

Financial markets and Central Bank measures:¹

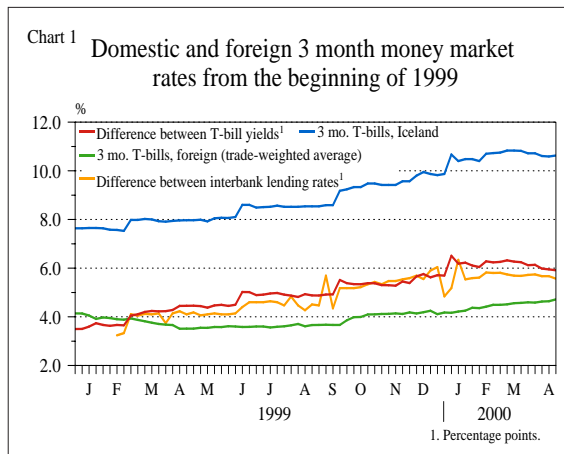
High interest rates have contributed to a stronger currency

The króna has appreciated after the extension of the exchange rate band and the Central Bank's interest rate rises in February, to reach its strongest position since the devaluation of June 28, 1993. The interest rate differential between Iceland and abroad has narrowed very slightly recently. Nonetheless, it remains large and is the main explanation for the strong exchange rate. Trading in the foreign exchange and domestic currency markets has been growing during the year, while trading in treasury bills has contracted. The yield on main categories of treasury-guaranteed bonds rose significantly in March and April. The greatest rise, as great as 0.9 percentage points, took place in savings bonds, while the yield on housing bonds increased by up to 0.6 percentage points. Sharp fluctuations have occurred in share prices during the year, following a period of almost continuous rises since October 1998.

Monetary measures in February

The exchange rate band was extended on February 14 by 3 percentage points in either direction, from $\pm 6\%$ to $\pm 9\%$. In the Central Bank's opinion, the earlier band was beginning to constrain further appreciation, as the exchange rate approached the upper limit. At the same time as extending the target zone, the Central Bank raised its policy rate by 0.3 percentage points to 10.1%, following an increase of 0.8 percentage points in January. All things being equal, the rise in interest rates increases the interest rate differential between Iceland and abroad and contributes to further strengthening of the króna. Higher capital costs ought to reduce credit demand in the long term as well, and thereby the demand pressure which has caused inflation to accelerate. The higher exchange rate leads to a fall in import prices, thus bringing down the inflation rate. With its measures, the Central Bank underlines the pressing need to reduce inflation and ensure stability in the long term.

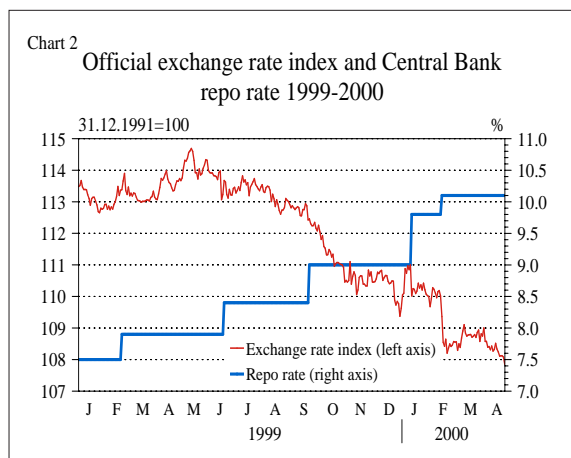
1. This article uses monthly data from the end of March 2000 while daily data extend to April 25 2000.



Higher domestic interest rates have strengthened the króna ...

The differential between three-month trade-weighted money market rates in Iceland and abroad averaged 5.4 percentage points in January but has been close to 5.7 percentage points over the past three months. The exchange rate strengthened following the Central Bank's measures in February. The exchange

