

Table 1 presents highlights from the FX market for 2001-2004. The exchange rate of the króna has fluctuated in both directions over these years, with fairly long periods of stability in between. Reflecting its slide in international markets, the US dollar has weakened sharply against the króna since it reached a high towards the end of 2001. The Central Bank made net sales of foreign currency to market agents in 2001 but net purchases from 2002 to 2004.

Table 1 FX market highlights 2001-2004

		Exchange rate index						
				Appreci- Change over depreci- ation/			Euro/ króna	USD/ króna
Turnover (m.kr.)	Central Bank turnover (m.kr.)	Average daily turnover (m.kr.)	End of year	year (%)	ation (%)	at end of year	at end of year	
2001	1,218,045	29,538	4,892	141.7985	17.35	-14.78	91.33	103.20
2002	834,444	4,528	3,378	124.8994	-11.92	13.53	84.71	80.77
2003	1,185,566	43,208	4,781	123.4179	-1.19	1.20	89.76	71.16
2004	948,249	27,228	3,763	113.0158	-8.43	9.20	83.51	61.19

Turnover and trading

Total turnover in the FX market in 2004 was just over 948 b.kr., a decrease of 237 b.kr. year-on-year. Monthly turnover peaked in December at 173.6 b.kr. Turnover was low in April, May and June – below 50 b.kr. in all three months – and lowest in May at 41.9 b.kr. Average daily turnover for these three months was 2.3 b.kr. Daily turnover for the year was 3.8 b.kr., down by 1 b.kr. from 2003 and 2002 but 400 m.kr. higher than in 2002. The most turnover in a single day, excluding Central Bank trading, was 19.3 b.kr. on December 3. Including a Central Bank purchase of 80 m. US dollars, total daily turnover was marginally higher on January 19 at 19.6 b.kr.

No changes were made to the market framework in 2004. Regulations and market agents' obligations have remained unchanged for the past two years.

Exchange rate developments

In 2004, the exchange rate index decreased by 8.43% and the króna appreciated by 9.2%, which is a marked change in trend from the preceding year. The highest exchange rate index value was registered on May 5 at 124.7766. For the first eleven months of the year the index value was above 118, and lay in the range 120 to 123 for most of that period. The lowest index value was on December 8 at 112.7771. In the course of the year the Central Bank raised its policy interest rate by 2.95 percentage points, which had an effect on the FX market. At the end of November the exchange rate index was registered at 117.96 and it strengthened sharply after the Central Bank raised the policy rate by 1 percentage point.

Table 2 Exchange rate volatility 2001-2004

Standard deviation of day-on-day changes against the króna

Standard deviation (%)	Exchange rate index	USD	Euro
2001	0.72	0.84	0.77
2002	0.46	0.56	0.54
2003	0.50	0.69	0.56
2004	0.35	0.58	0.39

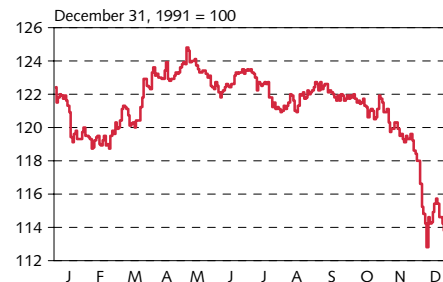
Box 1

Foreign exchange market highlights 2004

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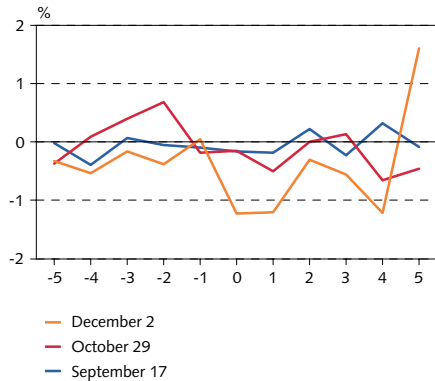
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Chart 1
Exchange rate index of the króna
Daily data January 5 - December 31, 2004
December 31, 1991 = 100



Source: Central Bank of Iceland.

Chart 2
Day-on-day changes in the exchange rate index 5 days before and 5 days after announced policy interest rate changes



Source: Central Bank of Iceland.

On the whole, 2004 was a calm year in the FX market. This is shown by turnover figures for most of the year and in very low exchange rate volatility compared with preceding years. Measured as the standard deviation in day-on-day changes, volatility has declined since 2003 and was less than in 2002 relative to the exchange rate index and euro, but similar against the US dollar. The high volatility of the dollar in international markets in recent months is reflected in these figures.

Interest rate changes and the FX market

The Central Bank raised its policy interest rate six times in 2004. Pending interest rate hikes could be inferred from the Central Bank's published inflation forecasts that indicated growing inflationary pressures. An increase of 0.50 percentage points was announced in September and again in October, neither of them surprising. However, there was a stronger response to the 1 percentage-point hike at the beginning of December, when a number of market agents had predicted a rise of 0.5 percentage points.

Chart 2 shows day-on-day changes in the exchange rate index 5 days before and 5 days after announcements of policy interest rate changes in September, October and December.

Only a muted response to policy rate changes can be discerned from exchange rate index movements in September and October. Fluctuations in December were rather more marked and the exchange rate index went down in the build-up to the hike, as can be seen between day -1 and day 0 on Chart 2. A few days later, the appreciation unwound in part.