

Growing optimism in domestic markets

Domestic markets have been upbeat since the second half of June. The króna has appreciated by nearly 10% and domestic equity market indices have risen by 20% over the same period. The first króna-denominated Eurobonds (glacier bonds) matured in mid-September but did not seem to have a palpable effect on the FX market. The three largest commercial banks all announced that they had secured their refinancing through 2007, when more than €11 billion in foreign loans will mature. Carry trades increased and foreign parties have issued some new glacier bonds. Exista investment company was listed on Iceland Stock Exchange (ICEX) after a successful IPO and Icelandair was sold by FL Group to a domestic investor consortium and will also be listed. The Central Bank raised its policy interest rate three times, by a total of 1.75 percentage points, and inflation expectations have dropped since mid-year.

Global financial environment

The global economic environment has been buoyant in recent months, though the optimism that reigned in the first half of the year has diminished somewhat.

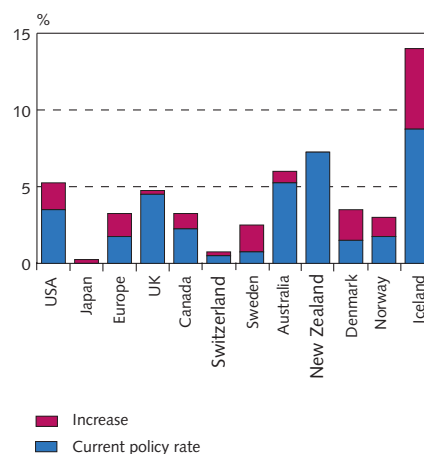
Given the conflict between a weaker economic outlook and increased inflationary pressures, uncertainty surrounds the US Federal Reserve's next interest rate decisions. The US housing market has cooled and is even seen as a potential brake on economic growth over the medium term.

The European Central Bank has raised its minimum bid rate by 1.25 percentage points this year in an attempt to contain inflationary pressures. Economic growth has been on the rise in the euro area, but developments in Germany will prove most crucial. Tax increases intended for next year could hamper economic growth in Germany and there are still no signs of change in the labour market rigidities that are viewed as an obstacle to progress.

In the summer, the Bank of Japan increased its uncollateralised overnight call rate from zero to 0.25%. The Japanese economy has been picking up after 15 years of almost continuous stagnation.

Modest inflation coupled with continuing economic growth in industrialised countries implies that interest rates will remain broadly low, which will sustain the sizeable interest rate differential between Iceland and its chief trading partner countries. Following unease in the first half of 2006, when the króna and other high-interest currencies came under strong pressure, position-taking for carry trades appears to have picked up in global markets. After the Icelandic króna has become part of international portfolios, certain changes can be discerned in the behaviour of its exchange rate. Because domestic markets are increasingly sensitive to global economic developments, unease and uncertainty in foreign markets could have a strong impact in Iceland. International markets have been highly liquid in recent years, but experience shows that this could change at short notice. In such an event, it could prove more difficult to fund the current account deficit in the future. Of particular concern is Iceland's large deficit on the in-

Chart 1
Increases in selected central banks' policy interest rates since the beginning of 2006

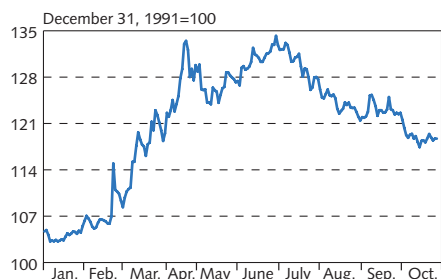


Source: Central Bank of Iceland.

1. This article uses data available on October 26, 2006.

Chart 2
Exchange rate index of the króna

Daily data January 3, 2006 - October 27, 2006



Source: Central Bank of Iceland.

come account, which is estimated at 4% of annual GDP over the next 2-3 years and is especially sensitive to interest rate hikes and tighter credit terms in international financial markets.

