

8 Capital account liberalisation

This chapter discusses Iceland's capital controls, why they were introduced, the steps taken thus far in lifting them, and the potential risks accompanying their liberalisation. It describes the three phases in the liberalisation policy; i.e., the resolution of the failed banks' estates, the approach concerning offshore krónur, and the lifting of restrictions on firms and households.

Background to the capital controls

In October 2008, Iceland suffered a currency and systemic banking crisis of extraordinary proportions. Iceland was among the countries hardest hit by the global financial crisis, as the massive external shock coincided with a significant mismatch between large macro-financial imbalances, which had built up during the pre-crisis period, and Iceland's domestic financial support capacity, which, despite a favourable fiscal position, was not prepared for one of the largest bankruptcies in history.

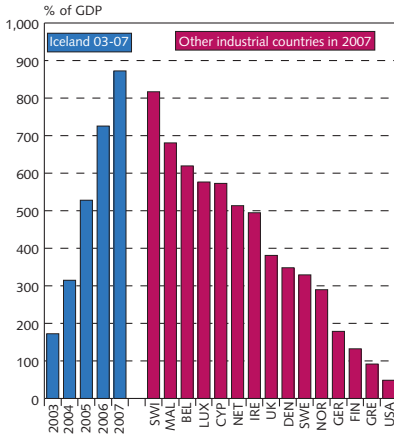
What followed was the passage of the so-called Emergency Act (the Act on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances, etc., no. 125/2008) which provided, among other things, for immediate intervention in the operations of the collapsing banks. The capital controls were adopted in late November 2008, following the formal adoption of the IMF Stand-By Arrangement with Iceland.¹ Parliament extended a provision in the Foreign Exchange Act authorising the Central Bank of Iceland to set Rules on Foreign Exchange limiting international capital transactions. In the fall of 2011, Parliament incorporated the Rules into the Foreign Exchange Act.

Role of the capital controls

The objective of the capital controls was to place temporary restrictions on certain types of cross-border capital transfers and foreign exchange transactions that could cause monetary and exchange rate instability while the resurrection of the Icelandic economy and financial system was underway. The capital controls played an important role in achieving and safeguarding the objectives of the policy response developed by the domestic authorities with the support of the IMF: to stabilise the exchange rate, ensure medium-term fiscal sustainability, and develop a comprehensive bank restructuring strategy. The controls hindered a further drop in the exchange rate by restricting capital outflows and supported asset prices by limiting fire sales, in addition to allowing for more accommodative monetary policy, facilitating the restructuring of private sector balance sheets, and giving the authorities time to develop appropriate policy responses and re-

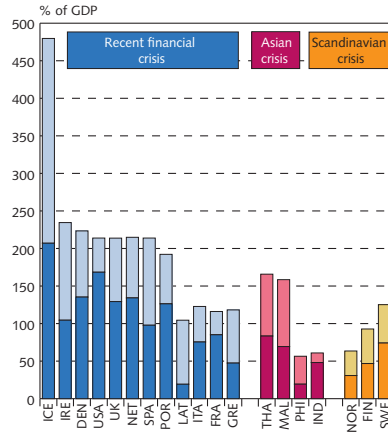
1. On 10 October 2008, the Central Bank issued instructions to financial institutions to limit currency outflows because of the extraordinary circumstances then prevailing. On 15 October, after almost two weeks of no trading in the foreign exchange market, the Central Bank initiated trading in the market through limited auctions of foreign currency. Capital controls were formally adopted on 28 November 2008.

Chart 8.1
Banking system size in the run-up to the international financial crisis in selected industrial countries¹



1. The figure shows developments in Iceland in 2003-2007 but the position in 2007 in other countries.
Sources: Central Bank of Iceland, Thorvardur Tjörvi Ólafsson and Thórarinn G. Pétursson (2011). *Weathering the financial storm: The importance of fundamentals and flexibility*. In *The Euro Area and the Financial Crisis*. Editors M. Bablavý, D. Cobham and L. Ódor. Cambridge University Press.

