Financial markets and Central Bank measures[1]

Interest rate cuts and relatively stable exchange rate

The Central Bank of Iceland cut interest rates twice in August, once in September and once again in October, by a total of 1.7 percentage points. Interest on non-indexed market bonds have gone down more or less in pace with the Central Bank's cuts, especially on shorter-term liabilities, while indexed rates have been lowered rather more slowly. Bank rates have still not reached a comparable level to that of three to four years ago. The exchange rate of the króna has swung within a fairly narrow range since the beginning of May. The Central Bank sold currency to one market maker in August due to special circumstances but since the beginning of September, in accordance with announcements to that effect, it has regularly bought currency in the market, although small amounts at each time. Bank liquidity has been ample and Central Bank facilities largely seem to involve providing hedging for commercial banks on account of their bond trading. The interest rate differential with abroad has narrowed in the past few months, mainly because of domestic interest rate cuts. Equity and bond trading on Iceland Stock Exchange have been very lively, while equity prices have more or less remained unchanged.

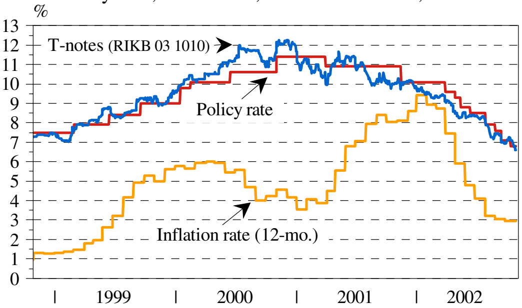
The Central Bank lowered interest rates ...

The Central Bank has lowered interest rates rapidly in recent months. Since the beginning of the year, the Bank's policy interest rate has been brought down by 3.3 percentage points, reflecting the turnaround that has taken place in the economy. On August 1 the Bank announced a cut of 0.6 percentage points in its policy rate, from 8.5% to 7.9%. The CPI announced on August 10 had gone down by 0.54% from the previous month, an unexpectedly large reduction. On August 30 an interest rate cut was announced amounting to 0.3 percentage points, and another on September 18 by 0.5 percentage points. On October 14 the fourth interest rate cut was announced, by 0.3 percentage points. After this, the Bank's policy rate was 6.8%, measured as the rate used in repo transactions by credit institutions with the Central Bank. The policy rate was lower than it had ever been since the current framework for the Bank's transactions with credit institutions went into effect early in 1998. The process for lowering interest rates has relied very much on the Bank's inflation forecast, and the inflation curve in recent months has matched it almost completely. Chart 1 shows the development of the Central Bank policy rate since the end of 1998, non-indexed interest rates as measured with the

Chart 1

The policy rate, the non-indexed bond yield and the inflation rate

Daily data, October 30, 1998 - October 31, 2002



Sources: Statistics Iceland, Central Bank of Iceland.

1. This article uses data available on October 31, apart from Chart 7 which is based on data from November 4.

T-bond yield, and inflation as measured by the twelve-month change in the CPI.

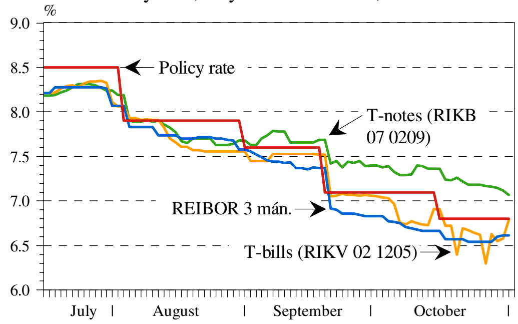
... and cuts in other interest rates followed

Interest rates in the interbank market for domestic currency and on non-indexed market bonds, have as a rule gone down in the wake of changes in the Central Bank policy rate and in line with them. Chart 2 shows the trend for non-indexed interest rates in recent months.

Chart 2

Yields on non-indexed securities

Daily data, July 15 - October 31, 2002



Source: Central Bank of Iceland.

Scope for further cuts in bank lending rates?

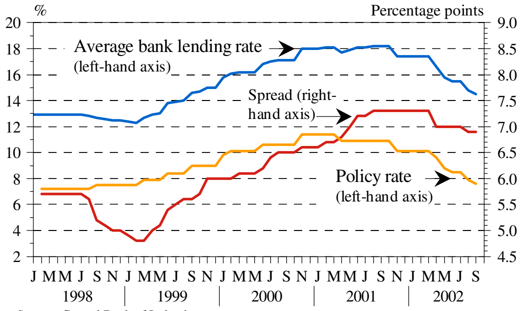
Although the commercial banks' lending rates have gone down in pace with changes in the Central Bank policy rate recently, they have not yet reached the level the stood at in the beginning of 1998, while the Central Bank rate is lower now than it was then. Average interest rates of commercial banks and savings banks rose by more than the policy rate during the upward trend. This can be seen in Chart 3, where the red line shows the spread between bank rates and the Central Bank policy rate. Essentially this spread has remained unchanged for well over a year. (Note, however, that the scales on the axes are different and the red line showing the spread refers to the right axis.)

