Box III-1

Domestic asset prices and the Bank of England financial market liquidity index

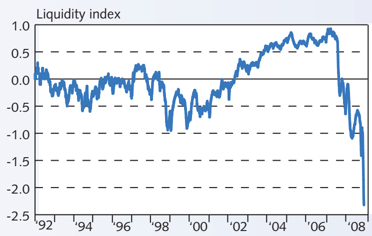
Ready access to foreign liquidity was an important driver of the recent years' economic upswing. Interest rates and interest premia were at historical lows in credit markets worldwide, and new financial products became increasingly popular. Icelandic businesses took advantage of attractive terms and easy access to credit and invested heavily in housing and equities, both in Iceland and abroad. Asset values skyrocketed afterward – share prices, real estate values, and the exchange rate of the Icelandic króna. As a result, access to credit became even easier, and those who took the most risk reaped the greatest rewards. There was a strong incentive to increase leverage, and households and businesses did so in spite of warnings. But circumstances changed almost overnight. Credit was suddenly difficult to obtain, and closure of credit lines ultimately felled the banking system.

The recent years' abundant credit supply reflected in some measure the relaxed monetary stance among central banks worldwide, as well as the glut of debt market liquidity resulting from securitisation. Since the global financial crisis began in 2007, liquidity squeezes have developed, as is manifested by financial institutions' grave difficulties in obtaining funding and by severe market illiquidity, among other things. The Bank of England publishes a financial market liquidity index on a regular basis, so as to provide an indication of the ease with which assets can be sold without substantial impact on market prices, which in turn has a strong effect on individuals', companies' and banks' access to credit. The charts below show the financial market liquidity index in the context of developments in domestic share prices and house prices and in the exchange rate of the króna. As can be seen, there is a close correlation between access to global liquidity and the asset bubble that developed in Iceland over the past several years.

Chart I

Bank of England financial market liquidity index[1]

Daily data, January 1, 1992 - October 17, 2008

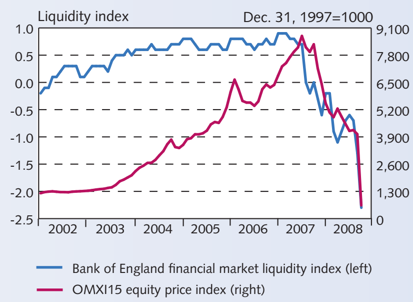


1. The liquidity index shows the number of standard deviations from the mean. It is a simple unweighted average of nine liquidity measures, normalised on the period 1999-2004. See box 2 in the Bank of England Financial Stability Report, April 2007.
Source: Bank of England.

Chart 2

Bank of England financial market liquidity index and the Icelandic OMXI15 equity price index

Monthly data, January 2002 - October 2008

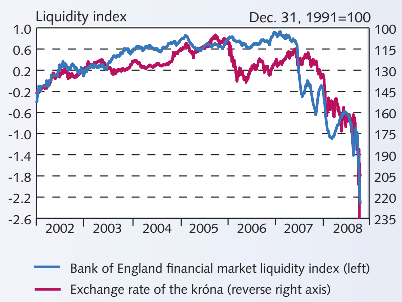


Sources: Bank of England, OMX Iceland.

Chart 3

Bank of England financial market liquidity index and the exchange rate of the króna

Daily data, January 1, 2002 - October 17, 2008

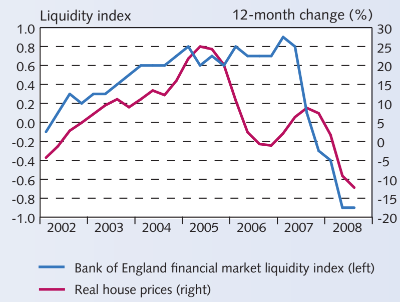


Sources: Bank of England, Central Bank of Iceland.

Chart 4

Bank of England financial market liquidity index and real house prices in Iceland

2002/Q1 - 2008/Q3



Sources: Bank of England, Statistics Iceland, Central Bank of Iceland.