Financial markets and Central Bank measures [1]

Exchange rate slide in autumn but interest rate rise tightens the monetary stance

Foreign exchange market developments since mid-July have been characterised by a gradual depreciation of the króna and rising interest rates abroad. Measured in terms of the currency index, the króna weakened by 4.2% from July 26 to the end of October, and the interest rate differential between Iceland and abroad also narrowed. Mounting uncertainty about the exchange rate trend of the króna also reduced positions in króna-denominated liabilities which was aimed at taking advantage of the positive interest rate differential, thereby putting even more pressure on the exchange rate. When the Central Bank announced a 0.8% rise in its policy rate at the end of October, it had an immediate impact the next day with the strengthening of the króna. Raising the interest rate was the Bank's response to a poorer inflation outlook and on-going high credit demand. The foreign exchange market upheavals in July spawned expectations of a rise in the policy rate among participants in the interbank market for króna, and interest rates on instruments with a longer maturity than one month rose somewhat. In the course of August expectations waned and these interest rates fell again, since the yield on three-month credit had exceeded that on Central Bank repos. The bond market appears to be in reasonable equilibrium. The emergence of new market makers for housing bonds and housing fund bonds in September had a positive impact on the market. Share indices have dropped in recent weeks and trading has contracted following publication of interim reports with half-year results, which fell somewhat short of forecasts.

The króna stabilised temporarily, but weakened in September …

Movements in the foreign exchange market slowed down somewhat in August after some upheaval in June and July. In the beginning of August the currency index reached 112 points. By then, the króna had strengthened by 3.4% from its lowest value on July 14 and it seemed that the Central Bank's measures in July, coupled with the market's view that an index of 116 was above long-term expectations, led to an appreciation during the first days of August. The index remained close to 113 throughout August, but during September it weakened and stood at 116 in the beginning of October. This development was fairly slow and without major changes on a day-to-day basis. For most of October the pattern continued, until heavy demand for foreign currencies caused the króna to weaken considerably every day from October 23 to 27. The index peaked within the day at 119 on October 27, but rallied during the course of the day. In all, the currency index rose by 1.7% from October 23 until the 27th. At the end of the day's trading on October 27 foreign currency supply and demand seemed to have stabilised. On October 30 and 31 the króna strengthened somewhat and the index was 118.1 at the official quotation on the 31st. The Central Bank monitored developments in the foreign exchange market closely, but saw no grounds for direct intervention. On the last day of October, however, the Central Bank announced an 0.8% rise

1. This article uses data available on November 1, 2000.

Revised rules for the foreign exchange market

Following the sharp depreciation of the króna in the early morning of July 13, 2000, market participants resorted to a suspension of trading in the foreign exchange market in accordance with Art. 10 of the market's rules. This stipulated that a majority of market makers could decide on a temporary suspension of trading without consulting with the Central Bank. The action proved controversial and was seen as warranting a review of the rules for the market.

This review has been completed and the Central Bank issued new rules for the foreign exchange market which entered into effect on October 20. They replace the earlier rules set on December 8, 1999. Two main changes are entailed by the new rules:

1. Withdrawal of authorisation for participants in the foreign exchange market to agree on a temporary suspension of trading under exceptional circumstances.
2. The minimum binding bid amount required from market makers is raised from USD 1 million to USD 1½ million.

The aim of this reform is to increase the functionality and depth of the market.

Concurrent with these changes to the rules, market makers in the foreign exchange market made an agreement on the exchange rate spread, cf. Art. 9 of the rules. It provides for an increase in the spread on bids under specific conditions.

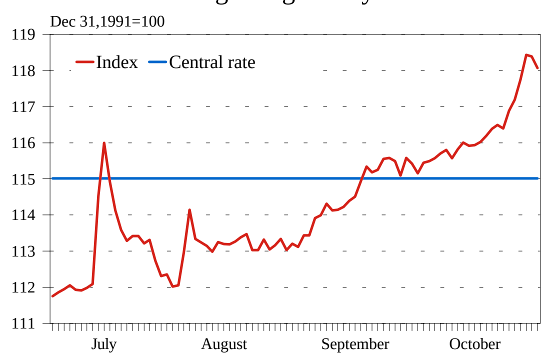
1. The maximum spread on bids shall be 0.07 kr. Nonetheless, market makers shall use a general reference spread of 0.05 kr. unless market conditions are exceptional.
2. If the currency index for the Icelandic króna changes by more than 1.25% from the opening value for the day, the maximum spread shall be increased to 0.10 kr. until the end of that day.
3. If the currency index for the Icelandic króna changes by more than 2% from the opening value for the day, the maximum spread shall be increased to 0.20 kr. until the end of that day.
4. Art. 1 of this agreement shall be reviewed one month after signature. If the spread in market makers' bids has generally risen to the maximum specified in Art. 1, the maximum exchange rate spread shall be reduced to 0.06 kr. which will remain in effect until the market makers decide otherwise.

