

Financial markets and Central Bank measures¹

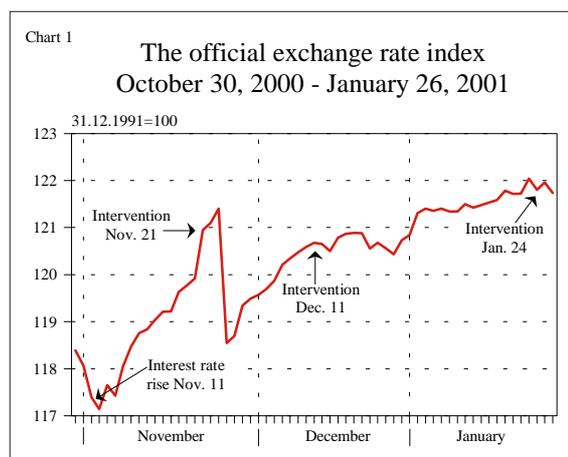
Króna on a slow slide despite tighter stance

Despite the Central Bank's rise in its policy rate at the beginning of November and its measures in the market, the exchange rate index continued to rise (i.e. the króna weakened). From November 1 to January 26 the index rose by 3.7%. The interest rate differential with abroad was virtually the same at the beginning and end of the period, although some changes took place in between. Domestic interbank trading decreased and interest rates rose. Market participants opted for Central Bank repo transactions and intraday loans rather than trading with each other in the interbank market. Trading in the bonds market turned more sluggish in November but rallied at the end of December. From that time onwards, the yield fell somewhat. Equities trading decreased and the ICEX-15 index dropped by 11.4% from November 1 to January 26. Reports of poor company profits appear to have dampened investor interest in this area. Reforms to payments intermediation are in progress and could have some impact on the banks' dealings with the Central Bank.

The króna strengthened at first after the interest rate rise, then slid

When interest rates were raised on November 1, 2000 the exchange rate index stood at just over 118 points, but fell to 117.15 soon afterwards. This strengthening did not last for long, and a week later the index passed 118 once again. Despite the rise in interest rates, the currency outflow continued, while the inflow did not increase as expected. Confidence in the stability of the króna seems to be inadequate and investors are not as willing as before to take positions in it. Speculation arose as to whether the Central Bank would defend the króna in the event of pressure on its fluctuation bands, which lie $\pm 9\%$ from the 115.01 central value of the exchange rate index. Heavy demand pressure built up in the inter-bank market, but the Central Bank's announcements of a firm commitment to the exchange rate policy and its sales of US dollars for domestic currency calmed the market and reduced the currency outflow. The Central Bank sold dollars for króna in the market on November 21 and the following four days, for

a total of 4.7 b.kr. The largest intervention was on November 24 when it sold dollars for the equivalent of 1.5 b.kr. Before the Central Bank entered the market the exchange rate index stood at 121.5 points. Following the market operations, it went down as far as 118.5 on November 24. However, the impact was only temporary, and on December 5 the index was back above 120 points. After its strong action at the



1. This article uses data available on January 26, 2001.

end of November the bank entered the market again on December 11, selling US dollars for ½ b.kr. Pressure on the króna in November was not on the scale of the speculative attack in mid-July, however, when the Bank sold foreign currency for 7 b.kr. over a shorter period. While the Central Bank's action served to calm the market, the exchange rate index continued to rise slightly every day and reached a historical high on January 18, 2001 when it registered 121.79 points, somewhat above the level before the November interventions. For the next two trading days the index went down, but climbed on January 23 and the market showed some unease. The index registered 122.04 then, but trading dwindled later in the day despite awareness of considerable pressure. In the morning of January 24 the Central Bank intervened in the market with the sale of 24 million US dollars. On January 25 it sold 12 million dollars, and the same again on January 26. This action caused a fairly strong fall in the index, which registered 121.74 on January 26.

The Central Bank has only intervened in foreign exchange market developments if there have been signs that a swift and undesirable change is pending or under way. In other respects the exchange rate of the króna is determined in the marketplace, without any intervention on the Bank's part. Nonetheless, the Central Bank recently reinforced its foreign position with an agreement on an unconditional loan facility to the amount of 250 million US dollars.

