Financial markets and Central Bank measures [1]

Adequate liquidity position of credit institutions

The Central Bank lowered its policy interest rate by 0.5 percentage points in February and the rate is currently 5.3%. Interest rates in the interbank market for domestic currency fell by somewhat more than the cut in the policy rate on account of adequate liquidity in the banking system, the reasons for which include the Central Bank's purchases of foreign currency in domestic FX markets, lowering of required reserves and redemption of a large Treasury bond class in February. For certain deposit money banks at present, the main function of Central Bank repos is for hedging purposes. The króna strengthened somewhat from the beginning of February to the end of April when the foreign exchange index stood at 119.6, having gone down by 1.45% since the end of January. Interest rate differentials with abroad have narrowed in the wake of the policy interest rate cuts. The Central Bank plans to step up its regular purchases of currency in order to strengthen its foreign reserves. Equity prices have risen by almost 5% so far this year, after good profitability last year by most listed companies.

Interest rates cut in February

On February 10, 2003 the Central Bank announced a cut in its policy interest rate from 5.8% to 5.3% as of February 18. Before then, the last change had been the cut made on November 12, 2002. Deposit money banks (DMBs) immediately announced a corresponding change in interest rates on their non-indexed deposits and lending, and also lowered their indexed interest rates by 0.15-0.2 percentage points. Since beginning to lower interest rates in March 2001, the Central Bank has cut is policy rate by 6.1 percentage points.

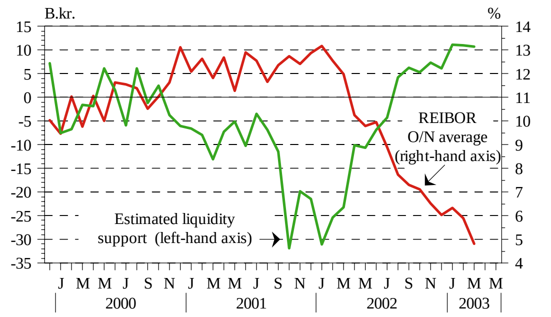
Liquidity position of credit institutions eased ...

The liquidity position of credit institutions has eased significantly in recent months, in part because of the Central Bank's currency purchases in the interbank market amounting to around 17 b.kr. since the beginning of September 2002. In March this year the Central Bank lowered the credit institutions' required reserves by more than 8 b.kr. Further reductions in required reserves are planned to bring them broadly into line with the rules in effect at the European Central Bank. The second reduction is expected to take effect before the end of the year and overall will probably be on a similar scale to that in March, although it may be spread differently among institutions. Redemption of a fairly large Treasury bond class in February also helped to ease liquidity. Conceivably, the banks may in effect have funded their sales of currency to the Central Bank by increasing their foreign borrowing, since no corresponding growth has taken place in their foreign-denominated lending, but since their foreign exchange balance is close to zero the explanation would appear to lie in off balance-sheet forward contracts. From the end of September to the end of April, the DMBs' foreign-denominated liabilities grew by 15 b.kr. more than their foreign-denominated assets. In the space of a few months the banking system has shifted from tapping Central Bank liquidity to holding a liquid "deposit" there, excluding the share of Central Bank repos used to hedge interest rate swaps with foreign entities. This is shown on Chart 1.

1. This article uses data available on April 30, 2003.

Chart 1

Estimated Central Bank liquidity support and interest rates December 1999 - March 2003



Source: Central Bank of Iceland.

... which forces interest rates down ...

This situation has supported the Central Bank's interest rate policy, since adequate liquidity forces down interest rates. The interaction between estimated Central Bank liquidity support and average O/N rates per month in the interbank market for domestic currency is shown on Chart 1. Adequate liquidity has also taken the form of lending by individual banks to others well in excess of negotiated credit lines. Chart 2 shows the daily development of interest rates in the interbank market for domestic currency since the beginning of 2003. For most of this period interest rates were higher than the policy rate, which may partly have been caused by individual banks' measures at the end of the year to limit their exposures towards the Central Bank and partly because changed arrangements concerning collateral security for payment systems restricted their scope for using their required reserves. The government bond redemption in March eased liquidity and put strong downward pressure on interest rates. Interest rates also moved quite sharply following the change in required reserves. In the beginning of April limitations were introduced on credit institutions' scope for using required reserves as collateral security in payment systems, in line with international practice.

