

### Lively foreign exchange market

The Central Bank of Iceland announced a 0.25 percentage-point rise in its policy interest rate on March 22, 2005, at the same time as the last Monetary Bulletin was published. A sharp depreciation of the króna followed. In the beginning of May an announcement of a foreign currency purchase to pay down Treasury foreign debt led to a further weakening. In mid-May the trend was reversed, however. Yields on Housing Financing Fund bonds have inched upwards. Equity prices rose fairly decisively in March and April, but calmed down in May.

#### Currency appreciation and reversal

The króna appreciated by almost 3% from March 1 to March 21, when the foreign exchange index reached its lowest value (106.42) since June 25, 1993. The Central Bank of Iceland announced a 0.25 percentage-point rise in its policy interest rate on March 22, 2005, at the same time as the last *Monetary Bulletin* was published. Judging from the market response, a hike of at least as much had apparently been widely expected, and some shifts took place in the foreign exchange and securities markets as a result. The exchange rate index rose by more than 2% from March 22 to 23 and the króna slid for the whole of April, i.e. the index value went up. At the end of April the index stood at 112.9, having risen by 6% since March 21. Chart 1 shows the development of the exchange rate index.

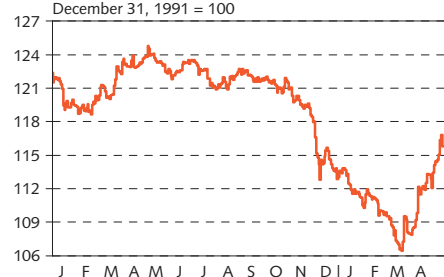
#### Currency purchase on behalf of the Treasury

In the beginning of May the Central Bank announced plans to purchase foreign currency on account of the Treasury's discretionary amortisation of foreign debt, over and above its regular purchases during the year. The reason for the currency purchase was the Treasury's exceptionally ample liquidity, which it was considered appropriate to deploy on amortising short-term borrowing in May rather than rolling the debt over. At the same time, the Treasury announced that it had no plans for further discretionary purchases of currency for the rest of the year, but its regular purchases will continue under the format described in *Monetary Bulletin* in December 2004. The announcement caused a minor tremor which contributed to the weakening of the króna by more than 4% from May 2 to May 12, when the first tranche of the purchase took place that morning.

#### Króna climbs back

The króna began to rally on May 17 following news of possible plans by Norðurál to build an aluminium smelter on the southwest Suðurnes peninsula over the period 2010-2015. Reports were later received that Alcoa was interested in exploring the possibility of

Chart 1  
Exchange rate index of the króna  
Daily data January 5, 2004 - May 17, 2005  
December 31, 1991 = 100

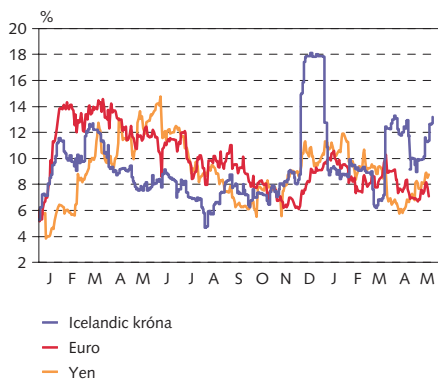


Source: Central Bank of Iceland.

1. This article uses data available on May 17, 2005.

Chart 2  
Exchange rate volatility of Icelandic króna,  
euro and yen against US dollar<sup>1</sup>

Daily data January 1, 2004 - May 17, 2005



building a smelter in north Iceland, which also appeared to bolster the króna. However, neither news report entailed more than an intention about or interest in exploring the possibility of building a smelter.

