

Financial markets and Central Bank actions¹

Further strengthening of the króna, lower interest rates

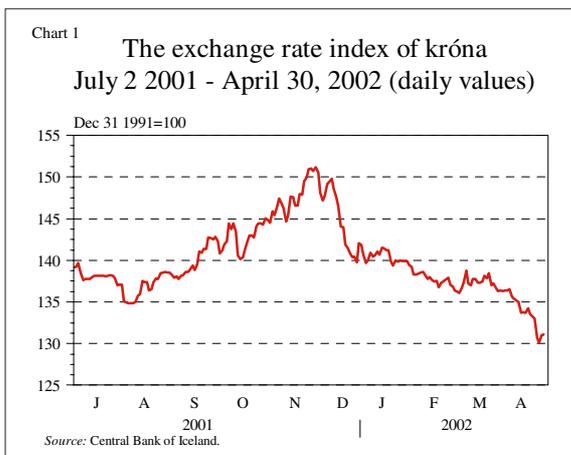
From the end of January to the end of February the exchange rate of the króna strengthened steadily. A short-lived drop occurred then, but in March the exchange rate changed little. As April progressed the exchange rate strengthened substantially, which in part is attributable to speculation. At the end of April the exchange rate index had gone down (i.e. the exchange rate strengthened) to roughly 130 from 140 at the end of January, or more than 7% over this period. Since the Central Bank did not conduct any trading in the foreign exchange market at this time, it was clear that a considerable net inflow of currency took place, generally without large movements in price although occasional bursts occurred towards the end of April. Interest rates in the interbank market for domestic currency dropped significantly after the middle of March, partly as a result of measures by the Central Bank and treasury, although other events also had a considerable effect. Central Bank repos reached a new high in mid-March, then dropped again after liquidity improved following heavy redemption of government bonds at the beginning of April. The bond market has been ticking over reasonably well and the equity market has rallied.

Foreign exchange market on a smooth upward trend...

At the end of January the exchange rate index was around 140 and a period of further strengthening of the króna ensued. The strengthening lasted until the beginning of March, with the occasional weakening between days. Currency flow was quite steady and there was more often ample currency than not; figures for the merchandise balance confirm that exports exceeded imports during the first months of this year. Investment in foreign securities was also moderate. The market appeared to take a calm view of the postponement of the planned privatisation of Iceland Telecom and other events seem to have little effect on the mood of the market. In the first half of March the market wrestled with a major investment linked to foreign exchange trading and the króna gave way for a while, but rallied afterwards. It

strengthened further even after the Central Bank's interest rate cut. Publication of figures for foreign trade in February may have more than compensated for the negative impact that, all things being equal, the interest rate reduction should have had. Reports of the proposed government guarantee for a loan that deCode Genetics intends to take to set up a new pharmaceuticals development company served to bolster the króna in the beginning of April and so did expectations of a modest change in the pending CPI announcement in mid-April. These expectations were borne out and the exchange rate of the króna strengthened even further in consequence, although certain players seized the opportunity and wound up their derivatives deals at a suitable juncture. In mid-April the market bounced back, the króna strengthened and the exchange rate index dipped below 129 in the afternoon of April 24. Fairly sharp movements took place in the market on individual days. The change on April 24, for example, was more than 2% at its highest point, although this was for the most

1. This article uses data available on April 30, 2002.



part cancelled out. Trading that day amounted to more than 16 b.kr., the highest daily figure since the beginning of the year. The exchange rate was fixed at 130.13 on Friday, April 26. It is thought that there were two reasons for the strengthening of the currency in the second half of April. One was that exporters who had been keeping hold of their export revenues apparently felt that they were missing out on high currency prices, and wanted to snap up profits in Icelandic currency, and the other was that some foreign investors were seen taking advantage of the favourable interest rate differential between Iceland and abroad to profit from short-term fluctuations. On April 30 the exchange rate index stood at 131.09, having gone down by 6.3% since January 30. Such a low index value cannot be seen until as far back as April 27, 2001. The Central Bank did not conduct any trading in the foreign exchange market over the period from the end of January to the end of April, but in the middle of February, March and April currency swaps matured which the Bank had made with Búnadarbanki Íslands hf. in December 2001. All these swaps have now matured. Chart 1 shows the development of the exchange rate index since the middle of last year.

Interest rates came down ...

