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Capital Control Liberalisation

A. Introduction

While controls were deemed necessary to stabilise the Icelandic economy following the financial crisis of October 2008, gradual removal of the controls is an important step towards normalising economic conditions. Icelandic businesses view access to capital markets, international funding, and investments as one of the main preconditions for economic recovery.

Even though gradual removal of the controls is a priority, the sequencing must be carefully designed in light of the remaining imbalances of the Icelandic economy. The sequence of the policy mix is thus designed in a way that allows each step to be taken while preserving the stability of the króna.

During the liberalization phase, underlying economic developments and policies will be in place that should contribute to the stability of the króna: 1) Each liberalization step will only be taken when the certain preconditions are in place, 2) Monetary policy will be conducted in a way that promotes stability, 3) Expected progress on the recovery program and a prospective current account surpluses will support the krona, 4) The Central Bank will have in place very sizeable currency reserves.

This document is divided into the following sections:

- Reasons for introducing controls
- Current capital controls regime
- Preconditions for liberalisation
- Liberalisation strategy
- Administration and enforcement

B. Reasons for introducing controls

The period 2005-2008 saw significant capital inflow into Iceland. The combination of wide interest rate differentials and an appreciating currency attracted international capital, some through 'normal' financial investments and some through instruments (e.g., glacier bonds) constructed to benefit from this combination. Some inflow was also linked to the Icelandic financial system and international borrowing by Icelandic companies. As a result, non-residents held large positions in Icelandic krónur (ISK), some immediately available and some available through 2009-2010 as the instruments matured. Non-residents' ISK positions totalled 680 b.kr. in late 2008. Short-term positions totalled approximately 330 b.kr.

In October 2008, Iceland suffered a banking crisis of extraordinary proportions. The ensuing loss of confidence threatened to trigger large capital outflows, with highly adverse effects on an already weakened exchange rate. Such capital outflows (immediate and delayed) could have led to further depreciation of the króna, and higher inflation. Because private sector balance sheets are characterised by both high leverage and a large proportion of foreign-denominated and inflation-indexed debt, this could trigger a wave of defaults, with adverse macroeconomic implications. Consequently, on October 10, the Central Bank introduced measures to temporary modify currency outflow.

Given the substantial macroeconomic risks, capital controls were an unfortunate but indispensable ingredient in the policy mix that was adopted to stabilise the króna when the interbank foreign-exchange market was restarted in early December 2008.

C. Current capital controls regime

The current capital controls were adopted on November 28, 2008, according to the Rules on Foreign Exchange (the Rules), which were authorised by a provision in the Act on Foreign Exchange. The Rules were reissued on December 15, 2008, and in mid-March the Foreign Exchange Act was amended so as to tighten the controls. In parallel, clarifications of the Rules have been issued on numerous occasions.

Payments linked to current account transactions and inward FDI were released after a short period of time. Thus, transactions involving actual imports and exports of goods and services are allowed and so are interest payments, if exchanged within a specified time limit. Most capital transactions are controlled both for residents and non-residents;

that is, their ability to shift between ISK and FX is restricted. Króna-denominated bonds and other like instruments cannot be converted to foreign currency upon maturity. The proceeds must be reinvested in other ISK instruments. Furthermore, the Rules require residents to repatriate all foreign currency that they acquire.

Certain companies, including major exporters and firms with large international operations, were given full or partial exemption from the Rules upon fulfilment of certain criteria.

The Foreign Exchange Act is under the auspices of the Ministry of Business Affairs; however, the Act authorises the CBI to issue the Rules on Foreign Exchange, which are subject to the Minister of Business Affairs' approval. The CBI is responsible for the overall surveillance of the capital controls and for the day-to-day administration of the Rules. That surveillance has gradually been stepped up. According to the Foreign Exchange Act, the Financial Supervisory Authority (FME) shall investigate possible violations of the capital controls when notified of such suspected violations by the CBI. To ensure effective and efficient cooperation between the CBI and the FME, the two institutions signed a collaboration agreement in June 2009.

Circumvention of the capital controls is to be identified by the CBI. Data on transactions and flows are monitored, and possible circumvention is identified. The general impression is that the majority of Iceland's largest companies and financial institutions are operating according to the letter and intention of the law. However, many are building up their own FX reserves (primarily in Icelandic banks) as a buffer/hedge that limits their conversion to krónur.

With effective controls in place, exchange rate developments will be determined largely by current account flows (i.e., exports, imports, interest payments, and debt repayment), but not, as has been for the last 5 to 8 years, predominantly by capital flows. However, the market is shallow.

Because the current account has been broadly balanced, capital controls have helped to stabilise the exchange rate by preventing large capital outflows and thereby enabling the CBI to lower its policy rate. The controls have also provided a relatively stable environment for bank restructuring and have kept liquidity in the system.

In general, it appears as if the tension in the system has been reduced over the past few months. The spread between the ISK exchange rate in the onshore and offshore markets has narrowed. According to CBI statistics, ISK holdings of non-residents have declined from approximately 680 b.kr. at year-end 2008 to roughly 610 b.kr. at end-July 2009. Long-term holdings have increased slightly, while short-term positions have fallen from about 330 b.kr. to 260 b.kr. Although these figures are somewhat uncertain, they suggest a significant reduction in the possible overhang of non-resident ISK positions.