in its policy interest rate. This action was largely aimed to counter the foreseeable negative impact that the weakening of the króna would have on inflation, threatening the goal of bringing inflation in Iceland into line with that in main trading countries within the next two years. Also, credit demand had only declined marginally. The initial reaction in the foreign exchange market was for the króna to strengthen, with the currency index moving to 117.1 at the end of the day on November 1, which is 1.85% below the central rate (i.e. on the weaker side of the target bands). Currency index developments since the beginning of July are shown in chart 1.

On October 20 new rules on foreign exchange markets went into effect, the main changes of which are outlined in the box on this page.

Chart 1

The official exchange rate index since the beginning of July 2000



... due to changed assumptions and expectations

A number of recent changes in the economic environment have caused the króna to weaken. Catch quotas were cut back for the fishing season which commenced on September 1, inflation is still running higher than among main trading partners, the current account deficit is sizeable and tough wage negotiations lie ahead, both with public sector employees and seamen. The equilibrium exchange rate of the króna dropped accordingly at the start of the summer and market assessments of the economic environment turned more pessimistic. In turn, this put pressure on the exchange rate in the marketplace. Until the middle of the year, investors exploited the wide interest rate differential between Iceland and abroad, coupled with the steady exchange rate, for profit. When the króna began to slide together with the growth of the current account deficit, capital outflows for purchases of foreign securities continued. Inflation also turned out to be more persistent than had been expected, dampening investor enthusiasm towards the interest rate differential. In addition, interest rate rises abroad have tended to narrow the differential in recent months. Heavy capital outflows and reduced inflows have therefore worked in tandem to weaken the króna.

Tighter monetary stance ought to dispel uncertainties

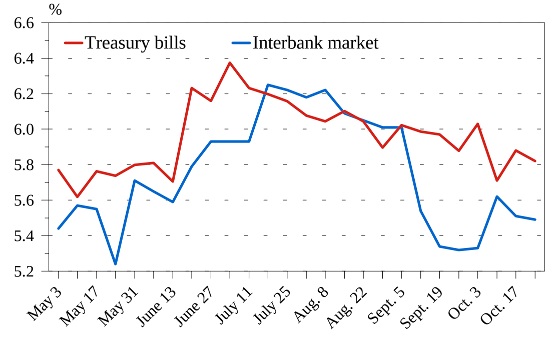
The rise in Central Bank interest rates at the beginning of November tightened the monetary stance. The previous change in the policy rate was made in June. At the moment, the Central Bank's policy rates are the highest anywhere among the industrialised countries, and their restraining capacity is very high. Nonetheless, a tight monetary stance by itself has not proved sufficient to keep inflation in check and maintain confidence in economic stability. The persistent current account deficit is too large a problem for its impact on the exchange rate to be eradicated with monetary measures. Under such conditions, there is a need for a firm fiscal stance, responsible wages policy and tight credit supply.

Interest rate differential widens again after domestic interest rate raise

The interest rate differential with abroad had been narrowing significantly until the interest rate rise in the beginning of November. Many foreign central banks have raised their policy rates since the middle of the year. The Norwegian Central Bank raised its rate by 50 points on August 9 and again by 25 points on September 20. The Japanese Central Bank announced a 25-point rise on August 11. The Danish Central Bank raised its rates several times by a total of 80 points. The European Central Bank has announced two rises, by 50 points in all. The interest

Chart 2

Interest rate differential between domestic and foreign short-term rates May - October 2000



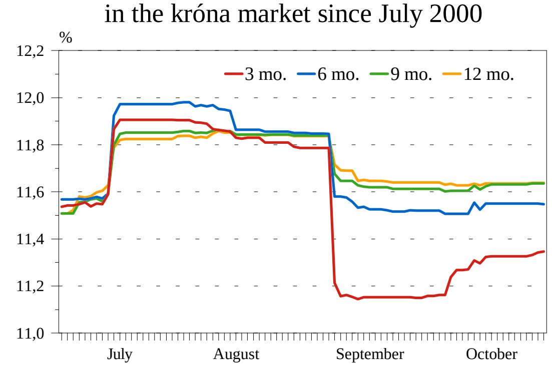
rate differential between Iceland and its main trading partners on three-month interbank deposits and lending was at its peak at 6.2% after mid-July, then it came down to 5.5% before the policy rate rise at the end of October, which left it at 6.3%. For a while the narrowing of the interest rate differential was not solely due to rises abroad, because longer-term rates in Iceland's interbank domestic currency also fell. Chart 2 shows the development of the interest rate differential between Icelandic and foreign T-bills and the corresponding trend in interest rate differential on interbank markets from May to November 1.

