the Supervisory Board in more detail. It is charged with observing whether the activities of the Central Bank of Iceland are consistent with the laws which govern its activities. The Board of Governors shall inform the Supervisory Board of the main elements of the Bank's monetary policy and of rules which the Bank sets. As before, however, the authority to make monetary decisions rests with the Board of Governors. In other respects the Supervisory Board is charged with handling the tasks specified under Article 28 (see Appendix). Noteworthy new functions there include the Supervisory Board's duty to confirm the main elements in the Bank's organisation, the abovementioned rules set by the Board of Governors relating to the preparations of, arguments for and presentation of its monetary policy decisions, and the Bank's annual operating budget.

#### *Collection of information, research and reports*

Chapter VI authorises the Bank to collect information from institutions which engage in transactions with it, and elsewhere, which it needs to compile statistical reports. This chapter also states that the Bank shall compile reports and forecasts on monetary matters, the balance of payments and exchange rate and foreign exchange issues, and other matters pertaining to its functions and policies. According to the commentary, alongside this the function the Bank is expected to publish reports on its monetary policy and on monetary, exchange rate and foreign exchange developments and its measures in these fields. Such obligations are taken for granted in central bank legislation today. It was pointed out that many countries have firmly underlined greater transparency in public administration, not least in monetary policy formulation and implementation. Certain guidelines were agreed in autumn 1998 by the IMF, which monitors that central banks in its member countries adhere to them in all respects. Elsewhere in this chapter the Bank is obliged to conduct economic research in the area of monetary policy and the

financial system. Among other things, such research is important to provide the best possible assessment of ways for the Bank to use its instruments in order to achieve its price stability objective, which calls for forecasting of economic developments and knowledge of the way that the impact of its measures is transmitted to the economy over the course of time.

Another point outlined in the commentary is the requirement now made for accountability. One aspect of greater demands for transparency is that central banks should explain in as much detail as possible their monetary policies, the assumptions behind their decisions, the assessments of the economic and monetary situation and outlook on which its policies are based, and last but not least various aspects of its activities besides those directly concerning monetary policy. The Central Bank now addresses these tasks with the publication of its quarterly *Monetary Bulletin*, in which it outlines its policy, measures and assessments of the economic and monetary situation and outlook. In its annual report, the Bank accounts for various aspects of its activities. Even though this arrangement was already in effect, it seemed natural to make the demand for the Bank's duty to provide information legally binding.

#### *Accounting and provision of profit*

The chapter on accounting and provision of profit contains various important innovations. Earlier legislation provided for the annual payment to the treasury of a part of the Central Bank's profit amounting to half of the average profit for the preceding three years, as calculated under specified rules. Given the need that was identified to strengthen the Bank's capital position, the new law stipulates that an amount equal to two-thirds of the profit of the Central Bank in the preceding fiscal year shall be paid annually to the State Treasury. Nonetheless, the Bank only pays one-third of its profit to the State Treasury if its capital and own reserves at the end of any fiscal year are less than 2.25% of the amount of lending and domestic securities assets of the credit system at the end of the preceding fiscal year. Based on credit system accounts at the end of 2000, the Bank's capital ought to have been 36.4 b.kr., but was actually 21.6 b.kr.

The reason for incorporating this framework into the Article was that it was felt necessary to ensure a consistent minimum level of capital to equip the

Bank to perform its functions. Among other things, the Bank needs a sufficiently high level of capital to be able to cover its operating costs from the return on investing it. Besides funds to cover its operations, the Bank needs resources for pursuing its objectives for monetary and financial stability. A strong relationship can be argued between a central bank's capital requirement and the exchange rate and interest rate risks that it faces. The Central Bank of Iceland faces a high exchange rate risk on account of the composition of its assets, besides which its proportion of notes and coins to total assets is very low compared with other central banks. According to the commentary, no universal rules or references apply to central bank capital levels. Nonetheless, it can be ascertained that Iceland's small economy and the fluctuations in its economic environment mean that the Central Bank of Iceland needs a stronger capital position than its counterparts in larger countries which are not prone to swings on the same scale.

The Bank's capital position may be boosted in two ways: through a direct treasury contribution, and by enabling the Bank to strengthen it over an interval of several years until a target is reached, as the law assumes.

