Exchange rate depreciation, interest rate cut and tighter liquidity

On March 27 it was announced that the fluctuation band of the exchange rate would be abolished, and the reform took effect the following day. Over the days prior to that, the króna came under serious pressure. The exchange rate slid even further after the reform and has now weakened by 7.3% since the beginning of the year. Of this figure, 5.2% occurred in the period after the March reform. At the same time as the new exchange rate framework was adopted, the Central Bank lowered interest rates on its repo agreements by half a percentage point. The interest rate cut was based on the assessment that inflation would decelerate next year and that the overheating targeted by the Bank with its measures over the past few years would ease. The interest rate differential with abroad changed little, however, and has remained relatively stable since mid-January. Bond yields have fallen somewhat and share prices have lost more than 14% since the New Year.

After a relatively slow weakening of the króna ...

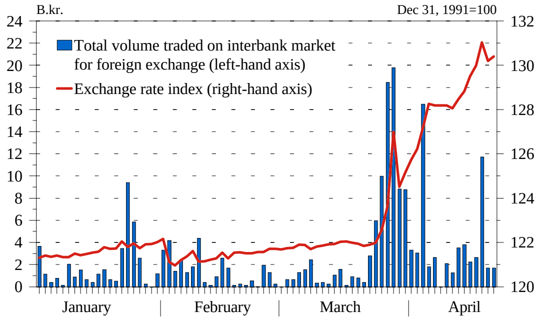
Following the short-lived impact of extensive Central Bank intervention at the end of January, the króna continued to weaken, albeit without major swings. The exchange rate index stood at 121.74 on January 26 but had reached 122.02 on the 31st of the same month. A short-lived strengthening began on February 2, but on February 9 the Bank deemed there to be grounds for further intervention when signs of a shortage of foreign currency appeared. From February 10 until March 23 the index rose relatively steadily, but apart from two days remained below 122. Forex market trading volumes were relatively low throughout this period.

... the exchange rate index jumped upwards when the market thought a change in policy was likely

As the Central Bank's annual meeting approached, a rumour spread that a change in the exchange rate framework would be made on that occasion. Widespread media coverage of inflation targeting, the publication of a new national economic forecast and the review of the Central Bank Act were viewed as the main indicators of a pending change. Pressure then began to build up and the exchange rate of the króna rapidly slid. The impact of extensive intervention on March 23 proved short-lived. Sharp swings took place during the day and at the most severe point the index jumped by 0.25% in the space of sev-

Chart 1 Exchange rate of Icelandic króna and volume traded on the foreign exchange market

Daily data, January 3 - April 26, 2001



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

eral minutes. This tension continued until the annual meeting and the Central Bank intervened in foreign exchange market trading. In all, it sold US dollars for the equivalent of 3.6 b.kr. over these days, and trading volume ran extremely high to reach 34.4 b.kr. in all during the last three days before the change. Nonetheless, the Bank kept the króna within its fluctuation band. It seems obvious that, when the rumour started to spread, investors began to make early settlements of agreements which were based on the assumption that the fluctuation band would endure.

A monetary framework reform was announced at the Bank's annual meeting on March 27, taking immediate effect the following day. The fluctuation band, which allowed a ±9% deviation in the foreign currency index from its central value of 115.01, were abolished and the króna was floated. This reform is discussed in more detail in a separate article on the monetary policy framework elsewhere in this Bulletin.

The króna weakened after the flotation

When the forex market opened on March 28, the exchange rate dropped in the space of several minutes, but it rallied quickly later the same day. The index was fixed at 126.22 on March 28 but the currency strengthened considerably over the following day to 124.51. Since then, the króna has weakened. For a while it remained more or less stable at 128.2, then rose on April 17. On April 24 it rose to 131.04, the highest value until that time. From the beginning of the year until April 26 the index rose by 7.9%. Uncertainty in connection with the fishermen's strike may have had a negative effect on the exchange rate, but the large rise in the CPI in April may also have played some part.