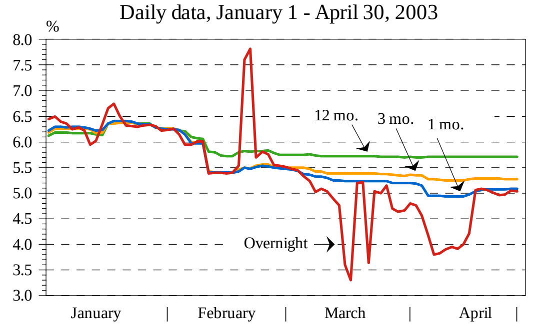
... but bond market interest rates obey other laws

Interest rate developments have not followed the same pattern in the bond market and interbank market. Interest rates on non-indexed securities went down from mid-January to mid-February until a sharp turnaround took place, which was largely attributed to the Government's announcement of temporary measures to reduce unemployment with stepped-up road building programmes and other projects. Non-indexed rates edged downwards again until another sharp rise in early April which was attributed to remarks from Landsvirkjun (the National Power Company) that it would conceivably finance part of its hydropower investment costs with domestic borrowing. This was a fairly short-lived rise, however, and interest rates soon began inching downwards again, as shown on Chart 3. All in all, non-indexed rates have remained virtually unchanged from end-January to end-April, despite sharp swings in both directions. The yield curve for indexed bonds was similar in many respects, as shown on Chart 4.

Chart 2

Interest rates in the interbank market for domestic currency

Daily data, January 1 - April 30, 2003

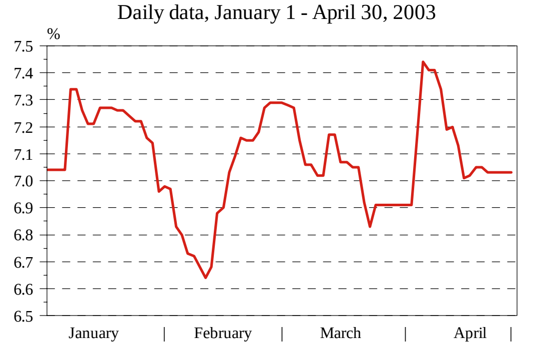


Source: Central Bank of Iceland.

Chart 3

The non-indexed bond yield

Daily data, January 1 - April 30, 2003

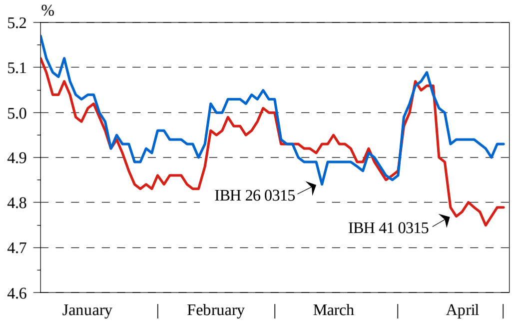


Source: Central Bank of Iceland.

Chart 4

Housing bond yields

Daily data, January 1 - April 30, 2003



Source: Central Bank of Iceland.

Strong demand for housing bonds ...

Some of the demand for housing bonds has been connected with interest rate swaps with foreign investors. To hedge against exchange rate changes, intermediaries (credit institutions) have been buying indexed housing bonds and then pledged them as collateral security for a repo loan from the Central Bank. The foreign investor then pays the interest on the repo and earns the yield on the indexed housing bonds instead. Such trading is partly responsible for lower housing bond yields despite an increase in supply. It has not contributed to maintaining the strong króna, however, since it does not entail any exchange rate risk. Nonetheless, there may be a risk that interest rate volatility could provoke investor flight. This would leave the intermediary with a large quantity of securities to dispose of quickly, with the consequent risk of a price crash which could spark a chain reaction to divest bonds sold by similar arrangements.

... and for Treasury bills

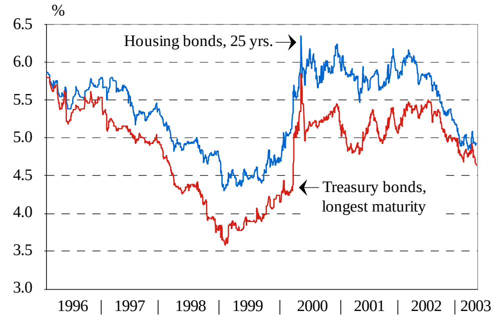
The Treasury decided to increase the flexibility of its T-bill issues by raising the maximum offer every two months from 4 b.kr. to 7 b.kr. One idea behind this change is to step up Treasury short-term domestic financing at the expense of foreign short-term borrowing. In the first auction under this new arrangement, held in March, total bids amounted to 16.5

