

## Financial markets and Central Bank measures<sup>1</sup>

### Lively trading in the markets

Domestic markets have witnessed lively activity since the last Monetary Bulletin was published in November 2006. The ICEX-15 index has risen by 17% so far in 2007. Most listed companies reported strong profits last year, and some made record profits, led by the three commercial banks with combined profits of 167 b.kr. Illiquidity was felt in the money market, which now appears to have normalised after an increase in the types of bonds eligible as collateral for Central Bank facilities. Glacier bond issuance continued and, for the first time, an issue was managed by a domestic financial institution. A change in the rules on transactions with the Central Bank may have been instrumental in that development. Yields on indexed and nominal bonds have been volatile. A cut in VAT at the beginning of March drove up yields on indexed bonds sharply and they are still higher than in November. The króna depreciated somewhat until the end of 2006 but has since climbed back to broadly the same rate as when Monetary Bulletin was published in November.

#### Even wider interest rate differential with abroad

The Central Bank has raised its policy rate by 0.25 percentage points since the last *Monetary Bulletin* was published in November 2006. The Bank of England and the Bank of Japan have raised their policy rates by the same amount and the European Central Bank by 0.5 percentage points, while the US federal funds rate has been unchanged since last summer. The interest rate differential with abroad narrowed slightly, from just below 10 percentage points at the end of October to the current 9.2 percentage points as measured by three-month interbank rates.<sup>2</sup> Conditions for carry trading have remained favourable but have deteriorated marginally in terms of the interest rate differential alone, mainly because of lower rates in domestic money markets.

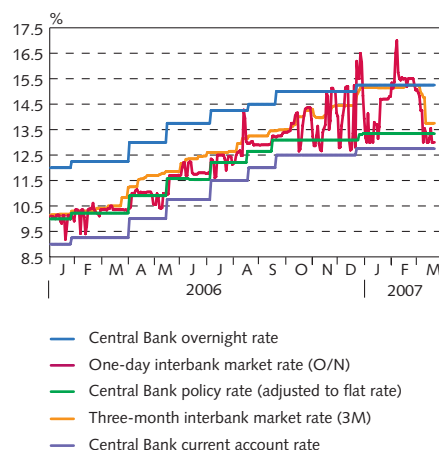
#### Liquidity squeeze in the money market

Repeated illiquidity was noted in the domestic money market since November. Interest rates there often exceeded the Central Bank's overnight rate, impeding efficient market functioning. Several inter-related factors were at work, but the most decisive was the Treasury's substantial deposits in the Central Bank. The balance on the Treasury's current account has grown steadily over the recent term and now stands at 90 b.kr., not including a time deposit of 32 b.kr. representing the proceeds from the privatisation of Iceland Telecom in 2005.

Limited Treasury note issues and dwindling issues of Housing Financing Fund (HFF) bonds in the wake of structural changes in the mortgage market have reduced domestic financial institutions' holdings of bonds that are eligible as collateral for transactions with the Central Bank. In response, the Central Bank decided to accept as collateral króna-denominated bonds that are registered in foreign settlement systems or issued by non-residents (glacier bonds). It was decided to interpret the rules on transactions with the Central Bank so as to enable a foreign issue larger than 20 b.kr. to be eligible to have

Chart 1  
Interest rates in the interbank market  
and Central Bank policy rate

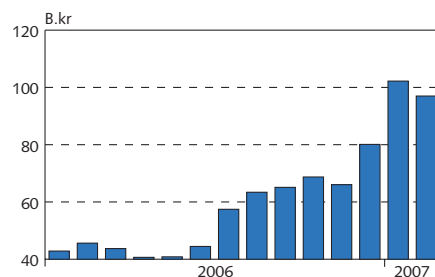
Daily data January 3, 2006 - March 23, 2006



Source: Central Bank of Iceland.

