Financial markets and Central Bank measures[1]

The króna appreciates and equity prices rise

The króna and other high-yielding currencies have continued to appreciate since Monetary Bulletin *was published at the end of March. At the same time, low-yielding currencies such as the yen and the Swiss franc have depreciated and been a lucrative source of carry trades. Global interest rates have risen and Iceland's interest rate differential with abroad has narrowed, but not enough to reduce position-taking in the króna. Treasury bond issues have decreased, especially in Europe, and investors have sought out opportunities in emerging market and developing countries on a growing scale. This development may also be one explanation for the appetite for glacier bonds. The Central Bank of Iceland changed its presentation of the policy rate from annual yield to nominal discounted rate in June, bringing it into line with general central banking practice. Equity prices in Iceland and elsewhere are rising steadily and leading indices in Europe and the US are at or close to a historical peak. Iceland's OMXI15 index is at a record high.*

Policy interest rate

The Central Bank of Iceland has not changed its policy interest rate since December 2006. Policy rates have been raised in the UK, the euro area, Sweden, Norway and Denmark since *Monetary Bulletin* was published in March, but they have been left unchanged in Japan and the US. Thus Iceland's interest rate differential with abroad has narrowed slightly.

Changed presentation of the policy rate

The Central Bank recently changed the presentation of its policy rate, bringing it into line with general central banking practice which is to state a nominal rate instead of annual yield. The nominal rate is discounted and, stated in the new terms, is now 13.3%, which corresponds to an annual yield of 14.25%, the rate that the Central Bank has quoted hitherto. New Rules on Central Bank Facilities for Financial Undertakings also entered into force, replacing a framework from December 2004. They do not entail major changes to arrangements. However, three points should be noted:

1. Regular facilities with the Central Bank are now termed collateral loans, which is technically more accurate. In earlier rules they were known as repurchase agreements, even though they were strictly speaking collateral loans.
2. The business day for collateral loan facilities has been moved from Tuesday to Wednesday.
3. The haircut on the reference price of eligible collateral securities for loans has been reduced by 1-2% in the case of Treasury issues. The maximum haircut is now 5% of the value of bonds with a maturity of longer than 5 years, but was previously 7%.

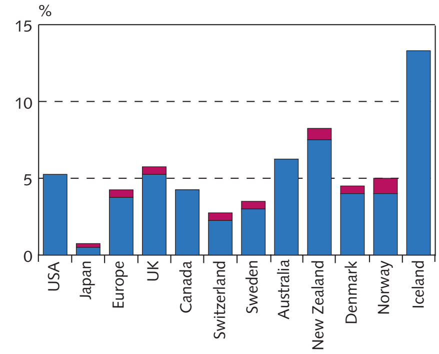
Rating requirements for eligibility of collateral, minimum issue size and market making are unchanged.

Money market in balance

The domestic money market has been in better balance after the definition of eligible collateral for Central Bank facilities was broadened, as described in *Monetary Bulletin* in March. Minimum required reserves

1. This article uses data available on June 29, 2007.

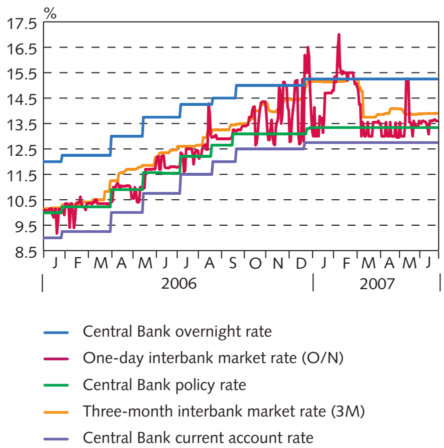
Chart 1
Increases in selected central banks' policy interest rates since MB 2007/1[1]



1. The red part of the column shows the increase since the last *Monetary Bulletin* was published in March 2007. The policy rate varies between countries and can refer to either lending or deposit rates.
Source: Reuters.