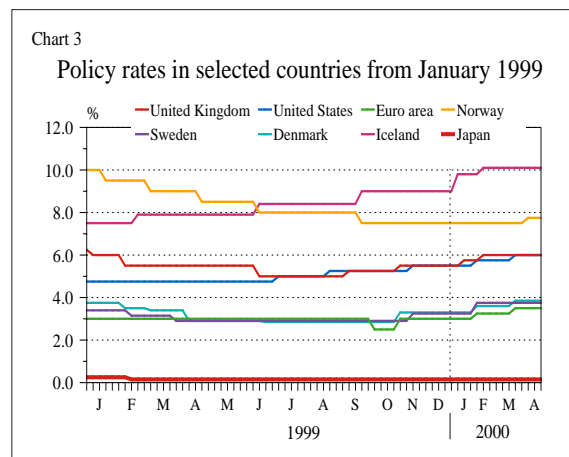
rate rose immediately to 6% in the stronger half of the target zone after these measures. Afterwards, this appreciation was partly cancelled out to leave the exchange rate in the range 5.4% to 5.8% above the central rate in the second half of February. A further weakening took place in the beginning of March, but since then the króna has strengthened. The exchange rate was 6.24% above the central rate on April 25, meaning that the króna had appreciated by 2% since the beginning of the year. The króna has not been stronger since the devaluation of June 1993. Various factors have contributed to such a high exchange rate. These include high interest rates in Iceland, which have been attracting foreign capital inflows on an increasing scale, and a more favourable merchandise account balance during the first months of the year compared with the same period in 1999. Volatility in international equity markets this April may also lead to a temporary drop in demand for foreign equities by domestic institutional investors, and thereby a lower capital outflow than would otherwise be the case.



...but foreign central banks have also raised their interest rates

Central banks in other countries have also responded to accelerating inflation and higher economic growth by raising their policy rates this year. The US Federal Bank and the European Central Bank raised their interest rates by 0.25 percentage points on February 3. The Bank of England followed suit with an increase of the same amount on February 10. The ECB announced a further 0.25 percentage point rise

on March 16 and the Federal Bank did likewise on March 21. Thus foreign central banks have raised their policy rates by up to 0.50 percentage points this year, while the Central Bank of Iceland has raised its by 1.1 percentage point. There are various signs that further rises in interest rates may be expected from foreign central banks in the near future.

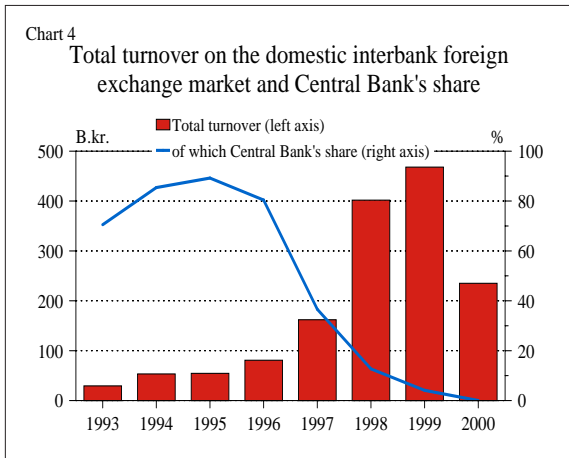


Growing foreign exchange trading in the interbank market but no Central Bank intervention

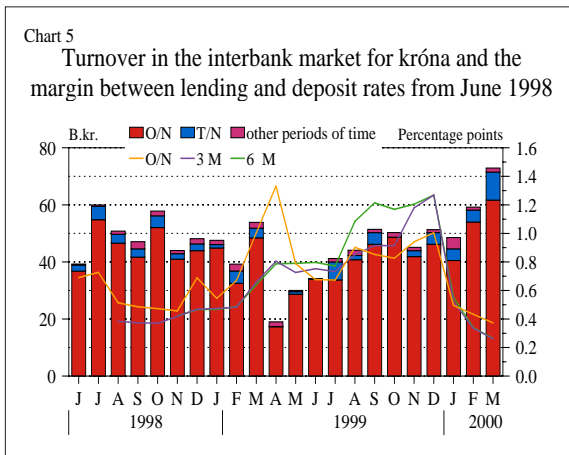
The interbank market in foreign exchange has been lively during the first months of the year with considerably more trading volume than at the same time in 1999. During the first four months of 1999, which was a record year in foreign exchange trading, transaction volume amounted to 128 b.kr., while by April 25 this year it had reached 235 b.kr., or more than half that of the entire preceding year. A record for foreign exchange trading in a single month was set in February 2000, at almost 83 b.kr. The Central Bank has not intervened in the foreign exchange interbank trading market since June 1999.