Robust growth in Housing Financing Fund lending

In 2002 the Housing Financing Fund disbursed housing bonds to the market value 34.9 b.kr., a 13% increase from the previous year. Housing authority bond issues amounted to 15.7 b.kr. A heavy need for housing, especially in the Greater Reykjavík Area, has caused supply to increase and the Fund has financed a sizeable share of it. Housing bond disbursements over the first three months of this year amounted to 9.5 b.kr., somewhat in excess of the Fund's forecasts. The average amount per disbursed loan application has risen from 3.4 m.kr. in Q1/2002 to 3.8 m.kr. in the same quarter this year. Even though Housing Financing Fund bonds have ranked with the most secure on the market – price-indexed, generally with a high-priority pledge and backed by a Treasury guarantee of collection – yields on them have been noticeably out of alignment with government bonds, as the Chart shows. There are very strong indications that the main reason is certain features of these bonds, especially the lottery drawing system for redemptions and also the number of smaller bond classes. Changes to the lottery drawing features of electronically registered securities has already narrowed the spread, as the Chart shows. Further changes in the format for Housing Financing Fund bond issues could presumably make them more lucrative, narrowing the gap even further.

Housing bond and Treasury bond yields

Daily data February 1, 1996 - May 2, 2003



Source: Central Bank of Iceland.

b.kr., of which 7 b.kr. were accepted. Bids amounting to 6 b.kr. were accepted in an auction in the beginning of May. The Treasury has gradually reduced the use of price indexation in its domestic portfolio (issued market securities) in recent years. From 1993 to 2000 the proportion of indexed loans was 80% or more, but this figure was down to 69% at the end of 2001 and 54% at the end of last year. The redemption in February brought the proportion down to 47% and it can be expected to drop below 30% over the next two years.

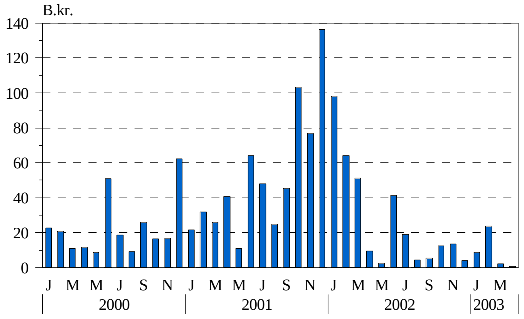
More active domestic currency market

Trading in the interbank market for domestic currency amounted to 220 b.kr. over the first four months of the year, compared with 124 b.kr. over the same period in 2002. In the FX swap market, trading in the first four months was 35 b.kr., just under half the 73 b.kr. recorded in the same months last year. Easier liquidity has significantly reduced the credit institutions' need for Central Bank O/N facilities. O/N lending over the first four months of 2003 amounted to 36 b.kr., compared with 223 b.kr. in the same months the year before. Lending liable for penalty interest amounted to only 6 b.kr. from January to the end of April as against 40 b.kr. over the same months last year. Chart 5 shows the O/N lending trend. The outstanding repo stock was 78 b.kr. at the end of January and 76 b.kr. at the end of April

Chart 5

Overnight Central Bank lending (monthly totals)

January 2000 - April 2003



Source: Central Bank of Iceland.

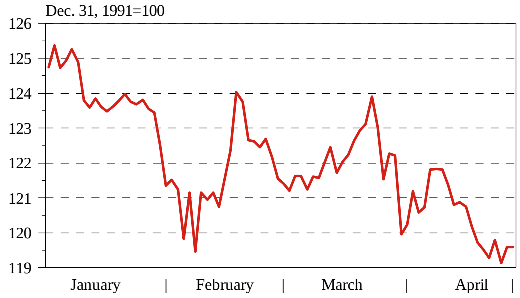
The króna has strengthened ...

At the beginning of the year the foreign exchange index stood at 124.75 but by the end of April it had fallen to 119.6. The index has moved within this range, with some volatility, as Chart 6 shows. Reports of the planned expansion of the Norðurál aluminium smelter, conceivable fishing quota increases and a favourable merchandise account balance during the first months of the year have contributed to the strengthening, while there has also been some foreign capital inflow. Reports of the Government's stepped-up construction programme to reduce unemployment, and concerns about the war in Iraq, caused a temporary weakening. Foreign banks have been taking positions in Icelandic currency by purchasing krónur and depositing them with a domestic bank, in order to sell later after the further strengthening that they expect. Turnover in the foreign exchange market was brisk in February at 112 b.kr. but in the range 68-83 b.kr. in the other months. On three days turnover exceeded 10 b.kr. and the highest figure was on February 5 at 12.2 b.kr.

Chart 6

The nominal effective exchange rate index of the króna

Daily data, January 1 - April 30, 2003



Source: Central Bank of Iceland.

... and interest rate differentials narrowed ...