Chart 2
Interest rates in the interbank market and Central Bank policy rate

Daily data May 22, 2006 - June 28, 2007

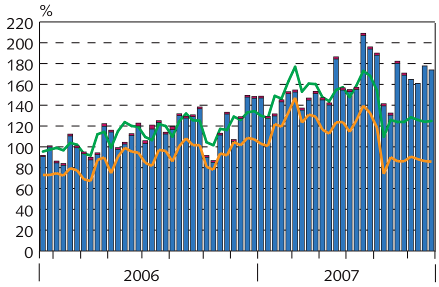


Source: Central Bank of Iceland.

Chart 3

Collateral loans, CD sales, Treasury deposits and reserve requirement

Weekly data May 23, 2006 - June 27, 2007



Collateral loans

CD sales

Treasury deposits

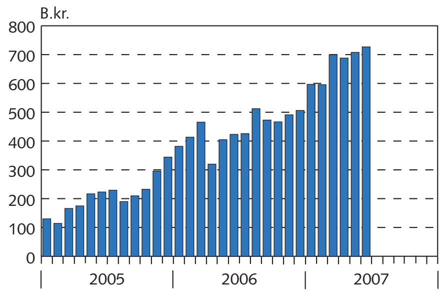
Reserve requirement and Treasury deposits

Source: Central Bank of Iceland.

Chart 4

Forward currency position of the commercial banks

At end of month January 2005 - June 2007

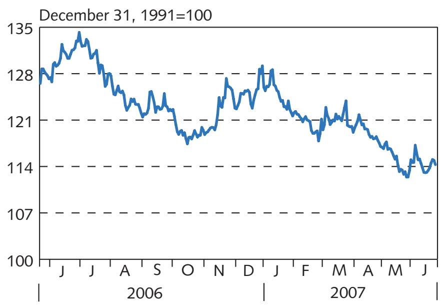


Source: Central Bank of Iceland.

Chart 5

Exchange rate index of the króna

Daily data May 22, 2006 - June 28, 2007



Source: Central Bank of Iceland.

have grown in pace with the increase in deposits in the banking system, while credit institutions' demand for collateral loans has shown sharp weekly fluctuations. Money market interest rates have been fairly stable and generally well within the Central Bank's rate corridor. Liquidity was tight on one occasion during the period, after an unexpected change in the Treasury position.

The balance on the Treasury's current account in the Central Bank dropped sharply when the Treasury deployed 44 b.kr. to strengthen the Bank's capital in May. Because the Treasury's balance has exceeded forecasts, it has added to its deposit in the Central Bank if this capital contribution is excluded.

High gains on carry trades

Carry trades with the króna have been continued to be profitable since the end of March. High-yielding currencies have appreciated and low-yielding currencies such as the yen and Swiss franc have depreciated at the same time. The króna has appreciated by 5% while the yen has depreciated by 5% and the Swiss franc by 3%. Position-taking in the króna which is financed with yen and Swiss francs in equal proportions has therefore yielded an exchange rate gain of 9%, on top of an interest rate differential amounting to 3 percentage points over that period.

The króna appreciated almost continuously from Easter until June. Exchange rate volatility was at a low until the Marine Research Institute's recommendations for a cut in the cod quota sent a mild tremor through markets, causing the króna to slip somewhat.

Brisk glacier bond issuance

A sizeable volume of glacier bonds has been issued net of maturities. Issuance from the beginning of the year has amounted to 174 b.kr., while bonds in the nominal value of 54.1 b.kr. have matured. The total outstanding glacier bond stock is currently 383.5 b.kr. Bonds to the value 82.5 b.kr. will mature in September 2007. This is the largest maturity in a single month to date, and is large relative to the size of both the market and Iceland's economy. Some market impact cannot be ruled out, but hitherto glacier bond maturities have not had a noticeable effect on the exchange rate of the króna. This is consistent with the experience of other countries, since many investors manage their risks through the FX and money markets and do not defer their decisions to wait for individual assets in their portfolios to mature.

The banks' foreign currency-denominated assets, i.e. in forwards and options, provide an indication of how position-taking in the króna is developing. At the end of June, the banks' total foreign currency-denominated assets amounted to 727 b.kr., an increase of 112 b.kr. since the end of February. Virtually all the addition was made in March and the position has changed little since. In foreign currency terms the increase is even greater, due to the appreciation of the króna over the period.

