

## Financial markets and Central Bank measures<sup>1</sup>

### Tighter monetary stance

The Central Bank of Iceland announced a rise of 0.25 percentage points in its policy interest rate on June 1, 2004 and a further 0.5 percentage points on July 1. The impact was immediately felt on interest rates in the interbank króna market, but the change in the exchange rate was fairly small and short-lived. This summer the exchange rate index moved within a fairly narrow range. Liquidity was unequally distributed among financial institutions and could only be levelled out with Central Bank intermediation. New Housing Financing Fund (HFF) bonds were issued at the beginning of July. Towards the end of August, the commercial banks and largest savings banks announced long-term mortgage loans on similar terms to the HFF, except that there are no conditions confining them to real estate transactions. In mid-June, KB banki acquired a Danish bank, and subsequently sold new share capital under the largest offering in Iceland's history, for more than 39 b.kr. Central banks around the world have raised their policy rates over the past three months. Equity prices in Iceland continued to climb.

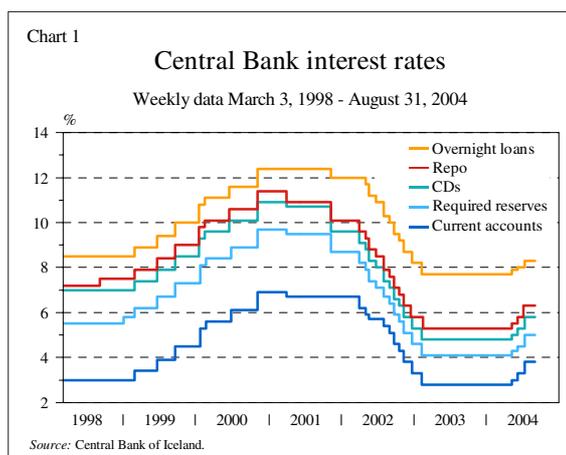
#### Two policy rate hikes ...

In light of accelerating inflation and the outlook that, other things being equal, it would remain above target, the Governors of the Central Bank of Iceland decided to raise the policy interest rate by 0.25 percentage points on June 1. Although some of the growth in inflation could be traced to rises in items that are beyond the scope of monetary policy, the development of other items posed a risk that inflation might move beyond the tolerance limits. At the same time it was announced that further interest rate increases could be expected shortly, unless new data provided a strong indication of an improved inflation outlook. When price developments in June and other economic statistics published then suggested a rather poorer-than-expected outlook, the Central Bank decided to raise the policy interest rate again on July 1, by a further 0.5 percentage points. Since the increases began in May, the Central Bank had by then raised the policy rate by 0.95 percentage points.

1. This article uses data available on August 31, 2004.

#### ... and tighter interest rate corridor

The spread between the Bank's highest and lowest interest rates was narrowed when the policy rate changed in June and July. In May, the interest rate corridor was 4.9 percentage points, but was tightened to 4.5 percentage points in June and July. The O/N loans rate in July was 8.25% and interest on current



accounts with the Central Bank 3.75%. The interest rate on required reserves was set at 5% as of July 11.

#### Interest rate steps

Since June 1, the Bank has changed its interest rates in steps which are multiples of 0.25 percentage points, instead of 0.1 percentage point as before. This is in line with the general western central bank practice. Chart 1 shows the development of Central Bank interest rates in recent years.

#### Shorter-term instruments

On June 1, new rules went into effect which shortened maturities in the Central Bank's regular (weekly) repo facilities for credit institutions from 14 days to 7 days. Purposes of this change included eliminating the one-week overlap in the old fortnightly auctions, and bringing practice more closely into line with that of the European Central Bank (ECB). The changeover also enabled more systematic liquidity management by credit institutions and has facilitated the Central Bank's short-term liquidity forecasting.

