

Summary and Conclusions

ISK fluctuations continue

Despite a sharp drop in the ISK exchange rate in late April and early May, the real ISK exchange rate is still high and appears likely to remain so. News that power-related industrial developments will continue after the current projects conclude, have reversed forex market expectations and strengthened the ISK in the past few days. Research predicts that the ISK index will average around 115 for the remainder of this year and until close to mid-2006, to be replaced by a period of depreciation of relatively short duration, as was the case towards the end of the last business cycle.

Temporary drop in inflation

An unexpected drop in the Consumer Price Index (CPI) in May reduced 12-month inflation in a single stroke from 4.3% to 2.9%. The drop can be attributed primarily to special, temporary factors and will have little impact on the longer-term inflation outlook. A high ISK during the early months of this year has also reined back inflation and this effect can be expected to last somewhat longer. Towards the latter part of the summer the impact of these temporary factors is likely to be reversed and inflation could gather pace again. We therefore predict inflation of 3.4% between annual averages and 3.1% from the beginning to the end of 2005.

Increased labour market tension spurs inflation pressure

Unemployment figures indicate a change in the labour market situation towards increased tension. In a single year, the seasonally adjusted unemployment rate has fallen from 3.1% to 2.3%. To judge by the experience of the past decade, unemployment rate below 2% and inflation rate below 4% have never co-existed. As unemployment approaches the 2% level, the likelihood of wage drift rises substantially. In our estimation, this situation is more likely to prompt the Central Bank (CB) to tighten monetary policy further. We expect a policy rate increase of 0.25% to 0.5% in connection with the publication of the CB's *Monetary Bulletin* on 3 June, and a policy rate of 10% by this autumn.

Record corporate and municipal bond issuance

During the year to date, there has been a net negative supply of government-backed bonds, leaving a gap which has been filled by the highest issuance of corporate and municipal bonds ever. According to our calculations, such bond issuance amounted to around ISK 70 billion (bn) during the first four months of 2005, and has totalled around ISK 115 bn in the past seven months. This substantial supply of bonds has, in our estimation, made a decisive difference in pushing yields slowly upwards.

Our forecast for HFF bond development is a continuing rise in yields for the remainder of this year, with yields of 3.5-3.6 until mid-year and rising to 3.7-3.8 by Q4. We expect a policy rate hike plus accelerating inflation will result in an increase of 30-40 bp in short, non-indexed Treasury notes.

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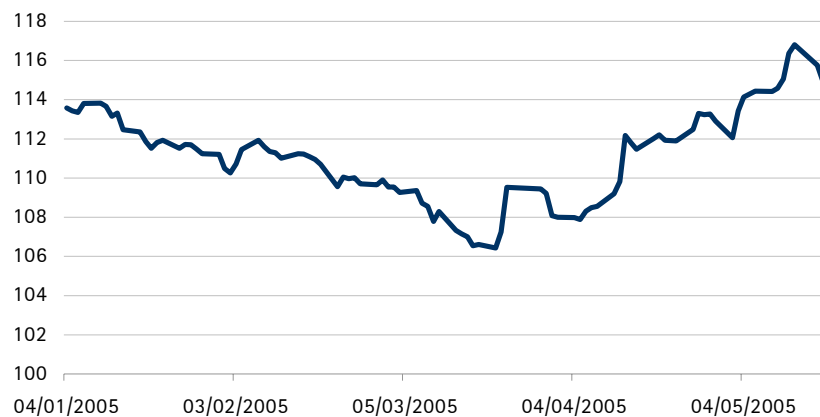
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ISK exchange rate fluctuations reflect the experience of other countries with floating currencies and are evidence that the floating exchange rate is functioning properly

ISK weakens – only to gain strength anew

After depreciating practically continuously since 20 April this year, when the ISK index reached an historical low (and the *króna* record strength) at 106.4, the current downward ISK slide appears to be over, as the index has strengthened significantly in the past few days. It would appear that discussion of possible additional aluminium projects have managed to reverse the market trend, although it is by no means certain that these plans will be realised. Major changes in currency exchange rates almost without exception cause some unrest, since it is impossible to predict with any certainty just when such trends will conclude, nor how substantial they will be. In the short term, currency fluctuations appear to be practically uncontrolled and occur at random. But fluctuations of the type we have here in fact reflect the experience of other countries with floating currencies and are evidence that the floating exchange rate is functioning properly.

ISK exchange rate during the year to date



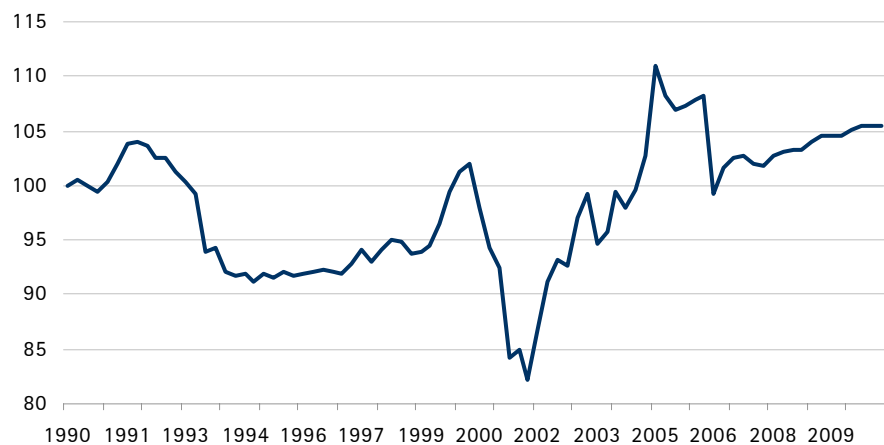
Source: EcoWin

Real exchange rate still very high

The real exchange rate has not been stronger since 1988

When it reached a peak in April, the real ISK exchange rate was naturally higher than it has been for a long time. Based on relative price levels, the real ISK exchange rate at that time was around 111 (1990 = 100) and we have to go back to the year 1988 to find a similar real exchange rate.

