3 November 2010

Statement on capital controls

This statement is given in order to explain the policy framework and current intentions regarding the removal of capital controls. The only new specific information is in Point 8.

1. Comprehensive capital controls were introduced in November 2008 as a part of the Government economic programme, which is supported by the IMF, in order to prevent serious difficulties as regards Iceland's balance of payments, and with the aim of stabilising the exchange rate without overreliance on the interest rate tool. The controls are a deviation from Iceland's obligations under the EEA Agreement to uphold free capital movements. Under the EEA Agreement, such controls are permitted only as a short-term emergency measure. The measures have been notified to EEA institutions, as is provided for in the Agreement, without any objections. However, it would be a breach of the EEA Agreement if best efforts are not made to lift the capital controls once the conditions that created the emergency have been overcome.

2. It has therefore been one of the aims of the Government programme to create the conditions for lifting the capital controls. In addition, capital controls have economic and social costs that tend to accumulate over time.

3. In August 2009, the Central Bank published a strategy for lifting the capital controls. The strategy was developed in consultation with the Ministry of Business Affairs and the IMF and was approved by the Government. As is stipulated in the original strategy, the first step of lifting controls on capital inflows and all subsequent associated outflows was taken on 1 November 2009. It is important to bear in mind that, although the strategy provides a broad blueprint for lifting controls on capital outflows, it does not specify any dates. Instead, it was stated that sequential steps in lifting the controls would depend on conditions. The pace of lifting the controls would thus depend on whether specific conditions were fulfilled and how well, or badly, preceding steps went.

4. The strategy lists several key conditions for lifting the capital controls. The most important ones were: 1) macroeconomic stabilisation, including the implementation of a credible plan for fiscal sustainability and declining inflation; 2) a sound financial system; 3) an

adequate level of foreign exchange reserves. These conditions have formed the basis for the Central Bank and MPC statements on capital controls. Two of these conditions are being met, but the required financial soundness is not fulfilled, partially due to uncertainty regarding the capital position of the banking system following two Supreme Court rulings. In the last Letter of Intent written to the IMF, the Icelandic authorities committed to recapitalising the banking system before year-end should it be needed. This is a necessary condition for financial sector soundness, but it might not be a sufficient condition.

5. The MPC does not develop or take decisions on the strategy for lifting capital controls, although the Central Bank seeks its views and advice on the issue. Monetary policy does, however, take the existing strategy into account and the prospects for its implementation. In doing so, the MPC has taken note of the conditions mentioned above. The evolution of MPC statements should be seen in that light.

6. Although the strategy from August 2009 has not been formally revised, Central Bank officials have stated, and this was echoed in the August MPC statement, that the strategy may need to be revised in view of the change in conditions and the experience so far. The revised strategy will be designed by the Central Bank in consultation with the Ministry of Economic Affairs and finally endorsed by the Government. This is in line with the process used to prepare the original strategy. A revision of the strategy does not imply a departure from the goal of lifting capital controls in the coming period, but rather it recognises the need to reconsider the manner in which the controls will be lifted in light of recent experience and changed conditions.

7. Provided legal or other impediments are not uncovered prior to the announcement of a revised strategy, some action might be taken in order to prepare for the comprehensive removal of controls on capital outflows. This might include measures to allow legally acquired offshore krónur to be swapped through controlled auctions against legal holdings of foreign assets by domestic residents, and to allow legally acquired offshore krónur to be invested in targeted long-term business ventures or other specific projects in Iceland.

8. Given that the issue of a potential short-fall in the capital position of the banking system might not be fully addressed until year-end, it is not realistic that any other steps than those described in Point 7 will be taken to lift the controls on outflows this year. Furthermore, no such steps will be taken until a revised strategy has been made public. In addition, even if such a strategy were ready earlier, no fundamental

changes will be made to current rules before March 2011, except those that might be needed in order to execute the planned action mentioned in Point 7. This commitment is supported by the Minister of Economic Affairs. It should be borne in mind that the enabling legislation for the capital controls will at present expire at the end of August 2011. However, a proposal to extend the legislation might become part of the revised strategy that will be announced before March 2011.

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