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Capital Controls, Fiscal Policy and Economic Recovery

Ladies and gentlemen.

At the eleventh hour, just prior to the collapse of the banking system, it did not remotely occur to me that signing exemptions from rules significantly restricting the rights of residents to trade in foreign currency could become one of my responsibilities. Admittedly, it had been mentioned on several occasions, in meetings with foreign bankers and investors during the weeks and months leading up to the collapse, that they were of the opinion that capital account restrictions were among the conceivable measures that Icelandic authorities could apply in the dire straits into which the Icelandic economy was clearly headed. When I was asked whether capital controls could be considered, in the difficult situation that had arisen, I naturally replied in the negative, with reference to the international agreements Iceland had signed – any other answer would have been risky. Even less did it occur to me that the IMF would endorse capital controls as a key factor in an economic strategy for the reconstruction of Iceland's financial system and economy, as the Fund has often been criticised for encouraging premature removal of capital controls in many countries around the world. The capital controls are controversial. Other routes were considered but eventually rejected as too risky. The necessity of temporary controls now appears to be generally recognised, and support for them appears to have grown, so much so that this actually gives cause for some concern. There are likely two reasons for this. In the first place, many people appreciate the exchange rate stability they have brought – that is, after their tightening started to have some effect. Second, this change in attitude may indicate that a certain group has benefited to some extent from the controls, which prompts me to conclude that it is desirable to begin lifting them as soon as is practicable, but without jeopardising stability. To find our way out of the capital controls, we must understand the reason they were imposed. To start with, we can recall a few basic facts.

It is true of both banks and currencies that their stability is based on confidence. If confidence evaporates, banks fail and currencies plunge, often far below the levels justified by fundamentals. Confidence in a country's currency and confidence its main financial institutions are closely connected, because the banking system links domestic and foreign financial markets. It is the lifeline of any currency. If that lifeline is cut, the consequences are catastrophic. In simple terms, this is what happened when the Icelandic banking system collapsed.

There was a real danger that a vicious circle, as capital fled ISK-denominated assets, could have amplified major difficulties faced by highly indebted households and businesses. When an entire country's financial system collapses, as was the case here, it can take a long time to make it fully operational once more. As a result, it could take some time, given the global financial crisis, for foreign credit markets to re-open, as

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turned out to be the case. In view of the fact that considerable refinancing of Treasury debt was scheduled for 2011 and 2012, there was clearly limited scope to use the Central Bank's foreign reserves to mitigate exchange rate fluctuations without risking the Treasury's ability to refinance or pay off the loans maturing in these years. For whatever reason, when it came down to it, the IMF was not prepared to extend loans to facilitate in the reconstruction of the Icelandic economy unless it could be guaranteed that funds provided would not be sucked down a whirlpool of capital fleeing the country. The capital controls provided the authorities with leeway to restructure the financial system, get a grip on Treasury finances, and deal with the problems of debt-ridden households and businesses. All of this is a prerequisite for regaining the trust of international credit markets in the Icelandic economy and in the ability of the Treasury to meet its obligations.

Since the controls were tightened, they have contributed to greater exchange rate stability than has been seen for a long time, albeit at a lower level than is desirable. This stability has facilitated implementing economic policy. It therefore comes as no surprise to hear the view expressed that the capital controls should be maintained on a more permanent basis. This is not as attractive an option as might appear at first glance, however. In the first place, liquid capital cannot be kept here forcibly for an indefinite period of time. The controls are a violation of various international agreements signed by Iceland. They are tolerated as long as Iceland follows the economic recovery programme supported by the IMF, and thus indirectly by the member states of the EEA, OECD, and the Fund itself. Soon after this programme concludes, the controls will likely have to disappear; i.e., if the Icelandic government does not wish to renege on international treaties it has ratified. Eventually, frozen capital will have to be allowed to go wherever it wishes. Second, long-term confidence cannot be established as long as uncertainty exists as to how much capital is tied up in ISK assets simply because of the capital controls. This uncertainty will not dissipate fully until they are removed. Until that time, there is a risk that it will restrain foreign investment, which is a premise for export-driven economic recovery. Third, the hefty profits that can accrue to parties that circumvent the capital controls undermine business ethics and create a competitive advantage vis-à-vis those who abide by the law. The controls prompt individuals and firms to devote efforts to seeking ways to circumvent them, resulting in waste of resources and excess cost in the economy in the longer term. The negative impact of capital controls is likely to be greater the longer they last and the more lenient their enforcement is. The aim, therefore, is to remove the controls as soon as it is safe, while enforcing them very strictly, not least during the liberalisation phase.