Real ISK exchange rate 1990-2005



Source: Central Bank of Iceland, Landsbanki Research forecast

The real exchange rate is still around 10% higher than its historical average 1990-2004

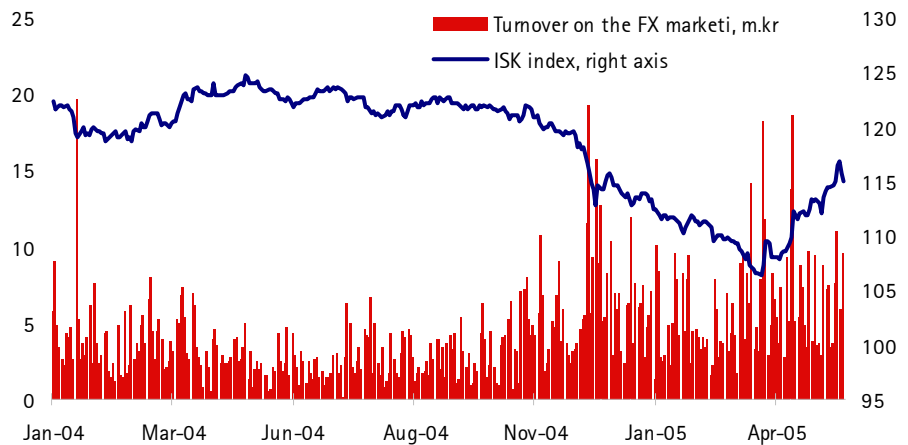
It was thus fairly clear that such a level could not be maintained for long, as recently proved to be the case. Even the nominal exchange rate of the past few days has to be considered fairly high in an historical context, although the real exchange rate has dropped by 5% since the peak in April, and the real exchange rate is still around 10% higher than its historical average 1990-2004.

Announcement of foreign currency purchases accelerated ISK decline

Repayment of Treasury foreign debt in the amount of USD 100 million requires forex purchases equivalent to the average daily turnover on the interbank market

Following the close of markets on 2 May, there was an announcement of a decision on special repayment of Treasury foreign debt amounting to over ISK 6 bn. The CB will purchase currency on the domestic interbank FX market for the purpose, in five transactions totalling USK 100 million (m). Following the announcement it was clear that a sharp fall was in store for the ISK. Although this is not an especially large amount, since average daily turnover on the FX market since the beginning of this year has in fact been about ISK 6 bn, it was not the amount, but rather the timing of the decision which appears to have taken the market by surprise. During the YtD, the CB has made regular weekly FX purchases of USD 2.5 m solely to meet the Treasury's needs for foreign debt repayment. The May purchases were therefore in addition to the CB's regular transactions.

Exchange rate and turnover



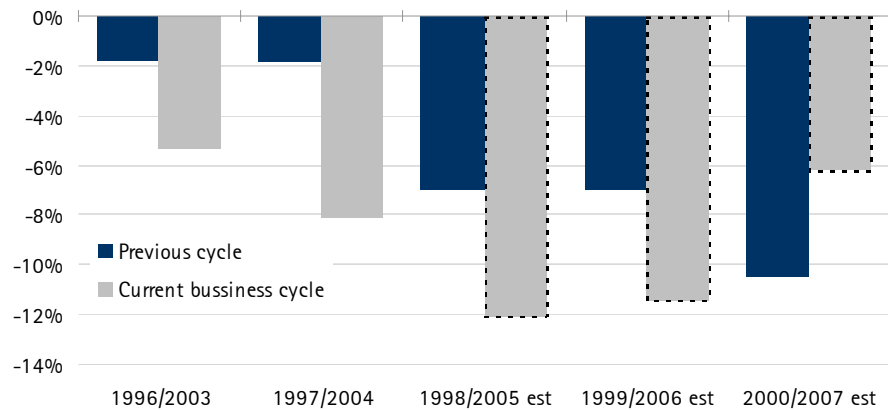
Source: EcoWin, Central Bank of Iceland

What happens next?

Newly published forecasts for the current account deficit by the CB and the Ministry of Finance are practically identical: 12% of GDP, or the equivalent of close to ISK 120 bn

The burning question concerning the ISK exchange rate is whether the large current account can be sustained. Looking only at the external balance situation, it could be claimed that the very large current account deficit which has already developed means that a further depreciation is unavoidable. The deficit for the first three months of this year had reached ISK 11.6 bn, as compared to 0.5 bn at the same time the previous year, making it clear that the deficit for this year will substantially exceed that of 2004. Newly published forecasts for the current account deficit by the CB and the Ministry of Finance are practically identical: 12% of GDP, or the equivalent of close to ISK 120 bn In the last economic upswing the current account deficit did not grow nearly as fast as it has this time, and did not peak until 2000, the fourth year of the upswing. In the current situation, however, the deficit is forecast to peak this year at a somewhat higher level than in 2000, when it was equivalent to 10.5% of GDP.