Chart 2  
Treasury current account in the Central Bank

Monthly data, January 2006 - February 2007

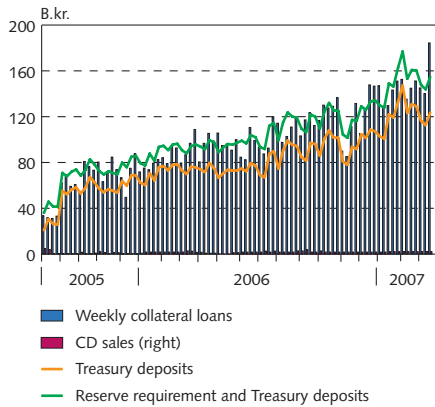


Source: Central Bank of Iceland.

1. This article uses data available on March 23, 2007.

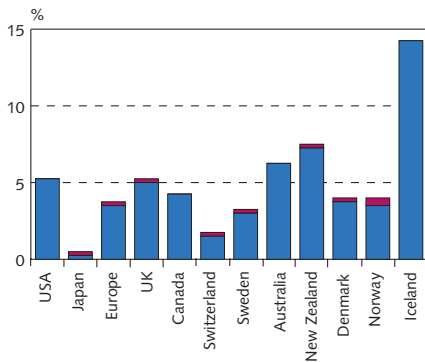
2. Trade-weighted foreign interest rates.

Chart 3  
Weekly collateral loans, CD sales, Treasury deposits and reserve requirement  
Weekly data August 9, 2005 - March 20, 2007



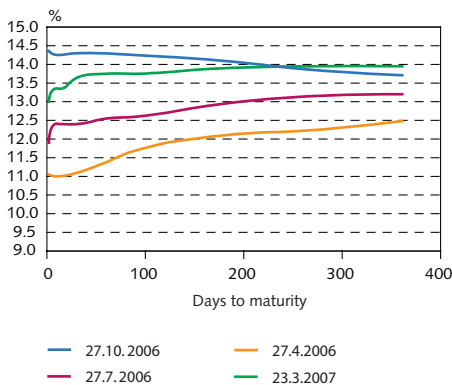
Source: Central Bank of Iceland.

Chart 4  
Increases in selected central banks' policy interest rates since the beginning of 2006<sup>1</sup>



1. The red part of the column shows the increase from the beginning of the year. The policy rate varies between countries and can refer to either lending or deposit rates and show either yield or nominal rate.  
Source: Central Bank of Iceland.

Chart 5  
Yield curve on money market



Source: Central Bank of Iceland.

a market maker, provided that indicative buying and selling bids are posted on systems such as Bloomberg. The interbank money market normalised following this measure. In recent months the banks have increased their borrowing from the Central Bank, at one point reaching a high of 184 b.kr.

### Increased position-taking in the króna

Issuance of glacier bonds has continued apace, with foreign issues since November 2006 totalling some 119.5 b.kr. A single 40 b.kr. issue by the Dutch bank Rabobank accounts for more than a third of that total. Nearly 32 b.kr. matured from then until the end of March 2007, boosting the net glacier bond position by 87.5 b.kr. over that period. For the first time since issuance of glacier bonds began, a domestic bank managed such an issue when Landsbanki placed and underwrote 25 b.kr. for the Austrian Treasury. A large portion is likely to remain held by Landsbanki or sold on to residents. If so, the issue marks something of a turning point, because virtually all glacier bonds issued so far are owned by non-residents. Icelandic banks have more incentive to acquire glacier bonds after they were made eligible as collateral for Central Bank facilities.

Since the end of October the commercial banks' foreign forward contract exposures have continued to grow. By the end of February they had risen by 147 b.kr. to 612 b.kr., so it is clear that foreign investors are adding to their already large long positions in the króna. Added to this are foreign investors' Treasury bond holdings and the current account deficit, which reached a record 305 b.kr. in 2006.

Such an exposure is very large relative to the size of the Icelandic economy and market. There is a growing risk that investor sentiment towards the króna could cause substantial exchange rate volatility. Sudden investor flight from the króna could be sparked by events utterly unrelated to conditions in the Icelandic economy or among Icelandic corporations. This could take the form of instability in the equities market, which would first affect exchange rates and then prompt investors to close their positions on a large scale. There were hints of such a phenomenon in late February and early March, when share prices plummeted in all markets, low-interest currencies such as the yen appreciated and high-interest currencies weakened.

