

The official exchange rate of the króna is determined by trading on the domestic interbank market between the Central Bank's market makers. Since the first half of 2005, trading by foreign banks, both among themselves and with Icelandic banks, has considerably affected the exchange rate. Transactions in krónur between two foreign banks are referred to as offshore trading.

Until the Icelandic banks collapsed and the interbank market temporarily ceased to function, both interbank and offshore trading were closely related, as free movement of capital ensured that any price differences would be short-lived. Such differences would create an arbitrage opportunity which meant they would quickly disappear.

Offshore trading in krónur is now available in several trading systems and on an over-the-counter (OTC) basis. Since the adoption of emergency legislation last year, offshore trading has been substantially lower than before and price formation erratic. The offshore exchange rate is determined primarily by settlement of financial instruments and market-related news. When the market has reached temporary equilibrium, the price of a euro has ranged from 190-210 krónur, while on several occasions demand for krónur has been practically non-existent and its exchange rate has plunged. This occurred in mid-November, for example, and again around the middle of March, when there were instances of transactions where over 250 krónur were paid for a euro. Following the adoption of capital controls, the offshore króna exchange rate rose against the euro at the beginning of December, and towards the end of April transactions have gradually begun once more.

Currency trading on the offshore market is estimated to be only a fraction of total trading in krónur; turnover is mostly within the domestic banking system. The Rules on Foreign Exchange of November 28, 2008 prohibit trading between the domestic and offshore markets. Foreign exchange trading between domestic and foreign parties is also very limited. Foreign direct investment and transactions resulting from interest payments are examples of authorised currency trading. As a result of the capital controls, arbitrage opportunities can develop without a correction in the difference in the króna price between the two markets, with the result that a price differential can persist as long as controls are in effect.

Offshore trading affects the domestic market both directly and indirectly. It directly affects the market by preventing foreign currency obtained for exports from finding its way to the domestic market, with the result that the exchange rate on the domestic market is lower than it would otherwise be. Offshore trading indirectly affects the domestic market by encouraging expectations of a possible weakening of the króna on the domestic market, with the result that law-abiding parties complying with provisions on currency repatriation delay selling their currency.

Without capital controls there is a grave danger that the domestic exchange rate would fall to the current level of the offshore market, and it could be argued that it could weaken even more and remain at that level for some time. Because the offshore exchange rate is determined by limited trading, the króna price on this market can rise rapidly to its level on the domestic market once confidence in the currency grows and the possibilities of transactions by both domestic and foreign parties increase.

Box III-1

The offshore market for krónur