#### Little change in the exchange rate

The exchange rate of the króna has been stable in recent months. The exchange rate index measured just below 121 at the lowest and reached a high of 123.5 over the period from mid-May to the end of August (Chart 2). Summer trading has been similar in volume terms to the same season in 2000 and 2002. Daily turnover in the forex market exceeded 5 b.kr. only three times over this period. Presumably, part of the explanation lies in fewer mergers and acquisitions

than in 2003, while the merger between Kaupþing and Búnaðarbanki Íslands, to form KB banki, has probably reduced interbank trading. The Central Bank has made regular currency purchases from market makers according to a schedule announced in November last year. Currency to the value 2.5 million US dollars is purchased twice a week. The purpose of the purchases is to strengthen the Bank's foreign currency reserves; it also acquires currency to meet the Treasury's requirements. At the end of August, the Bank's foreign reserves amounted to 70 b.kr.

#### Revised currency basket

As usual, the currency basket was revised at the beginning of July to reflect as closely as possible the composition of Iceland's external trade in goods and services with major trading partner countries. In

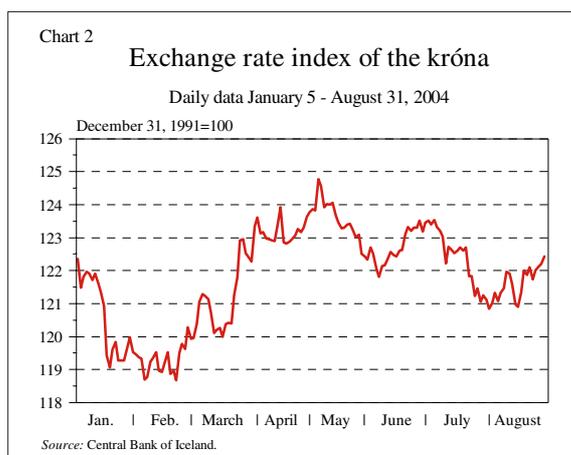
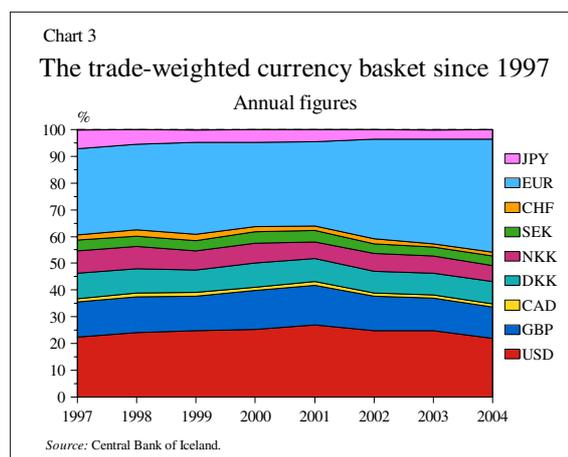


Table 1 New currency basket 2004

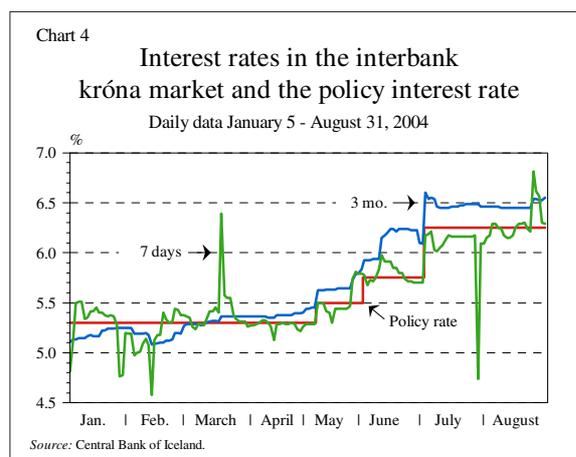
Region		New currency basket (%)	Change on previous basket (percentage points)
USA .....	USD	21.84	-2.89
UK .....	GBP	11.89	-0.46
Canada .....	CAD	1.07	-0.02
Denmark .....	DKK	8.41	0.17
Norway .....	NOK	5.90	-0.51
Sweden .....	SEK	3.68	0.26
Switzerland .....	CHF	1.39	0.18
Euro area .....	EUR	42.37	3.30
Japan .....	JPY	3.45	-0.03

Source: Central Bank of Iceland.

recent years the weight of the euro has been increasing while the dollar has been diminishing, as shown in Chart 3. The latest currency basket and changes since last year are shown in Table 1.

