Financial markets and Central Bank measures[1]

The Central Bank raised its policy interest rate

The Central Bank of Iceland announced a rise in its policy interest rate by 0.2 percentage points on May 6, 2004. Interest rates in the money markets and bond market subsequently rose and the effect was also felt in the equity and FX markets. However, the króna has slipped slightly in recent weeks after strengthening in the first weeks of the year. One explanation has been currency outflows in connection with portfolio investments. Liquidity in the banking system has been ample and the Central Bank has mopped some of it up by issuing certificates of deposit. Interest rate movements in the interbank króna market have closely matched the Bank's policy rate, apart from the shortest-term rates, which have been quite volatile. Yields on housing bonds and housing authority bonds slid at the beginning of April when it was announced that these instruments were eligible for settlement and custody in Clearstream Banking, then rose at the end of April and again following the announcement of the policy rate rise. Equity prices have been climbing steadily.

The policy rate rise had an immediate impact

The Central Bank of Iceland announced a rise in its policy interest rate by 0.2 percentage points on May 6, 2004, which went into force on May 11. Economic developments that had unfolded by then were considered to have confirmed important assumptions in the Bank's inflation forecast from March. Agreements on the Norðurál aluminium smelter expansion had also been finalised, and indicators continued to point to ongoing growth of domestic demand and a narrowing of the output gap. The day after the policy rate announcement, the impact was felt as soon as the forex market opened – the króna strengthened by more than ½%, but slid back slightly later in the day. Interbank króna market rates rose by the same amount as the policy rate as soon as the market opened. A strong response was also felt in the bond market, with an immediate rise in non-indexed bond rates. The rise in yield on housing bonds and housing authority bonds came as a surprise. Equity prices fell as well, but it is uncertain whether this can be linked to the higher policy rate. Not all commercial banks upped their interest rates immediately after the Central Bank hike.

The króna slipped in March ...

In the second half of January the króna appreciated and the exchange rate index began to fluctuate in the range 118 to 120, which was broadly the same rate as in the middle of 2003. Expectations that the Norðurál smelter expansion would be agreed played some part, along with inflows of foreign capital in connection with leveraged buyouts. The merchandise balance was also relatively favourable at that time, and an increase in fishing quotas was expected. Outflows due to investments in foreign portfolios had a counteracting effect, as discussed below. After the publication of *Monetary Bulletin* on March 17 the króna dipped and the exchange rate index rose by more than 2% in the space of a few days. However, flows in the FX market seemed smooth and the market managed to level out fluctuations in supply and demand effectively.

1. This article uses data available on May 19, 2004.

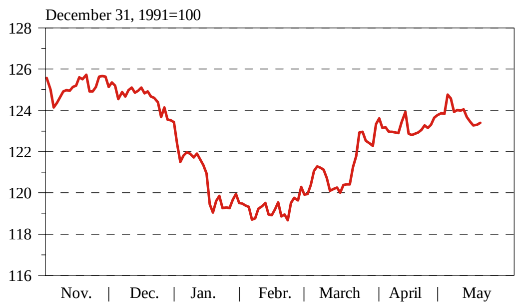
... then fluctuated within a narrow range in April and May

In April and May the exchange rate index fluctuated within a relatively narrow range between 123 and 124. On one occasion it rose to 125, then swiftly returned to its previous level. Currency flows slowed down and turnover was subdued in April. Average daily turnover was 2.7 b.kr., compared with 4.7 b.kr. during the year in 2003. The development of the exchange rate index is shown in Chart 1. Exchange rate movements have been very modest since the beginning of the year – the standard deviation of daily changes against the euro is 0.4%, but rather more (0.7%) against the US dollar. Over the same period the standard deviation for daily EUR-USD movements was 0.8% and for JPY-USD it was 0.7%, measured with the same methods. As previously reported, the Central Bank has made regular currency purchases in the domestic forex market since September 2002. Total purchases over the period are in excess of 60 b.kr. The Central Bank's net foreign reserves presently amount to 66 b.kr., compared with 26 b.kr. at the corresponding time a year before. When needed, the Central Bank sells currency to the Treasury for its foreign debt service.

