

Non-residents have issued króna-denominated bonds to a nominal value of 95 b.kr since the last edition of *Monetary Bulletin* was published in the beginning of December 2005. This brought the total outstanding stock of króna-denominated Eurobond issues by non-residents up to 220 b.kr. on March 16. The first issues mature in Q3/2006.¹

Slower issuance since December

Last year's issuance of króna Eurobonds amounted to 150 b.kr., equivalent to 15% of GDP. Issuance has slowed down in recent months. Over the fourteen weeks from the launch of issues at the end of August to the publication of *Monetary Bulletin* in the beginning of December, bonds were issued for the equivalent of 8.8 b.kr. per week. Over the following fourteen weeks, average weekly issues ran at 6.8 b.kr. Bonds to the value of only 2 b.kr. have been issued in March at the time of writing. Issuers are probably holding back until the FX market settles down from the turmoil caused by the Fitch ratings update and reports on the Icelandic economy by overseas securities companies.

Securities valued at 50 b.kr. will mature this year

Chart 2 shows the maturity profile of offshore króna bonds. The red part of the columns shows the distribution of maturity dates for bonds issued since the publication of *Monetary Bulletin* in December. The bulk of the bonds mature in the second half of this year and in 2007. Bonds to the equivalent value of roughly 50 b.kr. mature in the second half of this year and roughly 120 b.kr. over the whole of next year. The maturity profile peaks in Q3/2007 when bonds mature for the equivalent of almost 70 b.kr.

It is difficult to state with any certainty what will happen when the first bonds approach maturity. Since they are all coupon bonds, buyers are paid the entire principal in krónur on maturity, plus the final interest payment. Buyers of the bonds can choose between converting the krónur into foreign currency in the Icelandic FX market or reinvesting it in new króna-denominated bonds. Which option is chosen will affect the exchange rate of the króna. The former option will clearly increase the supply of krónur. However, expectations about the response by the bonds' owners are likely to be reflected in the FX market before they mature.

It should be pointed out that extensive research by economists at the Reserve Bank of New Zealand has not established any significant exchange-rate effect from offshore bonds, neither on issuance nor maturity.

Impact on the capital markets and exchange rate of the króna

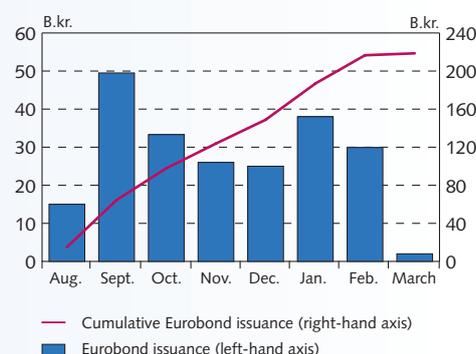
The impact that issuance of króna Eurobonds has had on the Icelandic capital markets appears to be in line with the analysis presented in the last *Monetary Bulletin* in December. Turnover has increased in the interbank markets for krónur and foreign exchange, and bond issues have also put downward pressure on nominal interest rates, hindering the Central Bank's policy rate rises from being transmitted in full across the nominal yield curve. Limited supply of non-indexed Treasury notes has also driven interest rates down at the same time.

It is difficult to ascertain the exchange-rate effect of bond issuance. In *Monetary Bulletin* in December it was underlined that while the króna had strengthened in tandem with a tighter mon-

Box III-1

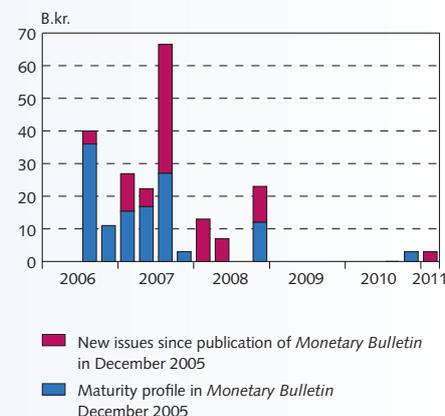
Króna-denominated Eurobond issues

Chart 1
Króna Eurobond issuance
August 2005 - March 2006¹
Monthly and cumulative volume