Under the old act, the Central Bank was supposed to pay an annual allocation to the Science Fund, calculated according to specific rules laid down by law. This provision was rescinded.

Another provision was dropped, which had allowed for a separate external auditor to be appointed by the Minister. Now the law states only that the Bank shall be audited by the Chief Auditor appointed by the Supervisory Board, and by the State Audit.

#### *Temporary provisions*

As mentioned earlier, the new Act entered into effect on May 23, 2001. One temporary provision stated that, once the act took force, Parliament would elect seven members of the Supervisory Board together with an equal number of alternates. From the same time, the mandate of members then sitting on the Board would expire. Another temporary provision stated that the appointment of Governors would apply from the first appointment of Governor after the act entered into force. When the act enters into force, the Prime Minister appoints the Chairman of

the Board of Governors from the ranks of the Governors for the remainder of his term as Governor.

The general commentary concludes that the changes represented by the bill would make Iceland's main monetary policy objectives the same as those in most other countries, make similar demands for transparency and professionalism in implementation of monetary policy to those made for central banks elsewhere, grant the Bank independence to apply its instruments in order to achieve the main objectives of the act, and increase its financial independence with the removal by law of possible treasury access to Central Bank funds. International evaluations of central bank legislation have set great store by these points. Once the bill was passed, the Central Bank of Iceland Act would therefore measure up well by the criteria that have been applied to such legislation in recent years, as described in more detail below.

### **3. Election to the Supervisory Board and appointment of the Chairman of the Board of Governors**

After approving the Act, Parliament elected a new Supervisory Board in accordance with its provisions. The following were elected to the Supervisory Board: Ólafur G. Einarsson, Thröstur Ólafsson, Hannes Hólmsteinn Gissurarson, Jón Sigurdsson, Sigríður Stefánsdóttir, Davíð Adalsteinsson and Ragnar Arnalds. The following alternates were elected: Erna Gísladóttir, Kristín Sigurdardóttir, Hilmar Gunnlaugsson, Finnur Thór Birgisson, Hördur Zophanfásson, Leó Löve and Tryggvi Fridjónsson. At its first meeting on May 21, 2001 the newly elected Supervisory Board chose Ólafur G. Einarsson as its Chairman and Davíð Adalsteinsson Vice Chairman.

On the basis of the provisions of the new law, the Prime Minister appointed Birgir Ísleifur Gunnarsson Chairman of the Board of Governors.

### **4. The Central Bank of Iceland's new position in an international comparison**

As revealed in the article by Thórarinn G. Pétursson (2000), the Central Bank of Iceland was evaluated as one of the least independent of 94 central banks from all over the world in an international comparative

study by Fry et al. (2000). This study ranked the Central Bank of Iceland 27th of 28 industrialised countries and 74th among the entire 94. The comparison was based on relative weightings of five key aspects of central banks' positions for formulating an independent and forward-looking monetary policy: the extent to which statutory objectives provide the central bank with a clear focus on price stability; the extent to which the central bank determines the setting of policy targets; the extent to which the central bank determines the adjustment of monetary policy instruments; the extent to which treasury funding through the central bank is prohibited; and the length of the governor's term of office.

Pétursson's article found that the most important

factor for an effective and transparent monetary policy is to set the central bank a single main policy target and then grant it full scope for employing its instruments in order to achieve that objective, without government intervention. The comparative study clearly revealed that earlier legislation on the Central Bank of Iceland fell some way short of fulfilling these conditions. Its position within the government administration was therefore very weak in comparison with central banks in other industrialised countries and even farther afield. Sweeping changes have been made to central bank legislation in many parts of the world over the past decade, and Iceland had clearly been left behind.

