# Ingimundur Friðriksson: Interest rates and financial markets in February 2008

Speech by Mr Ingimundur Friðriksson, Governor of the Central Bank of Iceland, at a Rotary Club meeting, Reykjavik, 28 February 2008.

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On Thursday 14 February 2007, the Board of Governors of the Central Bank of Iceland announced its decision to keep the Bank's policy interest rate unchanged at 13.75%. In its announcement, which can be found on the Bank's website, the Board of Governors explained the rationale behind its decision. It mentioned the fact that inflation was higher than November forecasts indicated, and that the short-term inflation outlook had deteriorated since November. This is borne out by the rise in the Consumer Price Index in February. The Board of Governors emphasised that uncertainty has increased, and that the Central Bank intends to monitor developments in economic indicators very closely, particularly those that reflect the impact of poorer financial market conditions on lending and demand. In the conclusion of its announcement, the Board of Governors stated that, as before, it was critical for households and businesses that inflation be controlled and inflation expectations anchored successfully. The policy rate decision was based on these considerations.

The Central Bank is required by law to promote price stability. Currently in effect is a joint declaration issued by the Icelandic government and the Bank in 2001, stating that the Bank must aim at keeping inflation as close as possible to 2½%. Inflation is well above that target for a multitude of reasons, which will not be itemised here. These contributing factors have been discussed numerous times by the Central Bank, in verbal and written form. Suffice it to say that enormous investments, radical changes in the domestic financial markets, ready access to inexpensive credit from abroad, and – last but not least – the substantial increase in disposable household income, especially in the past year, have played their part.

Critics maintain sedulously that the Central Bank's tools are weak, that its policy of restraint is ineffective, and even that its inflation target is a failed experiment. The Bank rejects this. It can be considered established that, were it not for the Central Bank's tight monetary policy, inflation would have been much higher than it has indeed been – with the concomitant strain on households and businesses. It is not the Central Bank's objective as such to keep interest rates high – indeed, the Bank is of the opinion that it is disadvantageous if the policy rate is high for a sustained period of time. Inflationary pressure has been greater than forecasts indicated – and more than was easily dealt with – and as a result, it has proven difficult to contain inflation. It took a while before the impact of the Central Bank's restraining measures was sufficiently felt, but considerable changes took place over the past year, when policy rate decisions made themselves felt more strongly in all areas of the credit market. In the fall and in early winter, the market also felt the weight of rapidly deteriorating global lending terms, which will undeniably support the Central Bank's tightening measures and will reduce domestic demand and inflationary pressure, as was mentioned in the Board of Governors' announcement of 14 February.

It is possible that there will be a rapid drop in domestic demand as a result of high interest rates and a tightening credit supply. At this point, however, it is impossible to assert that this will be the case. Exactly when it will be possible to lower the policy rate will be determined by economic developments and outlook. Precipitate interest rate reductions would push inflation upward and standards of living downward. The suggestion that it is necessary to lower interest rates in order to control inflation is absurd. Indeed, it is astounding how carelessly many people seem to view inflation.

Furthermore, it is appropriate to stress that the Central Bank believes it is impossible to choose between price stability and financial stability. If we were to relax our stance on price stability, it would surely undermine the credibility of monetary policy. Inflation – and no less important – inflation expectations would increase drastically, which could lead, in short order, to an upward spiral of prices and wages and falling exchange rate. Even though domestic financial institutions might seem to profit, for the short term, by a depreciation in the króna and a rise in inflation, a trend in this direction would quickly take its toll on indebted households and businesses and would eventually result in loan losses. From the standpoint of financial stability, it is critical that inflation be reined in. It is also appropriate to emphasise the obvious fact that Icelandic banks' access to foreign credit will not change if the Central Bank lowers the policy rate.

It has been maintained that, because central banks in other countries have lowered their interest rates, the wider interest rate differential with abroad that resulted should have given the Central Bank of Iceland the margin to reduce its policy rate this February. This is not entirely correct. As is well known, the US Federal Reserve Bank reduced its interest rates in several stages, for a total reduction of 2.25%, over the course of the fall and winter. The Bank of England has lowered its base lending rate twice this winter, for a total reduction of 0.5%. Other central banks in our neighbouring countries have not lowered their rates. The European Central Bank has kept its interest rates unchanged for several months, and the central banks in Norway and Sweden raised their rates earlier this year. The Reserve Bank of Australia also raised its rates recently. Australia belongs to the group generally referred to as high-yield countries. At this point, it is impossible to say what these banks' next interest rate decisions will be.