Growth in carry trades

Since autumn 2005, foreign investors have traded on the Icelandic markets on a growing scale. There has been considerable interest in the FX, króna and bond markets, though interest in domestic equities is still limited.

High interest rates in the markets for domestic currency have been the main magnet for foreign investors. The Central Bank raised its policy interest rate three times since the end of June, first by 0.75 percentage points followed by increases of 0.5 percentage points each in August and September. The spread between domestic three-month interest rates and LIBOR now stands at just below 10 percentage points based on the present currency basket, up from 8.6 percentage points at the end of June. Outstanding foreign glacier bond issues total 270 b.kr. and the majority are held by foreign investors. Issuers have presumably covered their short positions vis-à-vis the króna by contracts with Icelandic financial institutions. The balance of forward contracts in the banking system indicates a 430 b.kr. long position in the króna in the money and FX markets. Not included in this figure are non-residents' holdings of Treasury notes and government-guaranteed housing bonds, which could amount to roughly 20% of their outstanding stock, or approximately 120 b.kr. Besides this position-taking in the króna, the current account deficit represents a further exposure estimated at 200 b.kr. this year.

Iceland is the smallest economy in the world with its own floating currency. Relative to FX market turnover and GDP, such an exposure is of unprecedented magnitude. Investor flight from these positions could put sudden and substantial pressure on the króna. However, the Icelandic FX market is better equipped than before to handle heavy flows, as turnover has multiplied in recent years and trading in the króna is now spread over a more diverse group of investors. The generally positive economic situation also reduces the probability of sudden major pressures on the currency.

The FX market – króna appreciation and increased turnover

The króna has appreciated almost without interruption since the end of June. The month-end exchange rate index for June was 134.23 but had gone down by 11.8% by the end of October.

Volatility in the domestic currency market has eased again after turbulence from February to June. Fluctuations over the past few months have been only slightly more pronounced than in the second half of 2005 and into February 2006. Turnover has soared in the FX market this year as well. If the trend continues, FX market turnover could reach 4,500 b.kr., or more than double the 2005 volume of 2,077 b.kr. By comparison, turnover in 2004 totalled 948 b.kr. The explanation for this surge is doubtless increased interest in the Icelandic currency among foreign investors.

Chart 3
ISK volatility against USD

Daily data January 3, 2005 - October 27, 2006



Source: Reuters.

Issuance and maturities of glacier bonds

The first glacier bonds from foreign issuers matured in the middle of September. In all, the equivalent of 51 b.kr. in glacier bonds have matured since the last *Monetary Bulletin* was published in July, but this is offset by new issues totalling 59 b.kr. Only a small part of the new issues have been made by issuers of bonds that have already matured, and their dates do not conflict with existing maturities. These movements have had little impact on the FX market, though there are indications of increasing position-taking with the króna through the money and FX markets. As pointed out above, the FX balance of the three commercial banks' forward contracts was 430 b.kr. at the end of Q3/2006.

Decrease in foreign reserves in króna terms

Since the beginning of July, the Central Bank's foreign reserves have decreased in domestic currency terms in pace with the appreciation of the króna. Reserves now stand at 71 b.kr. The Treasury has continued to retire its foreign debt and the Central Bank has purchased 5 million US dollars weekly in the domestic FX market on behalf of the Treasury for this purpose. The Treasury's foreign currency deposit with the Central Bank is now sufficient to cover its foreign commitments until the end of the year. As previously announced, the Central Bank will continue to purchase currency on the same scale for the rest of the year in order to boost its foreign reserves. Future purchases will depend on market conditions, Treasury requirements and estimates of the preferable size of the reserves, and the Central Bank will make a separate announcement of its plans in this respect. Next year, Treasury foreign loan maturities and debt service will amount to 208 m.