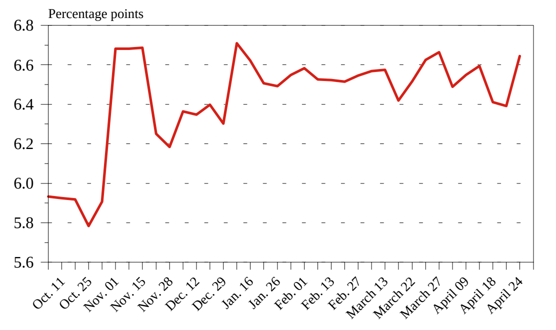
Interest rate cut and a change in the interest rate structure

The Central Bank's annual meeting was informed of the Board of Governors' decision to lower the Bank's policy rate by 0.5 percentage points. However, this cut did not extend across the entire interest rate spectrum, the overnight loan rates remained unchanged and the rate on certificates of deposit was reduced by only 0.2 percentage points. This cut was made on the assumption that the near-term inflation outlook was in line with the Bank's newly set inflation targets,

Chart 2

3 mo. T-bills interest rate differential with abroad

Weekly data, Oct. 11, 2000 - April 24, 2001



since significant signs had emerged that overheating was on the wane and the economy could be expected to continue to cool over the following months. Interest rates on day loans and certificates of deposit were not lowered as much as the policy rate, in order to encourage credit institutions to implement more active liquidity management, in addition to which it was hoped that the measure would help to reinvigorate the interbank domestic market.

The interest rate differential has not changed much, despite the cut in Iceland

Little change has taken place in the interest rate differential with abroad. Since mid-January 2001 the differential for three-month T-bills has fluctuated within a relatively narrow range between 6.4 and 6.7 percentage points. The impact of the Central Bank's interest rate cut at the end of March was short-lived, since the US Federal Reserve lowered its policy rate again in mid-April. So far this year it has cut its rate four times, by a total of 2 percentage points. The Central Bank of Japan lowered its rate by 0.15 percentage points. The European Central Bank has not altered its interest rates since October. The Bank of England lowered its rate by 0.25 percentage points at the beginning of April and the Bank of Canada likewise around the middle of that month.

High interest rates in the interbank domestic market

For the past five months, short-term interest rates in the interbank market have remained very high. It is worth noting that interbank rates have been higher than the Central Bank's policy rate on many occa-

Chart 3

Monthly turnover on the interbank market

January 1998 - April 2001

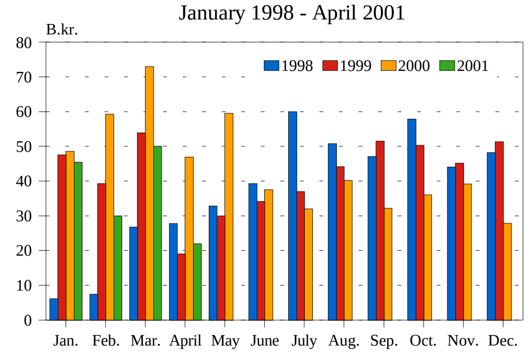
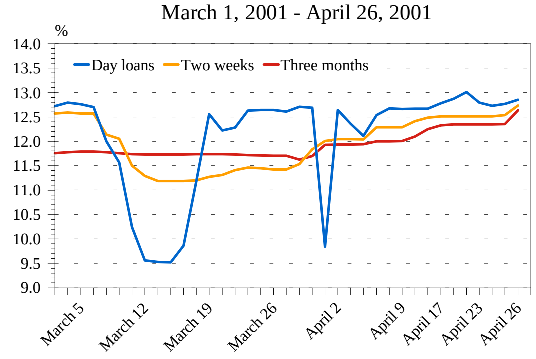


Chart 4

Lending rates in the interbank market

March 1, 2001 - April 26, 2001



sions during this period, which is inconsistent with an active and well-informed market since it presents participants with an obvious arbitrage opportunity by borrowing from the Central Bank. There may be many reasons for these high interest rates in the interbank market, but the root cause is a shortage of domestic currency. In one sense it may seem paradoxical for the exchange rate to weaken at the same time as there is a shortage of the domestic currency in the Icelandic financial markets. Thus it is clear that market participants are not prepared to sell foreign currency in order to ease the shortage of domestic currency, which at the same time would contribute towards strengthening the króna.