Interest rates in the interbank market for krónur remained abnormally high for quite a long period after the Central Bank reduced its policy rate in November. Overnight interest rates in the interbank króna market were in some cases higher than the Central bank's rates, suggesting that something was

New rules on collateral for securities in repurchase agreements

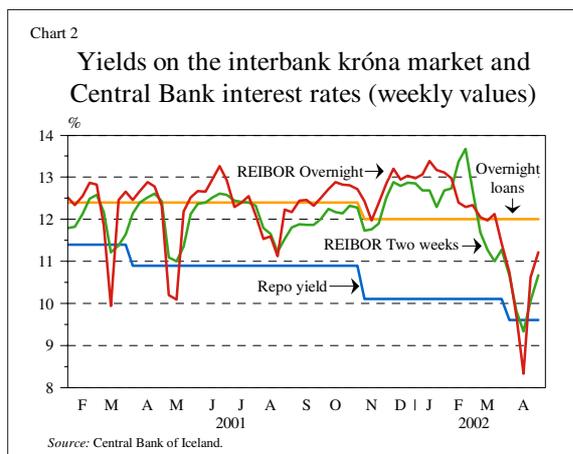
On March 5, 2002 the Central Bank of Iceland announced plans to change which securities qualify for repurchase agreements. The main principle of the rules is that bonds will be usable as collateral for repurchase agreements, if they fulfil the following conditions:

1. Bonds shall be issued denominated in Icelandic krónur.
2. The issued market value of the bond category shall be greater than 3 b.kr. and confirmation shall be at hand that this quantity has been sold.
3. The issuer shall have a credit rating from one of the following three rating agencies: Standard & Poor's, Moody's or Fitch, and a long-term rating of A- or better as awarded by Standard & Poor's and Fitch, and A3 or better from Moody's.
4. Bonds carrying treasury guarantees shall be evaluated as if issued by the treasury.
5. Bonds shall be covered by market making agreements at Iceland Stock Exchange or a comparable institution.
6. Bonds shall not be subordinated, nor will the issuer be allowed to use his own securities in transactions with the Central Bank.
7. In order to avoid excessive disruption to the conditions of issued categories which already qualify for repurchase agreements, these will continue to qualify for repurchase agreements for as long as they are covered by market making agreements at Iceland Stock Exchange or a comparable institution.

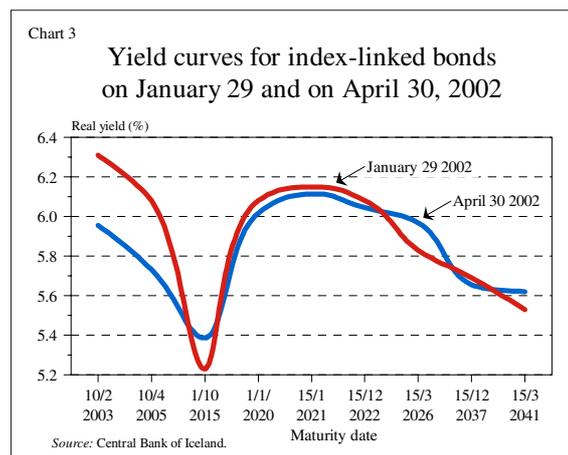
It is proposed that this rule shall take effect from June 1, 2002.

amiss. In the beginning of March the Central Bank announced that rules on the instruments qualifying as collateral security for its repo transactions would be changed (See Box) Subsequently, interbank interest rates dropped significantly. The commercial banks announced their own interest rate cuts around the

middle of the month, which also had some effect, and so did the policy rate cut of 0.5 percentage points that the Central Bank announced on March 26, effective from April 1. Interest rates on overnight lending remained unchanged, while the Bank's other rates were brought down in line with the cut in the repo rate. The decisive factor in the interbank market, however, was probably large-scale redemption of government bonds, because the treasury took an 8 b.kr. short-term foreign loan which was converted into krónur to meet the redemption. Liquidity thereby improved substantially and the impact was reflected at first in interbank market interest rates, and later in a drop in repo transaction volume with the Central Bank. This enabled deposit institutions to deposit large amounts of funds in their required reserve accounts with the Central Bank at the beginning of the month, and fulfil their reserve requirement well before the end of the reserve period. As soon as the new reserve period began (on the 21st of each month) interest rates in the interbank market for domestic currency began to rise again. Chart 2 shows the development of overnight and two-week rates in the interbank market for krónur, and Central Bank interest rates on loans of the same duration. Yields in the bond market also dropped markedly, e.g. the yield on non-indexed treasury bonds with a maturity in 2007 fell from 9.31% at the end of January to 8.44% at the end of April. Yields on shorter indexed bonds also came down considerably while yields on those with a medium or longer maturity have changed relatively little. Investors have probably



looked towards short-term indexation to some degree because of inflation expectations, spurring demand for shorter indexed instruments which raised their price and thereby cut their yield. Chart 3 shows the development of the interest rate spectrum for indexed bonds at two points in time.



