Financial markets and Central Bank measures [1]

Króna and bonds fall in domestic markets

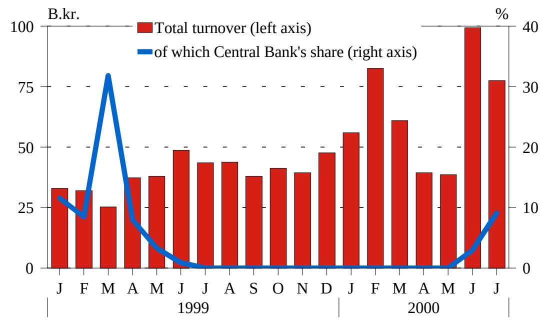
The past quarter has been eventful in domestic financial markets. In the middle of May two domestic bond market participants announced that they intended to cease market making for treasury-guaranteed bonds. As a result, the yield on indexed bonds rose sharply. The Debt Management Agency and the Housing Financing Fund responded by revising their procedures and tendering out market making. Yields in the bond market dropped as a result and trading rallied. The yield on indexed treasury-guaranteed bonds has nonetheless risen and now stands at around 6%. The króna came under significant pressure in the middle of June and again in the first part on July. Apparently, expectations had diminished that the króna could maintain the strength it had reached at the end of May, partly because of the poorer outlook for fish catches, current account deficit and prices. During the first speculative attack the króna fell by 3% to finish 3% above the central rate of its target bands. In the second attack the exchange rate fell almost 1% below the central rate, but picked up again and the time of writing is around 1.4% above the central rate. Both these attacks prompted the Central Bank to take measures aimed at preventing excessive fluctuations which could have led to even greater uncertainty in the market. In addition, the Central Bank raised its policy rate on June 19, partly to support the króna but also to match interest rate rises among major trading countries, since the Bank considered it necessary to maintain the interest differential between Iceland and them.

The króna came under pressure and fell despite Central Bank's measures

The króna was exceptionally buoyant in the spring and reached a historical high in April and May when it went above the old 6% target zone bands on several occasions. Proposals presented by the Marine Institute at the beginning of June for a lower Total Allowable Catch during the coming fishing year, coupled with other negative news including reports about the current account balance and inflation, appear to have caused a reassessment of the credibility of the króna. Until then, market participants and other domestic parties generally appear to have been more optimistic about economic prospects than official economic agencies were, and assumed that the current account deficit and the rate of inflation could turn out lower than had been forecast.

Chart 1

Total turnover on the domestic interbank foreign exchange market and Central Bank's share



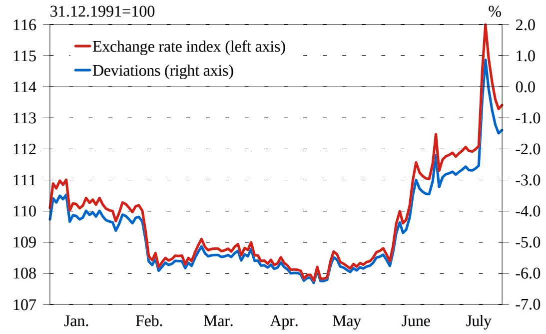
To July 21.

1. Daily data quoted in this article are until July 21, 2000.

The króna had been very strong in late winter and spring, for most of the time hovering around 6% above the central rate, and stood 5.76% above it at the beginning of June. Then, the króna began to slide, but the main drop took place on the 14th and 15th when it fell to 3% above the central rate. The second day saw small-scale market intervention by the Central Bank, its first transactions in the foreign exchange market for more than a year. Trading was brisk on the 15th and 16th of June at around 7 b.kr. each day. The Bank's measures and its decision to raise the policy rate, which was announced on June 16th, appeared to calm the market, and the króna remained stable until the following Friday when it dropped by just over 0.8% in a relatively large trading volume. At the end of the day the króna was even lower, around 2% above the central rate.