As Table 1 shows, the Central Bank of Iceland's

Table 1 Central bank independence in selected countries

	<i>Emphasis on price stability</i>	<i>Goal independ- ence</i>	<i>Instrument independ- ence</i>	<i>Access to treasury funding</i>	<i>Governors' term of office</i>	<i>Total independ- ence</i>
USA .....	7.5	10.0	10.0	10.0	4.3	9.2
UK .....	7.5	0.0	10.0	10.0	5.7	7.7
UK .....	7.5	10.0	10.0	10.0	5.7	9.3
Japan .....	7.5	10.0	10.0	10.0	5.7	9.3
Industrialised countries.....	7.3	7.1	9.5	9.6	5.7	8.6
Transition economies.....	8.5	5.9	9.1	7.8	7.0	8.0
Developing countries.....	7.1	5.8	7.1	6.1	5.1	6.5
Denmark .....	7.5	5.0	10.0	10.0	10.0	8.8
Finland .....	7.5	10.0	10.0	10.0	5.7	9.3
Norway .....	0.0	0.0	6.7	10.0	7.1	5.7
Sweden.....	10.0	10.0	10.0	10.0	5.7	9.7
<i>Central Bank of Iceland's score before the new legislation</i>						
Score .....	5.0	5.0	3.3	10.0	5.7	6.1
Ranking among indu- ustrialised countries .....	25-27	16-25	28	1-26	7-23	27
Overall ranking.....	79-90	36-81	79-89	1-45	30-74	74
<i>Central Bank of Iceland's score after the new legislation</i>						
Score .....	7.5	5.0	10.0	10.0	8.6	8.7
Ranking among indu- ustrialised countries .....	5-25	16-25	1-26	1-26	2-4	19
Overall ranking.....	20-79	36-81	1-66	1-45	4-12	27

The table shows an updated assessment of the Central Bank of Iceland's position compared with 93 other central banks, according to a study by Fry et al. (2000). Their study was based on the position towards the end of 1998. The position of the EMU countries has been brought into line with the position of the European Central Bank. The highest score is 10. The sample covers 28 industrialised countries in all, and a total of 94 countries.

Source: Thórarinn G. Pétursson (2000).



position changes considerably following the new legislation. Its degree of independence is comparable to that of other industrialised countries' central banks, in particular with respect to the most important factors for monetary policy implementation, i.e. the clarity of its objectives and its independence to achieve them without government intervention. Policy targeting in the new Central Bank of Iceland Act is similar to that in other countries' legislation. According to Fry's criteria it falls short of a full score for stipulating that the Bank shall promote the advancement of the government's economic policies if it does not regard them as jeopardising its own objective of price stability. Such an arrangement, however, is fully consistent with the legislation of most leading central banks in the world, as the table shows.

As discussed earlier, the ultimate objective of monetary policy is still decided jointly by the government and the Central Bank. Since there are important democratic grounds for maintaining this arrangement, as Pétursson's article pointed out, it was not considered right to change this.

Increased instrument independence has been identified above as probably the most important change entailed by the new legislation. The Central Bank is now at complete liberty to use its interest instruments without government intervention, and is thereby on a par with central banks in by far the greatest number of industrialised countries and other countries.

Closure of treasury access to direct Central Bank funding under the new act is discussed above. Pétursson's article pointed out that the Bank's score on this count had probably been overestimated in the study by Fry et al. Although earlier legislation did not prevent such access, an agreement was in effect between the Minister of Finance and the Bank that the treasury would not take advantage of its authori-

sation to do so. This agreement needed to be renewed regularly and there was nothing to prevent its cancellation or a decision not to renew it. The Central Bank was clearly in a weaker position in this respect than under current legislation, although its score on this factor remains unchanged. Thus the change in the Bank's score in Table 1 underestimates the real change in its independence in this regard.

Finally, it can be pointed out the extension of the Governors' term of office from five to seven years increases the Bank's score, although this factor has a relatively low weighting in the overall score.

The new legislation raises the Central Bank's overall score from 6.1 to 8.7, ranking it now as the 27th most independent central bank of the 94 covered in the study, and in 19th place among industrialised nations. On first impression the Bank may still seem some way behind the leaders, but it should be remembered that the factors lowering its overall score are ones which, it has been argued, are less significant for those aspects of independence which affect the success of monetary policy, and would not bring about an obvious improvement in its effectiveness and transparency. The most important aspects have been brought into line with the best in the world today.

#### *Sources:*

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# Act on the Central Bank of Iceland<sup>1</sup>

## CHAPTER I

### Status, objectives and tasks.

#### Article 1

The Central Bank of Iceland is an independent institution owned by the State. Its governance is subject to the provisions of this Act.