Chart 8.2
Domestic credit to the private sector in the run-up to three financial crises¹



1. Darker-shaded bars show the debt level of the non-financial private sector in 2000 in the current crisis, 1990 in the Asian crisis, and 1980 in the Scandinavian crisis. Lighter-shaded bars show the increase in debt to the peak level during the crisis.
Sources: Macrobond, Central Bank of Iceland.

forms. Although the controls were instrumental in preserving financial stability and safeguarding the medium-term balance of payments in the wake of the crisis, the longer they remained in effect, the more the drawbacks overshadowed the benefits, ultimately necessitating liberalisation.

Risks associated with capital account liberalisation

Liberalisation is not without risks, however. These risks reflect possible capital outflows from three sources in particular: (i) so-called offshore króna assets; (ii) the winding-up of the failed banks' estates; and (iii) other possible outflows, especially those related to domestic residents' portfolio rebalancing in favour of more foreign assets. Offshore krónur have broadly been defined as króna assets owned or held in custody by foreign financial undertakings.² These assets are mainly in the form of bank deposits and securities issued by the Government and the Housing Financing Fund (HFF), and they reflect the remains of pre-crisis carry trade. Offshore krónur amounted to approximately 15% of GDP (2 billion euros, roughly 300 b.kr.) just prior to the launch of the liberalisation strategy in June 2015, down from almost 40% of GDP in 2009. The reduction was achieved mainly through Central Bank auctions and bilateral transactions. A large share of these assets were concentrated with a few institutional investors. Offshore króna assets are potentially more volatile than other króna-denominated assets, as the latter are subject

2. A legal definition of offshore krónur was laid down in the bill of legislation passed as the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016. The definition in the Act was broader than before, as it had become clear that more categories of króna-denominated assets could cause monetary and exchange rate instability upon liberalisation.

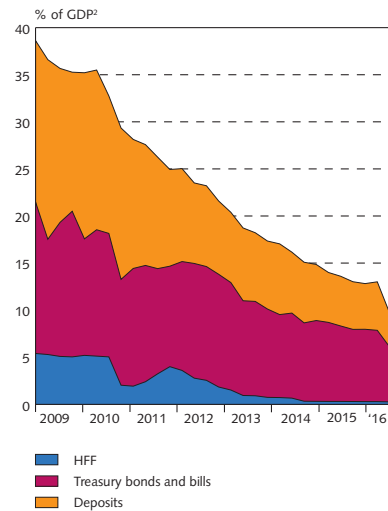
to a home bias. This applies regardless of whether the beneficial owners are domestic or foreign. The risk associated with liberalisation is that it could result in offshore króna holders' selling their securities on the fixed income market, withdrawing their deposits from the banking system, and converting their króna proceeds into foreign currency in the foreign exchange markets, which could have a profound impact on the exchange rate, as well as on monetary and overall economic and financial stability.

The winding-up of the failed banks' estates was deemed to be the largest individual source of risk to the balance of payments outlook associated with liberalisation. This reflected, first of all, the sizable mismatch between foreign claims and foreign assets, resulting in substantial (*pro rata*) distributions of domestic assets to foreign creditors and giving rise to significant capital outflows. About 40% of the estates' assets were domestic, whereas some 93% of the claims were owned by non-residents. Second, the size of the balance sheets that needed to be wound up – the combined total of króna-denominated assets held by the estates and foreign-denominated claims against domestic parties – amounted to over 40% of GDP. Third, the composition of foreign claimants was an issue, as a significant share were distressed securities investors and, as such, unlikely to undertake long-term investments in Icelandic assets and therefore likely to exit their positions at the earliest opportunity. Other things being equal, settling the failed banks' estates would have had a negative impact on Iceland's net international investment position (NIIP) in the amount of 5.5 billion euros (787 b.kr.), or nearly 36% of GDP, based on the position in Q3/2015. This is equivalent to the difference between the value of domestic assets that would have reverted to foreign creditors, on the one hand, and foreign assets that would have reverted to domestic creditors, on the other.

Furthermore, it was difficult to assess the possible extent of other outflows from residents – most importantly, pension funds. On the one hand, an orderly, price-sensitive portfolio reallocation could be expected, while disorderly, price-insensitive capital flight had to be avoided. This was reflected in the design of the liberalisation plan.