Chart 1

Exchange rate index of the króna

Daily data November 3, 2003 - May 19, 2004



Source: Central Bank of Iceland.

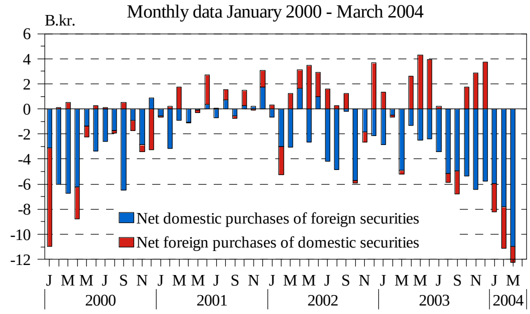
Securities trading has caused substantial currency outflows

Transactions by domestic investors with foreign securities and by foreign investors with domestic securities can have a substantial impact in the forex market. Domestic investors have often made sizeable purchases of foreign securities, for example in 2000, when net foreign investment by Icelanders amounted to 40 b.kr. Transactions by foreign investors with domestic securities have had less impact, although they have been on the increase recently. Over the 12 months to March 2004, net domestic purchases of foreign securities amounted to 62 b.kr., and net foreign purchases of Icelandic securities 10 b.kr. Thus the net balance was 52 b.kr. Chart 2 shows developments since the beginning of 2000. In Q1/2004 Icelandic investors stepped up their foreign securities purchases sharply, to almost 25 b.kr., while foreign investors made net sales of Icelandic bonds amounting to 7 b.kr. The result was a net currency outflow of almost 32 b.kr. over the first quarter.

Chart 2

Estimated net currency inflow resulting from securities transactions

Monthly data January 2000 - March 2004



Source: Central Bank of Iceland.

Liquidity has been ample ...

Following the reduction of the Central Bank's minimum reserve requirements in December 2003, credit institutions' liquidity has increased significantly. Some have even had to tackle excess liquidity. A large currency purchase by the Central Bank in the FX market in January added to liquidity even further. The impact was deferred until April by a currency swap with one (interbank) FX market maker. Regular Central Bank currency purchases have also served to increase liquidity. The redemption of a government bond category in April boosted liquidity by a further 5 b.kr., although only temporarily, because in March the Treasury issued a new T-notes class maturing in 2010. After several auctions, the class has been built up to 5.5 b.kr., thereby cancelling out the liquidity effect of the redemption. Nonetheless, it is a sign of flaws in liquidity intermediation when certain institutions may have substantial excess liquidity while others are seriously squeezed, and they do not manage to balance the position by trading with each other. The reason for this blockage is that credit institutions have only limited scope for providing each other with unsecured credit, due to the risk involved. Institutions set credit lines for borrowing by others, and when these lines are exhausted the two parties can no longer transact. Securing interbank loans with collateral would completely alter the picture, by confining the risk to changes in the price of the underlying collateral, which is a mere fraction of the total risk under the current arrangement.

... and the Central Bank has issued certificates of deposit

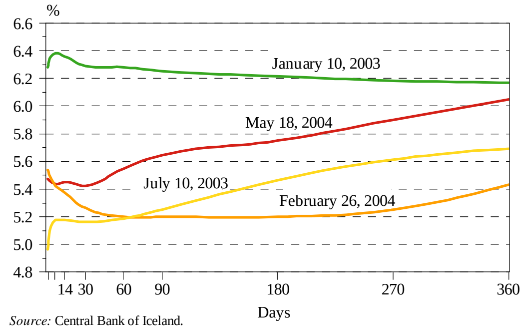
To facilitate normal price formation in the interbank market, the Central Bank has offered certificates of deposit (CDs), as described in *Monetary Bulletin* 2004/1 in March. In the beginning of April, CD issues hit a spike when their outstanding stock went up to 10 b.kr. or more for a period of several weeks. Among the reasons were the government bond redemption and the expiry of the currency swap agreement. An innovation was made in mid-May with the first repo agreements between credit institutions, a new market instrument that reduces the need for Central bank facilities. As a result, the stock of outstanding Central Bank repos and CDs declined. The weekly position is shown in Chart 3. New rules on transactions with the Central Bank by credit institutions subject to minimum reserve requirements have shortened the maturity of repos and CDs from 14 to 7 days, thereby eliminating the one-week overlap that has caused problems in liquidity management. The change goes into effect on June 1, 2004.

