

Foreign exchange market highlights 2001

Foreign exchange index

The foreign exchange index stood at 120.8381 points at the end of 2000 but 141.7985 points at the end of 2001. The index therefore rose by 17.35% over the year, meaning that the króna weakened by 14.78%. It peaked at 151.1638 points on November 28 but but-tomed at 120.9555 points on February 5.

Turnover in the foreign exchange market

Turnover in the foreign exchange market amounted to 1,218 b.kr. in 2001, compared with 768 b.kr. the previous year. The table shows average daily turnover for various periods during the year. Inflation targeting was adopted on March 28 and commissions for foreign exchange market making on July 1. Some tremors were felt in the forex market following the terrorist attacks on the USA on September 11.

Table 1 Average turnover per day in 2001, by period

<i>From</i>	<i>To</i>	<i>Turn- over (m.kr.)</i>	<i>Period length (days)</i>	<i>Average daily turn- over (m.kr.)</i>	<i>Change in exchange rate index (%)</i>
Jan. 3	March 27	116,677	61	1,913	1.91
March 28	June 29	550,015	60	9,167	10.73
July 1	Sept. 11	120,817	51	2,369	-0.11
Sept. 12	Dec. 31	431,731	76	5,681	2.05
March 28	Dec. 31	1,101,368	187	5,890	11.67
July 1	Dec. 31	551,353	127	4,341	1.93
Jan. 1	Dec. 31	1,218,045	248	4,911	16.89

The table shows how average daily turnover increased after inflation targeting was introduced, then dropped when the commission system went into effect. However, it is disputable whether the introduction of inflation targeting served to quell the market, or whether summer vacations, the commission system or announcements on treasury foreign borrowing at the end of June had some effect. After the events of

September 11, trading picked up considerably. The most trading on a single day was on May 2. Trading volume then amounted to 36.3 b.kr., the largest turnover in a single day in the history of Iceland's foreign exchange market.

Commission

A commission system was introduced on July 1, whereby market makers are paid commission on a quarterly basis. Maximum commission paid to market makers as a whole is 100 m.kr. per quarter. The commission is paid for presenting bids in dollars to buy or sell, which other market makers consider lucrative to accept. Thus the system is supposed to discourage market entrants who aim to take advantage of arbitrage opportunities, thereby reducing the probability of spirals. Total calculated commission exceeded 100 m.kr. in both Q3 and Q4 of 2001, so the maximum amount was shared out proportionately among market participants. Calculated total commission for the second half of the year was almost 357 m.kr.

Exchange rate volatility

Exchange rate volatility shows the standard deviation in day-on-day changes in the exchange rate index. Volatility became far more pronounced after inflation

Table 2 Exchange rate volatility

<i>Selected periods in 2001</i>	
	<i>Standard deviation</i>
January 1 - March 27	0.20%
March 28 - June 30	1.14%
July 1 - September 11	0.41%
September 12 - December 31	0.71%
<i>In the 3 past years</i>	
	<i>Standard deviation</i>
1999	0.17%
2000	0.35%
2001	0.72%

targeting was introduced and dwindled again after July 1, although not back to its former level. This trend is fairly consistently mapped against forex market turnover. Volatility has doubled between the years for the past three years.

Interventions

The Central Bank intervened in the foreign exchange market 14 times in the course of 2001, selling currency to the total amount of 24.4 b.kr. In addition to direct

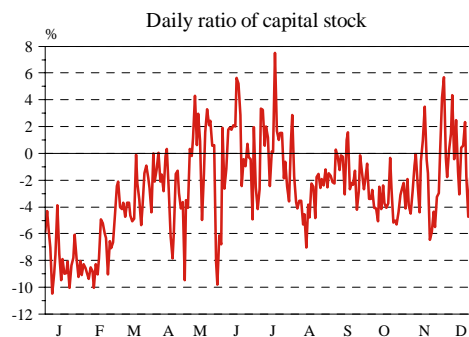
intervention, the Bank traded off-market with two market makers for a total of 5.1 b.kr. in December. The Bank's total sales of dollars to market makers therefore amounted to 30 b.kr. during the year. The largest intervention was on March 27, with the sale of US\$ 42 million to market makers.

Table 3 Central Bank sales in the forex market

	<i>Million krónur</i>	<i>Million USD</i>
January 24	2,060	24
January 25	1,039	12
January 26	1,031	12
February 9	1,033	12
March 23	1,592	18
March 26	1,464	16.5
March 27	3,768	42
June 21	2,545	24
September 28	1,063	10.5
October 1	1,207	12
October 3	1,199	12
October 8	3,390	33
October 10	1,834	18
October 12	1,208	12
December 7	1,088	10
December 12	4,017	38.5
Total	29,538	306.5

Chart 1

Market makers' total foreign balance in 2001



Foreign balance

Market makers are obliged to maintain a broad balance between their foreign-denominated assets and liabilities. The ratio of foreign balance to capital stock must be within 30% in either direction. In spite of this rule, market makers still enjoy considerable scope. However, they are long way from taking advantage of it. Chart 1 shows the development of foreign balance as a proportion of capital stock in 2001.