... and liquidity blockages burst

Considerable inconsistencies were noticeable in interbank interest rates ever since March last year, increasing in November and continuing until March this year. Over this period, the earlier correlation with the Central Bank's policy rates dwindled. These inconsistencies have been explained by blockages in liquidity intermediation and flaws in the trading framework for Icelandic krónur, rather than by general liquidity shortages in the market. While occasional institutions have been short on liquidity, others have not. Limited credit lines between banks and conceivable reluctance to finance rivals' expansion may explain why liquidity does not flow between institutions. Certain questions arise when credit institutions keep their liquid funds on current accounts with the Central Bank at a much lower rate of interest than was offered for a while in the interbank market for krónur. As mentioned above, this situation lasted until mid-March, but it was clear that reports about the Central Bank's planned changes to its rules about which securities qualify as collateral for repos (even though these were not supposed to take effect until June 1) spurred interest rate cuts in the interbank market. In the wake of reductions by the commercial banks and later the Central Bank, interest

rates came down even further, and the measures to finance the government bond redemption in April reinforced the availability of ample liquid funds through that month.

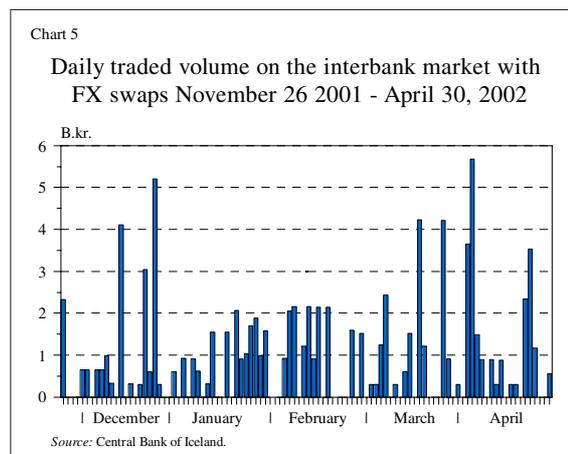
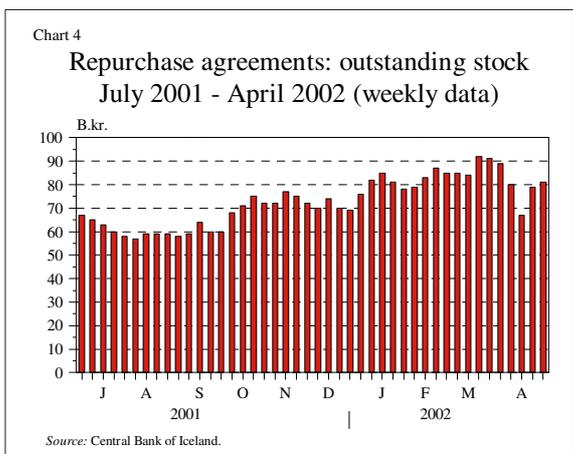
Repo transactions serve to level out fluctuations

Access to repurchase agreements has been unrestricted, but it appears that access to securities that qualify as collateral for them has been limited. The stock of instruments that qualify for repurchase agreements amounts to about 250 b.kr., of which just over one-third was used to that end. The Central Bank has regarded the purpose of repurchase agreements as levelling out fluctuations in credit institutions' liquidity, and the Central Bank's policy interest rate is based on repos being a marginal source of funding which is priced so high that credit institutions use it solely for this purpose. Through its policy rate, the Central Bank exercises a direct and indirect impact on the level of interest rates which are later transmitted to prices. However, credit institutions appear to take advantage of Central Bank funding in other ways, for example as derivatives instruments and to finance lending. Such funding is not risky, however, since it serves to hedge against currency risk and thereby, in effect, to reduce a risk which would otherwise act as a brake upon business. Iceland's small and concentrated finance market may hinder activities that ought to take place in the above instances. Thus there may be grounds for examining whether other channels are open for allowing market forces to determine the aspects of derivatives trading that hith-

erto have been funded with Central Bank repos. As described in the last *Monetary Bulletin*, the increase in repurchase agreements has been well in line with interventions in the foreign exchange market, increases in reserve deposits and the treasury's impact on domestic liquidity. The Central Bank has therefore neutralised its own negative effect on the króna position in the market, but without pouring liquidity into it. This can clearly be seen from the development of base money, which has fluctuated somewhat but invariably returned to the same course. The repo stock with the Central Bank was in the range 80-85 b.kr. until the middle of March, but after that it rose beyond 91 b.kr. for two weeks. Part of the explanation for this temporary increase was the strong balance on the treasury's current account with the Central Bank, but derivatives trading by credit institutions also exerted some effect. The repo stock dropped again and by mid-April it was around 66 b.kr., following the loan taken by the treasury to finance the bond redemptions, and because of the credit institutions' good position on their tied accounts. The outstanding repo stock on April 30, however, was 80.7 b.kr. Chart 4 shows the repo stock after weekly auctions since mid-2001.