Rates have gone down by much less on indexed bonds than on non-indexed ones and have evolved differently too. Being independent of inflation, they need not move in the same way as non-indexed rates. For some time, strong supply of housing bonds and housing authority bonds has restrained interest rate decreases in this area. Nonetheless, yields on housing

Chart 3

The spread between the average bank lending rate and the policy rate

At end of month, January 1998 - September 2002

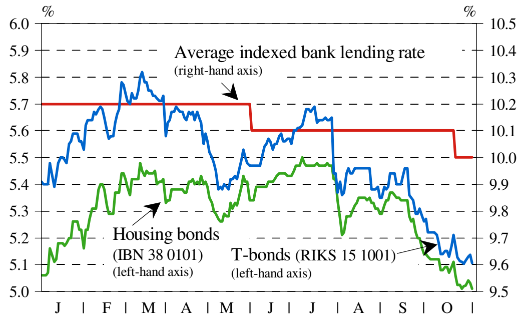


Source: Central Bank of Iceland.

Chart 4

The yield on indexed bonds

Daily data, January 3 - October 31, 2002

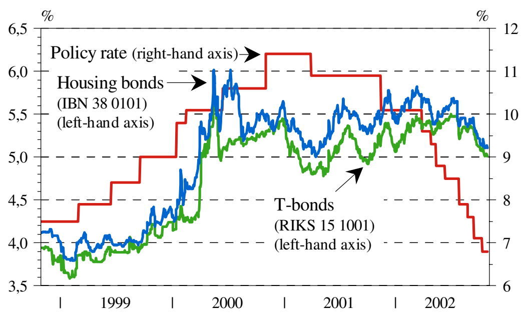


Source: Central Bank of Iceland.

Chart 5

The policy rate and the yield on indexed bonds

Daily data, October 30, 1998 - October 31, 2002



Source: Central Bank of Iceland.

bonds and government bonds have gone down somewhat in the course of the year. Interest rates on commercial banks' and savings banks' indexed bonds have remained virtually static until recent weeks when a reduction appeared after the Central Bank lowered its policy rate in September, as shown in Chart 4. The long-term trend for indexed interest rates is shown in Chart 5.

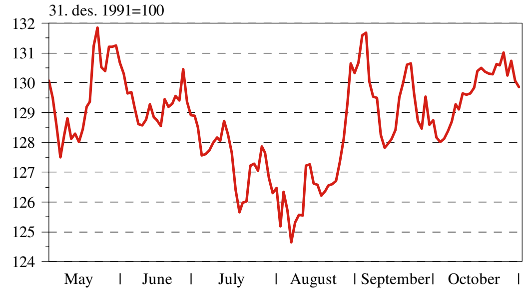
Exchange rate of the króna has swung within a relatively narrow range ...

At the end of July the fairly continuous strengthening of the króna since before the end of last year finally came to an end. However, the exchange rate index has swung within quite a narrow range since the spring, as can be seen from Chart 6. Currency flows appear to be in reasonable balance and the swings have generally been mild. A short-lived weakening occurred at the end of August which to some extent was linked to Central Bank measures, as described below. On October 20, Moody's announced its upgrading of the Republic of Iceland's credit rating for foreign obligations which, together with a report about the privatisation of a major share in Landsbanki Íslands, caused the króna to strengthen. A breakdown in the submarine telephone cable on August 28 meant there was no trading in the domestic currency market for a whole business day and ways are now being sought to reduce disruptions to activity in the market if the situation arises again.

Chart 6

The nominal effective exchange rate index of króna

Daily data, May 2 - October 31, 2002



Source: Central Bank of Iceland.

... in spite of Central Bank trading

In the beginning of August the Central Bank announced its intention to commence moderate foreign exchange purchases in order to reduce short-term funding of the foreign exchange reserve. The Bank subsequently discussed the proposed scope of these measures with forex market makers. Acting on the outcome of these talks, the Bank announced its planned purchasing arrangements on August 27. Thus it came as a surprise to the Bank to hear this announcement named as the cause of the weakening of the króna on August 28. Not only had the Bank formulated a fairly cautious policy which was well within the limits deemed normal by the market makers, but it had also been known since the beginning of August that such a measure was pending, so the announcement should not have caught anyone by surprise. On September 2 the Central Bank began buying small amounts of currency in the market. Foreign currency to the amount 1.5 million US$ is bought twice a week, on Mondays and Wednesdays, and it is conceivable that purchases will also be made on Fridays. These trades take place before the forex market opens. All the market makers are phoned to ask for bids, and the best one is taken. It is aimed to buy foreign currency for up to 20 b.kr. over the 16-month period until the end of 2003. From the beginning of September to the end of October the Bank purchased currency from market makers 18 times, for a total of 27 million US$. The Central Bank also stated its readiness to buy larger amounts of currency directly from the market makers on their initiative, provided that the exchange rate of the króna had strengthened since the last time it was recorded.