### Increasing exchange rate volatility

Exchange rate volatility, i.e. short-term fluctuations in the exchange rate, is typically measured in terms of the standard deviation in day-on-day changes in the exchange rate index over a given period. This measure enables comparisons of the exchange rate volatility of different currencies and their trends. Chart 2 shows the increasing one-month volatility of the króna vis-à-vis the US dollar recently, together with the volatility of the euro and the yen against the dollar over the same period. The market is clearly more sensitive than before with a risk of investor flight. There is always a tendency to overshoot in FX markets, but the exchange rate volatility shows that investors respond more sharply now than often before.

### Shifts in the bond market

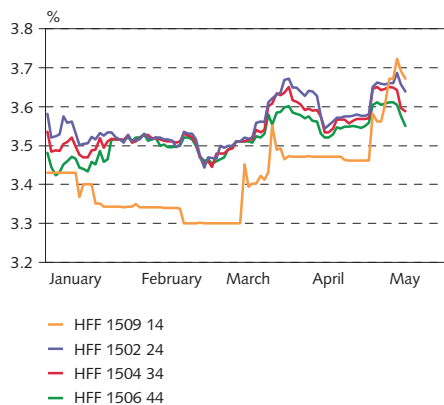
The bond market has not escaped the unrest of recent weeks, which has partly been connected with shifts in the FX market but has also been driven by other events, such as Statistics Iceland's announcement of a changed method for calculating mortgage interest cost in the housing component of the CPI.

### Are T-bonds on the way out?

In April, one of the last classes of Treasury bonds matured. A total of 18 b.kr. was redeemed, leaving only three issues listed on Iceland Stock Exchange (ICEX). The National Debt Management Agency (NDMA) has not announced whether this bond format will be maintained. While T-bonds clearly still interest investors, the Treasury's borrowing requirement is extremely low at present. Of the three T-bond issues now listed on ICEX, two have a nominal value of less than 500 m.kr., whereas the third amounts to more than 25 b.kr. and matures in 2015. It is not known whether the Treasury intends to maintain the indexed part of its debt instrument portfolio. The Treasury's position has been strong and its borrowing requirement negligible, but it is not certain that this will always be the case.

Chart 3  
HFF bond yields

Daily data January 4 - May 17, 2005



Source: Central Bank of Iceland.

### Yields on HFF bonds have edged upwards

Housing Financing Fund (HFF) bonds are the mainstay of the indexed end of the bond market and yields on the three longer classes have ranged from 3.42% to 3.69% since the beginning of the year. Sizeable day-to-day volatility has sometimes been noted, often coinciding with changes in the FX market. Yields on the shortest class, i.e. HFF bonds maturing in 2014, were for a long time lower than on the others, due to its small size and heavy demand for it. Demand has dwindled and yields now exceed those of other issues, as Chart 3 shows. For a while the interest rate spectrum of HFF bonds was unusual insofar as yields on the shortest issue, which was by far the smallest, were lower than on the others, even though there were no market makers for it. This situation changed in May, however, and the

interest rate spectrum is now more consistent. Since the beginning of March, yields on HFF bonds have edged upwards. Two auctions have been held so far this year, on March 14 when bids to the value 11 b.kr. were accepted, and on May 19 for 10 b.kr. The second was a closed auction. The HFF has had liquid funds available because of heavy prepayments of its loans last year and to some extent this year. Its responses have included arranging extra draws of bonds and prepayment of borrowing. From August 2004 to the end of April 2005, the deposit money banks lent 200 b.kr. in the form of new mortgage loans. It is clear that a significant share of this borrowing has been deployed on prepaying existing loans on less favourable terms, primarily earlier mortgage loans from the HFF and its predecessors.

### Yields on Treasury notes rose and fell

Three Treasury note issues, maturing between 2007 and 2013, are in the market. Yields on them are sensitive to changes in inflation expectations. The shortest class is the most sensitive, because with less than two years remaining until it matures, it falls within the Central Bank's inflation forecast horizon and appears to mould expectations to some extent.

