Central Bank's intervention in the currency market: ISK scraping the floorboards

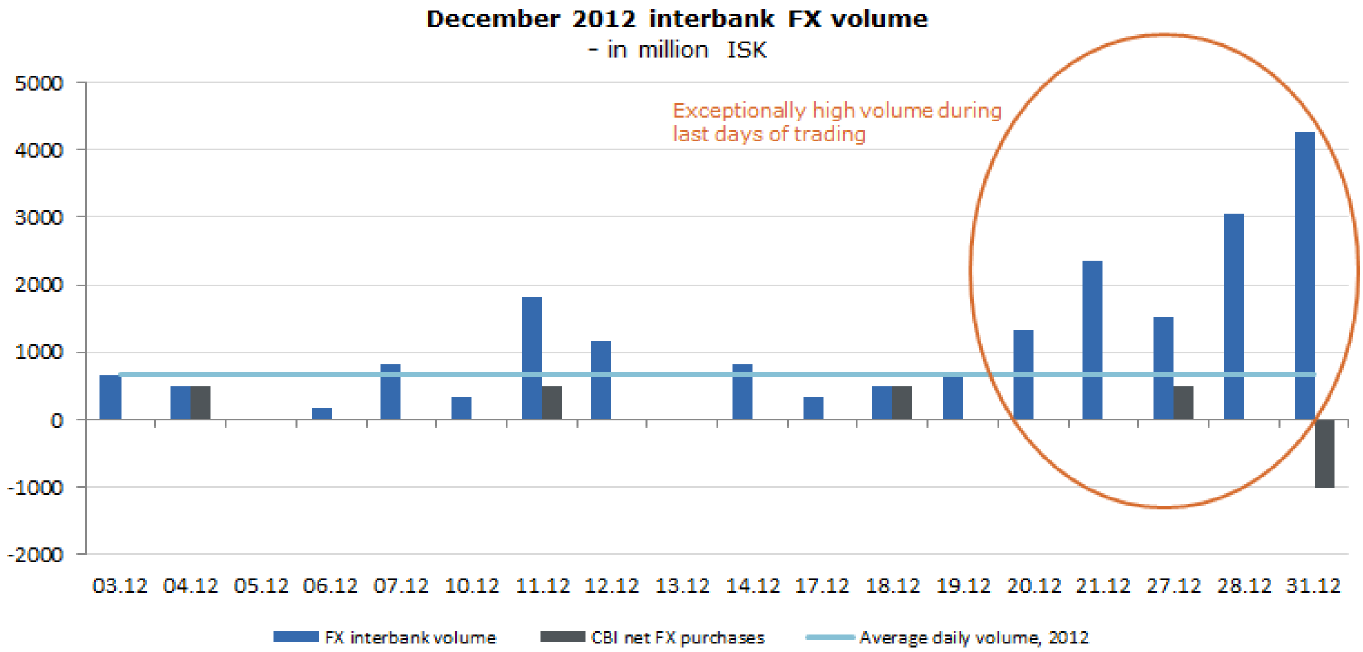
- The Icelandic króna (ISK) depreciated by 3.5% in December, with much of the drop coming in the final trading days of the year when the currency slid by almost 2% in high volume trading. The Central Bank of Iceland saw reason to intervene in the currency market and to sell €6 million to buoy the exchange rate of the ISK on the final day of the year. We wonder what the causes of the depreciation might be, and whether the CBI is ready and willing to support the ISK further at current levels.

Central Bank calls temporary halt to FX purchases: Expectations, expectations, expectations

- The Central Bank of Iceland announced on January 4 that it had decided to bring a temporary halt to its regular currency purchases. From September 2010 onwards it bought half a million euros a week from each of the three market makers in the interbank currency market to strengthen its reserves. At the end of July, it doubled that amount due to handsome seasonal inflows of currency and the appreciation of the ISK that accompanied them. Since the Bank began regularly intervening in the currency market, it has managed to amass ISK 60 billion in unleveraged reserves. At the moment the Central Bank's foreign liabilities exceed foreign assets by "only" ISK 39 billion.

ISK scraping the floorboards

The Icelandic króna (ISK) depreciated by 3.5% in December, with much of the drop coming in the final trading days of the year when the currency slid by almost 2%. The Central Bank of Iceland (CBI) saw reason to intervene in the currency market and to sell €6 million to buoy the exchange rate of the ISK on the final day of the year. On average, trading volume tends to be high on the interbank currency market in December, although 2012 saw a pretty exceptional increase. In the final month of the year the turnover was almost twice what it was during the same period last year.