The main reasons behind the shortage of domestic currency in Iceland's financial markets is Central Bank interventions in the forex market, which have amounted to 11.9 b.kr. so far this year, and the treasury's strong position on its current account with the Central Bank, while the credit institutions' higher required reserve can be expected to have had some effect as well. Offsetting this is the growth in market participants' repurchase agreements with the Central Bank, which has increased the outstanding repo balance by more than 15 b.kr., or just over 29%. At the same time as Central Bank repo trading has grown, required DMB reserves have been increasing, for example by 23% since December 2000. The growth in repos since the beginning of the year is largely explained by the higher required reserves and forex market intervention. Changes in the Central Bank's base money are actually a much better indicator than repurchase agreements of its contribution towards money creation, since base money covers all the crucial factors in this respect. Base money has fluctuated somewhat during the year, as usual, but overall it has not increased, cf. Chart 5.

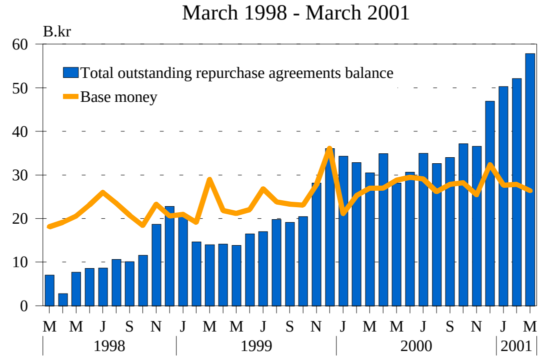
As said previously, on March 27 the Central Bank announced a reduction in its repo yield. All things being equal the expected response from the interbank market would have been a reduction in interest rates on short-term agreements.

As Chart 4 shows, the interest rate cut had virtually no effect in the interbank market. Interest rates on day loans fell immediately by 2.2 percentage points the day after the announcement, but went back up straight away and at the time of writing are somewhat higher than before the rate was lowered. The interest rate adjustment does not seem to have any impact on loans with a longer maturity than one day in the interbank market. Commercial banks, however,

Chart 5

Repo balance and base money

March 1998 - March 2001



lowered their rates by the same amount as the Central Bank immediately after the cut was announced.

Tighter liquidity increases Central Bank repos

The outstanding repo balance has invariably reached its highest levels around the end of the year. Fluctuations in DMB liquidity resulting from seasonal changes in the treasury's position with the Central Bank are the cause. The total outstanding repo balance at the end of last year was almost 47 b.kr. and is now (April 26) more than 60 b.kr., having dropped by over 4 b.kr. from its peak the week before.

Two main factors explain this large growth in repo transactions. Central Bank intervention in the forex market dries up the supply of krónur in the domestic market, and the treasury's liquidity position may also have some impact. One function of repos is as an instrument to enable the Central Bank to meet the credit institutions' liquidity requirements, but they are not conceived as a permanent source of finance for lending. There is a strong link between repurchase agreements and forex market intervention, which suggests that lending is not funded by repos. Repos are known to be used for financing derivatives. As mentioned earlier, the growth in Central Bank repos has hardly proved sufficient to counteract the factors that have led to tighter bank liquidity. Thus Central Bank base money has not increased during the year.