Decrease in foreign reserves

The Central Bank's foreign reserves have decreased by the equivalent of 10 b.kr. since the end of March. While the main factor at work was a 5% appreciation of the króna, the final instalment on a Treasury foreign loan amounting to €50 million (4.2 b.kr.) was also paid. The next maturity of a Treasury foreign loan is in May 2008, amounting to €150 million (13 b.kr.).

The Central Bank makes weekly purchases of 6 million US dollars in the interbank market. Currency is used to meet Treasury foreign debt service and any remainder is used to strengthen the Bank's foreign reserves.

Side-effects of lower Treasury debt

The small size of the outstanding Treasury note stock has created illiquidity in the domestic bond market. Strong Treasury surpluses in recent years have reduced the need for domestic issuance and its low debt position is a clear strength. Accordingly, the Treasury has been reluctant to issue debt instruments, desirable as this may be from a market viewpoint.

It is interesting to examine responses to decreasing Treasury debt in the other Nordic countries, where a similar development is taking place. Thanks to oil revenues, the Norwegian Treasury has no funding requirement, but its policy has nonetheless been to maintain combined issuance of domestic currency Treasury bills and government bonds for the equivalent of 10% of GDP. It merely views providing the financial markets with a risk-free interest rate path as a public good. Sweden and Denmark are in a similar position. Sweden's Treasury debt is currently equivalent to 40% of GDP and looks set to drop to 30% by 2009. The reduction could be even greater if the Swedish government goes ahead with its privatisation policies. In Denmark, Treasury debt is equivalent to 16% of GDP and is expected to fall to 12% by the end of 2008.

Denmark and Norway have ceased all bond issuance in foreign currencies and Sweden is likely to follow suit. Thin markets are already a concern in Denmark and Norway and Sweden foresees a similar development although the situation there is not yet tight. Around one-fifth of Swedish Treasury debt is denominated in foreign currency and 25% in indexed bonds. This would allow a sizeable amount of Treasury debt to be retired before depleting the issues that form the risk-free nominal interest rate path in Swedish domestic currency. In Denmark, the number of issues has been reduced in order to ensure a certain degree of depth. Issuance of bills and notes with maturities of less than 5 years has been discontinued.

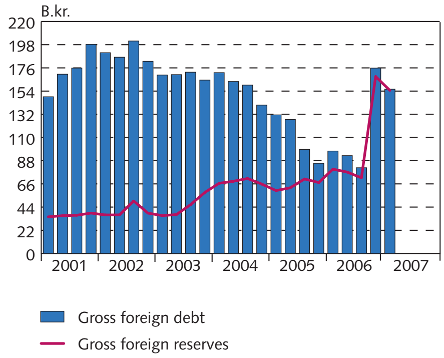
Iceland's small economy means that market liquidity will always be tight, compared with other countries. Total Treasury debt in Iceland is equivalent to 25% of GDP and domestic debt 12%. The market value of the total outstanding stock of T-notes, T-bills and government bonds amounts to 133 b.kr, compared with a stock of Treasury instruments of 210 billion DKK (equivalent to 2.350 b.kr.) in Denmark and 210 billion NOK (2,270 b.kr.) in Norway.

The critical size for an issue in order to achieve liquidity is difficult to estimate. In the euro area, the liquidity threshold for any Treasury issue is generally considered to be €5 billion. This amount corresponds to four times the Icelandic Treasury's domestic debt and double its total debt. Iceland can hardly be expected to produce an issue of such a size. However, reducing the current number of issues and expanding their size would surely deepen the domestic markets and improve price

Chart 6

Gross reserves and gross central government foreign debt

Quarterly data, Q1/2001 - Q1/2007

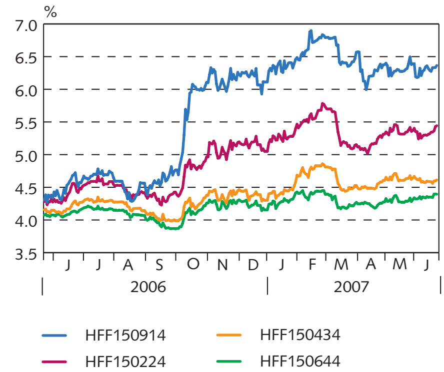


Source: Central Bank of Iceland.