Brisk trading in the interbank market for currency swaps ...

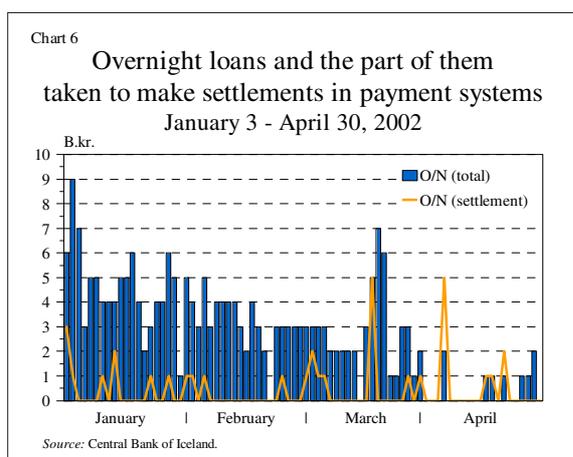
Formal rules on the interbank market for currency swaps were set by the Central Bank's Board of Governors on March 8 and took effect on March 15, 2002. Brisk trading in this newest market clearly



shows that its establishment was warranted. As expected, its operation had a substantial effect on the indicative value of interest rates in the króna market for longer periods than one week, making it an important supplement to information on expectations and developments. Chart 5 shows daily trading in this market since its commencement on November 26, 2001.

... and use of overnight lending diminished greatly when ample liquidity became available

The use of overnight loans with the Central Bank increased sharply towards the end of last year, and a continuation to this trend could be noticed during the first weeks of this year. However, this changed in the beginning of April and Central Bank overnight lending has been little used recently, since interest rates on such facilities have remained unchanged while others have gone down. There has also been a marked decrease in the volume of overnight lending which is liable for penalty interest when the current account deposit is insufficient to cover payment settlements - this is almost certainly connected with the liquidity position, although reforms in payment intermediation may also enable credit institutions to improve the management of flows through their current accounts. Payment system reforms are in progress, which will intermeditation reforms which will eliminate liability for penalty interest on overnight lending, and underline instead that credit institutions engaged in transactions with the Central Bank should pay attention to their liquidity positions



and manage them in such a way as to avoid problems. Chart 6 shows the development of overnight loans and the part of them taken to make settlements in payment systems. On specific days, the overnight loans taken for payment system settlements are higher than the total overnight lending for that day, which is explained by the fact that overnight loans taken on a Friday are also regarded as extending over the weekend, in which case they count triple.

Most central banks have held back

The interest rate differential between Iceland and abroad, measured in the development of three-month treasury bills, has decreased somewhat since the end of January. The differential was 6.8 percentage points then, but 6 percentage points at the end of April. The main reason for this decrease was that Icelandic bills came down from 9.84% to 9.13%, while foreign bills rose marginally. Apart from Sweden, Canada and New Zealand, central banks around the world have held back on interest rate changes. The Central Bank of Sweden raised its policy rate by 0.25 percentage points to 4% on March 19, and the following day the Central Bank of New Zealand raised its interest rates by the same amount, to the present 5%. The Central Bank of Sweden put its rates up again on April 26, by 0.25 percentage points. The Bank of Canada raised its policy interest rate by 0.25 percentage points on April 16 and it now stands at 2¼%.

The bonds market is ticking over ...

Trading in the bonds market was volatile over the period from the end of January to the end of April, but averaged almost 2 b.kr. a day. Housing bond issues have declined because of less demand in the market, although this has caused little change in their prices. Better balance in supply of long bonds can be expected in the near future as a result. Conceivably, changes to Central Bank rules on which instruments qualify as collateral for repo transactions may lead to expansion or merger of issues by institutions which have a higher credit rating than the reference limit stated there.

... and equity market trading has been steady and brisk

A major turnaround has taken place in the equity market. Prices have been fairly stable and the

ICEX-15 index has been around 1,300 points for some while, which is approximately 12% higher than the end-of-year value for 2001 and more than 30% up on than the low reached in August last year. It is clear that changes to the tax law have had a significant impact on profitability of Icelandic businesses which, coupled with the abolition of inflationary accounting principles, will exert a further effect this year. Prospects look fairly bright in export sectors, but less so in retail and service. Under new laws, Icelandic businesses may now enter their annual accounts in foreign currencies. A number of companies which have a substantial proportion of their revenues and costs outside Iceland have stated their intention to take advantage of this authorisation. Chart 7 shows the development of the ICEX-15 index since the beginning of the year.