On August 27 the Central Bank made a forward contract with Íslandsbanki for the sale of currency to a total of 3 b.kr. There are three delivery dates for the currency, in September 2002 and January and March 2003. This transaction was made in accordance with the Central Bank's policy as announced in *Monetary Bulletin* 1/2002, that it was prepared to conduct individual large trades in the forex market with the aim of softening price swings.

Credit institutions have ample liquidity ...

Credit institutions have had ample liquidity positions in recent months and interest rates on short-term liabilities in the interbank market for krónur have more often than not been somewhat below the Central Bank policy rate. In the beginning of September the treasury sold the Central Bank currency for 2 b.kr., and by disposing of this the treasury increased liquidity, which led to a fairly liquid position in the market. When an unexpected flow enters the market, banks respond as a rule by offering it in the interbank market for domestic currency, but if the excess liquidity is equally spread out the other participants have little interest in it, so the general recourse is to deposit it in reserve accounts with the Central Bank and thereby ease the pressure that can conceivably build up at the end of the reserve period. Interest rates in the interbank market usually give a fairly good indication about the liquidity position there, but occasionally liquidity increases or decreases unexpectedly, and sometimes in such a way that the change is hardly visible, which upsets this correlation. In interpreting these indicators, however, it should be borne in mind that Central Bank repo auctions are made every two weeks as well, and therefore distort the formation of interest rates with the same length in the market for krónur.

... and little need for Central Bank facilities ...

According to data available to the Central Bank, an estimated two-thirds of the repo stock at the moment is used for hedging of foreign derivative trading with domestic market bonds. Foreign investors apparently have little interest in Icelandic króna exposures and only want to invest in yields on domestic bonds. The trading arrangement is that a domestic credit institution buys the bonds in the market and borrows the equivalent of the purchase price from the Central Bank, putting the bonds up as collateral. A contract for the yield is then signed with the foreign buyer. Relatively little risk accompanies such trading and it is clearly possible to profit from it. This practice has been going on for some while and the Central Bank has not raised any objection to it since other domestic market participants still do not seem capable of solving this aspect of market trading. However, it must be questionable to call such trading "sale of Icelandic bonds to foreign investors," since the foreign party contributes little capital towards the purchase and takes neither currency risk nor principal risk.

Interest rate differential with abroad has narrowed due to lower rates in Iceland

The interest rate differential with abroad has narrowed significantly in recent months with lowering rates in Iceland. At the end of July the differential, measured as the difference between three-month treasury bill rates in Iceland and abroad, was 5.26 percentage points, and in the interbank market it measured 4.83 percentage points. At the end of October the differential was 3.15 percentage points for T-bills and 3.29 percentage points in the interbank market. Central banks in other countries have largely refrained from making interest rate changes recently, apart from the fact that the Swiss National Bank lowered its interest rate target range by 0.5 percentage points and the Central Bank of Denmark cut its 14-day lending rate twice in August, by 0.05 percentage points each time. This is a rather unusual measure on the part of Denmark, which as a rule has exactly followed the European Central Bank's interest changes. However, the Danish krone has been strengthening, and since the Central Bank there had bought currency over the period May-August for almost 16 b. DKK, it decided to ease the pressure on the exchange rate by lowering interest rates. To some extent this trend has now reversed.

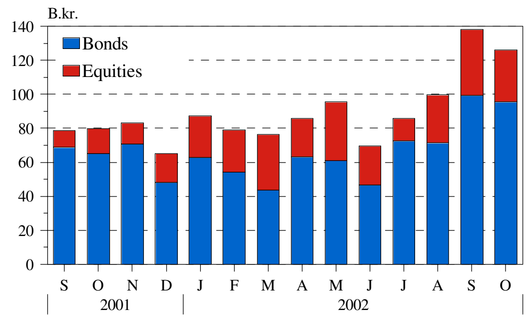
Brisk securities trading at present

Securities trading has been lively recently, in both the equity and the bond market. September was a record month for bond trading with turnover just below 100 b.kr., as shown in Chart 7. Housing bond and hous-

Chart 7

Turnover on Iceland Stock Exchange

Monthly data, September 2001 - October 2002



Source: Iceland Stock Exchange (ICEX).

ing authority bond issues have been very high recently and are heading for a record year at 49.3 b.kr., compared with 47.2 b.kr. as estimated in January. However, this does not tell the whole story, since 36.7 b.kr. of this amount will be deployed on repayment of earlier loans. The Housing Financing Fund now assumes somewhat larger issues next year, or 52.5 b.kr., and repayments of 40.5 b.kr. then. Equity prices have been relatively stable and the ICEX Main List index has been moving within the range 1,250 to 1,330 points since February this year.