### Growing turnover in the domestic currency market

So far this year, turnover in the market for loans in domestic currency (the króna market) has grown by 113%. Turnover has been greater in this market than in the FX market which for a long time far outstripped the other interbank markets. Interest rates in the króna market have provided good indications of market expectations, although overnight rates have been very volatile. Volatility at the shortest end partly reflects the impact of minimum reserve requirements, but fluctuations have also been caused by divergent expectations, unexpected events and position-taking. Chart 4 shows interest rates in the króna market for different maturities. It should be noted that various central banks are tackling the question of interest rate volatility on the final day of the maintenance period, and the Bank of England has aired ideas for a narrower rate corridor than on other days in order to reduce this problem. Because of the merger of credit institutions' reserve accounts and current accounts in the Central Bank of Iceland and enhanced liquidity management, the banks have had little need for Central Bank overnight lending facilities and their use has virtually disappeared. Nonetheless, overnight loans remain part of the Bank's instrument portfolio on account of their importance for payment systems and liquidity management. Since new rules on minimum reserve requirements entered force in January 2004, reserves have increased by 16%.

### Time structure of interest rates is just beginning to flatten out

Interest rates in the króna market imply a market perception that the Central Bank's policy interest rate is approaching a peak, because the spread between the shortest and longest domestic currency market rates has been narrowing recently. The policy rate is now 9%, which

Chart 4  
Interest rates in the interbank króna market  
and Central Bank policy interest rate  
Daily data January 4 - May 17, 2005

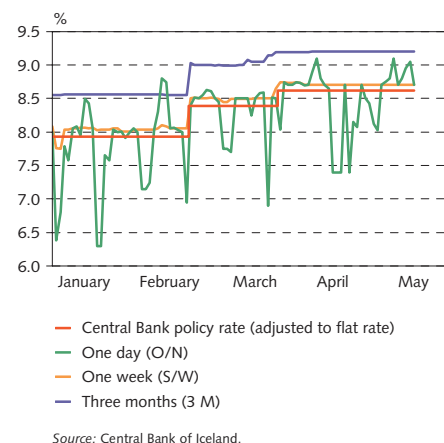
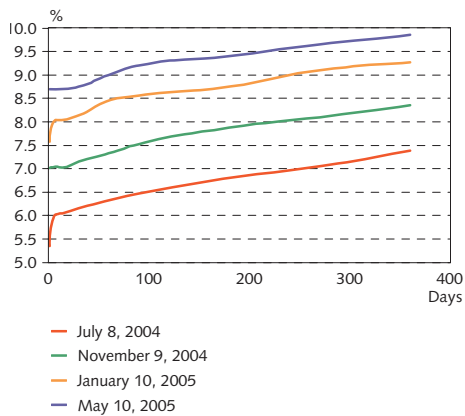
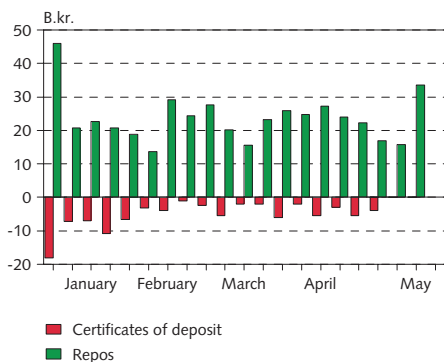


Chart 5  
Time structure of interest rates in the interbank  
króna market (Reibor average rates)



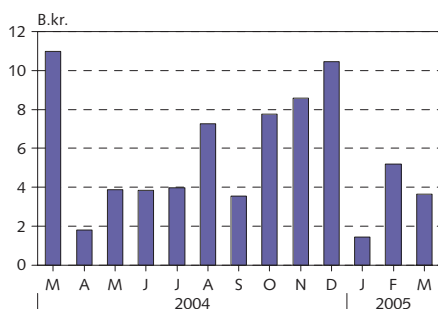
Source: Central Bank of Iceland.