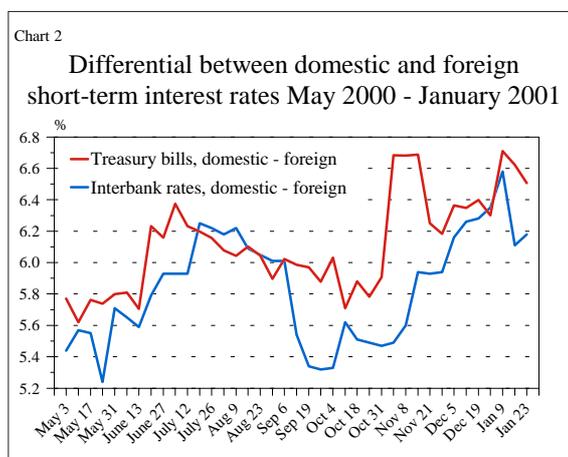
Table 1 Interbank foreign exchange market overview

	1999	2000	Change (%)
Market turnover (b.kr.)	468	768	64
Central Bank share (b.kr.)	19.2	17.4	-9.4
The króna exchange rate index ¹	110.0	120.8	9.8
Number of market participants.....	6	4	.

1. December 31, 1991 = 100.

Interest rate rises in Iceland and cuts in the USA widen the differential with abroad

The Central Bank's rise in its interest rate at the beginning of November produced the largest differential with abroad ever seen, at least since the pres-



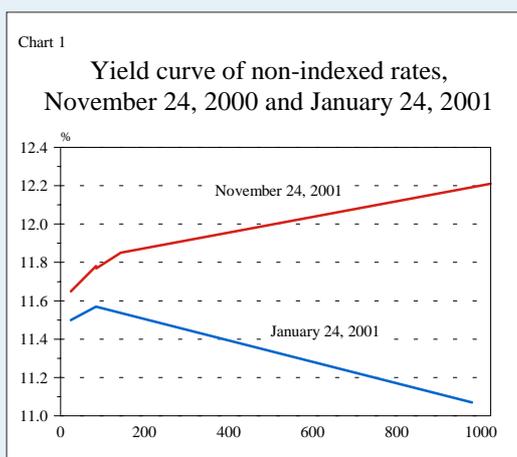
ent monetary framework was established. The differential between Icelandic and foreign trade-weighted interbank rates rose to almost 6.7% from 5.9%. As a rule, a wider interest rate differential should attract investors to benefit from it, which would have increased the currency inflow. However, this only happened on a limited scale, and the exchange rate continued to slide, as described above. The differential narrowed to 6.2% at the end of November, widened again to 6.4% around the middle of December but slipped to 6.3% at the end of that month. At the beginning of this year the US Federal Reserve cut its interest rate by 0.5 percentage points. This widened Iceland's differential which rose to 6.7% immediately afterwards but has slipped back to 6.6% at the time of writing. Interest rates are expected to come down in the UK during the year but the euro area is uncertain and interest rates there could just as easily go up. After a quite a prolonged slide the euro finally began to rally. It reached a low against the US dollar of just under 83 cents, but went past 95 cents in December before dropping back to 92 cents in the second half of January. Over the period from November 1, 2000 to January 26, 2001 it strengthened by 8.9%. Sterling strengthened 0.8% against the dollar over the same period, and the yen by 7.2%. The development of these currencies reflects market expectations about economic prospects in the respective countries.

Domestic interbank market interest rose and trading decreased ...

The domestic interbank market was characterised by

Box 1 Reading expectations from interest rates

Interest rates can provide an indication of the market's view of economic developments. For example, the yield curve can give an impression of the vision that the market has about the future inflation trend. The yield curve maps the relationship of interest rates to the length of a specific class of bonds. Examples are the yield curves of



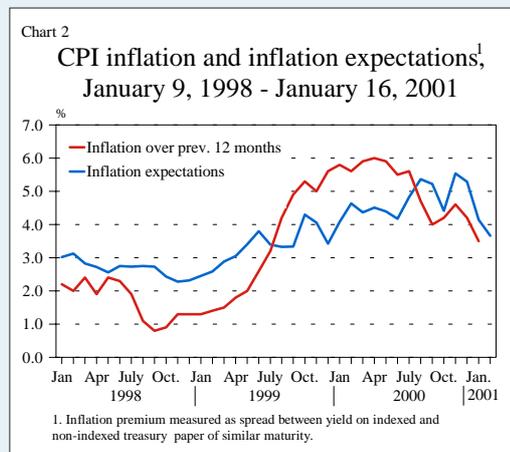
T-bills and T-notes shown in Chart 1. The chart shows two different interest rate trends where market expectations have changed. It is unwise to read too much into the calibration of the vertical axis, however, since an interest rate incorporates a specific return, risk premium and expected rate of inflation. The process since November 24, 2000 shows the market expecting a considerable degree of inflation over the following months. The process since January 24, 2001 shows different expectations, because the assumption seems to be that after a relatively short time inflation will be lower than at present. However, this is not an absolute indicator and other explanations could exist. For example, the bond class used for measuring the longest lifetime is known to be widely used as collateral for repurchase agreements with

a rise in interest rates and contraction in turnover. Although there is no single cause for this development, the Central Bank's interest rate rise on November 1 can definitely be said to have played some part.