All obligations of the Central Bank are guaranteed by the State Treasury.

#### Article 2

The domicile and venue of the Central Bank of Iceland is in Reykjavík.

#### Article 3

The main objective of the Central Bank of Iceland is to promote price stability. By agreement with the Prime Minister, the Central Bank can declare a numerical target for inflation.

The Central Bank shall promote the implementation of the economic policy of the government as long as it does not regard it to be inconsistent with its main objective as described in Paragraph 1 above.

#### Article 4

The Central Bank of Iceland shall undertake such tasks as are consistent with its role as a central bank, such as to maintain external reserves and promote an efficient and safe financial system, including payment systems domestically and with foreign countries.

## CHAPTER II

### The issue of notes and coins.

#### Article 5

The Central Bank of Iceland has the sole right to issue bank notes and mint and issue coins or other

currency which may circulate in place of banks notes or lawful coins.

The bank notes and coins issued by the Bank shall be legal tender for all payments at full nominal value.

Commemorative coins issued by the Central Bank shall be legal tender for all payments at full nominal value. The Central Bank is authorised to decide that commemorative coins are sold with a surcharge on their nominal value. Profits on the sale of commemorative coins shall be used to support art, culture or science as decided by the Prime Minister.

The Prime Minister decides, upon receiving proposals from the Central Bank, the form, appearance and denominations of the notes and coins issued by the Central Bank and has an announcement thereof published.

## CHAPTER III

### Domestic activities of the Central Bank.

#### Article 6

The Central Bank of Iceland accepts deposits from deposit institutions which consist of commercial banks, savings banks, branches of foreign deposit institutions and such other institutions and companies as may be authorised by law to accept deposits from the public for safe keeping and earning of interest. The Central Bank may also accept deposits from other credit institutions and securities companies.

The Central Bank lays down rules on its activities according to this Article including which credit institutions other than deposit institutions shall be allowed to maintain deposits in the Central Bank.

#### Article 7

The Central Bank of Iceland may advance loans to institutions referred to in Article 6 and engage in deposit transactions with them by way of the purchase of securities or in another manner against collateral which the Bank deems valid. These transac-

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1. Adopted by the Parliament on May 18, 2001.

tions may be in domestic or foreign currency. The Central Bank lays down further rules with respect to its transactions pursuant to this Paragraph.

In special circumstances when the Central Bank deems it necessary in order to protect the safety of the domestic financial system the Bank may issue guarantees to credit institutions which are in liquidity difficulties or grant loans to them other than those covered in Paragraph 1 above on special terms and against other collateral than stipulated in Paragraph 1 above or against other conditions laid down by the Bank.

#### Article 8

For the purpose of pursuing its monetary policy objectives the Central Bank of Iceland is authorised to buy and sell government bonds and other sound securities at an organised securities market or in direct transactions with credit institutions.

#### Article 9

The Central Bank of Iceland is authorised to issue transferable securities in domestic or foreign currency for sale to credit institutions which may transact business with the Bank, cf. Article 6.

#### Article 10

The Central Bank of Iceland determines the rate of interest on deposits with the Bank, on credit advanced by the Bank and on securities issued by it.

#### Article 11

The Central Bank of Iceland may determine that credit institutions be obliged to maintain funds on reserve requirement accounts with the Bank. The Bank is also authorised to determine that a specific portion of the increase in deposits or disposable funds of each institution shall be placed as required reserves with the Bank provided that the total deposit funds which the institution concerned is obliged to have at the Central Bank shall not exceed the maximum laid down in the first sentence of the present paragraph. The Bank is furthermore authorised to determine that unit trusts shall maintain funds on reserve requirement accounts with the Bank.

The Central Bank lays down further rules with respect to the basis and implementation of reserve requirements pursuant to this Article, including to

which credit institutions this applies. The rules may determine that the reserve requirement ratio be variable depending upon the nature of credit institutions and unit trusts and classes of deposits and other obligations to which the reserve requirement extends. The principle of impartiality shall be applied in determining the reserve requirement so that it does not alter the relative competitive position of the domestic firms to which it is applied.