Expectations of higher interest rates cause changes in króna market

The July upheavals in the foreign exchange market apparently created expectations in the interbank

Chart 3

Yield development in longer term instruments in the króna market since July 2000



króna market that a Central Bank policy rate rise was in the offing. Driven by these expectations, interest rates rose on interbank market debt instruments with a longer maturity than one month, while the yield on shorter instruments has hovered around 11% as in recent months. Longer-term interest rates remained in the range 11.8% to 12.0% from mid-July to the beginning of September. As August wore on, the market appeared to calm down and expectations of a policy rate rise dwindled. Eventually, this led to a significant drop in interest rates on longer-term debt instruments in the króna market on September 6. By then, the yield on three-month instruments was higher than on Central Bank repos. This spread between repo yields and interbank market instruments enabled market participants to exploit Central Bank repos to profit by trading in the króna market. Equilibrium was restored by a fall in interest rates on deposits following heavier trading with three-month instruments. Chart 3 shows the yield development for long-term instruments in the króna market.

Decrease in króna market turnover in the course of the year

At the beginning of this year, króna market turnover looked set to break all records. As the year has progressed, however, turnover has been steadily decreasing, and for the past five months fell short of the figure for the same months in 1999. The main explanations are increased day loan activity with the Central Bank and, possibly, increased repo trading. Growing day loan activity alongside a decrease in trading in the króna interbank market may indicate that certain market players are experiencing liquidity problems due to fully utilised króna market credit lines. From July to October, the greatest decline compared with the same period last year has been in overnight lending. Turnover there shrank by 41 b.kr., while Central Bank day lending grew by 36 b.kr. at the same time. The repurchase agreements balance was up by 7 b.kr. over the same period. Chart 4 shows trading developments in the króna market.

Sluggish trading in longer-term instruments

Trading in instruments with a maturity of more than one month is almost negligible as a proportion of total turnover in the króna market. Market participants are clearly using that market primarily to fulfil their liquidity requirements. There are no straightforward reasons for the low level of trading in longer instruments. Presumably, market participants consider it too risky to tie up funds for as long as one to twelve months, thereby limiting their scope for responding to interest rate changes which might take place in the immediate future. By using their credit lines to trade in longer instruments, participants would thus impair their own potential for using the króna market to fulfil their liquidity requirements.

Better balance in the bond market

Yields have been going down after rising during the upheaval on the bond market in May and appear to have stabilised to some degree. The main explanation for better equilibrium is probably the reform in

Chart 4

Trading in the króna market

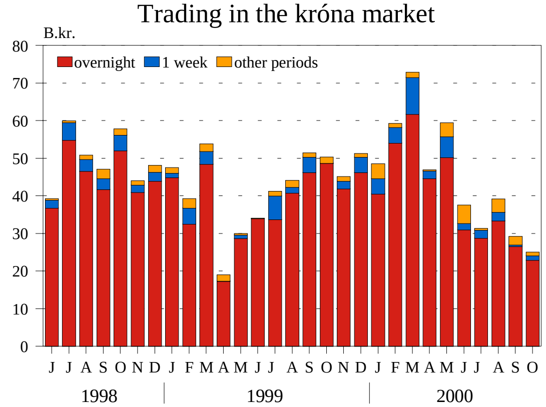
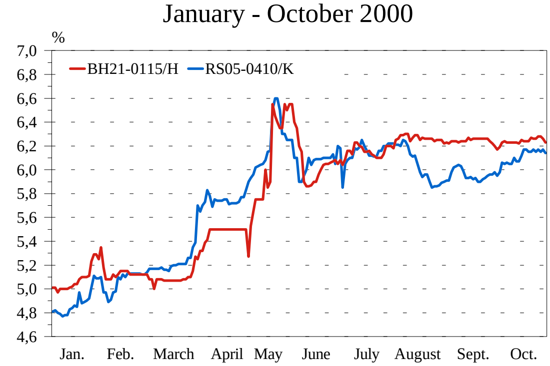


