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Currency swap agreements and attempts to reinforce the foreign exchange reserves

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Board of Governors of the Central Bank of Iceland:

Currency swap agreements and attempts to reinforce the foreign exchange reserves

The public discourse about the Central Bank's attempts to fortify its external position during the current year has been extremely critical, and many things have been said that have no basis in fact; therefore, it is necessary to state some facts concerning currency swap agreements and the strengthening of the foreign exchange reserves.

Swap agreements

In March 2008, the Central Bank of Iceland sought to conclude currency swap agreements with other central banks. The Bank's primary objective was to strengthen its external position and to use the cushion that such agreements would provide in order to obtain funding on the market with the aim of fortifying the reserves still further. It was clear, in the difficult environment that reigned at the time, that currency swap agreements would be of critical importance to this plan.

First, the Bank approached Danmarks Nationalbank, the central bank of Denmark, to determine whether it were willing to conclude such an agreement. The response from Denmark was positive. Next, the Bank discussed the matter with the Bank of England, whose response was positive at first. The two banks continued to communicate on the matter in the latter part of March, and negotiations moved forward successfully enough that work began on the agreement itself. The Central Bank also sought negotiations with the European Central Bank, the Bank for International Settlements in Basel, and the US Federal Reserve Bank, as well as the central banks in Sweden and Norway. The European Central Bank was unwilling to conclude an agreement with the Central Bank of Iceland without an assessment from the International Monetary Fund (IMF) on the Icelandic economy and the position of its financial system, as is routinely required by official lenders. It was obvious that the Bank of England and the European Central Bank discussed the matter because, at this point, the Bank of England requested an assessment from the IMF as well. At the request of the Central Bank of Iceland, the IMF immediately sent two experts to Iceland to review economic affairs and the status of the financial system.

In connection with the spring meetings of the International Monetary Fund, which were held in Washington in April, representatives of the Central Bank met numerous times with IMF experts, as well as with governors of the Bank of England and the Nordic central banks. The Fund staff assessment was completed very soon after these meetings concluded. At that time, the IMF staff assessment was that the currency swaps could help restore confidence and provided a window of opportunity to address underlying vulnerabilities related to the large size of the banking sector. In its discussions with other central banks, the Central Bank of Iceland also emphasised that currency swap agreements would serve the interests not only of Iceland but also of other parties because of Icelandic financial companies' extensive international connections.

At the meetings in Washington, the governor of the Bank of England requested, in addition to the IMF staff assessment, that the Central Bank of Iceland prepare a separate memorandum describing economic developments and the position of the Icelandic financial system. Both this memorandum and the IMF assessment were sent to the European Central Bank, the Bank of England, the US Federal Reserve Bank, and three Nordic central banks.

Those who had responded positively at the outset changed their minds, however, largely on the grounds that the Icelandic banking system was far too large and that swap agreements would not make any difference. It was clear that the foreign central banks consulted among themselves on the matter.

Discussions continued with the three Nordic central banks, and these resulted in the agreements announced in mid-May. Thereafter the Chairman of the Board of Governors of the Central Bank of Iceland continued discussions with US Federal Reserve Bank executives, but with no success.

Foreign borrowing

The currency swap agreements with the three Nordic central banks made a positive impact on the market, although the Central Bank's advisors had consistently stated that larger amounts might be needed to provide a stable base before private sector investors would participate. Nevertheless, in the absence of other alternatives, a decision was made to try to go to the global bond market. Three international banks were engaged to lead the endeavour. The necessary presentations among investors all over Europe took place in late May and early June. In May, market conditions improved markedly after having been unusually weak in March and early April. At around the time these presentations concluded, the markets turned sharply downward once again. In response to unequivocal advice from the three leading banks, it was decided not to seek credit at that time, as terms were so poor that the Treasury's reputation, including Iceland's sovereign credit ratings, would have been damaged.

In July, the Central Bank began expanding its foreign reserves with the issue of short-term bills on the European market. At around the same time, loans were negotiated with several foreign banks. Conditions in the bond market did not improve, however, and it was not possible to seek funding there. Bond market conditions were poor all summer and remain so, and it is impossible to engage in a bond issue or obtain any other credit. Any statements to the effect that the Treasury could have obtained any substantial sum of money on the global credit market at that time are based on a grave misunderstanding and a lack of knowledge of market conditions.

The Office of the Prime Minister and the Ministry of Finance followed these developments closely, and there was full agreement and co-operation on these matters.

Currency swap agreements with the US Federal Reserve Bank

In late September, the US Federal Reserve Bank concluded currency swap agreements with three Nordic central banks and the Reserve Bank of Australia. The Federal Reserve decided unilaterally to offer these agreements, and the other banks accepted most willingly. The fact that Iceland was not among the counterparties attracted considerable attention in this country. By the time the agreements were announced, the Central Bank of Iceland had already contacted the Federal Reserve and requested a comparable agreement. After some consideration, the Federal Reserve declared that it was not prepared to conclude such an agreement with the Central Bank of Iceland at that time but did not rule out a swap agreement at some later date.

At the beginning of October, the Central Bank contacted the Federal Reserve Bank once again and requested a currency swap agreement. Strong emphasis was placed on the importance, from Iceland's standpoint, of concluding an agreement with a central bank of the stature of the US Federal Reserve Bank, as this would greatly enhance the Central Bank's external position and would have a positive effect on the market. In this context, the amount was not of cardinal importance. The Central Bank's request was scrutinised very closely and was discussed at the highest levels. Ultimately the answer was the same as it had been earlier in the year: Iceland's financial system was so large in proportion to its economy that a currency swap agreement would have to be larger than the Federal Reserve considered itself able to commit to. In the Icelandic media, the Federal Reserve has been reported as stating that the Central Bank's request was poorly defined. This is incompatible with its responses to the Central Bank of Iceland. Information was provided, both in writing and by phone, both to the Federal Reserve Bank in New York and to its headquarters in Washington, and rich emphasis was placed on the Central Bank of Iceland's willingness to provide further information if the Federal Reserve considered it necessary. No further information was requested.