1. Data until March 15, 2006 inclusive.
Source: Central Bank of Iceland.

Chart 2
Maturity profile of króna-denominated Eurobond issues
Q3/2006 - Q1/2011

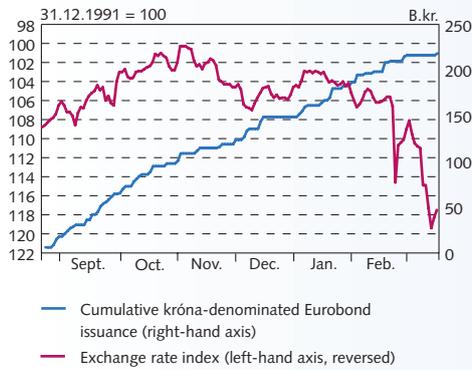


1. Data until March 15, 2006 inclusive.
Source: Central Bank of Iceland.

1. For a detailed discussion of króna-denominated Eurobond issues, see the article by Thorvardur Tjörvi Ólafsson in *Monetary Bulletin* 2005/4, 55-83.

Chart 3
Exchange rate index and króna-denominated Eurobond issuance

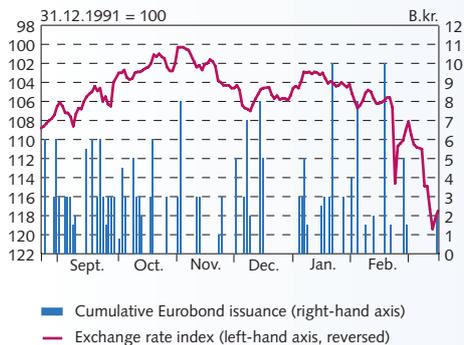
Daily data August 24, 2005 - March 15, 2006



Source: Central Bank of Iceland.

Chart 4
Exchange rate index and announcements of króna Eurobond issuance

Daily data August 24, 2005 - March 15, 2006



Source: Central Bank of Iceland.

etary stance in the autumn, it was impossible to isolate the contribution that bond issuance had made. The long-term impact of bond issuance would depend on market expectations of domestic and international interest-rate and inflation developments and investor appraisals of the risk posed by the strength of the króna. Developments in recent weeks and months have confirmed this.

The króna has depreciated in recent weeks in the wake of reports on the Icelandic economy by international rating agencies and analysts and new data on the size of last year's current account deficit. Investors appear to have adjusted their risk profiles, at least temporarily. At the same time, interest rates have been on the increase on both sides of the Atlantic and indications have emerged of a pending change in the Bank of Japan's monetary policy. Foreign portfolio investment by Icelandic investors has also offset the exchange-rate impact of bond issues. Outflows on securities purchases amounted to 210.9 b.kr. in 2005 compared with 98.7 b.kr. a year before, while króna-denominated bond issuance amounted to 150 b.kr. in 2005.

Expectations about the drivers of bond issuance

Monetary Bulletin in December maintained that issuance of króna Eurobonds will continue for as long as expectations persist that the forces driving them will remain in place, i.e. an ongoing wide interest-rate differential with abroad, strong króna and robust domestic demand for credit. Market expectations towards these drivers have probably changed since December, especially with regards to the exchange rate of the króna and the interest-rate differential with abroad.

As mentioned above, there were tremors in the FX market and the króna weakened in February and most of March. The exchange rate used in the present inflation forecast is 12% lower than in *Monetary Bulletin* in December. International capital markets have also changed tack somewhat with a tighter monetary stance. Interest rates, for example, have been rising in important funding countries in "carry trading", whereby investors borrow in currencies where interest rates are low to invest in currencies where they are high. Accordingly, foreign investors' appetite for króna Eurobonds is likely to have waned, because of a shift in expectations that the interest-rate differential will outweigh possible movements in the exchange rate of the króna. However, this is difficult to state for certain.