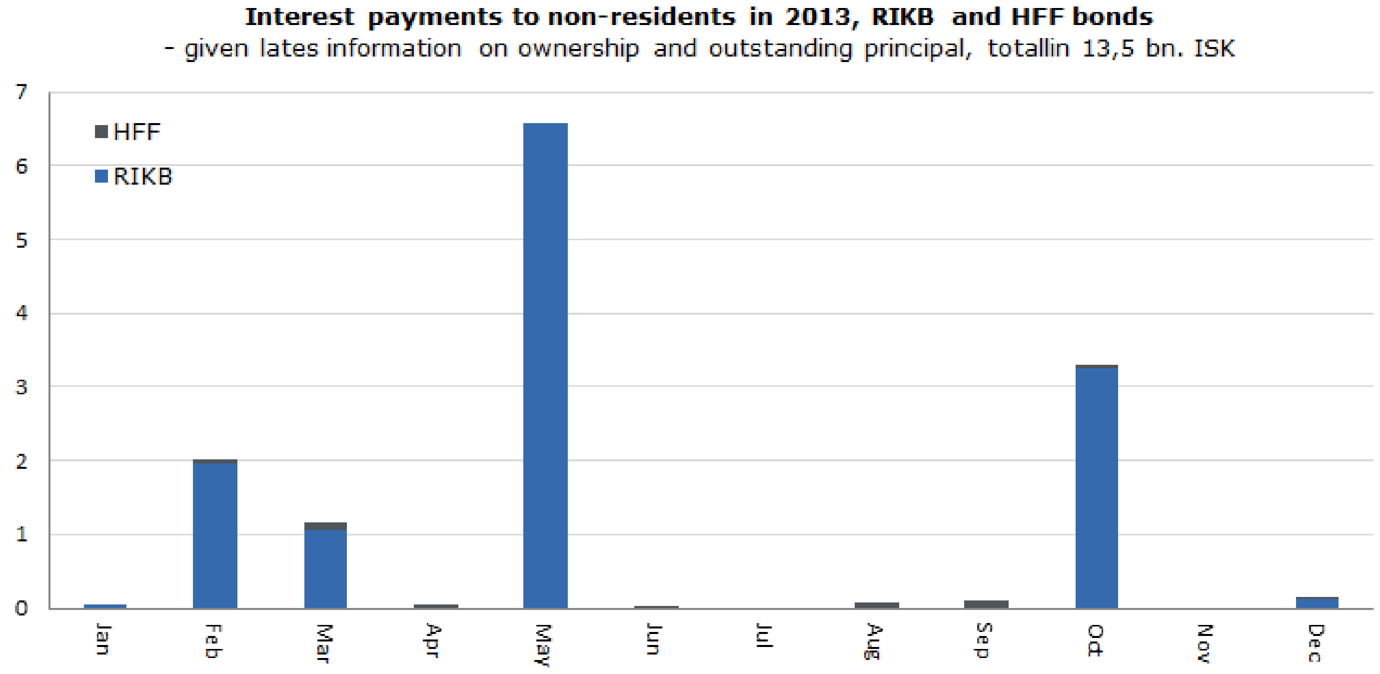
Source: CBI

Possible reasons for the depreciation of the ISK

It is not possible to state categorically what caused this depreciation, but the Central Bank governor has spoken of pressure on the currency stemming from maturity dates of foreign loans of companies and local authorities in interviews to the media. To be specific, we think the following factors played a role:

Landsbanki bonds in foreign currency. It was more or less known beforehand that the currency mismatch between Landsbanki's assets and liabilities would increase at the turn of the year on account of a contingent bond between the old and new banks which will be issued on 31 March 2013. It shouldn't have been surprising that the bank would try to adjust its mismatch by selling off ISK before the end of the year. Moreover, from 31 December onwards the instrument is entered in the bank's accounts in euros, whereas until then it had been entered at fair value in ISK. The amount of the bond was converted at the Central Bank's official exchange rate on 31 December. The low exchange rate of the ISK at the end of the year means that the value of the bond in euros is permanently lower than it would have otherwise been. In another move, the bank saved itself interest expenses by making advance payments on maturities of another foreign denominated bond between the old and new banks in 2012 and may want to make further advance payments, but first it will have to amass some foreign currency which will put pressure on the exchange rate.

Interest income of non-residents. The media quoted the Central Bank governor as saying there were signs that non-residents had taken more interest income out of Iceland than they did in December 2011 (which is permitted under the capital control regime). This might have something to do with the settlement period, while talk of tightening/extending the capital controls could also have affected the decision of non-resident investors to take more money out of Iceland. If this trend of interest income flight continues, interest payments could continue to weigh down the exchange rate of the ISK next year as non-residents will be paid interest of more than ISK 13 billion next year from RIKB and HFF. If we assume that the interest rate on their deposits is 1-2%, interest could amount to an additional ISK 1.7 billion to ISK 3.5 billion. This does not include the interest expenses which Icelandic companies and local authorities need to pay to non-residents on account of loans outlined below.