Chart 2

Official exchange rate index in the year 2000 and deviations from central value, 115.01



The foreign exchange market was the scene of more action on Monday June 26. According to Central Bank sources the outlook was for heavy demand for currency early that morning. The Central Bank responded by selling currency when trading opened. Huge trading took place in the interbank market that day with transactions totalling 19.3 b.kr., a record for a single day. The Central Bank's defence, involving more than 2.6 b.kr., led the króna to strengthen somewhat from its Friday level, to finish 3.2% above the central rate. The following day saw some market operations by the Bank once again, and the króna remained fairly stable without any intervention until July 12, when heavy trading in the interbank market caused the króna to weaken yet again. The Bank moved in to defend the króna once more and it remained virtually unchanged between quotations, but had slid by the close of day by almost ½%. Significant pressure remained on the króna for the following two days, during which the Central Bank engaged in further market activity. As before, the aim was to prevent panic in the foreign exchange market.

Foreign exchange market closed on July 13

On July 13 the króna dropped sharply in the morning when the market opened. Market makers resorted to closing the interbank market at ten o'clock that morning. According to the market's rules, a majority of market makers may decide on a temporary closure, until the following day of trading at the most. The Central Bank was not involved in this decision, but immediately summoned the market makers to a meeting where it was decided to reopen it at twelve o'clock. In the Central Bank's view, the closure of the market was regrettable, and the Bank has suggested to other market participants that these rules may need to be reviewed.

The króna reached a low on July 14 and then rallied

Despite the Central Bank's measures on those three days, the króna fell and reached a low on July 14 at almost 0.9% below the central rate, in another record day for foreign exchange market trading. Total volume then amounted to 20.8 b.kr., including 3 b.kr. on the part of the Central Bank, while trading was also heavy during the two preceding days, at 12.8 b.kr. and 15.4 b.kr. respectively. In all, the Central Bank measures involved more than 7 b.kr. during those three days. After July 14 the tension in the foreign exchange market slackened greatly, trading volume declined and the króna rallied again. At the time of writing the króna is 1.4% above the central rate, some 5% lower than at its peak in May.

Speculative attack

There is no doubt that a speculative attack was involved, in the sense that domestic and to some extent foreign market participants reviewed their position towards the exchange rate of the króna and took appropriate action, i.e. bought foreign currency and closed currency forward agreements or swaps to hedge against losses from the lower exchange rate.

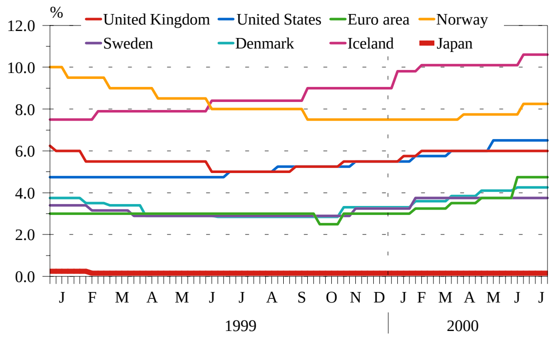
These actions exerted downward pressure on the króna, catalysing even more market participants into taking action. Nothing suggests that the foreign exchange market makers themselves adopted a stance against the króna. On the contrary, their total foreign currency balances remained almost unchanged for the course of these events. Nonetheless, they did not feel confident about taking action to stem the currency outflow and assessed the situation as signalling growing uncertainty about the position of the króna. Foreign exchange markets such as Iceland's, which are driven largely by capital movements, are extremely volatile and parties that operate or use services there keep a very close watch on exchange rate movements and the behaviour of other market participants, and react rapidly to unexpected changes. It does not take much to start a run. Participants are prone to panic by a kind of herd instinct. For this reason foreign exchange markets have a tendency to overshoot, i.e. exchange rate fluctuations tend to be sharper than the situation warrants, and then level out when the panic dies down, as Iceland's experience showed.