Comparison of the current account deficit during the current and previous economic upswings 1997-2000 and 2003-2006, % of GDP



Source: Statistics Iceland, Ministry of Finance forecast

In the short term it is primarily flow variables on the capital account which determine currency exchange rates, but in the longer term it is the impact of traditional foreign trade and economic fundamentals which determines the course

But it is not just the external trade balance which determines exchange rates. The experience of most countries adopting similar currency arrangements, i.e. a floating exchange rate and unrestricted capital transactions, is that in the short term it is primarily flow variables on the capital account which determine the course of events while in the long term it is the impact of traditional foreign trade and basic fundamentals which determines the course. In our estimation the most likely exchange rate scenario will be a fairly strong ISK for a while yet, with the impact of the very sizeable current account deficit not felt until next year, which will also be the final year of the current economic upswing. The high interest rate differential and inflow of foreign currency, on the other hand, offset the unusually high deficit and create the resistance required to halt further ISK depreciation than has already occurred. In addition, domestic and foreign investors, many of whom have made a good profit on ISK positions, are likely to be attracted once more, if and when the ISK index begins to approach a level of around 120.

As things stand today in international financial markets, high interest rates together with a strong currency are hardly a common occurrence, which is one of the reasons foreign capital has been attracted to Iceland to a growing extent. When interest rates begin to fall again, which can be expected to happen in the latter part of next year, the full impact of the current account deficit will in all likelihood be felt, resulting in some type of exchange rate adjustment not dissimilar to that of the last business cycle in 2001-2002. The ISK fell sharply to start with and the current account deficit disappeared practically overnight. This rapid correction of the economy's external imbalance eventually resulted in a strengthening of the currency once more, something which had not occurred previously but can be considered likely to reoccur now in one manner or another.

We still expect the ISK index to average around 115 until the middle of next year, after which a period of depreciation will set in which will last for a relatively short time, as was the case near the end of the last business cycle

The ISK exchange rate index has averaged just below 111 during the year to date, whereas in our previous forecasts we anticipated an index average of 115 for this year. For this to prove correct, the index would have to average around 120 for the remainder of the year. Although these index values appear to suggest a considerable deviation, it is important to bear in mind that the so-called volatility of the ISK index has been in the range of 5-6% during the past year. These fluctuations are thus within its normal limits, based on the standard deviation of daily changes.

Our conclusion is thus that we still expect the ISK index to remain around 115 for the remainder of this year and until close to mid-2006, after which a period of depreciation of relatively short duration will set in, as was the case upon the conclusion of the last economic upswing.

Inflation has not disappeared

An unexpected drop in the CPI of 0.54% in May slowed the 12-month inflation rate in one fell swoop from 4.3% to 2.9%, or once more well below the upper tolerance limit set by the

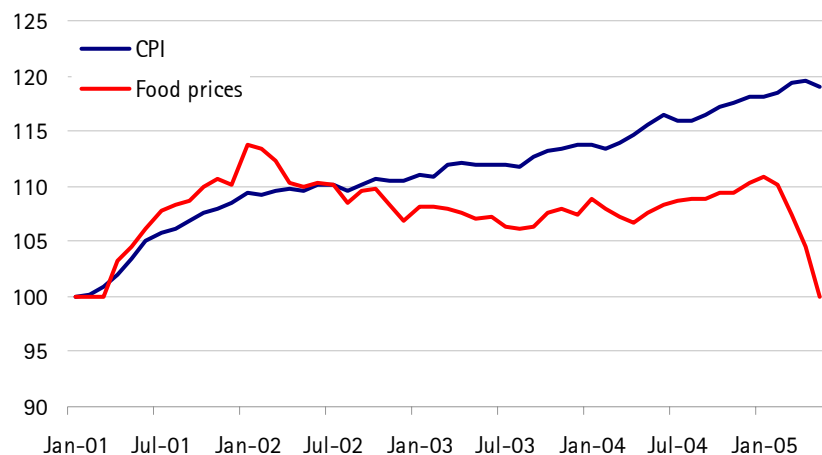
Central Bank (CB). There were two main reasons for this: on the one hand, Statistics Iceland (SI) changed its method of calculating interest in the Index's housing component and, on the other, stiff competition in food prices made an impact. Neither of these factors has basically changed the inflation outlook for the coming months.

Changes in methodology in connection with the CPI calculation are never well received on the financial market, since they smack of arbitrary decisions and government interference. In our estimation, however, the modification is fully justifiable, since SI had based its housing interest rate calculations on five-year averages, with the result that changes in financing cost were often only visible in the index with an abnormally long lag. The decision to use a one-year rather than a five-year average is thus an improvement in SI's methodology, in our opinion.

Food prices have dropped by 9.5% since the beginning of the year and price levels are now at the same level as at the beginning of 2001

The impact of a food price war was quite considerable in this instance, with prices for groceries falling 4% from the previous month and lowering the CPI by 0.65%. This impact is likely to be temporary, since some products are currently sold below cost price in discount food stores. Food prices in general have dropped considerably this year, to the point where they are 9.5% lower than at the end of last year or the same level as at the beginning of 2001.

Consumer Price Index (CPI) and food prices, January 2001 = 100



Source: Statistics Iceland

Assuming that these temporary effects will be reversed and that the impact of the ISK depreciation in recent weeks will start to be visible, it appears likely that the pace of inflation will rise during the latter part of the summer and approach once again the upper limits of the CB's inflation target (4%). We therefore predict inflation of 3.3% from the beginning to the end of 2005 and 3.6% between annual averages.