Source: Treasury, Housing Financing Fund, Arion research calculations

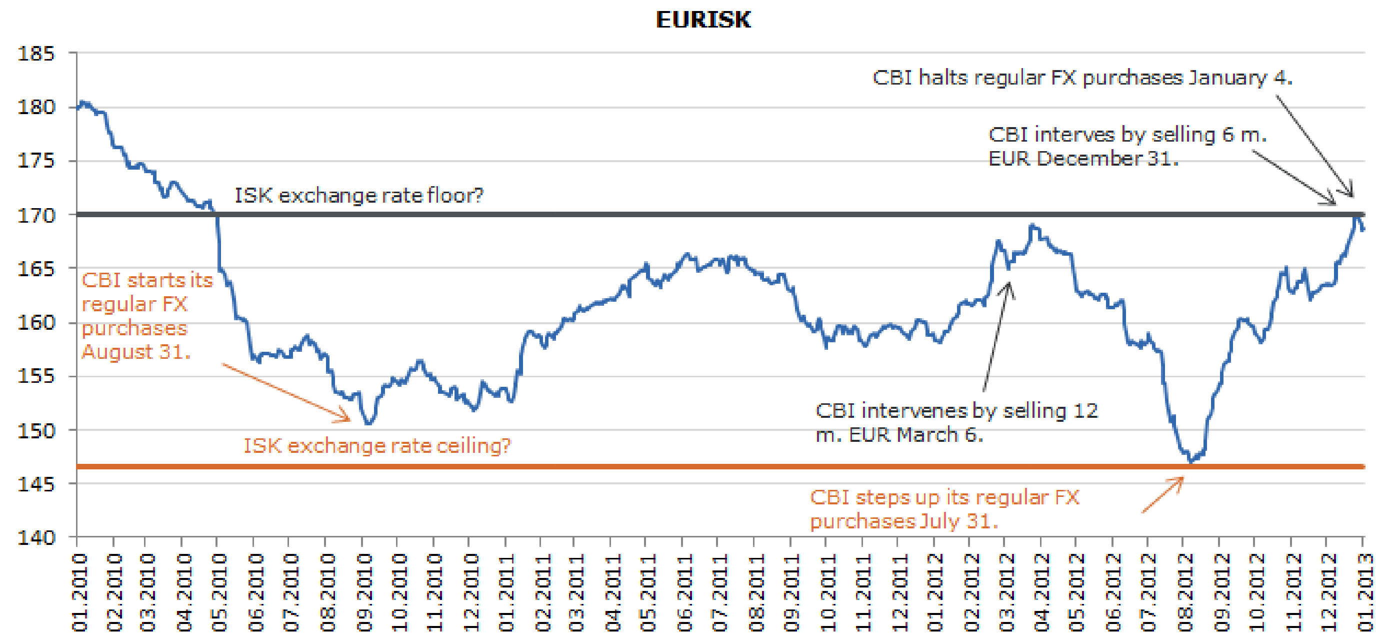
Repayments of foreign loans of OR, local authorities and others. In addition to the above, the reason most often cited for the depreciation of the ISK is the amassing of foreign currency reserves by various companies and local authorities to meet maturities of foreign loans. In the last issue of the CBI's Financial Stability, principal repayments on foreign loans by parties other than the government were estimated to be roughly ISK 90 billion in 2013, excluding interest.

Central Bank's intervention in the currency market

As mentioned above, the Central Bank of Iceland intervened in the currency market by selling €6 million to buoy the exchange rate of the ISK on the final day of 2012. This is not a particularly large amount, about a quarter of the turnover on that day or equivalent to two weeks of the bank's regular currency purchases, and half of the amount the bank sold on 6 March 2012 when it last intervened in response to an outflow of capital. These are the only two irregular FX interventions of the CBI to support the ISK by selling foreign currency since 2009.

The bank has not issued any statement regarding the latest selling off of currency but in March the intervention was linked to an abnormally large and temporary outflow of foreign currency (partly due to exemptions from the Foreign Currency Act), which the bank did not want to impact the exchange rate unduly. It is likely that the latest intervention was made for similar reasons; the Central Bank governor said in public interviews that the weakening of the ISK in December was due to circumstances which the bank considered temporary.

It is interesting to note that the Central Bank intervened on both occasions when the exchange rate approached ISK 170 to the euro. It may be that 170 is roughly the lower limit of what the bank considers to be an acceptable rate for the Euro and that the ISK simply scraped the boards of the exchange rate floor the Bank might be willing to enforce (it should be noted that the bank has no formal exchange rate target, and that FX interventions are discretionary).