#### Article 12

The Central Bank of Iceland is authorised to lay down rules as to credit institutions' minimum or average liquid assets which must at all times be available for the purpose of meeting for stable and conceivable payment obligation in a certain period of time, cf. Article 4. In the rules it may be determined that different provisions apply to different classes of credit institutions.

#### Article 13

The Central Bank of Iceland is authorised to impose upon credit institutions rules relating to foreign exchange balance. Such balance shall, in addition to exchange rate linked assets and liabilities, cover off-balance sheet exchange rate linked assets and liabilities, such as forward and options contracts.

#### Article 14

The Central Bank of Iceland undertakes for the Treasury any kind of banking services other than the granting of credits as stipulated in Article 16. Unless special conditions warrant otherwise, the deposits of the Treasury shall be held on accounts with the Central Bank.

The Central Bank shall advise the Government on all matters pertaining to foreign exchange issues, including foreign borrowing, and undertake the administration of affairs in this field as may be agreed upon.

#### Article 15

The Government shall provide the Central Bank of Iceland with information on economic developments in general and on the finances of the Treasury, Treasury borrowing and payments forecasts of the Treasury that are necessary for the activities of the Bank.

#### Article 16

The Central Bank of Iceland may not grant credit to the State Treasury, municipalities or government institutions other than credit institutions.

Bonds listed on an official securities exchange and issued by those institutions referred to in Paragraph 1 above and which the Central Bank purchases in a securities market or in direct transactions with credit institutions in order to promote its monetary policy objectives shall not be deemed to be credit according to the stipulations of this Article.

#### Article 17

The Central Bank of Iceland engages in such other banking and securities transactions as are consistent with its role as a central bank. In this connection, the Central Bank may inter alia be a party to and own shares in firms and institutions engaged in securities exchange activities, securities listing or payments systems.

The Central Bank shall not engage in business transactions with the public or firms which on the basis of law, custom or the nature of the case are the appropriate function of others. The Central Bank is nevertheless authorised to undertake primary sale and redemption of securities issued by the Treasury.

### CHAPTER IV

#### Exchange rate matters, the foreign exchange market and foreign transactions.

#### Article 18

The Central Bank of Iceland transacts in foreign currency, intermediates in foreign exchange transactions and engages in other foreign transactions consistent with its purpose and role as a central bank.

With the consent of the Prime Minister, the Central Bank determines the policy according to which the value of the Icelandic króna against foreign currencies is determined.

The Central Bank lays down rules on the operation of organised foreign exchange markets consistent with the provisions of the Foreign Exchange Act. Under special circumstances, the Central Bank may temporarily limit or halt business in an organised foreign exchange market.

#### Article 19

The Central Bank of Iceland shall during each day, when banking institutions are generally open for business, quote the rate of exchange of the króna against the principal foreign currencies. This rate shall be used as a standard for official agreements, court cases and other agreements between parties when an alternative standard for a rate of exchange is not specified. The Central Bank may also decide to quote the rate of exchange of the króna on days when organised foreign exchange markets are generally not operating. Under special circumstances, the Central Bank may temporarily suspend its own quotation of the rate of exchange of the króna.

#### Article 20

The Central Bank of Iceland shall maintain foreign exchange reserves in accordance with its objectives and role. The Board of Governors lays down rules on the management of the foreign reserves to be approved by the Supervisory Board, cf. Article 28.

The Central Bank is authorised to raise loans abroad for the purpose of strengthening its foreign exchange reserves. It is also authorised to participate in a co-operative effort among central banks and international banking or financial institutions for the purpose of strengthening the foreign exchange reserves of other participants.

#### Article 21

The Central Bank of Iceland co-operates and conducts business with international institutions on behalf of the Government or in line with provisions of law.

The Central Bank is, on behalf of the State, a financial agent of the International Monetary Fund. The Prime Minister appoints one person and one alternate for a period of five years at a time to the Board of Governors of the International Monetary Fund.

The Central Bank is also authorised to be a member of other international institutions provided that it is consistent with its role as a central bank.

## CHAPTER V Administration.

### Article 22

Authority over the Central Bank of Iceland is vested in the Prime Minister and a Supervisory Board as provided in this Act. Otherwise the administration of the Bank is in the hands of a Board of Governors.