Macroeconomic forecasts by the CB and Ministry of Finance

Both the Central Bank and Ministry of Finance, the public bodies publishing regular economic forecasts in Iceland, have recently reviewed their macroeconomic predictions. The CB published its forecast on 22 March and the Ministry just over a month later, on 27 April. The CB's forecast covers this year and next year, while the forecast from the Ministry of Finance extends to 2010. Basically, the forecasts are very similar, both expecting high GDP growth this year and next year, a large current account deficit, inflation close to the CB's upper tolerance limit and unemployment just above 2% in 2006.

The principal difference between forecasts by the CB and Ministry of Finance lies in their assessment of the output gap

The principal difference lies in the relative assessment of the output gap. In its evaluation of this year's situation, the CB regards the output gap as already very high, at 3.1%, and expects it to grow next year to 4.1% of GDP, which is very high in an historical context. The Ministry, however, assumes that the output gap which has already developed in the economy is negligible, and there is thus no danger of the economy overheating at present. Such a sharp contrast in the assessments of these two public bodies must be considered rather remarkable,

especially since an assessment of the output gap is used as a basis for evaluating the need for monetary restraint.

Landsbanki Research has maintained that there are various indications that the CB overestimates the danger of overheating when it predicts more tension now than during the income-tax-free year 1987. Sufficient consideration does not appear to have been given to increased labour market flexibility, especially due to the extensive use of foreign labour, both in connection with power-related industrial developments and in other sectors, such as housing construction. A substantial decrease in unemployment recently, however, does indicate that the slack is rapidly disappearing, a point to which we will return later.

Comparison of macroeconomic forecasts by the CB and Ministry of Finance

	2005		2006		2007	
	CB	MoF	CB	MoF	CB	MoF
GDP growth, %	6,4	5,9	6,1	5,7	-	2,4
Domestic demand, %	12,5	11,6	2,2	3,8	-	-5,1
Current account, % of GDP	-12,2	-12,1	-9,3	-11,4	-	-6,2
Unemployment, % of labour force	2,3	2,4	2,1	2,2	-	3,5
Real disposable income, % change	-	1,9	-	3,3	-	2,6
Inflation, %	3,6	3,9	2,7	3,8	-	3,4
ISK index	109,4	111,3	109,4	116,8	-	122,8
Output gap, % of GDP	3,1	0,5	4,1	1,7%	-	0,8

On the other hand, the Ministry's forecast could be said to be an underestimation. The Ministry assumes that the output gap has reached 0.5% this year and that GDP growth for the year will be 5.7%. This would mean that the economy's productive capacity would have to increase by no less than 4.5% in the coming year for the Ministry's prediction of a output gap of only 1.7% to be fulfilled. An increase in production capacity of this magnitude does seem rather unlikely, especially since, as the end of an upswing approaches, companies could be assumed to have already taken advantage of their best opportunities to increase productivity and the economy to have come close to maximum utilisation of the factors of production. If production capacity were thus to increase by around 3% and not 4.5%, as the Ministry assumes, while GDP growth remains unchanged at 5.7%, the assessment of the output gap would rise to 3.1%, or considerably closer to the CB's estimate.

There is a very real danger of overheating entrenching itself in the economy, which makes it urgent that the government apply all its available economic policy instruments

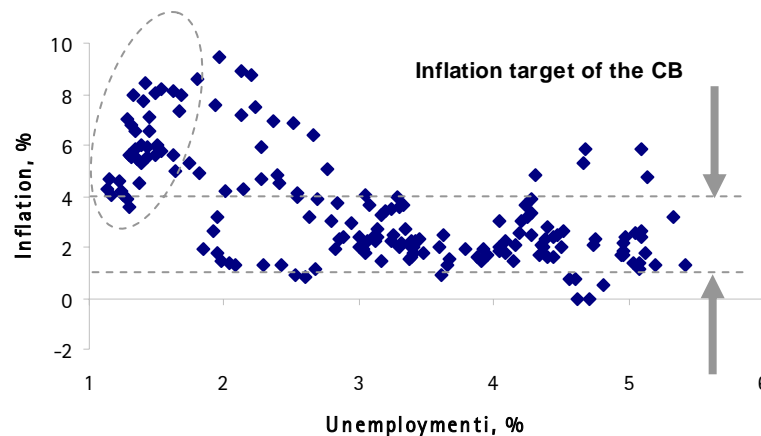
There is clearly no doubt that the need for economic restraint is currently very pressing. There is more than sufficient reason to echo the CB's statement that it is urgent to apply all the measures available to prevent overheating from becoming entrenched in the economy, as there appears to be a real danger of this happening. In such a situation it makes no difference whether the output gap is 4.1% or closer to 3%. The important thing is that inflation is already running out of control, wage agreement reviews this autumn could well disrupt the labour market, the current account deficit is already very sizeable and there are various indications that labour market tension is reaching a new level.