In 2007, the Central Bank will continue its regular purchase of currency in the domestic interbank market. It plans to purchase 3 million US dollars twice a week, instead of 2.5 million this year. Accordingly, the amount of individual transactions will be the same as the minimum applying to regular transactions by interbank market makers. Roughly two-thirds of the currency purchased next year will be sold to the Treasury to meet its foreign maturities and debt service. The remainder will be used to boost the Central Bank's foreign reserves.

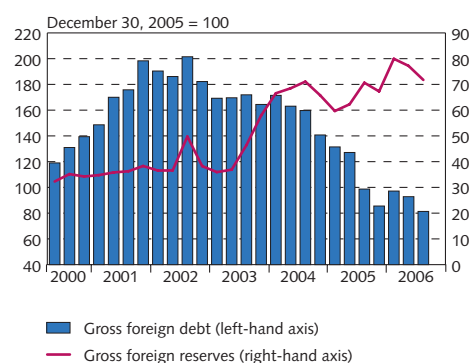
Foreign assets of the Central Bank are now less than 10 b.kr. lower than the Treasury's foreign debt. The Central Bank is considering linking its foreign assets to the Treasury's foreign debt, which would hedge the entire exchange rate risk and most of the interest rate risk of both parties. Similar methods are used by central banks in Denmark, Canada and New Zealand. Such a change would have no impact on the domestic currency market or the FX market.

Commercial banks' refinancing

At the end of September, Kaupthing Bank announced that it had completed its refinancing of the foreign loans that are due from now until year-end 2007. Similar announcements had previously been made by Glitnir and Landsbanki. A large portion of the three largest commercial banks' foreign debt – €11 billion – will mature next year. Additional financing is required to fund credit growth through the year 2007,

Chart 4
Gross reserves and gross central government foreign debt

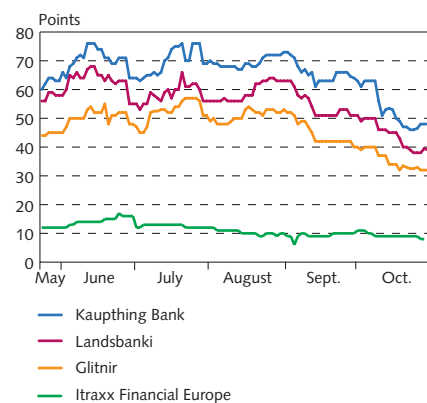
Quarterly data, Q2/2000 - Q3/2006



Source: Central Bank of Iceland.

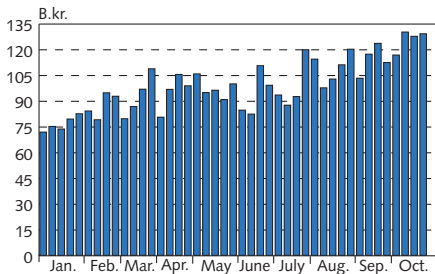
Chart 5
CDSs of Icelandic banks and Itraxx Financial Index

Daily data May 23, 2006 - October 27, 2006



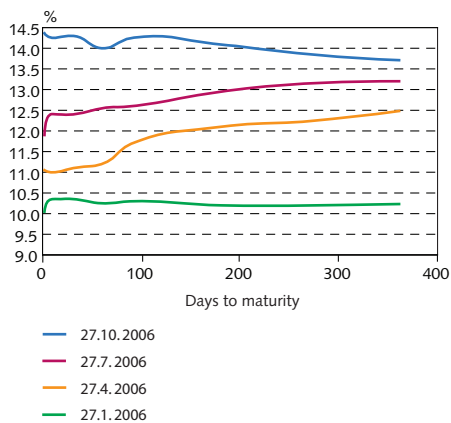
Sources: Bloomberg, Reuters.

Chart 6
Outstanding stock of Central Bank repos
Weekly data January 3, 2006 - October 24, 2006



Source: Central Bank of Iceland.