The Central Bank raised its policy rate in mid-June

As mentioned above the Central Bank raised its policy rate by half a percentage point in the middle of June, increasing the yield on its repurchase agreements to 10.6%, after several neighbouring countries had raised theirs. The policy rate increase was also partly aimed to reduce pressure on the króna. Interbank market interest rates only showed a small rise following the policy rate rise, and it appears to have already been incorporated into market participants' expectations. On the other hand, yields in trades with treasury and bank bills went up after the interest rate rise. The unrest in the foreign exchange market in July saw interbank interest rates rise considerably, by almost ½%, since market participants entertained strong expectations that the Central Bank would raise its interest rates even further.

Chart 3

Policy rates in selected countries from the beginning of 1999

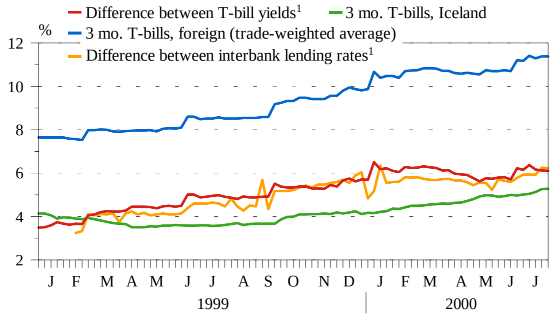


Interest rate differentials vis-à vis foreign countries remain high

After the rise in the policy rate in June, the differential between money market interest rates in Iceland and neighbouring countries, weighted against the exchange rate basket, amounted to just over 6 percentage points, similar to that at the beginning of the year. This differential is virtually the same in terms of both interbank market interest rates and T-bill yields.

Chart 4

Domestic and foreign 3 month money market rates from the beginning of 1999



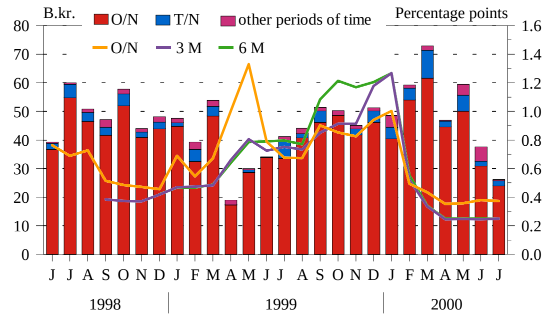
1. Percentage points.

Less trading in the króna market despite narrowing interest rate margins

Trading in the interbank market for krónur has decreased somewhat in recent months, which is surprising given the huge level of trading in the foreign exchanger market; a very close relationship often exists between the two. The margin between deposit and lending rates has also narrowed, which ought to spur trading in the market. Trading in longer maturities has shown a slight increase, although less than was expected after the margin between deposit and lending rates was fixed in March.

Chart 5

Turnover in the interbank market for króna and the margin between lending and deposit rates from June 1998

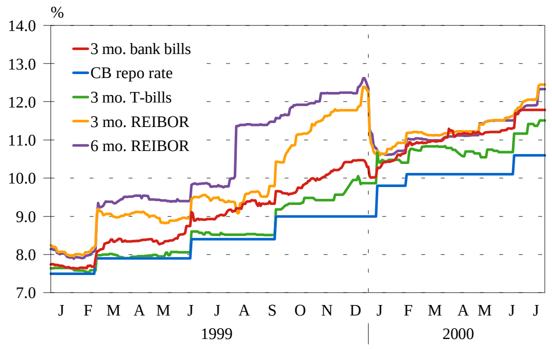


Upheavals in the bond market

The bond market was thrown into upheaval in May when two commercial banks ammounced their intention to withdraw as market makers for saving bonds and housing bonds on the Iceland Stock Exchange. The result was a significant rise in yields as well as tension in the market which was later to some extent dispelled with actions by the Debt Management Agency and the Housing Financing Fund. There were several reasons for this upheaval, but mainly that the pension funds, which for a long time had been major players in the bond market, have increasingly been focusing on investments overseas. An increase in housing bond issues has also filled the vacuum left by smaller issues of savings bonds and treasury instruments, and at least two banks had also taken a considerable position in housing bonds, having assumed a drop in yield which did not materialize. Furthermore, the market makers criticised the largest issuers of bonds for inadequate information. The new framework has so far not brought about much change in trading in housing bonds and housing fund bonds, but trading in treasury savings bonds and treasury instruments has rallied.