In Iceland's case, the possible extent of capital outflows relative to the limited depth of financial markets was an important factor, as large mismatches between potential shocks and the capacity of financial markets to absorb them can give rise to severe systemic externalities for the economy as a whole. The most immediate channel of transmission associated with the liberalisation process was considered to be the exchange rate channel, with a large sell-off of króna assets and deposit withdrawals leading to excessive one-way flows in the FX market, causing liquidity depletion, market dysfunction, and strong fire sale effects on the exchange rate of the króna, with severe repercussions for balance sheets and economic and financial stability in general.

Chart 8.3
Offshore króna assets¹



1. End of quarter. 2. Per cent of sum of four-quarter seasonally adjusted GDP from Statistics Iceland.

Sources: Statistics Iceland, Central Bank of Iceland.

Liberalisation strategy

In designing an appropriate liberalisation strategy, the Icelandic authorities took careful note of the IMF's institutional view on capital flow liberalisation and management.³ The strategy is based on a systematic and cautious approach, entailing a liberalisation process that is well planned, timed, and sequenced with regard to the remaining macro-financial vulnerabilities, the level of institutional and market development, and individual sectors' ability to withstand volatile capital flows. When the revised liberalisation strategy was introduced in June 2015, Icelandic economic factors that would affect capital outflows were relatively favourable. Relevant external factors were favourable as well: the international low-yield environment was expected to prevail for some time, risk appetite had been relatively strong worldwide, Iceland's terms of trade had improved, and an international economic recovery continued, albeit slowly and unevenly.

The revised capital account liberalisation strategy presented in June 2015 proposed that the controls be lifted in stages. The first phase would focus on the failed banks' estates, the second on offshore krónur, and the third on households and businesses. The strategy involved reducing the size of outflows through the foreign currency market in connection with the resolution of the failed banks' estates, either through decentralised composition agreements⁴ based on specific stability conditions or through taxation that would mitigate the adverse balance of payments effects, while reducing the externalities associated with outflows from offshore króna owners through an auction and secure segregation of the onshore and offshore markets during the liberalisation process.

The total scope of the risk addressed by the strategy amounted to as much as 56% of GDP. The assets concerned consisted of krona-denominated assets held by the insolvent estates of the failed commercial banks and savings banks (23% of GDP), foreign-denominated claims held by these estates against domestic parties (18% of GDP), and offshore krónur owned by non-residents (15% of GDP). The actions comprising the authorities' liberalisation strategy prevented the sales proceeds of these assets from flooding the foreign exchange market and thereby undermining economic, monetary, and financial stability.

The failed banks' estates

The failed banks' estates were presented with two options: conclude composition agreements in accordance with specific stability conditions before year-end 2015 (later extended to 15 March 2016), or face a one-off stability tax of 39% on their total assets (see Box 8.1). The stability conditions aimed to reduce the size of potential capital outflows related to the distribution of the estates' domestic assets and thereby neutralise, to the extent possible, their effects on Iceland's balance of payments and economic and financial stability.

The balance of payments effect of distributions from the estates was mitigated when króna-denominated assets were reduced; the stability contribution amounted to 17.2% of year-2015

3. IMF (2012b). The liberalization and management of capital flows: an institutional view. *IMF Policy Paper*, November 12, 2012. Also expressed in specific IMF reports on Iceland; e.g., Iceland: 2014 Article IV Consultation and fifth post-program monitoring discussions – Staff Report; Press Release; and Statement by the Executive Director for Iceland. *IMF Country Report*, no. 15/72.

4. A *composition agreement* generally refers to a contract made by an insolvent or financially pressed debtor with two or more creditors in which the creditors agree to accept one specific partial payment of the total amount of their claims, which is to be divided *pro rata* among them in full satisfaction of their claims.

