

Financial markets and Central Bank measures¹

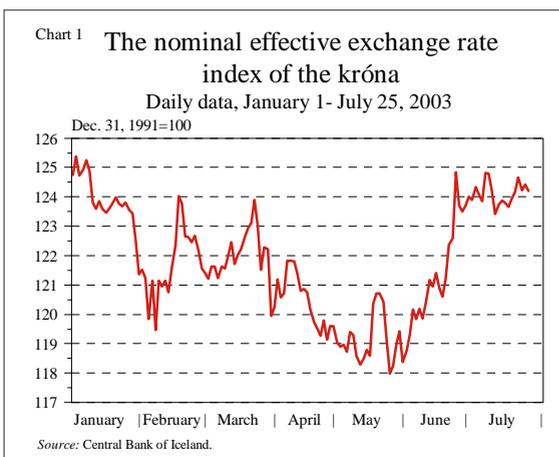
The króna weakens

The Icelandic króna weakened in May and June. This was caused by weaker currency inflows, greater outflows due to loan movements and other factors, and increased speculator activity. Increased purchases of currency by the Central Bank may also have had some effect. The exchange rate index has been close to a value of 124 so far in July. Yields decreased in the indexed bond market, driven by strong demand, and commercial banks lowered their deposit and lending rates in response. The banks' liquidity position has been adequate and interbank liquidity has been smoother than before. The interest rate differential with abroad has widened in recent months, reflecting international interest rate reductions and rising yields on Icelandic T-bills. First-half trading in equities and bonds on Iceland Stock Exchange surpassed the volume a year before and the ICEX-15 index has risen by 11% so far this year. Several companies have been delisted from Iceland Stock Exchange following mergers and acquisitions.

The króna weakened ...

After a long and more or less continuous period of strengthening, the króna began to slip as May wore on. The Central Bank's announcement that it would step up its regular currency purchases was followed by a short-lived weakening which was reversed after a few days, but after mid-June a brisk downturn wiped out virtually all the appreciation that had taken place since the beginning of the year. Since the end of June the exchange rate index has been fairly stable around a value of 124. As expectations play a large role in short-term exchange rate movements, these can be hard to explain. Among the explanations for the turnaround in May and June could be a temporary pause in various large movements which had created expectations of greater currency inflows, e.g. leveraged mergers and acquisitions. Also, uncertainty about the future of Iceland's defence treaty with the USA could conceivably have had some effect on the exchange rate in June. Another explanation could be that by mid-May the króna had simply overshot, as is

common in exchange rate fluctuations. The Central Bank stepped up its regular currency purchases in mid-May which apparently had a stronger impact as expectations of other flows in the market waned. Speculators who had taken stances in króna rapidly closed their positions when the weakening began, probably speeding up the slide. The development of the exchange rate index is shown in Chart 1.



1. This article uses data available on July 25, 2003.

... when there were fewer large movements

Over the past year, quite a number of large transactions have created expectations of major currency inflows. The bank privatisation programme spawned such expectations, despite announcements that no currency inflows were pending in connection with it. Expectations of currency inflows due to major transactions involving certain public limited companies, and in connection with hydropower and aluminium industry investments, also had a marked effect on exchange rate developments. Hitherto the real inflows on account of aluminium-related investments have only been on a small scale, but they acted strongly on the exchange rate. In the past few months there has been less news about these inflows, which has subdued the strengthening effect. The mounting deficit on the merchandise account also suggests growth in consumption which will result in an outflow, but this is countered by positive reports about fish catches and increased quotas.

The Central Bank stepped up its regular currency purchases ...

In accordance with its announcement in the last *Monetary Bulletin* in May, the Central Bank stepped up its daily currency purchases from 1.5 million US dollars to 2.5 million US dollars. The purchases are designed to take advantage of what the Bank sees as favourable conditions in the foreign exchange market for boosting the foreign reserve. Until recently a relatively large share of the foreign reserve was funded with short-term borrowing which has now largely been repaid. A stronger foreign reserve also coun-

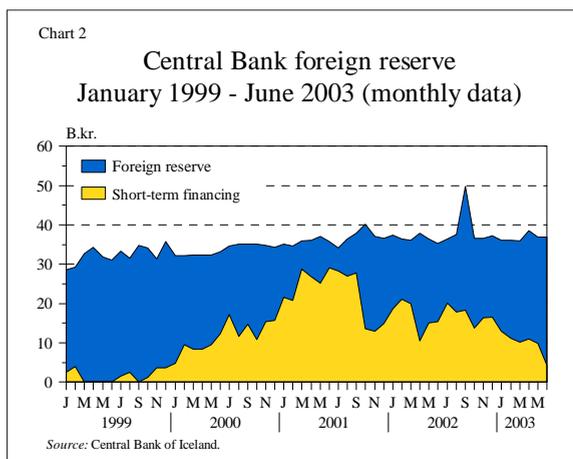
teracts concerns expressed by the IMF, credit rating agencies and others in connection with Iceland's increased external indebtedness. While public sector debt has been on the decrease for some time, private sector foreign debt has grown substantially, and since part of this consists of short-term borrowing, a larger reserve may be necessary for prudential reasons. From the start of these purchases in the beginning of September 2002 until July 25 the Bank has bought the equivalent of 26.8 b.kr. in foreign currency. The foreign reserve is expected to reach 55 b.kr. at the end of the year. The development of the foreign reserve and the financing of it are shown in Chart 2.