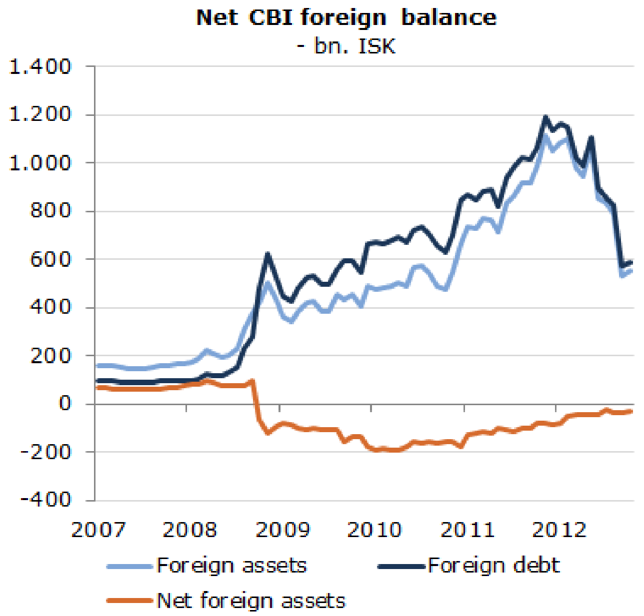
Source: CBI

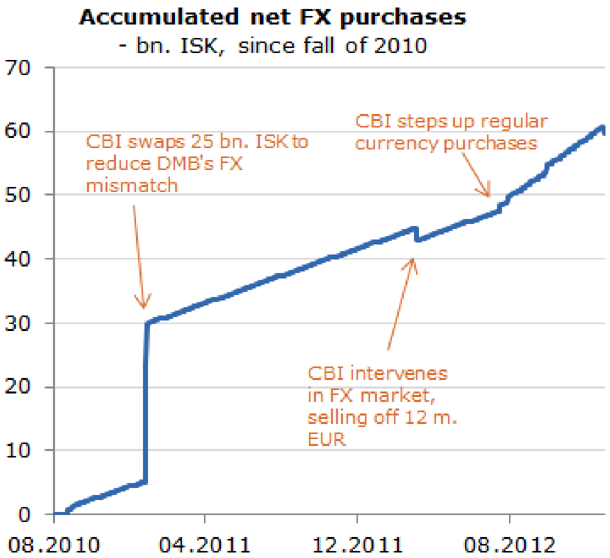
It is nevertheless not perfectly clear, however, how the intervention fitted into the Bank's overall strategy on the FX market, but it could undoubtedly have applied itself more forcefully to support the exchange rate of the ISK had it wanted to. There are certainly precedents, like the one in March. It is therefore conceivable that the bank simply wished to signal the market (we also speculated whether that might have been its intention last March). As the Central Bank should have a more complete picture of the in- and outflows of capital than most market participants, the bank's primary intention could have been to announce the end of the temporary outflow and to reinforce confidence that the ISK will not drop further (although it slid to around 172 in the two weeks following the intervention before appreciating to 171 in trading on 18 January).

Now that the bank has twice intervened when the exchange rate reaches a certain level, a natural floor might conceivably form at that exchange rate. If market participants do not expect the exchange rate to be allowed to drop far below ISK 170 to the euro, those who for some reason need to sell off foreign currency will use the opportunity to get a good deal when the exchange rate is at roughly that level, thus creating a natural floor under the ISK and making any Central Bank intervention unnecessary. The credibility of the floor is crucial in this respect. So far, we consider it unlikely that the size and frequency of interventions by the Central Bank are sufficient to establish a credible enough floor in the market.