Responses in the króna market are determined by the diversity of the investor group holding króna-denominated instruments in their portfolios. An informal survey indicates that 30-40% of investors in the króna are money market funds and hedge funds that, in general, invest for short periods of time and are highly mobile. The remainder are investment funds that take a long-term perspective and are less quick to open and close their positions. Impulsive investors and herd mentality in the market could pose the risk of volatility in the króna.

### Lively FX market

The FX market has been lively since the end of October, when the exchange rate index stood at 118.7 after strengthening steadily for several months. The index reached a high of 130.3 on December 22, the day that Standard & Poor's announced its downgrade of the Republic

of Iceland's issuer credit rating. The króna rallied by almost 3.5% before the end of the year but slipped again when debate about Icelandic companies switching their accounting currency to the euro from the króna came to the fore. By the end of February, however, the króna had surpassed its strength at the end of October. Contagion from late February's sharp drop in share prices in China seems to have catalysed the depreciation of the króna in February-March. This appears to have been a temporary adjustment, however, rather than a lasting downturn in sentiment.

### Foreign reserves bolstered

In November 2006 the Icelandic government launched a measure aimed at boosting the Central Bank's foreign reserves. It was financed with a €1 billion five-year Eurobond issue. The entire amount of the borrowed funds was deposited in the Central Bank and invested in a euro portfolio with a similar maturity, in keeping with the rules on foreign reserve management.

Domestic financial markets have changed profoundly in the past several years. Iceland's financial institutions have expanded by leaps and bounds and foreign investors are much more active in króna trading. In view of these factors and the ratings companies' concerns about tight foreign liquidity, it was decided to respond by bolstering the foreign reserves. The reserves expanded by 90 b.kr. as a result of this measure, from 70 b.kr. to 160 b.kr.

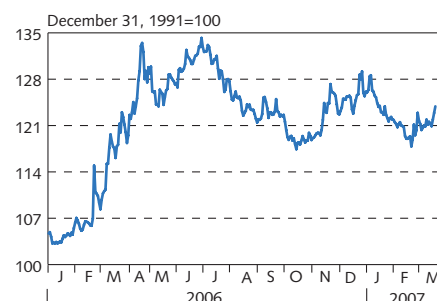
In recent years, the Central Bank's regular currency purchases in the market have been used almost exclusively to service the Treasury's foreign debt. The Central Bank intends to continue to buy currency on same scale, at 6 million US dollars a week. It is likely that the Central Bank's reserves will match all of the Treasury's foreign liabilities just after mid-2007.

### Bond market

The domestic bond market is challenged by its small size. Treasury issues are scant and are not required for funding purposes in the current strong fiscal position. Outstanding Treasury note issues are small and their price formation is inefficient. Yields on nominal instruments therefore show sharp day-to-day volatility relative to comparable issues in other countries. The lifetime of the longest outstanding bond is currently only six years.

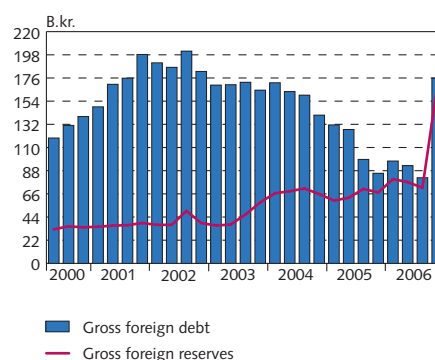
Treasury instruments perform a major function in all economies. They provide a benchmark for risk-free investments to which a premium is added to evaluate other investments. Given the strong fiscal position, issuance is unlikely to be stepped up in the near future. This is regrettable, because an adequate supply of Treasury notes deepens the nominal bond market and is an important precondition for efficient monetary policy transmission across the yield curve. Norway and Australia are two examples of countries in a strong fiscal position where Treasury issues have nonetheless been continued with the aim of contributing to a reliable yield curve and normal market interest rate formation. Other things being equal, a market presence also ensures smoother access to credit should the need arise.