Labour market heats up

The likelihood of widespread wage drift rises on the labour market has grown, calling for increased CB restraint

There are numerous indications that increased tension is developing on the labour market. Registered unemployment in April in Iceland was 2.3% as compared to 3% in January. Registered unemployment has not been this low since September 2002. In the space of only a year, seasonally adjusted unemployment has dropped from 3.1% to 2.3%, evidence of increased labour market tension. During the last upswing, the labour market situation began to tighten up considerably about the time unemployment fell below 2% at the beginning of 1999 and we have actually used this figure as a reference to gauge the NAIRU in Iceland. As unemployment is now approaching this level, the probability of creeping wage increases can be expected to grow substantially. The CB is thus likely to feel it urgent to increase monetary restraint with a further policy rate increase.

Inflation and unemployment 1991–2005



Source: Statistics Iceland, Landsbanki Research's calculations

There are practically no examples in Iceland where inflation has been within the CB's tolerance limits at the same time as unemployment was below 2%

The figure shows the monthly interaction between inflation and unemployment since the beginning of 1991 and up until April this year. During this 15-year period, inflation has fluctuated between 0% to 9.4% and unemployment (seasonally adjusted) from 1.1% to 5.4%. As is evident in the figure, for most of this period inflation has been within the levels now used as tolerance limits for the CB's inflation target, i.e. inflation of between 1% and 4%. In those instances where inflation has exceeded this level, unemployment has almost always been relatively low, most often below 2%. The most intriguing aspect of this figure, however, is that there are practically no examples of inflation within the tolerance limits together with unemployment below 2%. It therefore appears evident, in the light of historical experience, that it will be an uphill battle for the CB to achieve its inflation target if the labour market situation grows too hot and unemployment falls below 2%.

An aluminium smelter in every fjord

All the talk these days is of further power-intensive industry developments in Iceland, in addition to those already underway – the Alcoa project in Reyðarfjörður and Norðurál expansion in Hvalfjörður. As things stand, Norðurál, the Municipality of Reykjanes and Suðurnes Regional Heating Ltd. (south west part of Iceland) have signed an agreement to study the feasibility of operating an aluminium plant with a capacity of 200–250 thousand tonnes in Helguvík (near Keflavík). This announcement was followed by news that Alcoa had declared an interest in co-operating with the Icelandic national and local governments in North Iceland on the possible construction of an aluminium plant there.

Considerably stronger restraint measures clearly need to be applied if there is to be a chance of maintaining the current growth level in 2008–2010

There has been a visible response to this news on the forex market, boosting the ISK exchange rate, even though there is naturally no real possibility of predicting at the moment what the probability of any continuation of power-related development will be once the projects currently underway in this sector conclude. Taking into consideration the investment which has already gone towards projects of this sort, it looks hardly likely that the economy could withstand a major plunge into new development without some sort of cooling-off period first. Considerably stronger restraint measures clearly need to be applied if there is to be a chance of maintaining the current growth level in 2008–2010.

What will the CB do on 3 June?

The message sent by the CB in its next *Monetary Bulletin*, to be published on 3 June, will be fairly clear, in our opinion. Although at the moment, inflation has dropped below the tolerance limit of the CB's monetary policy, much of this development results from one-off effects, due to changes in Statistics Iceland's methodology and a temporary food price war. In other respects the economic situation is unchanged, except that the current account deficit is higher than anticipated and unemployment appears to be dropping more quickly than generally expected. There are no definitive indications yet of a slowdown on the housing market and growth in lending by the banks continues at full steam.

We expect a policy rate hike of 25 or 50 bp on 3 June, with the rate peaking at 10% this autumn

To these developments, the CB has but one response, which is to raise its policy rate still higher, in the hope that the rising financing cost will reduce household and corporate demand. The ISK depreciation in recent weeks will also give the CB more room to manoeuvre. Its monetary policy has been subject to the criticism that the only impact of a rising policy rate has been to push up the ISK exchange rate, causing further deterioration to the situation of export industries, but this claim is not as appropriate any longer. As has been repeatedly pointed out, both by CB spokesmen and others, the high ISK exchange rate is an important mediating factor in monetary policy, exerting a significant restraining effect on the Icelandic economy. A strong ISK directs domestic demand abroad, thereby reducing the pressure on domestic production factors. In the current situation it would be highly undesirable for the ISK exchange rate to fall too much, since the danger of inflation rapidly accelerating in its wake is very high now, when domestic demand is at its peak. In addition, the upcoming autumn months will be a delicate time because of the pending review of current collective bargaining agreements.

Most signs, therefore, point towards a hike in the policy rate of 25 or 50 bp on 3 June, bringing the rate to 9.25% or 9.5% early in the summer and followed by a further increase in late summer to bring the rate to a peak of 10% this autumn.

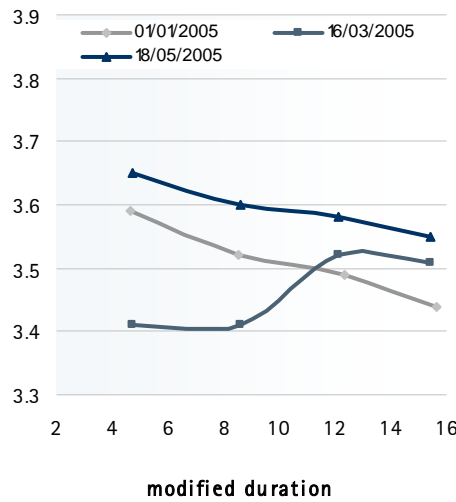
Bond Market

Turnover on the bond market has tended to fluctuate somewhat recently. The market appears to react strongly to news, with the result that trading warms up for a few days at a time, tapering off substantially in between. Such a trend indicates a rather sensitive market. Very substantial issuance of corporate and municipal bonds has also had an effect.