Chart 5

Treasury bond yield and housing bond yield
January - October 2000



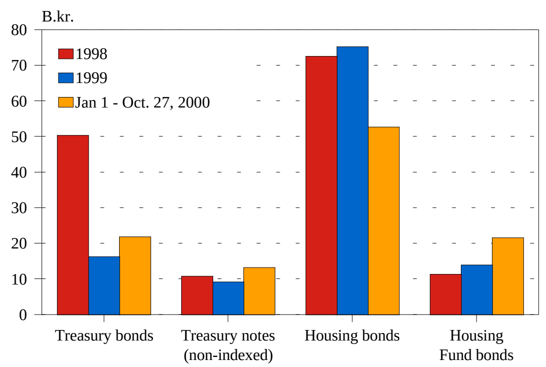
market making in the housing bonds and housing fund bonds market, when the number of market makers increased from two to five on September 11. Housing bond yield fell somewhat in August but climbed back slightly in September. The yield rose again in the beginning of October when the draft fiscal budget was announced, although it settled back down to some degree later. On October 10, inflation figures were published showing a 1% rise from the previous month, somewhat above market expectations. Yields on treasury bills rose sharply as a result, while the yield on indexed instruments went down marginally. Under high inflation conditions, indexed bond prices should rise with a corresponding reduction in yield. In recent months inflation has been running relatively high, although it is lower than in the spring. Despite these conditions, indexed bond prices have fallen and yields risen by the same token. Undoubtedly this stems from a drop in bond investments by major investors. The yield development for common issues of savings bonds and housing bonds is shown in Chart 5.

Investor interest in bond market

Attention has been drawn to the fact that major investors, especially pension funds, have scaled down their bond market participation and swung over towards foreign equities. New investors have entered the market, but have yet to fill the gap left by the pension funds. The bond market is still overshadowed by the equity market where investors apparently still see greater expectations of profit. This is happening at the same time as fairly poor interim results have been posted both in Iceland and abroad. In the USA, both the Nasdaq and Dow-Jones indices have fallen so far this year and share prices in Iceland have dropped by around 12%. This development could steer Icelandic pension funds back into the domestic bond market. However, one of the reasons for the original increase in foreign equity investments was conceivably that bonds constituted an abnormally large proportion of pension fund portfolios.

Chart 6

Bond trading in 1998, 1999 and 2000



Bond trading has grown

Brisk trading has been taking place in the bond market so far this year. Chart 6 shows that trading in treasury bonds, treasury notes and housing fund bonds this year has outstripped that for the same period in 1999. Total bond trading volume amounted to 145 b.kr in 1998 and 114 b.kr in 1999, and so far this year it has reached 103 b.kr. Housing bonds have dominated trading so far this year (48%), followed by housing fund bonds (20%), treasury bonds (20%) and treasury notes (12%).

Will the economic outlook stimulate the bond market?

The economic situation could generate new interest in the bond market. There are many signs that the economic upswing has peaked and experience shows that this boosts demand for bonds. The recent National Forecast assumes economic growth of 1.6% in 2001, which is considerably less than in recent years. During a downswing, equities tend to fall, making bonds a relatively more attractive investment option. The draft fiscal budget indicates a large surplus which should lead to falling interest rates on bonds, especially if forecasts hold for economic growth next year. No signs of such a development have emerged yet, and the main reason is that the Housing Financing Fund plans to step up its issuance of housing bonds and housing fund bonds in 2001.

Investment by foreigners

It will be interesting to see the impact that the NOREX cooperation which was launched on October 30 will have on the Icelandic securities market. Considerable changes are likely, not least because of the new common trading system, Saxess. With its change in the bid presentation format, the new system is likely to strengthen price formation in the market and deepen it. High yields and electronic securities depository may attract foreign investors to Icelandic bonds, although this could be offset by exchange rate risks.

Equity market declining

Share indices in Iceland have been sliding in recent weeks. Icelandic equity market prices were fairly stable from April until August, but prices began to drop when company interim results for the half-year were published and have been on a steady downward trend since. The ICEX-15 index fell by 8% from the end of August to the end of October. In most cases, first-half figures for companies listed on the Iceland Stock Exchange tended to fall short of market participants' forecasts. Trading volume has also shrunk by 20% from August to October compared with the same months last year.