Volatile short-term rates in the króna market

Some volatility has been felt in the shortest (i.e. overnight) rates in the interbank króna market. Fluctuations are generally connected with the end of reserve requirement periods, but they have also been noticed in the wake of Central Bank actions, probably due to imperfect information about the total market position. Rates of one week and more have been more stable, but the yield curve has altered in recent weeks, driven by expectations of rises in the Central Bank policy rate, as Chart 4 shows. Chart 5 shows interest rates in the króna market for different maturities. Trading has been fairly brisk in the interbank króna market, but currency swaps have

Chart 4

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

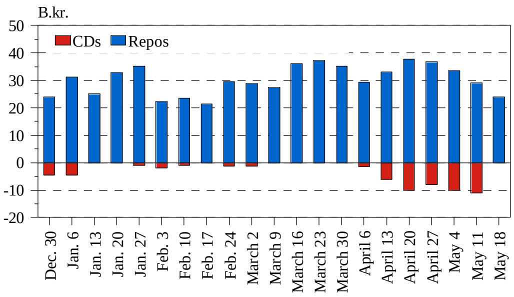


Source: Central Bank of Iceland.

Chart 3

Outstanding stock of Central Bank repos and CDs

Weekly data December 30, 2003 - May 18, 2004

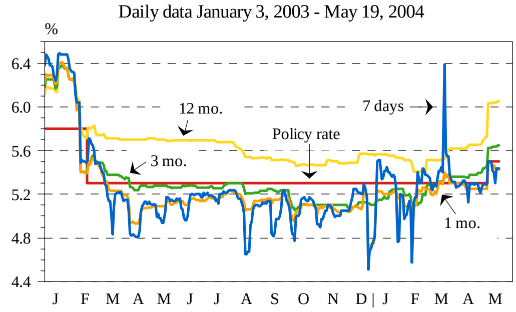


Source: Central Bank of Iceland.

Chart 5

Interest rates in the interbank króna market and the policy interest rate

Daily data January 3, 2003 - May 19, 2004



Source: Central Bank of Iceland.

been on the low side recently. Improved payment system management has pared down the need for Central Bank overnight loans with penalty premiums, but problems did occur in the payment system following changes made by the Icelandic Banks' Data Centre in February.

Interest-rate differential has widened after the policy rate hike

The interest rate differential between Iceland and main trading partner countries widened after the policy rate hike. On March 8, the differential (as measured by 3-month treasury bills) was 3.24 percentage points, but on May 18 it had stretched to 3.43 percentage points. The interbank market differential has widened by rather less, from 3.02 percentage points to 3.10. Table 1 shows policy interest rate changes in selected countries in recent months. A number of central banks are still lowering their policy rates while others are raising them in keeping with the rather more upbeat economic outlook at present. Rising oil prices in recent weeks could mar the prospects, however. Inflation expectations, measured as the spread between yields on non-indexed and indexed bonds, are currently 3.5% on a five-year horizon but 2.34% two years ahead.

Table 1 Changes in central bank policy rates in selected countries, January - May 2004

Date of change	*Central Bank*	*Changes % (policy rates after changes)*
Jan. 20, 2004	Bank of Canada	-0.25 (2.5%)
Jan. 28, 2004	Norges Bank	-0.25 (2.0%)
Jan. 29, 2004	Reserve Bank of New Zealand	+0.25 (5.25%)
Feb. 5, 2004	Bank of England	+0.25 (4.0%)
Feb. 6, 2004	Sveriges Riksbank	-0.25 (2.5%)
March 2, 2004	Bank of Canada	-0.25 (2.25%)
March 11, 2004	Norges Bank	-0.25 (1.75%)
April 1, 2004	Sveriges Riksbank	-0.5 (2.0%)
April 13, 2004	Bank of Canada	-0.25 (2.0%)
April 29, 2004	Reserve Bank of New Zealand	+0.25 (5.50%)
May 6, 2004	Bank of England	+0.25 (4.25%)
May 6, 2004	Central Bank of Iceland	+0.20 (5.50%)