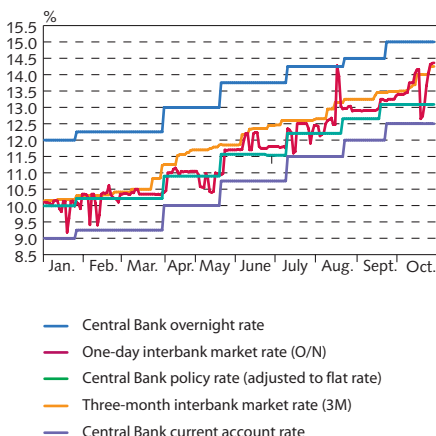
Chart 7
Yield curve on money market



Source: Central Bank of Iceland

Chart 8
Interest rates in the interbank market and
Central Bank policy rate

Daily data January 3, 2006 - October 27, 2006



Source: Central Bank of Iceland

the scale of which is still not known. The market had expressed doubt about the banks' ability to secure all their refinancing requirements. They have not tapped European markets this year, but by borrowing in the US they have been able to secure adequate liquidity over the medium term. Lending terms proved less favourable than those obtained in recent years, but the banks must have decided that they needed to dispel uncertainty about their access to capital. This approach seems to have paid off, at least judging from equity prices and pricing of credit default swaps (CDSs) over the past few weeks. A large proportion of the new funds has maturities of three, five and ten years, which sharply reduces the risks posed by high leverage through short-term borrowing.

Once it became clear that the Icelandic banks had clinched financing from abroad until the end of 2007, the CDS pricing on their debt finally began to drop. The three commercial banks are still some way short of commanding the terms that they enjoyed for most of 2005, and there is quite a difference in the prices of their respective five-year CDSs. For the first part of the period covered by Central Bank data, however, the market made little distinction between them.

In September, Moody's Investor Services downgraded the Bank Financial Strength Rating (BFSR) of Kaupthing Bank to C from C+. Reactions in the equity market and CDS market would indicate that the change in ratings was not unexpected. Moody's had had the BFSR rating under review for possible downgrade since April this year.

Money market

On average, year-to-date turnover in the REIBOR market has been down from 2005, with sluggish trading in the first four months of the year accounting for much of the drop. Since May, however, turnover has picked up sharply and August was the briskest month ever, with a volume of 193 b.kr.

The money market was liquid until autumn but seems to have tightened since then, as evidenced in the growing spread between interbank rates and repo rates. The likely explanation is the Treasury's large and growing deposits in the Central Bank, coupled with increased foreign investor appetite for the króna. A record for repo transaction volume of 130 b.kr. was set on October 10, following an upward trend beginning in early July. Another explanation of rising interest rates could be that financial institutions have begun to experience a shortage of bonds that are eligible as collateral for repo transactions with the Central Bank.

Turnover in the market for T-bills has been scant all year, and increased Treasury issuance has had little impact on trading. Last year's turnover was much greater, when market makers for T-bills were paid volume-linked commissions. Greater depth in T-bill issuance by the Treasury and other agents such as financial institutions could revive the Icelandic market, however.

Bond market

Inflation figures for September and October were lower than the Central Bank had forecast earlier in the year, and the bond market re-

flected this clearly. In addition, the government announced sizeable cuts in indirect taxes aimed at reducing household food costs by as much as 16%. The tax changes, which will take effect in March 2007, should reduce the CPI by up to 2.7%. Both these announcements have caused significant activity in the bond market. Yields on longer Treasury notes dropped by 1.06-1.26 percentage points between mid-summer and the end of October. The yield curve in Chart 7 illustrates clearly the recent changes in market inflation expectations.

The government's announcement triggered strong selling pressure on indexed bonds. In October, yields on HFF bonds shot up after the longer series had fallen by 20-40 basis points since mid-year. Yields on the shortest series have risen considerably since mid-August, as can be seen in Chart 9, while the jump in longer bonds has since partially unwound. Recent developments reflect considerable optimism regarding the inflation outlook, with a sharp drop in market expectations. The market expects a rapid decline in inflation despite continued labour market pressures, a wide current account deficit and proposed tax changes that must be deemed expansionary in the long run.