Shortly after the Central Bank raised its policy rate, the domestic interbank market turned around and interest rates went up sharply. Tight liquidity

the Central Bank, so that credit institutions have small exposures in it and may opt to price it in a way that makes it unattractive to investors. Another factor at work may be the great difference in length between the bonds forming the last two segments of the yield curve.

Another method of forecasting inflation is to examine the spread between indexed and unindexed securities. While this method provides certain indications, it is important to keep the lifetimes of the securities being compared as similar as possible, besides which the market always calculates a certain risk premium on unindexed interest rates to meet unforeseen swings in inflation. This premium is difficult to assess but probably varies somewhat depending on the economic outlook. Differences in how active the markets for indexed and unindexed bonds are may also distort the comparison. Chart 2 maps expected and real inflation as measured by the CPI for the past three years. It apparently reveals inertia towards changes in expectations, although this may be explained to some extent by interest rate formation embodying not only future expectations but also a retrospective inflation measurement.

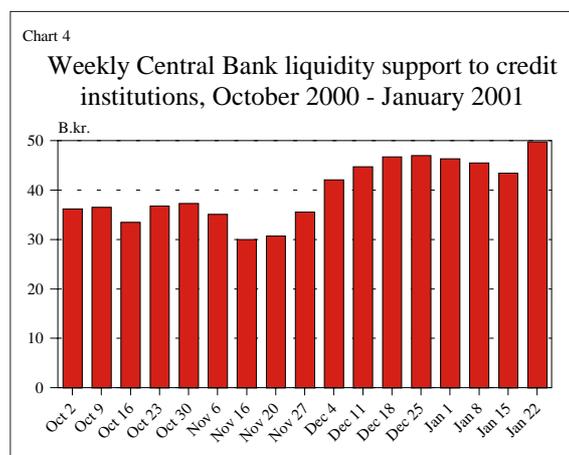
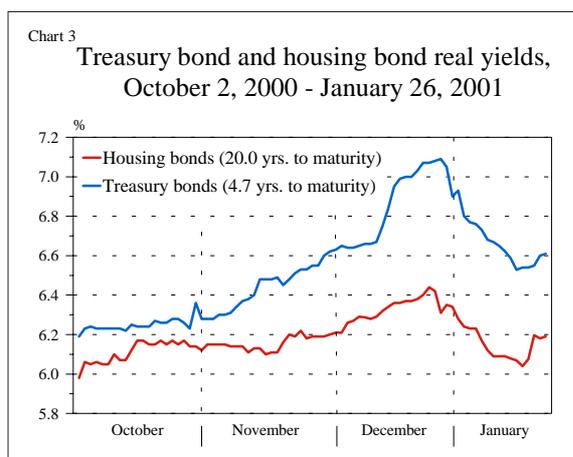


may also have been a factor at work during this period, giving further impetus to interest rate rises in the domestic interbank market. In this context it should be pointed out that the outflow from the treasury's current account with the Central Bank was unusually small from mid-November to the end of December. Furthermore, the Central Bank sold currency at the

end of November for 4.7 b.kr with the aim of supporting the exchange rate, which also drove up interbank market demand for liquidity. The characteristic feature of this market is that the bulk of trading is very short-term in nature, meaning that interest movements can be very sharp without necessarily being fully in line with the development of other short-term interest rates. General demand for liquidity grows progressively towards Christmas, so the interest rate rises in the interbank market during the period can also be expected to reflect caution on the part of market players. The importance of the domestic interbank market, and trading in it, will probably increase later in 2001 with the implementation of payments intermediation reforms described later in this article.

... but intraday and repo trading grew

Despite the Central Bank's interest rate rises, demand for its intraday loans and repo facilities grew over the period; in December, demand for intraday loans reached a record level for that month. December trading in the domestic interbank market amounted to 24.5 b.kr., the lowest monthly figure since April 1999. The market was sluggish in the first half of January too, with a marginal drop in interest rates and low trading volume. On January 19 the market perked up. Interest on overnight loans fell by 5.18% from the previous day's listing and trading for the day amounted to 8,300 m.kr, the largest figure ever for a single day in the domestic interbank market. The reason for the sharp drop in interest rates



and heavy turnover was that the tied period for credit institutions' accounts with the Central Bank came to an end on Saturday January 20 and their balance offered them fairly good scope. Under such conditions, traders in the domestic interbank market try to secure themselves better yields than are offered by tied accounts with the Central Bank.