GDP, thus reducing the estates' domestic assets and limiting outflows. The settlement of the estates through composition agreements based on stability conditions was more or less finalised between June 2015 and May 2016. With the composition agreements, the estates' liabilities were written off with reference to their assets. At the end of 2015, Iceland's net international investment position was negative by about 5.7% of GDP, whereas the calculated underlying NIIP⁵ at the end of Q3/2015 was negative by 31.5% of GDP. The NIIP therefore improved markedly because of the estates' stability contributions, as well as a revaluation of the estates' liabilities.⁶ If the stability contributions had not been paid, the position would have been worse by about 17% of GDP; i.e., non-residents' share of the stability contributions.

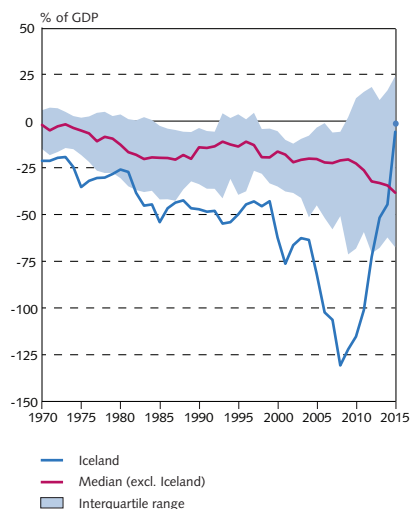
Offshore krónur

The revised liberalisation strategy addressed offshore krónur. The stock of offshore krónur had decreased markedly during the years prior to the presentation of the revised strategy, mainly due to Central Bank auctions. However, uncertainty still remained concerning the extent to which offshore króna owners would choose to reduce their exposure once controls were lifted. Therefore, in June 2016, the Central Bank offered to use part of its own foreign exchange reserves to buy offshore krónur in a single-price auction, the last auction of this type before removal of capital controls on domestic firms and households.

The bill of legislation on the treatment of króna-denominated assets subject to special restrictions, passed in May 2016,⁷ therefore enabled the authorities to segregate offshore krónur in a secure manner and take the next step towards lifting the capital controls. According to the bill, offshore króna holders are allowed to invest in the same instruments as before, with the addition of special certificates of deposit issued by the Central Bank. However, the banks holding the accounts of offshore króna owners will be required to buy certificates of deposit from the Bank for the same amount, and these instruments will bear an interest rate of 0.5%. The interest rates are reviewed every twelve months by the Central Bank of Iceland, with reference to the Bank's legally mandated objectives and returns on its assets. After the bill of legislation was passed, the Central Bank held a foreign currency auction in which all owners of offshore krónur were given

Chart 8.4

Net international investment position in 30 advanced countries¹



1. Figures for Iceland are from the National Economic Institute (1970-1994) and the Central Bank and Statistics Iceland (1995-2015) (data point shows preliminary figures for NIIP in Q2/2016), based on the underlying position during the period 2008-2014. Figures from the other countries are from the Lane and Milesi-Ferretti database for 1970-2011. Their data are extended through 2015 based on developments according to the IMF's international financial statistics (IFS) database.

Sources: IMF, Lane and Milesi-Ferretti (2007), National Economic Institute, Statistics Iceland, Central Bank of Iceland.

5. The underlying NIIP assumes that the failed banks' estates had been wound up based on the book value of assets and the underlying classification of approved claims according to claims registers.
6. The estates' liabilities as of end-2015 were revalued in Q1/2016. Liabilities are now presented at market value, as opposed to nominal value. As a result, the external position improved, from 14.3% of GDP at year-end 2015 to 5.7%.
7. See the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016.

the option of exchanging them for foreign currency, and the Bank decided to accept all offers submitted at a rate of 190 krónur per euro. Offshore krónur totalled 2.2 billion euros (over 300 b.kr.), or 15% of GDP, before the auction took place on 16 June 2016. On 21 June, the Bank published the results and offered to purchase the offshore króna assets not sold in the auction at the same exchange rate. A total of 1,715 offers were submitted, and 1,688, or 98.4% of the total, were accepted. Accepted offers amounted to 559 million euros (83 b.kr.) of a total of 1.4 billion euros (188 b.kr.) submitted in the auction and the post-auction tender.