Chart 6  
Outstanding stock of Central Bank repos and CDs  
Weekly data January 4 - May 17, 2005



Source: Central Bank of Iceland.

Chart 7  
Residents' net foreign portfolio purchases  
March 2004 - March 2005



Source: Central Bank of Iceland.

is the yield on one-week repos and corresponds to a flat interest rate of 8.62%. Since króna market rates are flat, it is misleading to compare them with the unadjusted policy rate. The fact that interest rates in the króna market always exceed the policy rate, coupled with a fair amount of demand for Central Bank facilities, implies that institutions subject to minimum reserve requirements face tighter liquidity than last year. Chart 5 shows the time structure of interest rates in the interbank króna market.

### Repo transaction volume still quite large

One side-effect of Treasury liquidity has been to generate some demand for Central Bank lending facilities, and it has also dampened demand for certificates of deposit. Since the beginning of the year, the average volume of repo transactions in weekly auctions has been around 24 b.kr. The highest volume was 45.9 b.kr. on January 4, followed by 33 b.kr. on May 17. CDs reached a high of 18 b.kr. on January 4, but two auctions did not result in any sales. Net Central Bank facilities for credit institutions (repos less CDs) have averaged 19 b.kr. from the beginning of the year. The Board of Governors of the Central Bank has decided to abolish ceilings in auctions of seven-day CDs and the Bank will include their yields in its interest rate announcements. Chart 6 shows the development of repo and CD transactions so far this year.

### Bank rates have tracked the policy rate more closely recently

Since the Central Bank began its cycle of policy interest rate rises in May 2004, the commercial banks and savings banks have raised their interest rates by varying amounts. Initially some banks hardly tracked the policy rate hikes, but subsequently they have followed suit quite closely. Average non-indexed lending rates are now 14.32%, as against 13.95% at the beginning of the year. Since deposit forms are very different and hardly comparable, it is difficult to estimate the banks' overall interest margin.

### Changes in portfolio holdings of foreign and domestic investors

An interesting development has taken place in foreign investors' transactions with Icelandic securities. Since the beginning of the year they have been net sellers of securities, to the tune of 10.7 b.kr. over the period from January to March. Residents have continued to invest in foreign securities, however. Over the period from January to March their net purchases amounted to 10.3 b.kr. Some connection can be discerned between exchange rate movements and securities trading, as can be expected in an environment of free capital movements. Chart 7 shows residents' purchases of foreign securities.

### Interest-rate differential with abroad widens in step with hikes in Iceland

In recent months the Central Bank of Iceland has raised its policy rate by more than most other central banks in major trading partner countries. This has naturally widened the interest rate differential with abroad. Among other central banks, the Federal Reserve has raised its

policy rate most frequently of late, hiking its funds rate in eight equal steps from 1% to 3% in the space of roughly a year.

### Equity prices climb on Iceland Stock Exchange

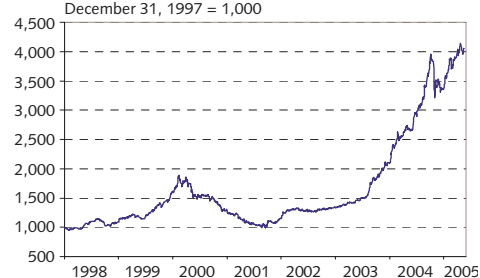
Iceland's equity market has been fairly lively and prices have continued to climb over the past few months. The ICEX-15 index passed the 4,000-mark on April 6, less than nine months after it moved above 3,000. In April and May it has hovered in the range 3,950 to 4,150 as shown on Chart 8. Four fewer companies are now listed than at the beginning of the year, but there are some hopes of an increase again – for example, one foreign company has announced plans to apply for a share listing.

Chart 8

### The ICEX-15 equity price index

Daily data January 6, 1998 - May 17, 2005

December 31, 1997 = 1,000



Source: Iceland Stock Exchange (ICEX).