On Thursday, April 10, the Central Bank will publish its next issue of *Monetary Bulletin*, which will contain its newest macroeconomic and inflation forecasts. At that time, the Board of Governors will announce its next policy rate decision.

The global financial markets have been in a state of flux in recent months, primarily because of the crisis in the US sub-prime mortgage market. Securitised assets based on sub-prime lending proved much more risky than previously believed, even by credit ratings agencies, which had given various collateralised debt obligations their highest ratings. But when they were put to the test, it emerged that they were far from reliable, and banks all over the world that had invested heavily in them lost staggering sums of money, amounts that are practically unheard of. In some instances, the losses were such that they compromised the banks' equity position and forced them to seek out new share capital. A large number of banks have had to write off billions of US dollars, and some have even been forced to write off tens of billions. And in all likelihood, the effects will continue to emerge.

Last year's changes in the global financial markets were swift. For a long time, liquidity had been ample, interest rates low, and risk appetite high. That situation changed – virtually overnight – to one characterised by a lack of liquidity and a re-evaluation of the pricing of risk, and this resulted in substantially increased interest rate premia. Banks became especially careful in their transactions with one another, and a considerable tightening of interbank markets ensued the world over. Central banks on both sides of the Atlantic reacted by granting special liquidity facilities with virtually unprecedented amounts and maturities.

As the end of the year approached, conditions in the interbank markets improved markedly, though they were still far from their prior state. On the other hand, the fundamentals of important financial undertakings became an ever greater source of concern. The general economic outlook deteriorated significantly, spurring greater pessimism in the global equity markets.

Iceland certainly did not escape the effects of these global developments. Here in Iceland, those developments emerged in the form of higher interest rate premia, shrinking credit supply, and risk aversion. Risk aversion means, among other things, that companies and regions at the periphery – if it can be expressed that way – feel the effects of the changes more than others do. This periphery includes Iceland and its banks. Among Icelandic banks, these changed conditions emerge most clearly in wide CDS spreads. CDS spreads among

Icelandic banks are much wider than among foreign banks with comparable credit ratings, and much wider than many – including respected financial analysis institutions abroad – consider appropriate and consistent with the banks' financial strength and performance.[1]

It is worth remembering that Iceland's financial system has grown by leaps and bounds recently, and the operations of Icelandic commercial banks extend to a large number of foreign locations. Iceland's three largest commercial banks now generate more than half of their income through their operations in other countries. Those operations are distributed over a wide geographical area. While they are most prominent in the Nordic region and the UK, they are also visible in Continental Europe and farther afield, though to a lesser extent. Through these operations, Iceland's banks have fortified their foundations and distributed their risk. They are international banks with headquarters in Iceland, and they are much less dependent on economic developments in Iceland than they were previously.

At the end of January, the banks published their annual accounts for the year 2007. These reflected both the success of the past several years and last year's changes in the global capital markets. For the year as a whole, the banks demonstrated excellent performance. Profits were good, and core operations yielded strong returns. As can be expected, profits dropped in the fourth quarter, as was the case with banks all over the globe. Nonetheless, all three of Iceland's large commercial banks recorded a profit in the fourth quarter of 2007, and they concluded the year with an ample equity position.

Banks all over the world have been forced to write off large amounts of money because of their investments in securitised assets related to the US mortgage market. Icelandic banks' investments in obligations of this sort were small. That being the case, they have had relatively little need for such write-offs – and some had no need whatsoever because they had not invested in securitised assets.

Furthermore, it is worth remembering that changes in the share price of Iceland's banks have not differed markedly from that of banks in other areas of the world. Over the past few years, for example, the share price of Icelandic commercial banks dropped by 7-30%, while various large Nordic banks fell 15-40% and the shares of well-known international banking giants depreciated by margins ranging from 30% to over 50%. The decline is greater if measured against the peak of share prices. Financial companies carry unusual weight in the Icelandic stock exchange's share price index (OMXI 15) – at present, some two-thirds. No matter where one looks, the price of financial company stock has declined all over the world – in most locations, it has fallen more than that of other companies that constitute equity indices. In other words, financial companies have pulled equity indices downward – much more so in Iceland, where banks constitute a greater proportion of the index than in other markets.