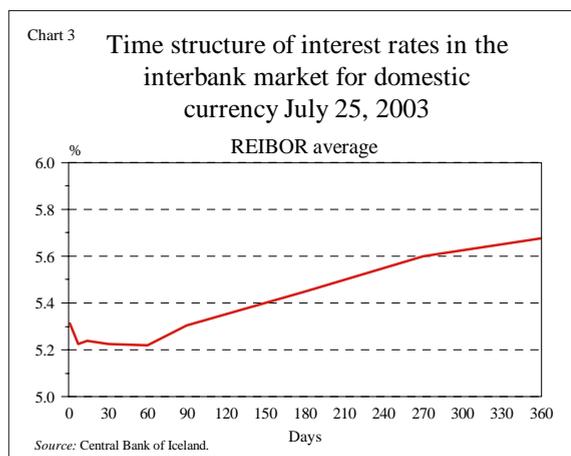
... and speculator activity increased

Foreign exchange market participants have indicated that speculators have been active in the market. Both domestic and foreign speculators have been involved, apparently including some foreign banks. Speculation can increase flows in the market and thereby make price formation smoother, but if a flight breaks out it often causes faster and more exaggerated price changes. Speculation involves buying or selling currency with the aim of profiting from expected price changes. A speculator who expects the króna to strengthen therefore buys króna in the hope of selling later for a profit. Similarly, a speculator who expects a weakening sells króna in the hope of buying them back at a lower price later. The situation is complicated by interest rates and terms for deposits and lending, both in Iceland and abroad. Speculation is often leveraged, i.e. speculators use derivatives in order to increase their exposures. While risky, this arrangement can reap large gains. The clearest evidence of speculation in the FX market was seen in the middle of June when the króna dropped sharply at the same time as T-bill interest rates surged as a result of a sudden increase in supply when speculators liquidated their domestic investments.

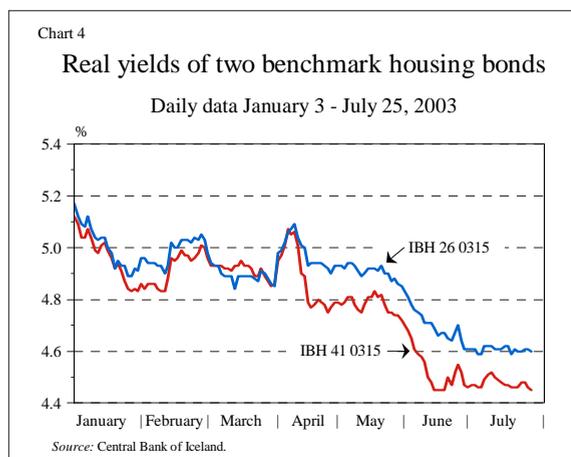
Interest rates decreased ...

Interest rates in the interbank market for domestic currency went down temporarily, for reasons including the increased liquidity produced by the Central Bank's currency purchases. For some time, interest rates on short-term króna market instruments have been fairly low relative to the Central Bank's policy rate, but expectations of a hike have affected the





longer end of the term structure, as Chart 3 shows. Buoyant demand for indexed bonds brought yields down and in June the commercial banks cut their deposit and lending rates accordingly. There has been robust demand for indexed bonds from abroad and investors have focused on housing bonds and housing authority bonds. A large proportion of these transactions are hedged against foreign exchange risk, sometimes through Central Bank repos, although investors have increasingly been seeking other hedging instruments. In some instances foreign investors assume the foreign exchange risk themselves, but statistical data do not reveal that substantial sums are involved. The yield curve for benchmark housing bonds is shown in Chart 4. In the wake of the new coalition Government's policy statement the Minister of Social Affairs announced that higher mortgage levels and mortgage amounts would be phased in by the



Housing Financing Fund over the next year years. How these ideas will be implemented has not been announced, but their conceivable economic impact is discussed in this *Monetary Bulletin*, in the Introduction and chapter on Economic and Monetary Developments and Prospects.