Repurchase agreements with the Central Bank increased sharply during the final months of 2000. Their year-end balance was 46.9 b.kr., an increase of roughly 10 b.kr. from the same time in 1999. The repo balance is normally highest at the end of the year, as a result of seasonal fluctuations in the credit institutions' liquidity. Furthermore, interest rates in the domestic interbank market in December were higher than those on Central Bank repos, as pointed out above, making the latter a more favourable source of short-term funding for credit institutions at that time. At the end of January the repo balance with the Central Bank stood at 50 b.kr., having grown by 3 b.kr. since the beginning of the year.

Bond interest rose, then fell again towards the end of the year

From the beginning of November and for most of December there was some rise in bond yields on Iceland Stock Exchange (ISE), which can be attributed to sales by one of the market participants, although the Central Bank's interest rate rise may conceivably have had an impact too. Hitches in relaying of information following changes to the ISE trading system could also have played some part. Many members had trouble navigating this new envi-

ronment, while a number of shortcomings were noticed in information from the exchange, besides which the members had to modify their in-house systems to match the reforms. Trading in November was somewhat lower than during the preceding months, but at the end of December there was heavy dealing in bonds, mainly housing bonds, leading to a considerable fall in yields. The downward trend continued in January and trading was brisk. However, in part this could be a seasonal fluctuation, following a pattern which has been noticed in recent years.

In February, a new category of 6-year unindexed T-notes was issued. It is planned to build up this category fairly briskly and the issue this year is estimated at 6 b.kr. Aimed at supporting interest rate formation for unindexed paper, the new issue is planned to be included in agreements with market makers. There will be two classes of T-notes, with maturities of six and three years respectively, and it is planned to cease issues of the shorter category, which matures in 2003.

Foreign investors showed little interest in Icelandic securities for most of 2000, but in the last days of the year Kaupthing New York sold housing bonds and housing fund bonds worth 4 b.kr. to an American investor. This was only one side of the deal, since Kaupthing hedged against the currency risk with a counter-purchase of foreign bonds, so no currency inflow to Iceland resulted. Several days before, foreign investors had bought Icelandic bonds for 600 m.kr. These trades conceivably played some part in the turnaround at the end of the year, because the yield began to fall afterwards, as described above.

Outlook for the bond market in 2001

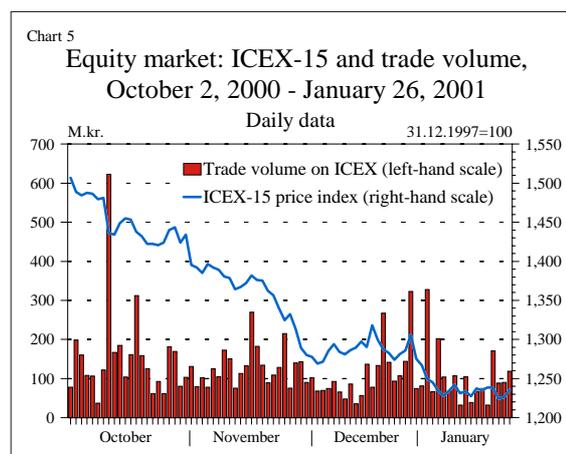
There are various signs that the bond market could become a favourable option for investors in the near future. Indications possibly suggesting some cooling of the economy should, other things being equal, reduce investor interest in equities, which have produced low returns recently, and increase their interest in bonds instead. Some market participants have made efforts to promote Icelandic bonds to foreign investors, which could both lead to higher external investment in Iceland and deepen the market. The speculator appeal of bonds could increase on account of the wide interest rate differential between Iceland and abroad.

Equity market prices drop

The ICEX-15 index fell by 20% in 2000 and continued to slide in January, by more than 6%. Despite the generally sluggish state of the equity market, total trading during the last two months of the year significantly outstripped that of the same period in 1999, boosted by the largest volume of December trading ever. Recent weeks have been characterised by falling prices and lower trading.