Chart 7

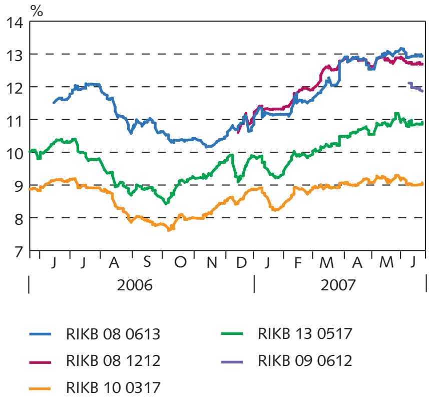
HFF bond real yields

Daily data May 22, 2006 - June 28, 2007



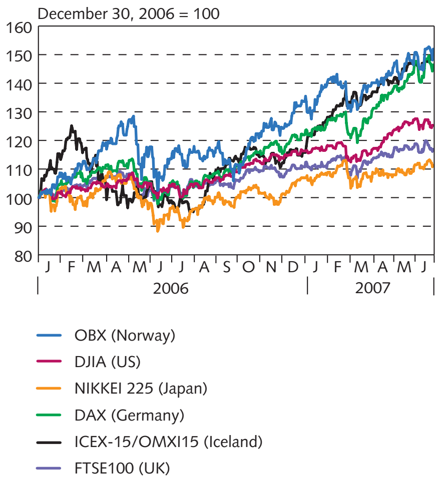
Source: Central Bank of Iceland.

Chart 8
Treasury note yields
Daily data May 22, 2006 - June 28, 2007



Source: Central Bank of Iceland.

Chart 9
Development of selected share indices
Daily data Jan 1, 2006 - June 28, 2007



Source: Reuters.

formation in them. The National Debt Management Agency (NDMA) has discontinued indexed issues and since 2006 has been buying back indexed government bonds. Retirement of foreign debt has been another Treasury focus in recent years. No sign of any change in this policy is in sight.

Measures such as market making agreements and the NDMA's securities lending arrangements enhance price formation. By stepping up its securities lending, the NDMA has boosted turnover in the market for Treasury instruments relative to the outstanding Treasury bond stock. Further depth could be added by establishing an organised stock lending market. By participating in such a market, pension funds, mutual funds and other holders of bonds could improve financial market depth, price formation and returns on their investment portfolios.

An active bond market is important not only from financial market and monetary policy perspectives. The market is also an instrument for the Treasury to procure capital. A deeper market would facilitate the Treasury in procuring prime-rate funds whenever required.

The decreasing debt of Treasuries, and thereby their decreasing issuance, raises questions about whether other players could perform the function of providing the market with risk-free interest rate paths. Asset-backed security portfolios come closest in terms of counterparty risk. Real estate is considered one of the safest forms of collateral available and securitised structures have enabled Icelandic financial institutions to achieve top ratings for such portfolios.

Yields high in spite of negative news

In spite of a temporary dip in bond yields at the beginning of June in response to news about recommendations of fishing quota cuts and the contraction in GDP, they are still higher than since *Monetary Bulletin* was published at the end of March.

Equity market

Equity prices have continued to climb. They are currently at a historical peak and no end appears to be in sight to upbeat market sentiment. International equity market prices have also risen in the recent term and have reached historical highs in Europe and the US.

In June, the oldest bank in the Faroe Islands, Føroya Bank, was listed simultaneously on the OMX Exchange in Iceland and Denmark. Listing followed privatisation of the bank by the Faroese home rule government

R&I assigns Treasury rating

The Japanese rating agency R&I announced its first credit rating for the Republic of Iceland, assigning it a foreign currency issuer rating of AA+. R&I operates primarily in the Japanese market but is also approved by the SEC in the US. Sovereign ratings set the ceiling for possible ratings by other issuers from the same country. R&I rated the Republic of Iceland on its own initiative and without this being requested by the Icelandic authorities, in connection with its rating for Kaupthing. R&I is the fourth agency to assign a rating to the Republic of Iceland. The Republic's corresponding ratings are Aaa from Moody's and A+ from S&P and Fitch Ratings.