

Turnover in the interbank market for loans denominated in Icelandic currency (króna market) amounted to 1,073 b.kr. in 2004, almost doubling year-on-year. This sharp increase was the result of a number of interacting factors, including Central Bank purchases of foreign currency, the lowering of the minimum reserve requirement and, not least, changes in the mortgage loan market. Table 1 shows turnover in the króna market and swap market from their respective years of establishment to the end of 2004. Increased turnover in the domestic currency market tracks the general growth in króna positions in the market, but the opposite seems to apply in the swap market. Since swaps have primarily been used as a liquidity management instrument, this development should not come as a surprise.

In the króna market, market makers make indicative bids for trades with a maturity from one day to one year. The market is regulated by Central Bank rules set on March 16, 2000 stating the maximum bid-ask spread for specified principal amounts. Although the rules have not been amended, the spread has narrowed to 15 points for all maturities. Trading volume has grown in line with improving market efficiency and easier liquidity among market agents.

When the swap market was set up, the specified principal amount was set at 3 m. US dollars, but most trades are now made for 5 m. US dollars. Once a day the Central Bank registers forward points in the swap market, based on the average of market makers' bids. Although it is not the most efficient of the interbank markets, the swap market supports price formation in both the króna and FX markets, and in the forward markets which are necessary for corporations in their hedging against foreign exchange risk.

Box 2

Domestic currency and swap markets

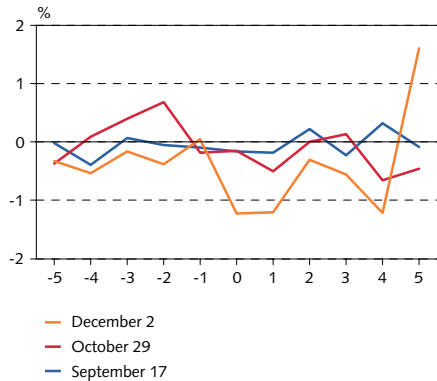
Table 1 Annual turnover in the króna market and swap market

<i>B.kr.</i>	<i>Króna market</i>	<i>Swap market</i>
1998	434.3	.
1999	500.3	.
2000	524.3	.
2001	426.1	.
2002	420.8	177.9
2003	585.0	112.1
2004	1,073.3	95.5

The króna market (domestic currency market) commenced operation on March 3, 1998.  
The swap market commenced operation on November 26, 2001.

Trading in the króna market is primarily at the shortest end of the market, with maturities from one day to one week. Other maturities are rarely traded. Trading at the shortest end was also most common in the swap market, but an increasing number of agreements are now being made for maturities of one month or more.

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.