

High interest rates and capital controls have been necessary over the past several months in order to stabilise the króna. At present, the need to establish several preconditions for capital account liberalisation rules out speedy removal of the controls.

The outward pressure from investors locked in by the capital controls creates a spread between the onshore exchange rate and the rate at which positions are exchanged in the offshore market despite a policy rate of 15.5% and an onshore rate weaker than what is consistent with the estimated medium-term equilibrium real exchange rate.

The offshore market appears thin and volatile, however. In late April, transactions at 215-220 krónur per euro were reported, following early April transactions at rates exceeding 250. Market information indicates that a number of large investors will not convert at offshore rates that deviate greatly from the onshore rate.

This market information is supported by the results of a segmentation of non-residents' ISK holdings (Table 1). The holdings have been categorised by instrument (horizontal axis) and by investor portfolio considerations (vertical axis). The first is based on Central Bank of Iceland data, while the latter is based on a market review and information on investor categories.

**Table 1 Estimation of current non-resident holders of ISK-denominated instruments (% of total)**

<i>Investor category<sup>1</sup></i>	<i>Indexed Government- guaranteed bonds</i>	<i>Nominal Government bonds and bills</i>	<i>Central Bank of Iceland certificates of deposit</i>	<i>Deposits</i>
Must exit	0	24	30	25
Wish to exit	5	24	30	30
Situational	10	21	30	25
Natural part of portfolio	20	21	5	10
Long-term bias	65	9	5	10

1. Allocation based on Central Bank assumptions and market information.

Source: Central Bank of Iceland.

Preliminary estimates indicate that roughly 40% (approximately 250 b.kr.) of the total holdings are held by those falling into the "impatient" non-residential investor category. A large portion of the remaining holdings is linked to long term-instruments and/or investors with a longer-term perspective. These numbers include the main share of positions locked in by the capital controls. They include already matured Glacier bonds which have been converted into other instruments that are listed in the table above. Other Glacier bond holdings maturing in the near future have non-residents as both payer and payee and do therefore not increase the króna position.

The short-term holdings are less sizeable than previously estimated. A conversion from short-term investors in "exit mode" to investors with a longer-term perspective – that is, a perspective based on their assessment of current and future interest rate levels, Icelandic investment opportunities, and the exchange rate outlook – should therefore allow for an increasingly robust investor base.

There are indications that some substitution of positions has already occurred on the offshore market, and the limited size of the short-term positions may allow such conversion to materialise. The Bank's analysis indicates that, given the limited depth of the offshore market, individual investors' decisions can make a significant difference in bringing the offshore rate up towards the onshore rate.

## Box III-2

### Facing the "impatient investor" challenge

The Central Bank has been studying measures to strengthen the investor base. Such measures must be non-discriminatory and must further strengthen the Central Bank's foreign exchange reserves. If successful, they will help to "dry up" the offshore market.

As a first step, on May 6, 2009, the Bank invited companies that have significant foreign exchange earnings and are engaged in new investment projects to apply for long-term loans issued in krónur but repayable in foreign currency. Applications for such loans will be reviewed soon. The Central Bank will also investigate other measures that serve the same purpose.