Chart 6

Yields in the money market
January 5, 1999 - July 21, 2000



Dwindling interest by pension funds in housing bonds and other guaranteed bonds

Ever since the housing bond system was established, the pension funds have been major buyers. In 1997 they held around two-thirds of the entire issued stock of housing bonds and housing fund bonds. At the end of last year this ratio had fallen below 50%, after pension funds made net sales of housing bonds amounting to more than 13 b.kr. in 1998 and around half a b.kr. last year. The reason was that pension funds considered they had tied up too large a share of their portfolios in domestic bonds, and saw reason to spread their risks with other securities, not least domestic and foreign equities.

More housing bonds and housing fund bonds issued

At the same time there has been a substantial increase in housing bond issues in pace with the great expansion in the housing market, whereby the housing bond/housing fund bond stock has increased by more than 55 b.kr during the past two years, i.e. 1998 and 1999. The treasury cut back savings bond issues sharply at the same time. It had been hoped that the treasury's declining borrowing requirement would create scope for bond issues by other parties, including corporate bonds, as well as a fall in yields, but such hopes have not been realized. The massive supply of housing bonds has naturally pushed up their yields. All things being equal this should tempt investors to re-enter the market, but conditions in foreign equity markets and the attitudes of domestic institutional investors have meant that they prefer to invest in domestic and foreign equities.

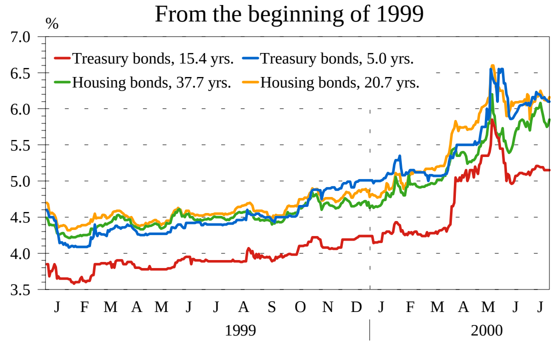
Banks increase their exposure

The deposit money banks' holdings of housing bonds and housing fund bonds rose sharply during the last quarter of 1999 and for the most part of this year. As a result of market yield trends this year, the DMBs involved in these purchases have shown significant losses on these holdings of late. However, these losses are not necessarily reflected in their financial statements, since the bonds may to some extent be entered in investment rather than turnover accounts, where gains or losses on sales do not need to be accounted for until final sale takes place, when there may still be hope that the market will turn in their favour. Although these purchases may have certain positive side-effects, such as enabling treasury-guaranteed bond classes to be put up as collateral in transactions with the Central Bank, it is clear that some banks which expected yields to drop have suffered setbacks. The assumptions on which the banks based these expectations are unclear, but some appear to have expected that the new liquidity rules and treasury bond buybacks would bring down yields in the bond market.

Chart 7

Daily yields in selected benchmark issues of treasury bonds and housing bonds

From the beginning of 1999



Inadequate information

Issuers of the largest classes of bonds have not always been providing the market with information which it would be natural to give. Some uncertainty prevailed about treasury bond buybacks and housing bond issues and buybacks. This put the market makers in a difficult position. Given their dominance in the market, it is natural to insist firmly on transparency and reliable supply of information from the largest bond issuers. Lack of information was among the points criticized by the market makers.

Less trading and greater spreads in the year 2000

There was a fairly lengthy background to the decision by two commercial banks to withdraw as market makers, in particular for treasury bonds. The spread on treasury paper on bids at the Iceland Stock Exchange had been increasing ever since autumn 1999, resulting in a contraction in trading. This year bid presentations have been more sluggish and market makers often ignored their obligation to present bids as soon as the market opened. It was different in the case of housing bonds and housing fund bonds, where the spread remained small and trading brisk, even though volume was down somewhat. Thus the spread remained at 4-7 points for the main housing bond classes, which was small in comparison with the spread on savings bond yields, which sometimes went as high as 40 points for various classes. Thus the secondary market for savings bonds and treasury instruments was virtually non-existent.