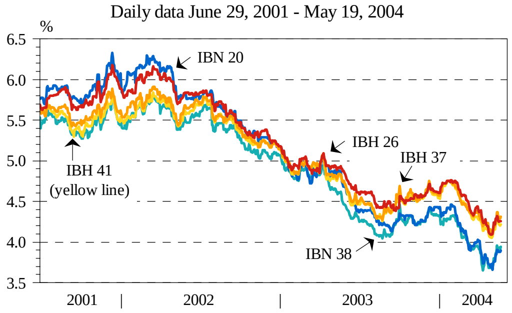
Yields on housing bonds and housing authority bonds hit a low in April

The housing bill presented to parliament in March was broadly in line with proposals from a Ministry of Committee which were announced at the end of last year. In an opinion submitted to parliament about the draft bill, the Central Bank criticised it for shelving the committee's proposal that a premium should be charged on prepayments of mortgage bonds in order to protect the Housing Financing Fund against possible financing problems as a result. At the beginning of April it was announced that benchmark bonds would become eligible for settlement and custody with Clearstream Banking. Yields on housing bonds and housing authority bonds have gone down significantly in recent months and they dropped sharply when the agreement with Clearstream was announced. For a while, housing authority bond yields were roughly the same as or lower than those on the longest class of government bonds. Housing bond yields have been somewhat higher – the difference reflects uncertainties about the planned swap with the new Housing Financing Fund bonds in mid-year. Chart 6 shows the yield development for several classes of housing bonds and housing authority bonds. Over the first quarter of this year, the value of approved bond swaps (of mortgage bonds for housing bonds) by the Housing Financing Fund was somewhat higher than in Q1/2003.

Chart 6

Yields on housing bonds and housing authority bonds

Daily data June 29, 2001 - May 19, 2004



Source: Central Bank of Iceland.

New primary dealers for National Debt Management Agency

The Treasury's borrowing requirement has shrunk in recent years. Treasury issues have focused to some extent on leading market evolution, for example with issues of long non-indexed instruments and regular issues of bills that play an anchor role in price formation. To coincide with the government bond redemption in April, a new class of T-bills was launched with a maturity date in 2010, to bridge the gap between existing issues maturing in 2007 and 2013. Six credit institutions now act as primary dealers in T-bill market making under agreements that were renewed in May. Participation in National Debt Management Agency offerings and access to bond loans is restricted to primary dealers. They are obliged to present indicative buying and selling bids on Iceland Stock Exchange, within specified price limits, for 60 m.kr. in each class. If a bid is accepted, they must renew it. A primary dealer that has traded for more than 360 m.kr. on a given business day is allowed to exceed the maximum spread between buying and selling bids.

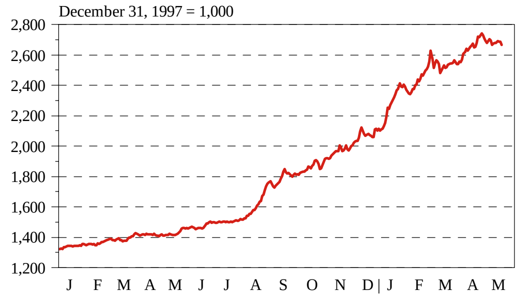
Equities still climbing

Equity prices have climbed sharply so far in 2004. From the beginning of the year to mid-May, the ICEX-15 index gained 26%, after slipping back from the record value it reached in late April. Over the past 12 months the ICEX-15 index has risen by 88%. The development of the index is shown in Chart 7. The construction and contracting index has increased the most since the beginning of this year, by 87%, and pharmaceuticals the least, by 0.33%. The twelve-month rise in the pharmaceuticals index has been 131% and in construction and contracting 128%. Over the same period, the fisheries index has gained the least, or 9%. Three fewer companies are now listed on ICEX than at the beginning of the year. Market capitalisation of listed companies remains buoyant, however, led by soaring prices of shares in specific companies.

Chart 7

The ICEX-15 equity price index

Daily data January 1, 2003 - May 19, 2004



Source: Iceland Stock Exchange (ICEX).