#### Interest rate developments and liquidity position

Interest rates rose in the interbank króna market on the back of the Central Bank's policy rate rise. The current upward yield curve indicates expectations of further interest rate hikes in the months to come. Chart 4 shows the development of one-week and three-month rates in the interbank króna market, mapped against the policy interest rate. Table 2 shows summer turnover in the interbank markets and at Iceland Stock Exchange (ICEX), with comparable data for the past five years. Liquidity was fairly ample at financial institutions, and at the end of July, just before the large Treasury payout of mortgage interest rebates and child allowance, interbank yields dropped by 1.5 percentage points for a single day. The Central Bank and the Treasury reached an agreement to pay, at the beginning of August, half of a Central Bank bond that matures at the beginning of December. The National Debt Management Agency informed the market of this decision more than a week in advance. This bond is the remainder of a loan taken by the Treasury in June 2001 to strengthen the Central Bank's foreign currency position, part of which was in the form of a capital contribution. Repo trading was brisk with an average outstanding stock of 27 b.kr. in June, July and August. The average stock of issued certificates of deposit (CDs) amounted to 10 b.kr. over the same period. Chart 5 shows the outstanding stock of repos

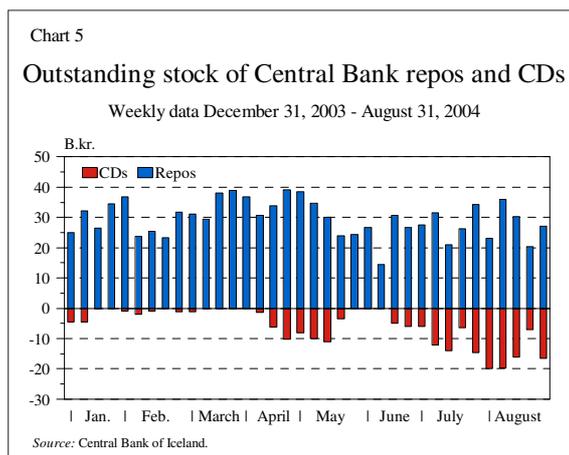


and CDs so far this year. Noticeably, there is relatively little intermediation of large amounts between participants in the market, as shown by the Central Bank's CD issues on the same day that it channels liquidity to credit institutions with repos.

Table 2 Summer trading (June-August)

B.kr.	2000	2001	2002	2003	2004
Interbank króna market .....	108	135	109	136	197
FX market.....	246	292	195	318	165
Currency swap market .....	0	0	39	32	41
Central Bank O/N lending .....	78	137	65	26	48
Central Bank					
certificates of deposit .....	0	0	0	0	144
Central Bank repos.....	205	392	512	414	365
ICEX, equities.....	9	28	64	103	127
ICEX, bonds.....	52	136	191	246	365

Sources: Iceland Stock Exchange (ICEX) and Central Bank of Iceland.



#### Changes at the Housing Financing Fund ...

At the beginning of July, the Housing Finance Fund made major changes with the issue of a new bond class, HFF bonds, which it offered to swap for the bulk of its earlier issues. On the whole, the changeover went smoothly. However, one unfortunate consequence was that trading with HFF securities stopped for a whole week. This caused some problems in the banking system when HFF bonds could temporarily not be pledged in the customary manner as collateral for Central Bank facilities, in which they had previously played a key role.

### ... and closed auctions

The HFF arranged a closed auction of HFF bonds on July 28, selling 5 b.kr. to foreign investors with a final maturity in 2044. Average yield was 3.91% after commission. Subsequently, it was announced that interest rates on HFF mortgage loans would initially be 4.5%. The auction was announced after its completion. A second closed HFF auction was made on August 26, when 2.5 b.kr. of bonds were sold with a maturity in 2024 and 4.5 b.kr. with a maturity in 2044. Average yield was 3.77% including commission, and subsequently the HFF lowered the rate on its mortgage loans to 4.35%.