Expectations, expectations, expectations

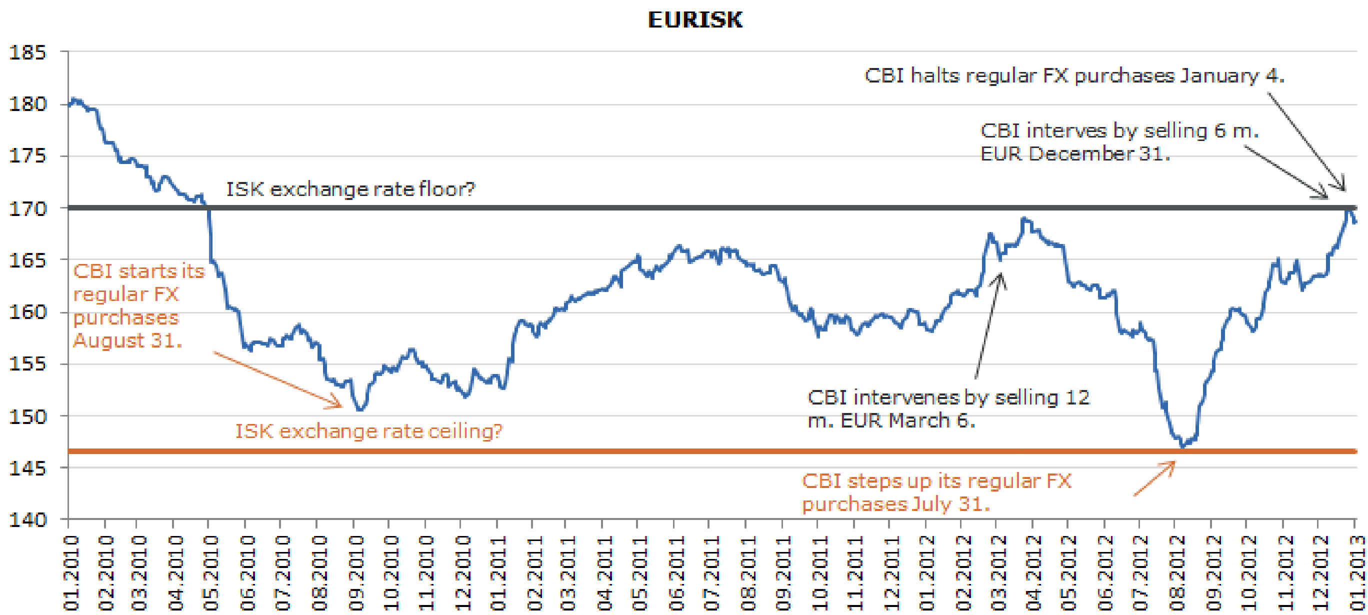
The Central Bank of Iceland announced on January 4 that it had decided to bring a temporary halt to its regular currency purchases. From September 2010 onwards it bought half a million euros a week from each of the three market makers in the interbank currency market to strengthen its reserves. At the end of July, it doubled that amount due to handsome seasonal inflows of currency and the appreciation of the ISK that accompanied them. Since the Bank began regularly intervening in the currency market, it has managed to amass ISK 60 billion in unleveraged reserves. At the moment the Central Bank's foreign liabilities exceed foreign assets by "only" ISK 39 billion.





Source: CBI

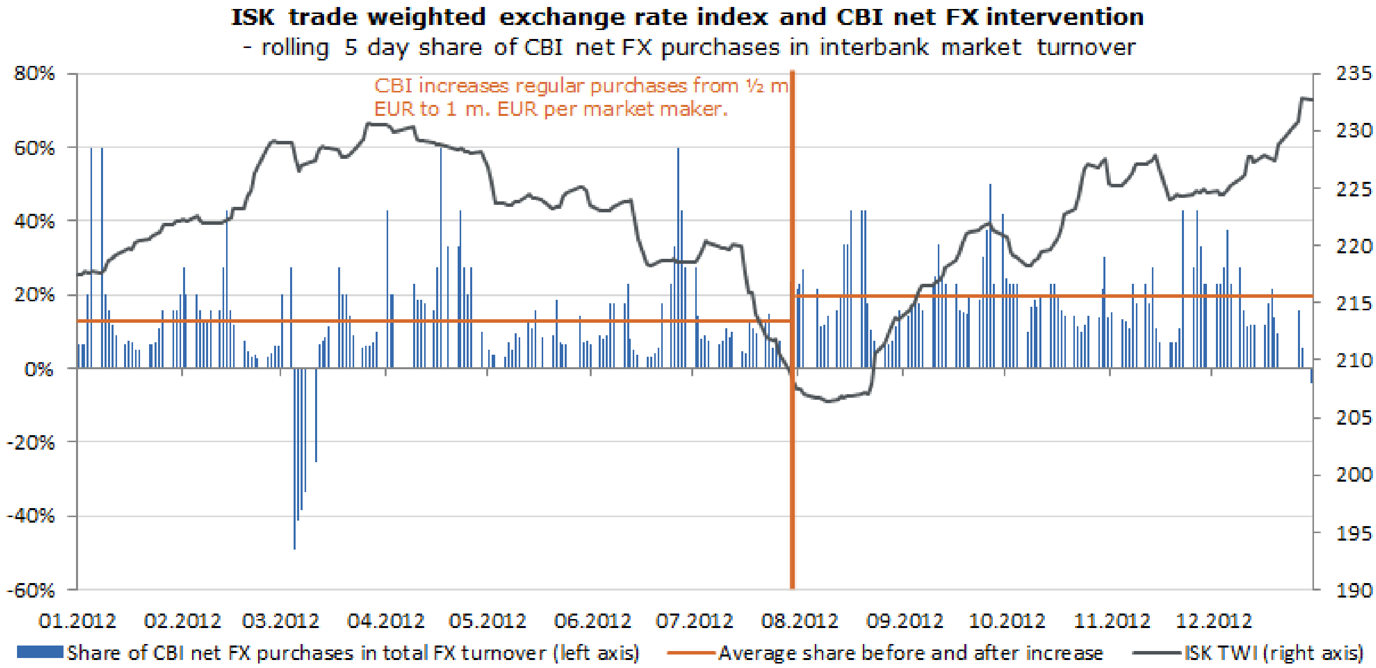
The Central Bank's decision on Friday lends support to the view that the Bank has a tendency to intervene when the euro is hovering around the ISK 170 barrier even though the bank hasn't committed formally to any exchange rate floor, or stated officially what its long term strategy in the currency market is. As we point out in our research note above (see "ISK scraping the floorboards"), the Central Bank last intervened in March 2012 just as the euro reached ISK 170. We also wonder whether a similarly informal exchange rate ceiling can be estimated to lie at the level when the Bank decided to step up its currency purchases this summer – especially since that happened when the exchange rate was at roughly the same level as when the Bank began strengthening its reserves with regular euro purchases to begin with.