Iceland's commercial banks went through a difficult period in early 2006 and learned a number of things from the experience. Among the lessons they learned was that they must increase transparency in their operations to a significant degree, reduce cross-ownership, significantly enhance their liquidity position, and increase the proportion of deposits in their funding. Having undergone these changes, they were much better prepared to weather last year's turmoil than they would otherwise have been. Iceland's banks have been considered bold in their investments, and they have a reputation for being more risk-tolerant than banks in many of our neighbouring countries. This may be correct, but it is also reflected by the fact that Icelandic banks have elected to maintain a relatively strong equity position.

The banks are all subject to surveillance by the Icelandic Financial Supervisory Authority, which bases its operations on the regulatory framework that applies to financial markets in the European Union. Subsidiaries of Icelandic banks are all subject to surveillance by the financial supervisory authorities in their home countries. The Icelandic Financial Supervisory

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[1] E.g. Credit Sights, February 3, 2008: *Icelandic Banks FY07: Heads You Lose, Tails You Lose.*

Authority carries out regular stress tests on the banks' accounts and publishes the results on its website. These stress tests assume extreme changes in fundamental premises. The banks have always passed the stress tests, most recently the one carried out on their balance sheets at year-end 2007. At that time, the equity ratio of Iceland's largest banks ranged from 11.2% to 11.8%. The result of the stress test was that, even if various severe shocks inherent in the premises of the test were to occur simultaneously, the banks would still have an equity ratio ranging from 10.4% to 11.2%. Their liquidity position was ample at year-end, so there was no driving need to seek funding in the international credit market. But at some point in time, they will need to return to the capital markets.

All of Iceland's large commercial banks have an international credit rating. Though these credit ratings are comparable to those awarded to similar banks in other countries, there is an abiding suspicion in the market toward Icelandic banks. This is difficult to explain fully, and it results, for example, in CDS spreads that are higher than in foreign banks, although CDS spreads also differ among Icelandic banks. It is worth remembering that Kaupthing Bank's CDS spreads rose when the bank announced its intent to acquire a Dutch bank last August. As the autumn progressed, the other banks' CDS spreads increased also. That trend continued intermittently until now. When Kaupthing abandoned its plans to acquire the Dutch bank, the reason for the increase last August vanished. Spreads declined slightly thereafter, as a large uncertainty factor had been eliminated. But the change was small, and then CDS spreads increased once again, as they did for many banks. The fact that Moody's announced a change in its outlook for the banks' credit ratings was no help.

To some degree, the sizeable CDS spreads arise from suspicion vis-à-vis Icelandic banks. In their penetration into new markets, Iceland's banks have doubtless threatened competitors that were established in those markets and were subjected to stiff competition as a result. Perhaps it also matters that Iceland's banks are in a peripheral area and that such banks are generally subjected to higher premia than are banks in large countries. The size of the banks in comparison with the national economy is doubtless a factor as well. Otherwise, higher premia could be explained by the fact that in recent years Iceland's banks sought out credit in the global bond market. When conditions for such transactions were most beneficial, there was considerable demand for the banks' bonds because they were considered to fit unusually well with the various CDOs that were then popular among investors. They generated relatively good yields, especially given the banks' credit ratings. Conditions have changed dramatically, and there is no longer a demand for such instruments. It would seem that many of them are unwinding – that is, that bonds are being sold off, including bonds from Icelandic banks. To a considerable degree, the banks' high CDS spreads could be a consequence of their enormous borrowings on the global markets, together with the unusual circumstances currently reigning in the financial markets.

The Icelandic banks' CDS spreads now range from 4% to over 6%. Well-known international banks must also tolerate high premia, even though they are lower than those in Iceland. For example, the American investment bank Bear Stearns has paid a premium of 3½% and over on five-year CDS agreements, and Lehman Brothers and Merrill Lynch have been charged 2% and over – not far from the premia charged to Landsbanki until very recently. The CDS spreads of many large, well-known international banks have risen by 0.4 – 0.8% so far this year. It may be mentioned that the proptional increase of the CDS spreads of the Icelandic banks over the last two years has not been greater than of many other and better known banks. This fact does not, however, improve their position in the captial markets.