Central banks in various countries have reduced their policy rates in recent months, but the Bank of Canada raised its key policy rate by 0.25 percentage points on March 4. The European Central Bank reduced its main financing operations minimum bid rate by 0.25 percentage points on March 6, to 2.5%. In Denmark, the Nationalbank followed suit with a cut by the same amount. The Swiss National Bank cut its rates by 0.25 to 0.5 percentage points the same day. The Central Bank of Norway cut its key interest rate by 0.5 percentage points on March 5 and by a further 0.5 percentage points on April 30. In Sweden, the

Riksbank lowered its repo rate by 0.25 percentage points on March 18. The Bank of Japan intervened in the Japanese foreign exchange markets in January, February and March in order to weaken the yen and also attempted to stimulate economic activity by easing access to its facilities even further. Japan's effective policy rate has been 0% for some time. The trade-weighted interest rate differential between Icelandic and foreign Treasury bills narrowed from 3.3% to 2.6% from the end of January to end of April. Weighted by foreign interbank rates, the reduction was from 3.4% to 2.6%.

... but the US dollar has weakened

The US dollar has weakened against most main currencies recently. While the war in Iraq and the disputes preceding it played some part, the main explanation surely lies in the sluggish US economic growth and policy response. Since the real exchange rate of the dollar rose to more than 30% above its historical average, this downturn had been expected for a long time. A growing US current account deficit and proposals for tax reforms have also been suggested as reasons for the weakening.

Central Bank currency purchases ...

At the beginning of September the Central Bank of Iceland began buying currency from interbank market makers, initially 1½ million US dollars in the market twice a week, then three times a week since January and on a daily basis since the beginning of February. In these transactions, the Bank bought currency totalling the equivalent of 12.8 b.kr. from the beginning of September 2002 to the end of April 2003. In January, the Bank purchased currency for almost 4 b.kr. in a single trade with one market maker. When plans to purchase currency were made known in August 2002, the Bank announced its intention to buy the equivalent of 20 b.kr. before the end of 2003. This figure was close to the short-term position of the foreign reserves at that time. Currency selling, including sales to the Treasury in connection with foreign debt service, has meant that short-term funding of the foreign reserves has not been reduced by the equivalent of these purchases and amounted to 11 b.kr. at the end of April. At the end of April the Central Bank's foreign reserves stood at 38.5 b.kr. and its external position had strengthened by 6.8 b.kr. since the end of August 2002. Currency sold to the Treasury in connection with foreign debt service amounts to several billion kr. over the period. On a longer-term view, once the Bank has built up its foreign reserves, it aims to procure currency in the domestic forex market to meet the Treasury's requirements rather than drawing on foreign reserves.

... will be stepped up

Conditions in the foreign exchange market have changed since the Central Bank announced its plans for currency purchases in August 2002. Currency inflows and the strong króna following the decision to construct an aluminium smelter and hydropower facilities in East Iceland present an opportunity for further currency purchases over and above the 20 b.kr. originally envisaged under the decision made in August. The Central Bank has decided to increase its daily purchases of foreign currency in the domestic interbank market to 2.5 million US dollars as of May 19 and continue with that amount until the end of the year. As before, the Bank is also willing to trade in the FX market on the initiative of market makers if large amounts are involved. While this measure can obviously have an effect on the exchange rate, at least in the short run, and will also increase liquidity in the financial system, the Bank's primary motive is to take advantage of favourable conditions in the FX market in order to strengthen its foreign position. Among other things, adequate foreign reserves are important for the credit rating of the Republic of Iceland and other domestic entities in foreign markets. In cases where the Central Bank does not consider the fundamentals are in place for scheduled currency purchases, it reserves the right not to trade, as was announced in August last year. Transactions will be conducted along the same lines as before, i.e. the Bank will purchase currency from market makers before the forex market formally opens for trading.

Fairly buoyant equity market

Good profitability by listed companies last year has undoubtedly contributed to higher equity prices on Iceland Stock Exchange (ICEX). Since the beginning of this year the ICEX-15 index has risen by 4.8%. Turnover in the equity market has been brisk although it may be dampened by delisting of companies as a result of changes in their ownership. New rules have been issued on the disclosure of information about salaries and related financial terms of chief officers. Companies listed on ICEX are now obliged to disclose these in their annual and interim statements. Privatisation of Landsbanki, Búnaðarbanki and Iceland Prime Contractors was concluded in February, March and April respectively with the sale of the former two through the ICEX trading system and a management buyout of the third. At the end of March it was announced that talks had begun on a merger between Kaupþing banki and Búnaðarbanki. Talks were concluded quickly with the announcement of an agreement on a merger on April 12. The merged bank is scheduled to commence operation on May 27, 2003.