In June the National Debt Management Agency (NMDA) issued a new two-year series of T-notes, as part of a strategy to strengthen the yield curve for the next two years and thus improve transmission of monetary policy across it. The series has now reached the intended volume of 15 b.kr. A new two-year T-note series will be auctioned in December.

The equity market

The equity market rallied in the third quarter, with the ICEX-15 index rising by 24% from a low of 5,240 in July. On October 25, the index stood at 6,500, after peaking at almost 7,000 in February and then plummeting in the wake of the market turbulence that began in February and lasted until the summer.

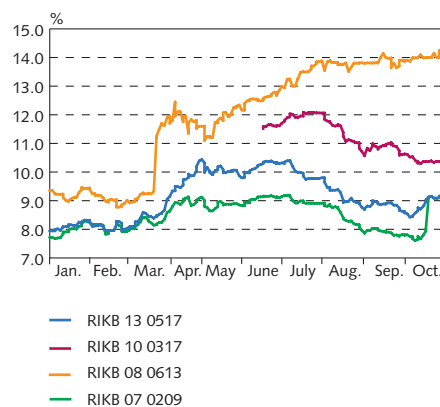
Kaupthing Bank sold its holding in Exista investment company in August and the offer was oversubscribed by double. Previously, Kaupthing had announced plans to sell its stake in Exista to Kaupthing shareholders, partially as a response to criticism of cross-ownership between the two companies. Exista was listed on Iceland Stock Exchange on September 15.

At the beginning of October, FL Group holding company announced plans to have Icelandair Group listed on ICEX by year-end 2006. Icelandair Group has an estimated market worth of 43 b.kr. and Glitnir underwrote and sold 51% of the shares to primary investors. A public offering for private and institutional investors is planned.

In September it was announced that OMX of Sweden and the holding company Eignarhaldsfélag verðbréfabings hf. (EV), owner of ICEX, had signed a letter of intent concerning OMX's acquisition of EV. OMX already offers access to some 80% of the Nordic and Baltic securities market – all except Norway.

Chart 9
Treasury note yields

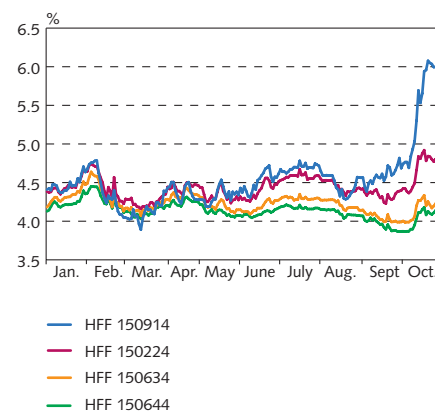
Daily data January 3, 2006 - October 27, 2006



Source: Central Bank of Iceland.

Chart 10
HFF bond real yields

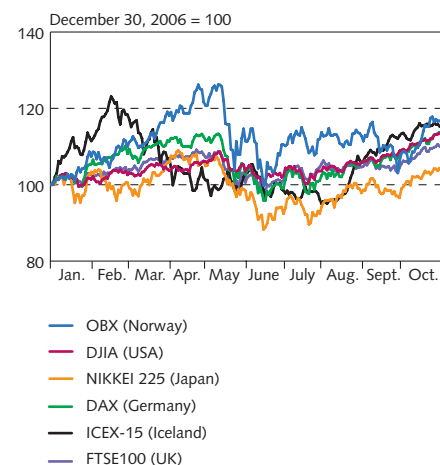
Daily data January 3, 2006 - October 27, 2006



Source: Central Bank of Iceland.

Chart 11
Development of selected share indices

Daily data December 30, 2005 - October 27, 2006



Source: Reuters.