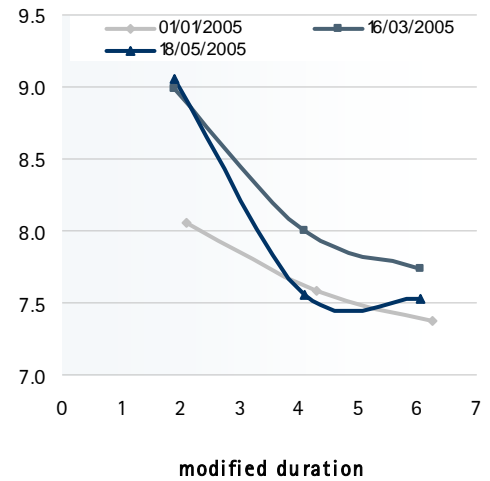
The recent trend is characteristic of a rather sensitive bond market

HFF bond yields remain unchanged, although there have been short term fluctuations, from their levels when the last *Economic Issues and the Bond Market* was issued on 17 March this year. Yields on treasury notes, on the other hand, have declined since the March issue. It should be mentioned that the changes in the CPI calculation announced by SI on 3 May had a considerable impact in raising HFF bond yields and lowering those of treasury notes, since the modified methodology resulted in lowering the May inflation rate by 0.45% (5.4% on an annual basis). The rise in HFF yields has been reversed recently, and is currently the same as it was in mid-March.

HFF bond interest rate curve



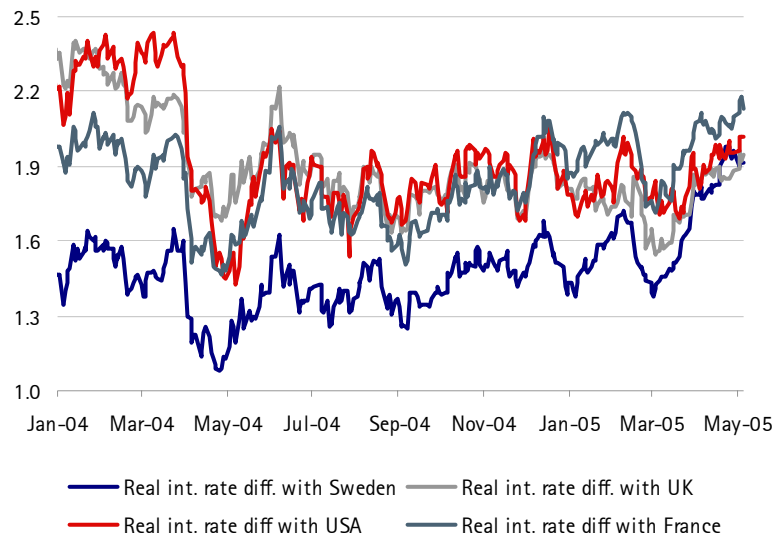
Treasury notes interest rate curve



The difference between inflation-indexed market interest rates in Iceland and abroad is about 200 bp

In parallel to the rise in HFF Bond yields, the real interest rate differential between inflation-indexed interest rates in Iceland and abroad has grown. The interest rate differential has risen by 50 bp on average, as inflation-indexed interest rates have decreased in the countries examined here at the same time as yields on Icelandic HFF Bonds have risen. As things now stand, the real domestic-foreign interest rate differential is around 200 bp, as compared to 150-170 bp in March.

Interest rate differential on inflation-indexed bonds with average 10 Y maturity



Source: EcoWin

Primary market supply – things are not quite what they seem

So far this quarter, additional HFF calls have amounted to ISK 6.7 bn, although the forecast figure was around ISK 9.0 bn

As discussed in the previous issue of *Economic Issues and the Bond Market*, the supply of government-backed bonds on the primary market was negative by around ISK 27 bn during Q1. This is primarily the result of additional Housing Bond calls totalling ISK 22 bn. According to the original forecast, the calls were to amount to ISK 33 bn, but turned out to be considerably lower due to the type of paybacks of older HFF loans. So far this quarter, additional HFF calls have amounted to ISK 6.7 bn, although the forecast figure was around ISK 9.0 bn. This forecast now looks likely to be realised, as HFF has given notice of an additional call in June.

Forecast issuance of government-backed bonds in 2005

MISK	Actual 1Q	Forecast HFF Issuance			Total 2005
		2Q	3Q	4Q	
HFF bond issuance	11,000	14,000	13,000	17,600	55,600
HFF payments					
Regular payments	-10,500	-11,200	-9,100	-10,900	-41,700
Additional Housing Bond payments	-22,300	-9,100	-8,400	-6,300	-46,100
Paybacks of older loans	-4,300	-3,900	0	0	-8,200
Net supply from HFF	-26,100	-10,200	-4,500	400	-40,400
		Forecast Treasury issuance			
National Treasury	2,420	1,500	3,000	1,500	8,420
Treasury payments	-3,248	-18,000	0	0	-21,248
Net supply from NMDA	-828	-16,500	3,000	1,500	-12,828
Net supply	-26,928	-26,700	-1,500	1,900	-53,228

* Forecasts of HFF and NMDA

As the above table shows, issuance of government-backed bonds on the primary market will also be negative in Q2. A major factor here is redemption of RIKS-05, which matured in April. The market value of this class was around ISK 18 bn on the redemption date. HFF intends to issue HFF Bonds in the amount of ISK 14 bn in Q2, but no auction has yet taken place. Judging by current HFF Bond yields, we can assume unchanged interest terms, i.e. a rate of 4.15%.