### Article 23

The Board of Governors of the Central Bank of Iceland consists of three Governors, one of whom is Chairman of the Board of Governors. The Board of Governors is responsible for the operations of the Bank and has the authority to make decisions in all of its affairs that is not specifically assigned to others in this Act.

The Prime Minister appoints the Chairman of the Board of Governors and other Governors for a seven-year term at a time. A vacant post of Governor does not have to be advertised. A Governor can only be appointed for two consecutive terms. A Governor who is not the Chairman of the Board of Governors but is in his second term of office may be appointed Chairman of the Board of Governors for one seven-year term. The provisions of the Act on the Rights and Obligations of Government Employees do not apply to the reappointment of a Governor.

If a Governor becomes unable to perform his duties in such a way that the Board of Governors is not filled by three Governors, then the Prime Minister may temporarily appoint a Governor in his place.

The signatures of two Governors are required to commit the Bank. The Board of Governors may, however, grant powers to specific employees of the Bank to commit the Bank by their signature on specific matters subject to rules which it lays down and the Supervisory Board approves, cf. Article 28.

### Article 24

The Chairman of the Board of Governors of the Central Bank of Iceland is the spokesman of the Bank and represents the Board of Governors. Otherwise, the Board of Governors decides on the division of tasks among the Governors, cf. the first paragraph of Article 23, including who shall represent the Chairman in his absence.

The Chairman of the Board of Governors calls meetings of the Board. The Board of Governors shall always meet at the request of either of the other Governors. A quorum is met when the majority of the Board of Governors attends a meeting. Decisions are made by majority vote. In the case of a tied vote, the Chairman of the Board of Governors casts the deciding vote.

Decisions of the Board of Governors shall be in writing and signed by the Board of Governors. The Board of Governors lays down internal rules to be approved by the Supervisory Board on the preparations of, arguments for and presentation of its monetary policy decisions. Monetary policy decisions of the Board of Governors shall be publicly presented along with the rationale behind them.

### Article 25

The Governors of the Central Bank of Iceland are not permitted to be members of the boards of institutions or business firms outside the Bank or otherwise engage in business unless stipulated in law or if the institution or firm concerned is one to which the Central Bank is a party. In the event of a dispute over the provisions of this Article, the Prime Minister shall decide the issue. Subject to the approval of the Supervisory Board, the Board of Governors lays down rules on the participation of other employees of the Central Bank in the boards of institutions or businesses outside the Bank, cf. Article 28.

### Article 26

The Supervisory Board of the Central Bank of Iceland shall be elected following elections to the Parliament. The Supervisory Board consists of seven members elected by the Parliament by proportional ballot and an equal number of alternates. Members of the management or employees of credit institutions or other financial institutions which do business with the Central Bank are automatically disqualified from membership of the Supervisory Board. The authority of the Supervisory Board expires once a new Board is elected by the Parliament. If a principal member of the Supervisory Board ceases to be a member during the elective term, then his seat shall be taken by his alternate until the Parliament has elected a new principal member for the remainder of the elective term of the Supervisory Board.

The Supervisory Board elects a Chairman and Vice Chairman from its own ranks. The Prime Minister determines the fee of the Supervisory Board which is to be paid by the Central Bank.

#### Article 27

The Chairman of the Supervisory Board of the Central Bank of Iceland calls meetings of the Board. The Supervisory Board shall meet when two members of the Board request a meeting. A quorum is met if the majority of the members attend the meeting. Decisions are made by majority vote. In the event of a tied vote, the Chairman casts the deciding vote. Minutes shall be kept of the meetings.

The Governors attend meetings of the Supervisory Board and participate in discussions. They shall, however, leave the meeting if the Supervisory Board so decides.

#### Article 28

The Supervisory Board is charged with observing whether the activities of the Central Bank of Iceland are consistent with the laws which govern its activities. The Board of Governors shall inform the Supervisory Board of the main elements of the Bank's monetary policy and of rules which the Bank lays down. Otherwise, the Supervisory Board is particularly charged with the following tasks:

- a. Confirm proposals of the Board of Governors of the main elements in the organisation of the Bank.
- b. Determine the salaries and salary-related benefits of the Governors, including their right to severance pay and pension and other issues that concern their financial interests.
- c. Be responsible for the internal auditing of the Bank and appoint the Chief Auditor.
- d. Confirm rules which the Board of Governors lays down on the preparation of, rationale for and presentation of monetary policy decisions, cf. Article 24.
- e. Confirm rules laid down by the Board of Governors relating to the authority of officials of the Bank to commit the Bank, cf. Article 23.
- f. Confirm the wage contracts for the employees of the Bank, consider rules concerning their pension fund and confirm the appointment of the representative of the Bank on the board of the pension fund when called for.