New market maker framework

The reforms to the market maker framework raised the amounts set both for bids and offers which market makers undertake to make within the day. A maximum spread between the buying and selling rates (7 points) was also set. On the other hand, when a bid has been accepted, the rate at which the market maker makes a new bid is left to his own discretion. Dissemination of information about issuers' plans for new classes and buybacks of older ones has also been greatly stepped up. The Debt Management Agency and the Housing Financing Fund tendered out market making and those asking the lowest commission were accepted.

Trade rallied under the new arrangement …

There are now four market makers for savings bonds and treasury instruments handling four benchmark classes of bonds, and they undertake to purchase up to 4.8 b.kr. per day if necessary. Nonetheless they can still price themselves out of the market before the maximum amounts are reached. There are two market makers for housing bonds/housing fund bonds, which could explain the small change in trading in these instruments paper under the new arrangement, while the required yield has risen as might have been expected. The treasury instrument market has rallied well and trading has increased significantly.

… but yields continue to rise

Even though the new arrangement for market making in treasury-guaranteed bonds has boosted trading in the secondary market, interest rates have continued to rise. Admittedly, the yield dropped somewhat from its peak in mid-May at the height of the market turmoil, when the yield on 25-year housing bonds reached a peak of 6.35%. This quickly dropped to 5.7% at the beginning of June, then slowly climbed to 6% and peaked again at almost 6.2%. In recent weeks the yield on housing bonds has fallen somewhat again and is 5.9% at the time of writing. Other classes of treasury bonds have developed along similar lines. The yield on 15-year savings bonds, for example, is 5.15% at the time of writing.

Commercial bank and savings bank interest rates have also risen

The commercial banks and savings banks made sharp hikes in their lending rates during the second quarter, considerably in excess of the rise in Central Bank policy rates. Following the Central Bank's interest rate rise by half a percentage point in June, the banks raised nominal interest rates on unindexed loans by 0.8 percentage points on average in June and July. Furthermore, the basic rate for indexed lending went up considerably in June, by an average of 0.7 percentage points. This increase followed the rise in the yield on housing bonds and savings bonds in the bond market and also shows that banking institutions are making efforts to curtail their credit growth. Weighted average interest rates on the commercial banks' and savings banks' unindexed secured loans were 17% at the end of July, having risen by 2 percentage points since the beginning of the year. Interest rates on indexed secured loans are up by 1 percentage point over the same period, at 9.8%.

Static equity market

Some fluctuations have been taking place in share prices in recent months. From the beginning of April to the middle of May the Iceland Stock Exchange ICEX-15 index fell by 19%, reaching a low of 1500. Since then the index has wavered between 1500 and 1560, at a similar level to that at the end of 1999. The scant changes in average share prices in recent weeks are not surprising, since company half-year figures have been awaited and will not be announced until the end of July or August.

During the year the greatest increase has been in the share prices of companies in information technology, at 74% (although during the second quarter of this year they dropped by 12%), and pharmaceutical companies at 43% (including 5% during the second quarter). Shares in transportation companies have fallen the most, by 27% (of which 20% in the second quarter) and in fisheries companies by 13% (of which 9% in the second quarter). Since the beginning of the year the Iceland Stock Exchange growth list has risen by 31%, although it fell by 13% during the second quarter.

Turnover has shown some decline in recent months, for reasons including the fluctuations which have taken place in share prices. The increased legal scope for pension funds to invest in foreign equities may also have hit the domestic market. However, pricing in the Icelandic equity market now appears to be based more than before on conventional assessment methods, and the market is increasingly sensitive to news which has an impact on the economic conditions of listed companies.