Chart 6  
Exchange rate index of the króna  
Daily data January 3, 2006 - March 23, 2007



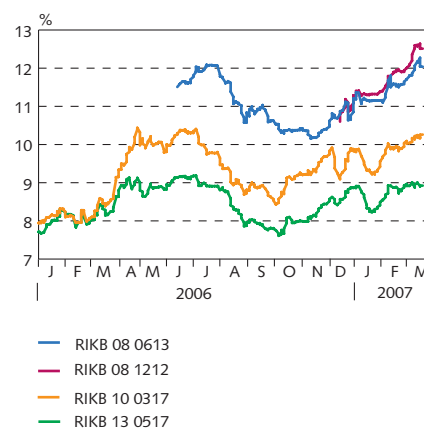
Source: Central Bank of Iceland.

Chart 7  
Gross reserves and gross central government foreign debt  
Quarterly data, Q2/2000 - 2006



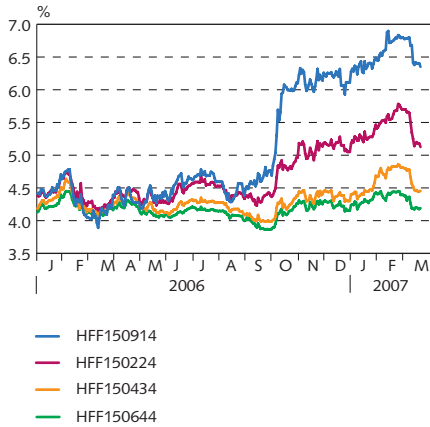
Source: Central Bank of Iceland.

Chart 8  
Treasury note yields  
Daily data January 3, 2006 - March 23, 2007



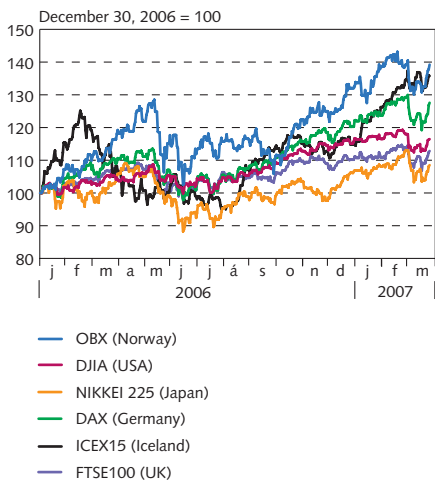
Source: Central Bank of Iceland.

Chart 9  
HFF bond real yields  
Daily data January 3, 2006 - March 22, 2007



Source: Central Bank of Iceland.

Chart 10  
Development of selected share indices  
Daily data December 30, 2005 - March 23, 2007



Source: Reuters.

Muted demand for two-year Treasury notes in the National Debt Management Agency's February auction can presumably be attributed to the tax cuts. The small size of T-note issues may also dampen investor demand. Demand for króna-denominated bonds is ample, judging from glacier bond issues in recent months. The Treasury retired T-notes that matured in early February in the amount 20 b.kr., reducing their supply in the market even further.

Bond supply is likely to be boosted by the Austrian Treasury's glacier bond issue, which should drive up yields on nominal Treasury notes, as well as enabling smoother monetary policy transmission over the next months. Since their maturity is only one year, however, further issuance is clearly required to support monetary policy transmission across the entire yield curve.

Bond yields have risen substantially since the government's announcement of a cut in value-added tax (VAT) on food and other goods. Real yields rose somewhat as soon as the government made the announcement, and they continued to climb until the beginning of March, when the changes took effect. By that time, HFF bond yields had risen by 0.25-0.85 percentage points, most sharply at the shortest maturity. HFF bond yields fell slightly afterwards.

### Equity market

Equity prices turned downward from October until the end of November, but since then they have risen virtually unchecked. The ICEX-15 index stood at 6,400 at the beginning of the year. In January it broke the 7,000 barrier and set a new record. Since then the index has risen even further and is now at 7,500, a 17% increase since the beginning of the year.

The majority of listed companies reported record profits last year, led by the three commercial banks, which returned combined profits of 167 b.kr. Together, the three banks constitute 59.1% of the ICEX-15 index.