- g. Confirm the proposal of the Central Bank to the Prime Minister on the rules for the Central bank's accounting principles and annual accounts, cf. Article 32.
- h. Provide the Prime Minister with its opinion on the regulation on the implementation of individual aspects of this Act when called for, cf. Article 39.
- i. Confirm the annual accounts of the Central Bank, cf. Article 32.
- j. Confirm the operating budget for the Bank which the Board of Governors shall present to the Supervisory Board at the beginning of each year.
- k. Monitor the assets and operations of the Bank and confirm decisions on major investments.
- l. Confirm rules on per diem penalties laid down by the Board of Governors, cf. Article 37.
- m. Confirm rules on the participation of employees of the Bank on the boards of institutions or businesses outside the Bank, cf. Article 25.
- n. Confirm rules on the maintenance of the foreign exchange reserves, cf. Article 20.

## Chapter VI

### Collection of information, research and reports.

#### Article 29

To fulfil its main objectives as described in Articles 3 and 4 above, the Central Bank of Iceland can directly collect information from those institutions which engage in transactions with the Bank on the basis of Article 6 above, cf. Article 7 above, in addition to institutions and firms engaged in payments systems, and other firms or institutions subject to official supervision on the basis of the Act on the Official Supervision of Financial Activities.

The Central Bank shall be provided with the information which it needs for the purpose of compiling statistical reports. Failure to provide information to the Bank is subject to penalties, cf. Article 37.

#### Article 30

The Central Bank of Iceland compiles reports and prepares forecasts on monetary matters, the balance of payments and exchange rate and foreign exchange issues and other matters pertaining to the functions and policies of the Bank. The Central Bank shall, at

no less frequent than quarterly intervals, publish reports on its monetary policy and monetary, exchange rate and foreign exchange developments and its measures in these areas. The Central Bank shall also issue an annual report in which it explains in detail its activities.

#### Article 31

The Central Bank of Iceland engages in economic research related to the tasks of the Bank in the area of monetary policy and the financial system. The Bank is also authorised to promote research by others in these areas.

### CHAPTER VII

#### Accounting and provision of profit.

#### Article 32

The fiscal year of the Central Bank of Iceland is the calendar year. Annual accounts shall be prepared for each fiscal year and shall be completed within three months after the close of the year. The preparations of the annual accounts shall be in accordance with the law and with recognised accounting principles.

The Prime Minister shall lay down further rules on the accounting principles and preparation of the annual accounts upon the recommendations of the Central Bank, cf. Article 28.

#### Article 33

Internal audit of the Central Bank of Iceland is the responsibility of the Chief Auditor, cf. Article 28. Furthermore, the State Auditor General shall audit the Central Bank.

Once auditing is completed, the annual accounts shall be signed by the Board of Governors and confirmed by the Supervisory Board, cf. Article 28. If a member of the Supervisory Board has any comments on the annual accounts, they shall be signed with a reservation, specifying the nature of the reservation.

The audited accounts shall be submitted to the Prime Minister for ratification not less than three months after the end of the fiscal year.

The annual accounts of the Central Bank shall be published in the annual report of the Bank, cf. Article 30. The Bank shall also publish a monthly balance sheet.

#### Article 34

In each year, an amount equal to two-thirds of the profit of the Central Bank in the preceding fiscal year shall be paid to the State Treasury. The payment shall be made not later than June 1 each year.

Notwithstanding the provisions of Paragraph 1 above, the Central Bank only pays one-third of its profit to the State Treasury if its capital and own reserves at the end of a fiscal year are less than 2.25% of the amount of lending and domestic securities assets of the credit system at the end of the preceding fiscal year.