ISK 70 bn in corporate and municipal bonds issued

According to our calculations, around ISK 70 bn in corporate and municipal bonds were issued during the first four months of this year

In contrast to the negative primary market supply of government-backed bonds, issuance of corporate and municipal paper has been lively. According to our calculations, around ISK 70 bn in bonds were issued during the first four months of this year, which is a very high figure. By comparison, total bond issuance in 2004 was around ISK 72 bn, and that was a record year for corporate and municipal bond issuance. Pension funds and other large investors view these bonds as highly attractive investment options, since they are most often inflation-indexed and bear interest rates 150-200 bp higher than the interest on government-backed bonds. So it comes as no surprise that Treasury bond turnover was at a low during the year to date.

Bond issuance by corporations, holding/investment companies, and municipalities, Jan-Apr 2005

Corporate issuer	MISK	Municipal issuer	MISK
Atorka	3,000	Municipal Loan Fund	1,500
SPK	1,500	Municipal Loan Fund	2,000
EGLA	5,000	Reykjanes Harbour	468
Íslandsbanki Iceland	2,000	City of Reykjavik	1,500
Drilling	2,000	Town of Vestmannaeyjar	325
Landsvirkjun	8,000		
Meiður	5,000		
Og Vodafone Reykjavík	2,000		
Energy	1,000		
Samson	10,000		
FL Group	10,000		
Spron	3,000		
Spölur	1,500		
Straumur	6,000		
Total	60,000	Total	5,793

Corporate and municipal bond issuance in the past seven months amounts to ISK 115 bn

This development has clearly affected benchmark government-backed bonds, and HFF Bonds in particular, with one result being a gradual increase in yields. Increased issuance of corporate and municipal bonds is a natural development when real interest rates in Iceland have been falling and the ISK strengthening steadily. ISK 70 bn in only four months, however, exceeds our expectations. Of the ISK 72 bn in bonds issued last year, 60% made their appearance in Q4. Corporate and municipal bond issuance in the past seven months thus amounts to ISK 115 bn. We expect this bond issuance to continue through the year, but probably at a somewhat lower rate.

Currently the only known issue upcoming is an ISK 6.0 bn bond which the UK fashion chain Mosaic intends to place on the Icelandic bond market in the next few months

Currently the only known issue upcoming is a ISK 6.0 bn bond with which the UK fashion chain Mosaic intends obtain financing on the Icelandic bond market in the next few months. Íslandsbanki has also announced a new bond issue, but whether this will be domestic or foreign financing is not yet known. The strong ISK and expectations that it will weaken in the latter half of next year will continue to encourage domestic financing, and as a result further corporate and municipal bond issuance can be expected this year.

Banks' inflation-indexed housing mortgages reach ISK 200 bn

During the first four months of this year, the banks have granted ISK 80 bn in credit, with the total amount of their new housing mortgages amounting to ISK 200 bn

During the first four months of this year, the banks have granted ISK 80 bn in credit. By the end of April, the total amount of their new housing mortgages had reached ISK 200 bn. During the year to date, the banks have been granting mortgages amounting to some ISK 20 bn per month while HFF lending has averaged around ISK 6.0 per month. As has been pointed out, a major portion of the banks' mortgages has probably been refinancing of older HFF mortgages. HFF lending, on the other hand, reflects only new borrowing in connection with housing purchases. Our March *Economic Issues and the Bond Market* included a forecast for mortgage financing from the banks and HFF this year. Since that time, the banks' actual figures for March and April have become available, and proved to be slightly higher than we anticipated. We estimated that the total mortgage stock would be at least ISK 250 bn by year-end, which is a cautious estimate in view of bank mortgage developments in the past two months. Household debt conversion and housing purchasing thus do not appear to be slowing.

We estimate that paybacks of older HFF mortgages amount to around ISK 70 bn in the YtD

Since figures are not available on paybacks of older HFF mortgages this year, it is impossible to say exactly how high the total amount of indexed housing mortgages is (members' pension fund mortgages, HFF mortgages and bank mortgages). The amount of paybacks can be estimated, however, from HFF notices of additional calls. HFF has announced calls of ISK 9.3 bn in dematerialised classes and around ISK 33 bn in bond certificates, or a total of ISK 42.3 bn. Based on this, we estimate that total paybacks of older HFF mortgages amount to around ISK 150 bn since the beginning of 2004 to the present day. According to HFF's annual report, paybacks in 2004 amounted to ISK 83 bn, which would mean that paybacks so far this year have been around ISK 70 bn according to our estimate.

Additional housing bond calls and estimated paybacks of older HFF mortgages

Series	Outstanding as of 30 June 2004	Market value of class after switching	HFF calls announced	Calls, %	Estimated paybacks
Dematerialised housing bond series					
IBH 21	30	1,7	1,2	73%	22
IBH 22	32	0,5	0,3	62%	20
IBH 26	33	0,8	0,2	25%	8
IBH 37	67	10,2	2,9	28%	19
IBH 41	118	18,4	4,7	26%	30
Total	280	31,6	9,3		99
Bond certificate series calls					33
Paybacks prior to banks' entry into the market 2004					20
Total paybacks 2004 – July 2005ly 2005					152
Paybacks in 2004					83
Paybacks Jan - July 2005					69

Total amount of inflation-indexed housing mortgages around ISK 700 bn

To judge by credit granted by both HFF and the banks since the beginning of this year, and estimated paybacks, the total amount of indexed housing mortgages is around ISK 700 bn, which corresponds to a net increase in housing financing of around ISK 100 bn since the end of August, when the banks first began to offer housing mortgages at competitive rates.