Growing volume in the króna market while T-bill trading decreases

Trading volume in the interbank króna market increased substantially during the first four months of 2000 compared with the previous year. So far this year, volume has amounted to 219 b.kr., but was 160 b.kr. during the same period in 1999. In March, transactions reached 73 b.kr., a record volume for a single month in the market's history. In most cases, trading is on an overnight or weekly basis. Overnight

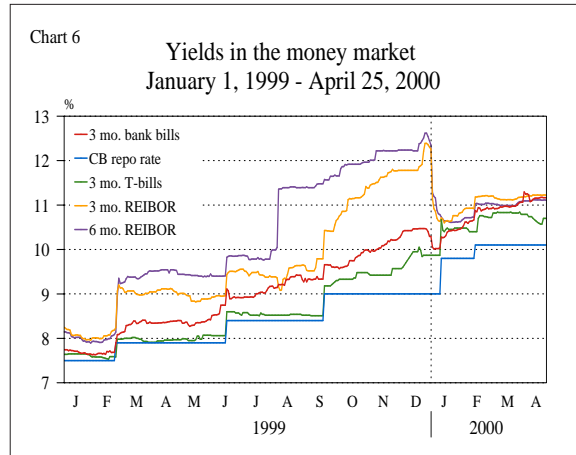


trading accounted for 88% of the total and weekly trading for 9%. The proportion of transactions for a longer term than one week was therefore only 3%. On February 1, market participants began quoting bids and offers for 9- and 12-month lending and deposits; before then, the bid obligation only covered lending for one day, one week, and one, three and six months. Market participants have not shown much interest in longer-term transactions, partly because of the wide margin which has existed between interest rates on deposits and lending. Rules on interbank trading in króna were changed on March 21 to specify the maximum margin between deposits and lending in bids for a term of one month or more, with the aim of trying to stimulate transactions longer than one week. The maximum spread is 0.25 percentage points.



Several reasons can be pointed out for the higher trading volume in the interbank króna market. An interaction takes place between the interbank markets for domestic and foreign currency, whereby higher foreign exchange transaction volume generates more trading in the króna market. New liquidity rules for credit institutions can be identified as another cause.

Bank bills were traded on Iceland Stock Exchange for 11 b.kr. during the first four months of this year, while the volume over the same period in 1999 was 6.5 b.kr. One reason for this growth was the new rules on liquidity which went into effect at the end of last year, whereby bank bills are now classified among liquid assets for holders of such bills. Trading in T-bills on the Exchange has decreased to 4.9 b.kr. during the first four months of this year compared with 6.5 b.kr. over the corresponding period in 1999. Nonetheless, primary sales of T-bills were 2 b.kr. higher than in the first four months of last year. New T-bills have been issued to the amount of 12 b.kr. so far in 2000. New issues have been sharply curtailed in recent years, partly as the result of the good treasury position. It should also be borne in mind that the auction market format generally leaves the real supply of T-bills unclear, and market participants' interest in taking part in auctions has been waning.

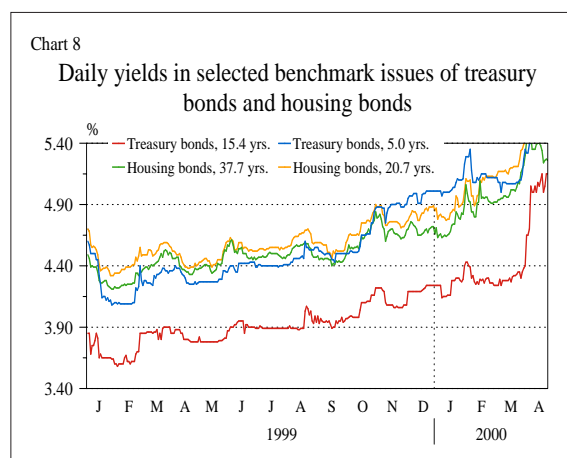
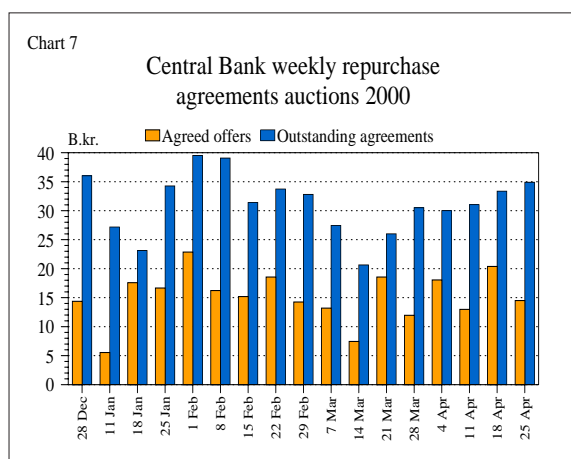