### CHAPTER VIII

#### Miscellaneous provisions.

#### Article 35

Members of the Supervisory Board, Governors and other employees of the Central Bank of Iceland are bound by secrecy concerning the affairs of the customers of the Bank, the affairs of the Bank itself and other matters of which they gain knowledge in the course of their work and which should be kept secret according to law or the nature of the case, except where a judge may decree that information must be provided in court or to the police or there is a duty to provide information according to law. The duty to secrecy shall prevail even though employment may cease.

Members of the Supervisory Board, Governors and other employees of the Central Bank are not allowed to use confidential information which they gain through their employment with the Bank for pecuniary gain or to avoid financial loss in business transactions.

Notwithstanding the provisions of Paragraph 1 above, the Central Bank may engage in mutual exchange of information with public authorities abroad relating to the items to which the present Act applies, provided that the party requesting information is subject to corresponding confidentiality.

The Central Bank of Iceland shall grant the Financial Supervisory Authority all the information held by the Bank and which may be utilised for the activities of the Financial Supervisory Authority. Information granted in accordance with the present Article is subject to confidentiality in accordance

with the present Act and the Act respecting the Official Supervision of Financial Activities. The Central Bank and the Financial Supervisory Authority shall conclude a special agreement on co-operation further stipulating the co-operation between the two institutions.

#### Article 36

The Central Bank of Iceland is exempt from income tax and property tax, cf. the Act on Income and Property Tax as it stands at any time.

Any obligations issued by the Bank and in its name as well as obligations giving the Bank title to a pledge, coupons of bonds issued by the Bank and transfers thereof shall be exempt from stamp duty.

#### Article 37

Any violations of the present Act shall be subject to penalty in the form of fines or imprisonment unless a heavier penalty is stipulated under another Act. Attempted violations of the present Act or participation in such violations is subject to penalties under the Penal Code.

The Central Bank of Iceland may levy per diem sanctions on credit institutions and mutual funds, subject to rules laid down by the Board of Governors and confirmed by the Supervisory Board, cf. Article 28, if they do not adhere to the Bank's rules on required reserves, liquid funds and foreign exchange balance. Per diem sanctions as decided pursuant to this Article may be collected by legal execution. The rules on sanctions shall be presented to the Financial Supervisory Authority and those institutions to which they apply. Decisions to levy per diem sanctions can be appealed to the Prime Minister. Three-quarters of the sanctions collected in accordance with the present Article shall be paid to the State Treasury before June 1st of each year for the preceding year.

The Central Bank is authorised to impose penalties in the form of per diem sanctions upon parties neglect to provide information to the Bank which the Bank is entitled to collect on the basis of the present Act, or that provide deliberately misleading information to the Bank. The Board of Governors lays down rules on these sanctions which shall be confirmed by the Supervisory Board.

#### Article 38

The Central Bank of Iceland is authorised to lay

down rules on its tasks according to the present Act as deemed necessary. The Central Bank publishes rules which it lays down on the basis of the present Act in such a manner that they are accessible by the public.

### Chapter IX

#### Entry into force and other matters.

#### Article 39

Having received the opinion of the Supervisory Board, the Prime Minister may issue a regulation stipulating the implementation of individual provisions of this Act.

#### Article 40

This Act shall take immediate effect. At the same time, the Act number 36/1986 on the Central Bank of Iceland with all subsequent amendments is repealed. The stipulations of Article 5 of Act No. 54/1974 on the participation of the Central Bank of Iceland in the payment of the cost of the National Economic Institute is repealed on January 1st 2002. The Central Bank shall make its last contribution to the Science Fund of Iceland in the year 2001.

#### Temporary provisions.

##### I

Upon entry into force of this Act, the Parliament shall elect seven members of the Supervisory Board together with an equal number of alternates. As from the same date, the mandate of members then sitting on the Board shall expire.

##### II

Governors of the Central Bank of Iceland upon entry into force of this Act shall conduct their duties to the end of their respective appointment periods. The stipulations of Paragraph two of Article 25 on the appointment of Governors shall apply from the first appointment of Governor after the entry into force of this Act. Upon entry into force of this Act, the Prime Minister appoints the Chairman of the Board of Governors from the ranks of the Governors for the remainder of his term as Governor.