Source: CBI

However, we doubt that the Bank's decision to temporarily stop its currency purchases will have a dramatic effect on the exchange rate of the ISK. The Central Bank's net purchase of currency totalled ISK 17 billion last year, its share in the turnover on the interbank currency market being more than 10%. Although such a considerable amount can't be ruled out to have some effect, it is unlikely that it is sufficient to seriously strengthen the ISK even if the bank desists from further purchases in the coming weeks or months.

At any rate, currency purchases by the Bank do not appear to have had a significant effect on the exchange rate of the ISK last year. The ISK appreciated sharply despite the Bank's considerable share in the currency market last summer. Other catalysts were probably way more accountable for the depreciation of the ISK in the latter half of last year than the increase in the Bank's regular currency purchases, e.g. a dramatic drop in currency inflows from tourists in the last quarter, falling prices for Icelandic exports in foreign markets, the amassing of foreign currencies by major market participants to meet large loan maturities etc.



Source: CBI

Mixed message - lack of guidance

In any case it is clear that actions such as the Bank's recent decision to halt regular FX purchases have a twofold effect, in common with most actions taken by central banks. Firstly, it has a direct effect via the FX market; and secondly, it has an indirect effect via the effect it has on expectations of market participants who may alter their behaviour in response to the action taken. Even if the direct effect is minimal, as we expect it to be in this instance, the effect could be magnified by the expectations channel.

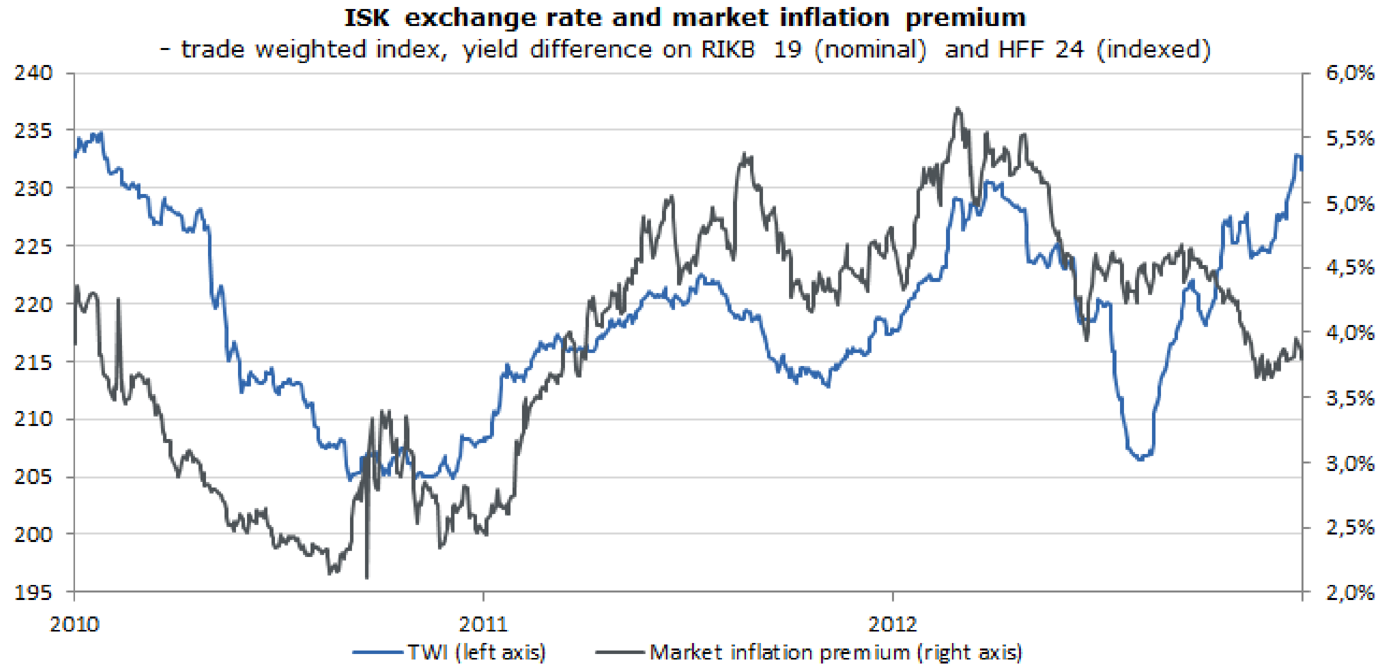
Those who have followed central bank interventions on a global scale in recent years know that the difference between success and failure often lies in whether they have the intended impact on expectations. Such actions are most effective when the direct and indirect effects provide positive feedback to one another. But is that the case here? The problem with the Central Bank's hiatus in regular FX purchases is that it sends out conflicting messages:

1) The amount of ISK available on the interbank currency market will decrease (which is to say that demand for foreign currencies will decrease), which will fuel expectations of a stronger exchange rate.

2) However, the Bank seems to think it possible that the downward pressure on the ISK will be so great in the near future that it would be irresponsible of it to buy €3 million a week, adding to expectations that the ISK will continue to weaken.

The exchange rate of the ISK is generally correlated with inflation expectations, as clearly shown in the diagram below. This is why we would have thought the bank would strive to ensure that exchange rate expectations did not jeopardise the success achieved in dampening inflation expectations.

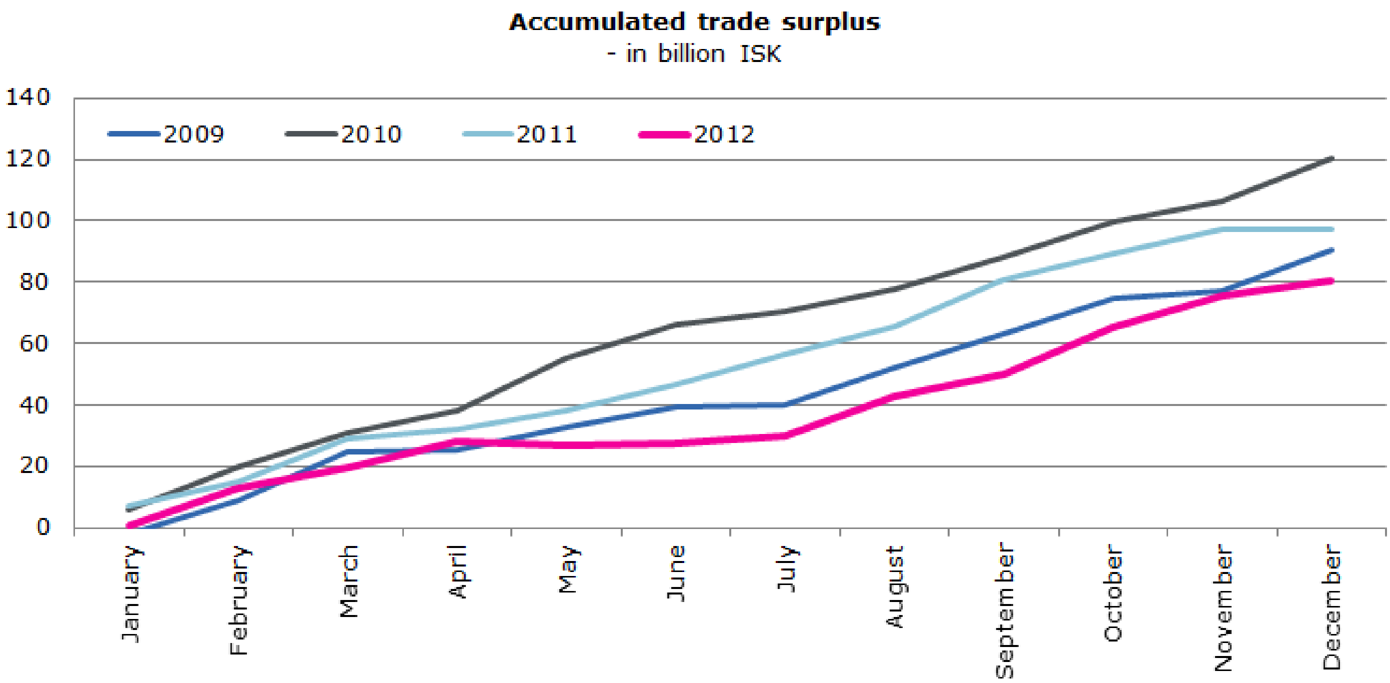
However, the bank has not given any clear indication of its strategy in the currency market, e.g. whether it is prepared to intervene further to prevent continuing depreciation of the exchange rate, and by how much. Overall it is rather difficult for market participants to read into the bank's actions when forming their expectations due to its lack of clear guidance or statement of intention, and they are therefore unlikely to provide an anchor for low inflation, neither in the short term nor long term.