Commercial banks' bond exposures

According to Research's estimates, total Icelandic bond exposures of foreign investors are around ISK 100 bn

No information is available on foreign investors' total exposures in Icelandic bonds, which is certainly unfortunate. The CB publishes a quarterly summary of foreign investors' direct purchases of Icelandic securities, but this information is only part of the actual picture. Previously it was possible to estimate the bond exposures of foreign investors by examining the banks' annual financial statements. Roughly speaking, forward bond contracts undertaken on behalf of the banks' customers could be assumed to be for the most part concluded for foreign investors. After the Danish investment bank FIH was merged into Kaupthing Bank's consolidated statements, and Kreditbanken added to Íslandsbanki's consolidated statements, the situation is no longer so simple. According to information from the CB, Icelandic bond exposures of foreign investors amounted to ISK 30 bn at the end of April, and we estimate that they hold forward contracts amounting to around ISK 70 bn, which would make foreign investors' total Icelandic bond exposures in the area of ISK 100 bn. By comparison, these positions were around ISK 130 bn at the end of last September, according to information issued by ICEX.

The commercial banks have been increasing their bond exposures, but not necessarily in government-backed bonds

The interim financial reports of the three commercial banks recently published show that in each case their net bond exposures have increased in Q1. It is highly likely that a major portion of the increase by Íslandsbanki and Landsbanki, which amounts to some ISK 30 bn, is an increase in domestic bond holdings. This does not necessarily mean that the increase is in government-backed bonds (issued by public authorities), since to judge by developments in Q4 of 2004, both banks were adding substantially to their Icelandic portfolio with bonds issued by other parties. Because of the introduction of new International Financial Reporting Standards (IFRS), the exact breakdown is no longer visible, but in light of government-backed bond developments in Q1, i.e. in HFF Bonds and treasury notes series, we expect that commercial banks' investments have not been directed at these bonds during the 1st quarter.

Rising yields still expected

So far this quarter, HFF bond yields have been 1-8 bp higher on average than we anticipated

Landsbanki Research's most recent general forecast for bond market developments was issued last March. The conclusion was that HFF Bond yields would average around 3.5% in Q1 and then start to rise during the latter part of this year. As far as treasury notes are concerned, we expected yields on RIKB 07 and RIKB 10 to continue to inch upwards during the quarter while the yield on the longest note series, RIKB 13, should decline.

So far this quarter, HFF bond yields have been 1-8 bp higher on average than we anticipated. The change in methodology applied by SI to CPI calculation resulted in considerable selling pressure, in addition to which the ISK has gone through a period of depreciation, falling by close to 5% during Q2. The ISK development may well have influenced foreign investors' profit-taking actions. On the other hand, once the index had risen to 115-116, it appears that some foreign investors decided it was to their advantage to re-enter the market, contributing to a drop in yields recently. A plentiful supply of corporate and municipal bonds has clearly influenced the actions of Icelandic pension funds and other large domestic investors, who have been investing in HFF bonds to a more limited extent than otherwise. A net drop in the supply of government-backed bonds of ISK 50 bn during the first half of this year has actually been filled by the high issuance of corporate and municipal bonds, with the result that instead of decreasing since the beginning of this year, yields on government-backed bonds have risen. The 3.5% "floor" also appears to have been a factor in HFF Bond yield development. As previously discussed, this is the critical discount rate used in annual actuarial assessment of the indexed assets of general pension funds.

The forecast assumes that yields on HFF bonds will range from 3.50% to 3.60% until the end of Q2

The forecast for the development of HFF yields has been updated to take developments in this past quarter into consideration, but the forecast for Q3 and Q4 is unchanged, since we still expect yields to inch upwards. The forecast assumes that yields on HFF bonds will range from 3.50% to 3.60% until the end of Q2.

Yields on treasury notes have tended to fluctuate considerably so far this quarter, influenced primarily by policy rate hikes and short-term inflation forecasts. We expect the CB to raise its policy rate by 25–50 bp concurrent to the publication of its *Monetary Bulletin* on 3 June, and that the rate will reach 10% around the middle of this year. Inflation in Q3 is expected to be higher than in Q2. This development will, in our estimation, result to a further drop in price for treasury notes, with the exception of RIKB 13.

Forecast development of benchmark bond classes in 2005*, %

	Avg. maturity, yrs.	18 May 05	Q1 *	Forecast		
				Q2	34	Q4
HFF Bonds, indexed						
HFF 1502 24	8.63	3.60	3.51	3.60	3.70	3.80
HFF 1504 34	12.12	3.58	3.49	3.55	3.65	3.75
HFF 1506 44	15.4	3.55	3.47	3.50	3.60	3.70
Treasury Bonds, indexed						
RIKS 15 1001	10.54	3.57	3.47	3.55	3.65	3.75
Treasury Notes, non-indexed						
RIKB 07 0209	1.9	9.05	8.45	8.90	9.00	9.00
RIKB 10 0317	4.08	7.55	7.73	7.70	8.00	8.00
RIKB 13 0517	6.05	7.53	7.46	7.50	7.50	7.50

* Average for each quarter

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