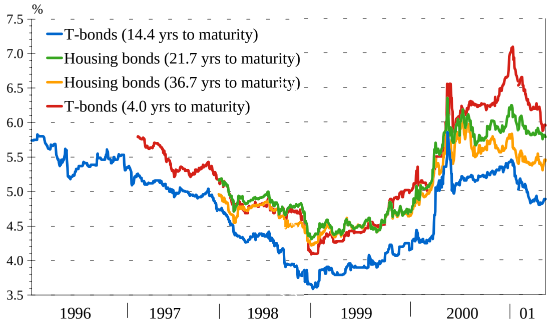
Bond market yields have gone down

So far this year, bond market trading has picked up and yields have fallen accordingly, as shown in Chart 6.

Chart 6

Treasury bond and housing bond real yields

Daily data, January 1, 1996 - April 26, 2001



Generally speaking, market participants expect a further fall in yields, for reasons including the contraction in housing bond issues, lower supply of treasury paper and stronger demand for bonds, which is partly at the expense of equities.

Yields on bonds with the longest lifetimes have dropped by 0.5 percentage points since the beginning of the year and on benchmark housing bonds and housing financing bonds by 0.23-0.53 percentage points. The yield on treasury bonds maturing in 2005 stood at 7.05% on January 3 but has fallen sharply and was 5.94% at the time of writing. Housing bond yields have also dropped, but by less. On January 3, housing bonds maturing in 2022 carried a 6.11% yield, which had gone down to 5.81% on April 20.

Institutional investors, who last year substantially increased their domestic and foreign equity stock, might re-enter the bond market to a growing extent in search of favourable investment opportunities because of the drop in equity prices both in Iceland and abroad.

In pace with the recent depreciation of the króna, the inflation premium on bonds has risen steeply. Immediately after the Central Bank cut its interest rates on March 27, a large drop was seen in the inflation premium, but following the depreciation of the króna it sharply once again.

The inflation premium (measured as the spread between buying rates for the bond classes RIKB 03 and RIKS 03) reflects investor expectations of an upward trend in inflation in the next few months.

Chart 7

Bond inflation premium

January 3, 2001 - April 26, 2001

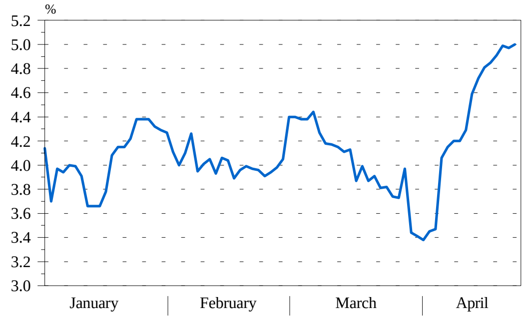
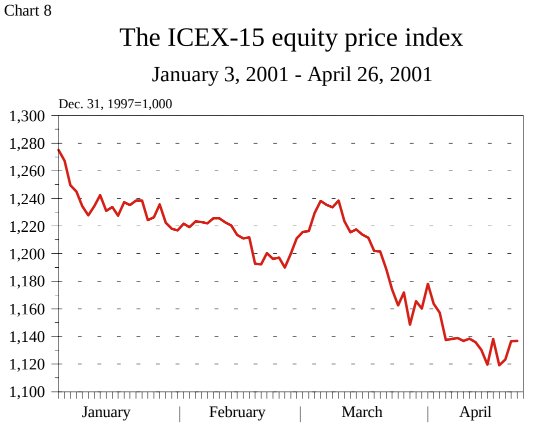


Chart 8



Equity prices still falling

The ICEX main index has fallen by 14.3% so far this year and by more than 36% in a single year. Domestic equity price trends can be described as similar to those on international markets, for example the Dow Jones and Nasdaq indices, which have also dropped significantly. In Iceland, the greatest fall has been in IT company shares, at 34.7% so far this year, and in manufacturing at 29.6%. Equity prices for service companies have gone down by 4.3% and fisheries companies by 6.6%.

In spite of the sharp downward trend, not all industrial sectors have fallen. Prices of shares in the pharmaceutical industry have risen by 3.4%.