Source: CBI

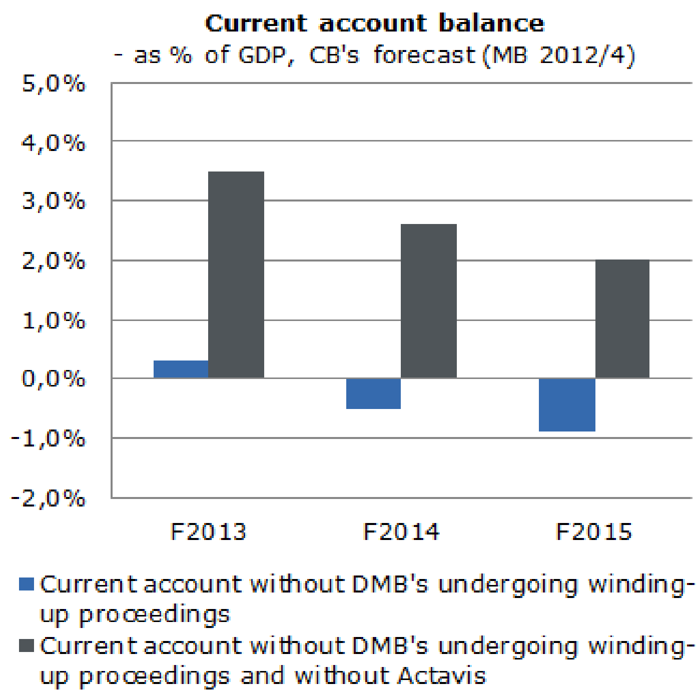
Lowest trade surplus since financial crisis

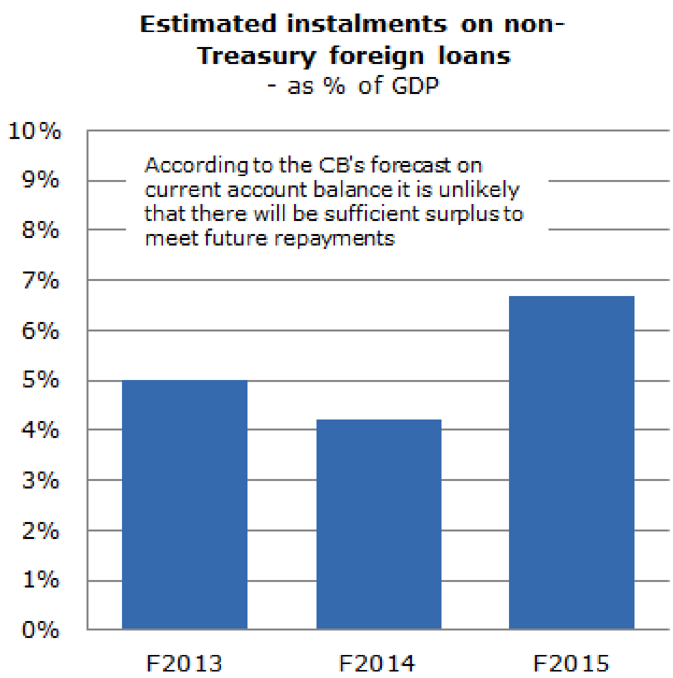
In our opinion the Central Bank's actions stem mainly from concerns over price stability, since there is considerable ambiguity to whether the exchange rate is abnormally low at the moment given the economic fundamentals - especially in light of the fact that the real exchange rate of the ISK has strengthened slightly with rising price levels over the last two years at the same time as the trade surplus has rapidly shrunk. Based on the preliminary figures published early January, the surplus in 2012 is estimated to be ISK 80 billion, the lowest figure since the eve of the financial crisis.



Source: Statistics Iceland

In our opinion the pattern in the balance of payments gives us reason to think that the ISK is far from being too weak, and if anything there is much to suggest that the ISK will struggle in the next few years. It is interesting to compare the Central Bank's forecast on the current account balance for the next few years and the estimated repayment schedule of parties other than the government during the same period. As the diagram below shows, it is unlikely that the current account surplus will be sufficient to meet future repayments unless agreements on refinancing and loan extensions can be reached, cf. Orkuveita, local authorities and Landsbankinn – which means that in the absence of such agreements, the only alternative seems to be a weaker exchange rate.





Source: Statistics Iceland

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