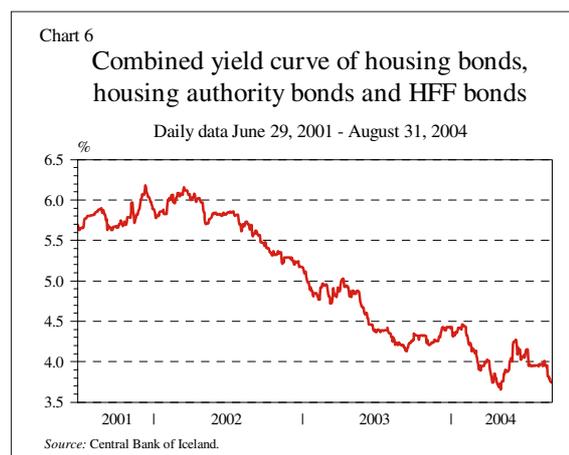
### Commercial banks and savings banks offered mortgage loans

On August 23, KB banki announced that it was offering price-indexed mortgage loans to customers, on certain conditions, for a term of 25 or 40 years with a fixed interest rate of 4.4% plus a surcharge for prepayment. Landsbanki Íslands and Íslandsbanki announced similar loans and so did savings banks SPRON and Sparisjóður Hafnarfjarðar shortly afterwards, then other savings banks. A real estate transaction is not a condition for receiving these loans, which may be taken for refinancing, but a first priority pledge is a condition in all cases. Further conditions are that borrowers use certain services offered by the lender, such as a salary account. Loan-to-value ratio can be as high as 80% in the Greater Reykjavik Area and Akureyri, but varies elsewhere depending on the bank. The maximum mortgage amount is 100% of fire insurance value. Frjálsi fjárfesingarbankinn investment bank joined the fray with a similar offer. A number of pension funds followed suit and lowered interest rates on existing loans to members, as well as offering new loans on similar terms to those of the banks. Maximum collateral that pension funds can lend against is 65% of the estimated market value of the property.

### Bond rate developments

Long-term interest rates have been decreasing fairly steadily since March 2002, as seen from Chart 6, which shows a combined yield curve composed of housing bonds with a final maturity in 2026, housing authority bonds with a final maturity in 2020 and HFF bonds with a final maturity in 2024. Yields hit a

low at the end of April this year, picked up to a high in June, then have dropped again. Long-term bond yields in Iceland are certainly at one of their lowest levels for a very long time. Chart 6 maps the lowest yields over several years on 25- or 20-year housing bonds, housing authority bonds and HFF bonds, and gives a good picture of the trend.



### Other central banks' interest rate changes, and interest-rate differentials

In the US, the Federal Reserve raised its funds rate in June and August, by 0.25 basis points each time. The Bank of England did likewise. The Swiss National Bank raised its repo rate by 0.5 percentage points and the New Zealand Reserve Bank increased its official cash rate by 0.25 percentage points in June and July. Table 3 shows policy rates in selected countries and

Table 3 Policy interest rates of selected central banks

%	December 31, 2003	August 31, 2004
Central Bank of Iceland .....	5.30	6.25
Reserve Bank of Australia .....	5.25	5.25
Reserve Bank of New Zealand .....	5.00	6.00
Bank of England.....	3.75	4.75
Norges Bank.....	2.25	1.75
Sveriges Riksbank.....	2.75	2.00
Bank of Canada.....	2.75	2.00
Federal Reserve System.....	1.00	1.50
European Central Bank.....	2.00	2.00

Source: Central Bank of Iceland.

changes in them so far this year. With their respective hikes, central banks are responding to expansionary pressures and inflationary risks. Iceland's interest-rate differential with abroad (trade-weighted) has risen from 3.5% (T-notes) and 3.3% (interbank market rates) since mid-May 2004 to 4.2% and 3.9% respectively towards the end of August.

#### *Equity trading*

Equity prices continued to climb at Iceland Stock Exchange and the ICEX index has gained almost 60% so far this year. Relatively few companies have led this trend, including the three commercial banks. In mid-June KB banki acquired the Danish bank FIH, partly financing it with more than 39 b.kr. in new capital raised among existing shareholders. The share issue was fully subscribed in the largest offering ever witnessed in Iceland. Chart 7 shows the development of the ICEX-15 index so far this year.