... and interbank liquidity has improved

The outstanding repo stock has declined in recent months. The lowering of the required reserve at the end of March is doubtless the main explanation, but the Central Bank's currency purchases are also likely to have had some effect, because when the Bank purchases currency it injects króna into the economy, thereby bolstering the commercial banks' lending capacity. Consequently, individual institutions have more scope for resolving temporary liquidity shortages by borrowing from others. Turnover in the domestic currency market in the first six months of this year was 53% higher than at the same time in 2002, and FX market turnover showed a similar trend. The outstanding repo stock had declined by more than one-fifth at the end of June compared with a year before. O/N loan use has shrunk by almost three-quarters over the first six months of this year, compared with the same period in 2002. Improved management as a result of new payment system arrangements and easier liquidity were the main factors bringing down the O/N loan requirement. Turnover in the interbank currency swap market, on the other hand, decreased by 44% during the first six months of this year compared with the same period a year before.

Table 1 New currency basket 2003

Region	New currency basket (%)	Change on previous basket (%)
USA	USD 24.73	-0.10
UK	GBP 12.35	-0.43
Canada	CAD 1.09	-0.14
Denmark	DKK 8.24	0.08
Norway	NOK 6.41	-0.37
Sweden.....	SEK 3.42	-0.06
Switzerland	CHF 1.21	-0.80
Euro area.....	EUR 39.07	1.99
Japan	JPY 3.48	-0.17

Source: Central Bank of Iceland.

Revised currency basket

The currency basket is revised annually to reflect as closely as possible the composition of Iceland's external trade in goods and services. Since external trade data only become available with some lag, the currency basket is customarily reviewed once a year, based on trade statistics for the preceding year. In recent years the weight of the euro has been increasing while the weights of the US dollar and most other countries has diminished. The new currency basket is shown in Table 1. The method of calculating the basket has been changed whereby trade with Eastern European countries apart from Russia is now assigned to the euro, because of their close links with that currency area and the planned accession by many of them to the European Union. As before, trade with Russia is equally divided between the euro and the US dollar.

Market altered by bank mergers

At the end of April a merger took place between Kaupþing banki hf. and Búnaðarbanki Íslands hf., which reduced the number of foreign exchange market participants from four to three and domestic currency market participants from seven to six. FX market participants responded by raising the indicative bid for foreign exchange trading from 1.5 million to 2.5 million US dollars. However, it is not certain that this change will be permanent, because it exaggerated price changes per trade and made participants more cautious. Further changes in market arrangements are therefore conceivable. Conditions in the domestic currency market, i.e. easy liquidity and restrictions which limit the use of credit lines, prompt the question whether the time has come to convert the interbank market for the króna from a pure interbank lending market, where the only guarantee for repayment of a loan is trust, into an interbank repo market modelled on the current format for Central Bank facilities. This would radically transform risk evaluation and the market could be expected to be both more efficient and more secure when operating under such an arrangement.

Many central banks lower their policy rates

The US Federal Reserve unexpectedly lowered its interest rate by 0.25 percentage points on June 25. In the beginning of June many central banks cut their

policy rates, e.g. the European Central Bank by 0.5 percentage points on June 5, likewise the New Zealand Reserve Bank the same day and Denmark's Nationalbanken the following day, by the same amount. Norway's Noregs Bank lowered its rate by one percentage point on June 25 and Sweden's Riksbank by 0.25 percentage points on July 4. The Bank of England and Bank of Canada cut their policy rates by 0.25 percentage points on July 10 and July 15 respectively. On July 24 the New Zealand Reserve Bank lowered its rate by a further 0.25 percentage points. The only central bank to raise its interest rates was the Reserve Bank of Australia, on June 5. Main reasons for the interest rate cuts are the slack global economic outlook and low inflation rates. Iceland's interest rate differential with abroad, measured by three-month T-bills, has widened from 2.06% at the end of April to 3.2% in the second half of July. Higher yields on the Icelandic benchmark T-bill have meant that the differential has widened by more than the equivalent of foreign interest rate cuts. Weighted by foreign interbank rates, the differential grew by less, from 2.57% to 2.96% over the same period.

Buoyant equity market

Over the first six months of this year, trading on Iceland Stock Exchange increased by 53% compared with the same period a year before, to amount to 753 b.kr. Equity trading grew by 41% and bond trading by 58%. At the end of June the ICEX-15 Index had appreciated 11% since the beginning of the year, while so far in July it has shown little change, hovering around the value 1,500. One new company listed its shares on ICEX while shares in eight companies were delisted in the first half of the year. Most of the delistings were the result of mergers and acquisitions and more companies will be delisted in the near future for this reason. At the end of June, 58 companies were listed on Iceland Stock Exchange, of which 8 were on the Alternative Market. Total market capitalisation of listed equities was 550 b.kr. at the end of June. The most bond trading was in the housing bond class IBH 41 0315, amounting to just over 100 b.kr. during the first six months of the year. Next came IBH 37 1215, amounting to 53 b.kr.