When the new rules on liquidity ratios went into effect at the beginning of this year, interest dropped sharply in the interbank króna market, after having risen by substantially more than other money market

interest rates. A reasonable balance has thus been achieved in króna market interest rates in 1999. Interest rates in the money market have kept pace with the Central Bank's interest rate changes. However, considerable fluctuations always take place in overnight interest rates in the króna market. At the end of January and first half of February, overnight interest rates were higher than the Central Bank's overnight lending rate, because of a temporary tight liquidity situation in the market, which was partly the result of a large capital inflow to the treasury.

Little reduction in Central Bank repos

The repo stock is invariably highest at the end of the year. The reason is seasonal fluctuations in the liquidity position of deposit money banks, caused by seasonal changes in the treasury's position with the Central Bank and a seasonal foreign exchange outflow. The total stock of outstanding repurchase agreements on April 25 was 35 b.kr., marginally less than the position at the end of the year. This year, however, there have been some fluctuations in the repo stock. At the beginning of February it stood at 40 b.kr.; in mid-March it was just under 21 b.kr. and has increased since, partly as a result of the treasury's good liquidity position. In recent months some credit institutions have used the repo facility of the Central Bank more or less continuously, indicating that they may have a liquidity problem. This kind of use of the repo facility is not to the Central Bank's liking, as the facility is not intended to fund credit expansion or exposure of credit institutions.



Rising yields in the bond market

Trading in the bond market has been fairly quiet. Buybacks of treasury paper by the Debt Management Agency and housing bonds by the State Housing Fund have reduced trading in this market even further. The interest margin has widened and financial institutions appear to see little benefit in market-making with these bonds.

A sizeable increase took place in bond yields in the secondary market in March and the first week of April. In the space of five weeks the required yield on the longest category of savings bonds rose by 0.8 percentage points and on the main categories of housing bonds and housing fund bonds by 0.45-0.65 percentage points. Since April 7, the yield on main bond categories has changed little. There has been some rise in savings bond yields, but a marginal drop in those on housing bonds.

The required yield on main housing fund bonds and 5- and 15-year savings bonds is at its highest level since mid-1997. For the category of housing bonds maturing in 2021 the required yield peaked at 5.83% on April 4, the highest since February 1996. It is noteworthy that this increase took place at the same time as the buyback of savings bonds and housing bonds. Reasons for the increase in long-term interest rates include greater interest among institutional investors in domestic and foreign equities in preference to treasury-guaranteed bonds. Furthermore, a marked increase has taken place in new housing bond issues during 2000. In the first quarter these amounted to 6.5 b.kr. (at average market prices for the month) compared with 4.6 b.kr. during the

same period in 1999. Investors have also increasingly transferred their assets from long-term funds which are exempt from net wealth tax to equity funds and short-term funds, among others, since yields from funds investing in indexed long-term securities have dropped at the same time as share prices have soared and the yield from short-term funds has been on the increase.

Fluctuations in the equities market

The ICEX-15 index of the most-traded companies listed on Iceland Stock Exchange reached a historical high on February 17. It stood at 1,889 points then after increasing by 85% since October 1998, of which 17% was added since the beginning of the year. So far in 2000 the greatest share price rises have been in information technology (69%) and pharmaceuticals (62%). Share prices of transportation companies have shown the greatest drop, or 10%, and fisheries companies 3%. From the beginning of this year, the ICEX Growth List has gained 37%.

On February 18 a turnabout took place in Icelandic share price trends. In the space of only two weeks, the ICEX-15 index fell by 10%, to 1,692 points. Since then it has fluctuated in the range 1,700-1,850 points and stood at 1,743 points on April 25. Domestic equities market trends no longer appear

to be immune to changes taking place in international share markets. In this context, it can be pointed out that over the period from March 27 to April 17, when the Nasdaq index fell by 32%, the prices of listed IT companies on Iceland Stock Exchange dropped by 13%. During the same period, the Dow Jones index fell by 4% and ICEX-15 by 5%.

Total equities trading on Iceland Stock Exchange has tripled between the years. Up to April 25 this year, total trading volume amounted to 30.4 b.kr. (including 1.6 b.kr. on the Growth List) compared with 10.1 b.kr. during the same period in 1999.