The auction helped to facilitate the exit of offshore krónur without negative effects on the foreign exchange market, and the outstanding stock of offshore krónur has been reduced markedly. The remaining owners of offshore króna assets in the form of cash or Treasury bonds and bills are a smaller and more homogeneous group, mostly a few fund management companies. The remaining offshore krónur were subsequently transferred to accounts subject to special restrictions and nominee accounts with the Central Bank of Iceland, in accordance with the newly passed legislation. Owners of offshore króna assets will continue to have the right to dispose of their assets; they can make withdrawals, exchange all interest payments in the foreign exchange market, and trade their krónur in the offshore market. An assessment of when and how to lift controls on the remaining offshore krónur will be made after the steps towards liberalisation of capital controls on households and businesses, provided for in the law passed by Parliament in autumn 2016, have been executed. The first of these steps was taken immediately upon the passage of the legislation, and the latter will be taken around the turn of the year 2016-2017.

Households and businesses

In accordance with the revised liberalisation strategy, the law passed in autumn 2016 greatly enhances the freedom of businesses and individuals to transfer capital to and from Iceland and engage in foreign exchange transactions. With it, important steps are taken towards general liberalisation of the capital controls. The law, which amends the Foreign Exchange Act, no. 87/1992, removes certain restrictions on foreign exchange transactions and cross-border movement of capital and expands specified authorisations under the Foreign Exchange Act. In addition, changes were made to the Central Bank's powers to gather information in connection with its role as a central bank, and the requirement to notify the Central Bank of foreign exchange transactions and cross-border capital transfers was laid down explicitly.

According to the law, liberalisation is sequenced as follows: Outward foreign direct investment and easing of restrictions on long- and short-term portfolio investment up to a limit of 226 thousand euros (30 m.kr.) were authorised first, immediately upon passage of the legislation. Effective 1 January 2017, the limit will be raised to 754 thousand euros (100 m.kr.) per party and expanded to include cross-border deposit transfers. The Central Bank is authorised to ease these limits until they are abolished, along with limitations on derivatives and other instruments and other remaining restrictions. This phase of liberalisation will exclude both offshore króna holdings and pension funds (in excess of the limits stated above); however pension funds will continue to be authorised to invest abroad on an exemption basis.

Upon the adoption of the measures provided for in the law, the capital controls should place only minor restrictions on most individuals, and by the turn of the year 2016-2017, only a very few individuals should be affected. The law does not have any impact on offshore króna holders' authorisations. When and how the remaining restrictions in the Foreign Exchange Act and the restrictions on offshore krónur will be abolished remains to be decided and will depend upon a

reassessment of the conditions for full liberalisation. This reassessment will be carried out after the first two steps have been taken.

Pension funds

Since mid-2015, pension funds have been granted exemptions for foreign investment in the amount of about 603 million euros (80 b.kr.), or 3.6% of GDP. As a result, some of their pent-up need for foreign investment has been met; however, their foreign investment is set to increase further. According to the funds' balance sheets, the ratio of foreign assets to total assets was 22% in July 2016, as compared with the 2001-2015 average of roughly 24%.

Box 8.1

Stability conditions and stability contributions

The Icelandic authorities' revised liberalisation strategy, presented in June 2015, provided the failed banks' estates with explicit deadlines for the finalisation of composition agreements fulfilling specific conditions. The stability conditions could be fulfilled by making a stability contribution to the Government, which was designed to take account of the level, composition, and degree of uncertainty of the estates' domestic assets so as to minimise potential disorderly outflows associated with the resolution of the estates.

The stability contribution consisted of (all or some of) four parts: (i) payment of a direct contribution to the Government; (ii) issuance of contingent financial instruments by the estates to the Government; (iii) an agreement to split uncertain future asset recoveries with the authorities through profit-sharing arrangements for future returns on the estates' equity stakes in the new banks or a direct transfer of shares; and (iv) the transfer to the Government of recoveries from domestic claims that are in dispute and/or have a nominal value far exceeding book value.

Furthermore, the stability conditions addressed the unwinding of remaining crisis legacy items that were related to the failed banks and remained on the new banks' balance sheets, both through repayment of loans and liquidity assistance provided by the Treasury and the Central Bank and through conversion of the estates' foreign currency deposits into longer-term foreign-denominated bonds.

Chart 1

The stability conditions