Payments intermediation reforms

On December 29, 2000 the Central Bank issued rules for access by payments systems to settlement accounts with the Central Bank. Designed as a framework for payments systems using participants' current accounts with the Central Bank for settlement of payments among themselves, the rules initially provide for a netting system owned by Fjölgreiðslumíðlun hf. (Multipayment Intermediary Services Ltd.) and operated by the Icelandic Banks' Data Centre. The system will handle all small payments and others up to 100 m.kr. Payments of 100 m.kr. or more between banks are now entered directly in their respective current accounts with the Central Bank. This is the first step towards a real-time gross settlements system (RTGS) which is now under preparation. When the RTGS is launched, no payments will be made within it unless the balance on the payer's account covers them. Overdrafts with the Central Bank will be negotiable for these accounts and will be secured against guarantees, although not for the entire overdraft authorisation until the end of 2001.



The future limits for gross settlements have not been set but will probably be somewhat lower than the present reference of 100 m.kr. This reform will substantially improve the security of payments intermediation in Iceland, as well as imposing firm demands

on participants regarding liquidity and risk management. Work is in progress on formulating these reforms further and the banks' customers will be notified of them before they are implemented.

Box 2 Amendments to legislation on securities trading

On December 16, 2000 Iceland's parliament passed an amendment to Act no. 13/1996 on Securities Transactions. The main changes from earlier legislation are that the concepts "confidential information", "primary insider" and "other insiders" are defined, together with detailed provisions on various issues related to these concepts. More detailed provisions are also set for public offerings. The following is a broad summary of the main points of the amendments:

Confidential information: Information about the issuer of securities, the securities themselves or other points which have not been made public but would be likely to affect the market value of the securities if they were. Information is regarded as public when it has been communicated in the securities market by public and approved means. Notifications to stock exchanges and regulated OTC markets are considered public once they have been communicated from there, cf. the Act on Activities of Stock Exchanges and Regulated OTC Markets (Art. 2 subparagraph 4).

Primary insiders: Parties in possession of or generally having access to confidential information on account of ownership, involvement in the board, operation or supervision, or on account of other duties on behalf of the issuer of securities which have been listed or have requested to be listed on a stock exchange or a regulated OTC market have to obtain an operating licence in Iceland.

Individuals or legal entities directly or indirectly owning shares in the issuer of securities which have been listed or have requested to be listed on a stock exchange or regulated OTC market have to obtain an operating licence in Iceland, and having representatives on the board of the said issuer by virtue of their ownership (Art. 2, subparagraph 5)

Other insiders: A party who is not regarded as a primary insider but, on account of his work, position or duties, has temporary access to confidential information.

A party who is not regarded as a primary insider but has gained knowledge of confidential information, provided that he knows or should have known the nature of such information. (Art. 2, subparagraph 5)

Companies providing securities services must not act as intermediaries in securities trading if their employees are aware, or have grounds for believing, that such trading is in violation of the provisions of the section on treatment of confidential information, insider trading and market manipulation. (Art. 18)

Insiders must not: 1. Employ confidential information, directly or indirectly, for the acquisition or disposal of securities; 2. Provide confidential information to a third party, unless this is in normal connection with the work, position or duties of the provider of the information; 3. Advise a third party, on the basis of confidential information, to acquire or dispose of securities or encourage in other respects trading in them. This provision also extends to legal entities and individuals who take part in decisions on trading in securities for the legal entity's own account. The provision does not apply to trading by the central government, Central Bank of Iceland or parties handling trading on their behalf, provided that the trading constitutes part of official monetary policy, exchange rate policy or debt management. (Art. 31)

Primary insiders are obliged to ensure that no confidential information is at hand before they trade in the securities, and they are also required to notify the specified party of the planned trading. A stock exchange shall make information about trading by primary insiders public if this exceeds specific limits and the ownership share is above specified limits or falls below such limits. The Financial Supervisory Authority shall maintain a record of primary insiders and companies are obliged to notify it of insiders. The board of a listed company shall set rules on the treatment of confidential information and insider trading. (Arts. 32-37)

Another related provision is found in the Act:

Individuals or legal entities must not take part in, promote or encourage trading in securities or other actions with the purpose of presenting an incorrect picture of the scope of trading with specific securities or having an abnormal or excessive impact on price formation in securities trading. (Art. 38)

Provisions on public offerings entail an obligation to publish a prospectus. Exceptions are allowed, however, mainly exempting issues targeted at small groups of prospective investors or institutional investors, or securi-

ties issued in special cases. The Financial Supervisory Authority supervises inspection of prospectuses, but prospectuses for IPOs at stock exchanges may be accepted as valid. The Financial Supervisory Authority may grant exemptions and defines who are institutional investors. The Central Bank of Iceland may set rules concerning the first day of sale of individual public offerings with the aim of reducing fluctuations in supply of new securities in the market. (Arts. 25-29)