Wednesday May 2, 2001

Prices in international foreign exchange markets have long been prone to sharp swings, upwards or downwards, generally following reports about the respective countries' economies, although international news often has a great impact too. Iceland's interbank forex market obeys the same laws, as events have borne out. After the replacement of the exchange rate deviation band with inflation targeting on March 27 it was clear that greater interbank forex market fluctuations would result, in line with the experience of other countries.

Wednesday May 2, 2001 witnessed the greatest swing ever seen in the exchange rate of the króna since Iceland launched its forex market in 1993. The following is a brief explanation of what happened then.

At the start of each trading day, the Central Bank's trading desk calls the interbank market makers to find out about their foreign balances and the outlook for the day. Their positions vary depending on volumes of currency inflow and outflow, and fluctuations may take place on a day-to-day basis – some participants have a shortage of currency and others have long positions. On Wednesday May 2 two market makers were short, one was in balance and one had a long position. Overall, there was a considerable shortage in the market. A noticeable feature was that all the market makers planned to start the day by buying currency. In such a situation, a weakening of the króna is inevitable – the only question is by how much. Conversations that morning did not reveal that one of the market makers intended to buy currency to the equivalent of 2 b.kr. in the market to meet repayments on a large loan. Under normal circumstances the market is fairly well equipped to handle such a sum, although such transactions admittedly weaken the króna.

Chart 1

The króna exchange rate index at 5-minute intervals on May 2, 2001

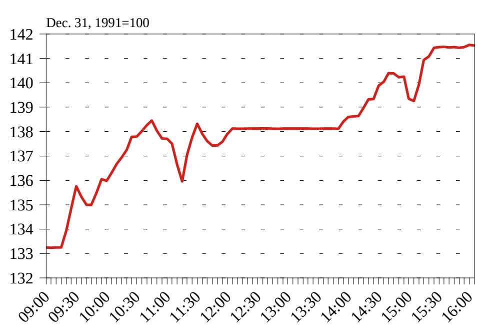


Fig. 1 shows that immediately after the market opened (09:15) the króna weakened rapidly. At the start of the day the exchange rate index stood at 133.2444 points, but by noon it had just passed 138. After a fairly long pause, the second round of weakening began around 14:00. At the end of the day (16:00) the index stood at 141.4645, having risen by almost 6.2% since the market opened. Accordingly, the króna weakened against foreign currencies by just over 5.8%. Trading amounted to 36.3 b.kr., which was also a record. It is difficult to estimate how much of this trading was on account of transactions by customers, but it is clear that a spiral of rapid price changes is caused when market makers go straight to the market to buy currency if others buy from them.[1] According to market makers, their net foreign balance changed by 3.2 b.kr. in the course of the day, meaning that just over 33 b.kr. of trading can be accounted for by their efforts to maintain their positions within limits they had set for themselves.

This was a busy day for the market makers, with orders for currency piling up which they had trouble in meeting due to their own foreign balances and the heavy risk of losses under rapid price changes. Some customers were therefore told that only limited orders to buy currency would be accepted, and others did not get a quote. Instances were also heard where prospective sellers of currency were unable to get their offers through, which obviously could have helped to counter the trend to some extent.

Naturally, the Icelandic economy experienced unrest after this day, and there was much discussion about the impact that the weakening of the króna would have, for example that inflation and foreign debt would increase too. In the view of the Central Bank and others, this sharp weakening was an overshot, i.e.

1. Further coverage of the forex market can be found in the article "The Icelandic foreign exchange market" elsewhere in this *Monetary Bulletin*.

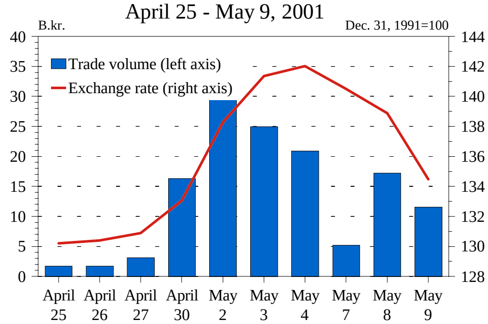
there was no justification for it taking place on such a scale over such a short period. A week later, the exchange rate index had returned to a similar value to when the market opened on May 2, as Fig. 2 shows.

It can also be seen that although the slide was most rapid on May 2, weakening also took place before and after it. After that day trading declined and the króna began to rally, but large swings continued, especially within individual days.

Chart 2

Króna exchange rate index and volume traded on foreign currency market

April 25 - May 9, 2001



There are several reasons why the Central Bank did not intervene in this sequence of events. Firstly, under the new exchange rate regime the Bank is no longer obliged to defend the króna within a specific deviation band. From the outset the Bank regarded the weakening as an overshot, and expected it to be won back. Intervention in the market was also considered to entail a certain risk, since it could be interpreted as a continuing indirect assurance that sharp swings would not take place without the Central Bank intervening in them, making it a kind of test case for the Bank's steadfastness after the monetary framework was changed. It has since emerged that certain market makers were firmly convinced that the Central Bank would intervene, and acted on this faith. Another factor influencing the Bank's attitude was that four-fifths of its foreign reserve is now funded with short-term borrowing after interventions in the forex market over the past year, so that there was not felt to be any justification for depleting it further unless this would be likely to have a long-term effect. It is fairly familiar for intervention when a currency is under pressure to have only a short-term impact and such action rarely manages to reverse the trend.