If it is unavoidable and desirable to lift the controls, how can this be accomplished without risking exchange rate instability? The strategy presented by the Central Bank last summer describes the principal aspects of the liberalisation process. While I do not intend to repeat what it says on this occasion, I would like to take the opportunity to point out that resolving the problems of Treasury financing is actually a precondition for renewed progress in economic recovery and for relaxing the capital controls without substantial risk. During the period of overheating leading up to the financial crisis, the non-tradable sector expanded far beyond what export sector growth could sustain for the long term. In many cases, production capacity in the non-tradable sector is excessive over the short to medium term. Hence the scope for economic recovery led by the non-tradable goods sector is scant; recovery must mainly commence in the tradable goods sector. Export growth will be weak, however, unless export companies have ready access to external financing. But their access to foreign capital markets will be difficult until the Treasury has blazed a trail, or as long as it faces terms that raise doubts about the sustainability of public debt. The borrowing terms that a country's Treasury enjoys from foreign creditors generally serve as a floor for the interest rate offered to the private sector. This makes it crucial to restore the Treasury's good credit rating. Not only will this pave the way for domestic enterprises to external financing, it will also significantly reduce the likelihood of a fire sale of domestic assets once the capital controls are lifted.

The principal task of the economic recovery programme drafted in co-operation with the IMF is to restore confidence in the Treasury's ability to meet its foreign currency obligations. How can this be done? First, by practicing sufficient fiscal restraint to convince financial markets that, despite a temporary spike in indebtedness in the wake of the banks' collapse, the Treasury will be fully capable of meeting its international obligations; i.e., that its debt position is sustainable for the long term. Second, the Treasury has to demonstrate that it has access to sufficient foreign currency reserves to repay, if it comes to the crunch, loans maturing over the next two years. We still are just short of reaching this position, as efforts to achieve it have been delayed for reasons known to all of us. Here it is important to bear in mind the common saying that banks, domestic as well as international, are ready to offer you an umbrella on a sunny day, only to demand it back promptly once the rain starts to fall. Anyone needing an umbrella when it's raining has to show that he can get alternative one on demand. Loans from the IMF and others are our umbrella. In the third place, co-operation with the IMF is important not only because of the access to credit contingent on the progress of the programme. The Fund serves as a sort of validation agency for the economic policies of countries that find themselves in economic difficulties. Its stamp of approval is a pre-condition for obtaining credit not only from other countries, but also from foreign banks and investors. In many instances it is a premise for foreign investment in domestic industry. This view has been clearly expressed in interviews with numerous foreign bankers, who are prepared to take Iceland to the global credit market as soon as the uncertainty delaying the progress of the programme is eliminated.

Many find the medicine prescribed by IMF bitter, and have requested a more palatable economic strategy without the Fund's involvement. Of course, it would be desirable to use automatic fiscal stabilisers or discretionary fiscal policy to mitigate the economic cycle. Countercyclical fiscal policy, however, is a privilege reserved for countries whose credit rating has not been tarnished. Iceland does not enjoy this privilege any more than Greece, Latvia, and various other states. To toss away the IMF's umbrella and set off empty-handed to meet with foreign creditors in an attempt to refinance the loans maturing in the next two years would be a fatal error. In fact, the loans that have already been received have guaranteed foreign exchange reserves sufficient to enable the Treasury to service its debt for the next two years without major foreign currency purchases. However, foreign reserves would fall to a level that is not acceptable. The cost would be a lower exchange rate than otherwise, and it would be inadvisable to relax the capital controls at the same time. Fourth, it is important to take the first steps towards removing the capital controls as soon as possible after the objectives described above have been achieved. The objective is to make the disappearance of the last vestige of controls an event that will hardly be noticed. We learned from the financial collapse that fair weather can turn foul at short notice. Once the storm has passed, however, the skies can also clear more quickly than most people expect.