The CDS spreads charged to Icelandic banks mean that they do not currently have access to international funding on acceptable terms. The pricing of international loans is based on CDS spreads, especially if liquidity is limited in underlying bonds. This is the case even though the CDS market is imperfect and non-transparent and quotes differ significantly in the market. It is nonetheless used as a reference. For Icelandic banks, it is therefore extremely important that CDS spreads decline, even though it is not clear what could cause it to do so in the current climate.

At the end of last month, Moody's Investor Service announced that the outlook for the credit ratings of two Icelandic banks had been downgraded from stable to negative, and that the outlook for the third bank remained negative. A decision on whether their credit ratings would be changed was to be expected within the month. This announcement came perhaps as no surprise, in view of the changes in the banks' credit ratings from Moody's over the past year. If they are downgraded by one notch, Glitnir and Kaupthing will revert to the credit rating they enjoyed before Moody's announced the implementation of its so-called Joint-Default Analysis methodology early last year. Landsbanki's current rating is two notches above that a year ago. In contrast with Moody's, Fitch Ratings recently affirmed its ratings for Iceland's banks and changed its outlook for Kaupthing Bank's rating from negative to stable. It should be noted that many banks have been subjected to changes in their credit rating outlook. For example, Standard & Poor's changed its outlook for many of the world's largest and best-known banks from stable to negative. Among the banks affected were Deutsche Bank, Dresdner Bank, Barclays Bank, UBS, Credit Suisse, and others of their ilk.

Last month Moody's issued a Special Comment on Iceland[2], bearing the title "Iceland's AAA ratings at a crossroads." The Special Comment provided grounds for the credit rating Moody's awarded Iceland – the highest the agency gives. In particular, it examined the ability of the Icelandic government to weather serious financial shocks and concluded that the government was able to do so. It also pointed out that further international expansion of the Icelandic financial system could strain that capacity. The report suggested that it might be worthwhile to examine the possibility of fortifying the Central Bank's foreign reserves, establishing a co-operative relationship with central banks in countries where Icelandic banks have extensive operations, and perhaps tightening the framework for the banks liquidity management. All of this is being considered. I wish to emphasise, however, that here in Iceland banks are subjected to more stringent liquidity requirements than banks in many other countries. Liquidity rules were set by the Central Bank a decade ago, and monitoring is carried out to ensure that individual banks abide by them. In addition, the Financial Supervisory Authority set its Guidelines on Foreign Currency Liquidity Management late in 2004. The objective of the Guidelines was to promote careful practise as regards liquidity management, and they contain 10 fundamental criteria for best practise. Since that time, the Financial Supervisory Authority has ensured that companies adopt these criteria. It can be said that Iceland is a step ahead of many other countries in this regard, as the events of the past year show that there is ever-increasing interest in setting even clearer liquidity requirements for banks.

The operational climate for banks is difficult all over the world. Under current conditions, Iceland's banks – and many others – have no other option but to furl their sails, and they have already begun to do so. They must implement stringent cost control and direct their attentions toward their core operations and the areas where they can truly compete. They might also have to sell off some assets. It is important that the banks continue to disclose information on their position, and where transparency is lacking, they must enhance it.

The conditions that have developed in the global financial markets were foreseen by very few, and they are virtually unprecedented. However, I would like to mention that the Central Bank of Iceland stated the following in its *Financial Stability 2007* publication last April: "The Central Bank underlines that global market conditions can take a sudden turn for the worse and it is important to be on the alert and prepared for such a contingency. The current episode of ample liquidity and lower interest rates which has been ideal for risk-seeking investors may change unexpectedly."

Even though conditions will eventually improve, they are unlikely to improve much in the near future. On the contrary, forecasts suggest that times will be difficult for the greater part of the

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[2] Moody's Investors Service: Special Comment: *Iceland's Aaa Ratings at a Crossroads*, January 2008.

year, if not longer. The conditions that reigned in the financial markets for several years, and changed abruptly in mid-2007, were also quite unusual, and it is unlikely that such a period will occur again in the foreseeable future. It can be considered certain that investors will be much more cautious in the future than they were until the middle of last year, and that the banks' room for manoeuvre will be more limited than it has been for a long time. Icelandic companies, including banks, must therefore adapt to changed circumstances, a tighter credit supply, and less advantageous terms. Under these circumstances, it is even more important to reduce the imbalances in the economy by, among other things, lowering inflation and anchoring inflation expectations. The Central Bank will continue its efforts to that end.