Non-residents appear to be relatively comfortable holding ISK assets in the form of Government bonds/HFF bonds, and CBI and bank deposits. There has been limited interest in shifting from such ISK positions to longer-term euro positions through the 'impatient investor' measures introduced in May 2009.

Overall the estimate is that at least half the ISK positions are attractive for non-residents in the longer term; e.g., long-term HFF bonds. In May 2009, the CBI estimated that around 250-300 b.kr. were held by "impatient" non-resident investors who would either need to be given incentive to stay, substituted by other non-resident or resident investors establishing ISK positions, or locked in during the initial phases of liberalization .

After the recent turbulence, it should be expected that some residents may want to shift out of the króna in order to balance their risks (earnings, currency, and solvency) and perhaps access instruments that cannot be fully acquired in krónur (equity, equity portfolios, and some fund categories). However, Icelandic instruments may be seen to provide an attractive mix of direct earnings and/or currency upside.

D. Preconditions for liberalisation

A significant reduction in the perceived risk of investments in Icelandic assets is a precondition for removing the capital controls. The Icelandic króna has depreciated some 5% against the euro since January 1, 2009; however, model projections (see the CBI's *Monetary Bulletin* 2009/2) suggest that the króna may appreciate substantially more than 5% by 2011, while still allowing for necessary improvements in the current account. With such developments, and with ISK interest rates currently well above international rates, the fundamental incentives for investors to hold their ISK positions should be in place. However, even though Iceland's risk premium has declined in line with and beyond international trends, it remains relatively high.

Over the past few months, many important steps have been taken to alleviate this situation. With the adoption of a medium-term fiscal plan, the Government has taken an important first step towards fiscal consolidation. Substantial progress has been made on the bank recapitalisation process, which is facilitated by new legislation on an asset management company and a bill of law on State banking agency. The IceSave loans and loan agreements with the Nordic countries have been signed. Together with the IMF loan facility, the Nordic loans bring total reserves to about 5 bn US dollars. The monetary policy has been focused on currency stability as and interim objective, and inflation has lost pace. A Stability Pact has been concluded between the Government and the social partners. Furthermore, exports have proven strong and imports weaker than expected, translating a sharp drop in domestic demand into a relatively moderate drop in GDP combined with a positive trade balance.

Against this background, the stage should be set for the achievement of the following preconditions over the next several months.

i. Full implementation of the macroeconomic stabilisation package. This includes the following:
    a. Confidence in the sustainability of government debt must be enhanced by a strong commitment to a medium term plan of fiscal consolidation. This would demonstrate that, although burdensome adjustments will be required, the Republic will be fully able to service its debt.
    b. Communication of the sustainability of the external debt situation, the mechanisms by which sufficient FX earnings to strengthen the króna will be ensured and a capital control liberalisation strategy designed to preserve the stability of the króna.
    c. Continued disinflation and a monetary policy focused on exchanged rate stability, as is illustrated in the last statement from the Monetary Policy Committee (MPC).
    d. The availability of instruments with attractive characteristics (deposits, bonds, FDI) to induce residents and non-residents to hold or establish longer-term ISK positions.

ii. Establishment of a strong, well-managed, and adequately supervised financial sector.

iii. Implementation and operation of an efficient liquidity management framework.

iv. Accumulation of adequate reserves (to support exchange rate stability and banking system liquidity, if necessary).

Stage 1 of the capital control liberalisation strategy – liberalising inflows – should only take place when the above preconditions have been met. It is expected that these preconditions will be in place well before November 1, 2009.

After Stage 1 is completed, later stages of the liberalisation process (liberalising outflows) will be initiated gradually, at the CBI's discretion, concurrent with the accumulation of surplus reserves to help cushion potential exchange rate volatility. Restored confidence in the Icelandic banking sector and equity market will be a particularly important prerequisite for liberalising capital outflows.

E. Liberalisation strategy

The liberalisation process will be closely managed to support the CBI's reserve management policy and the main monetary policy objectives of exchange rate and price stability. It takes place according to a sequence that is defined yet flexible, so as to allow for adjustments.

During Stage 1, controls on all foreign exchange capital inflows will be removed in a relatively short time frame. During Stage 2, the strategy distinguishes accounts, asset classes, and transactions to be liberalised early in the process from others that are to remain controlled for a longer period of time. The latter group – the so-called blocked accounts – will include those with significant potential for outflows and those whose early liberalisation could undermine the effectiveness of the system. Stage 2 will begin with the gradual liberalisation of outflows from specified accounts with the longest maturities, asset classes, and transactions, commensurate with the external reserves, the balance of payments outlook and increased confidence in the domestic banking sector. Once the release of these accounts is complete and sufficient surplus reserves have been accumulated, the next group of accounts and asset classes will be gradually released. The use of Icelandic krónur for international transactions will remain controlled until the final stage of liberalisation.

Stage 1: Liberalisation of foreign exchange inflows

At the beginning of Stage 1, new investments involving new FX inflows will be liberalised. New FX inflows exclude current FX deposits with domestic banks and FX current account transfers (e.g., export revenues). The new FX inflow shall be converted into krónur at a financial institution supervised by the FME. Such ISK holdings will be fully convertible and transferable. The new investment must be registered with the CBI in order to be eligible for re-exit. This will enable the CBI to monitor the inflow and possibly intervene by acquiring FX to build surplus reserves. No distinction will be made between investors making such an FX-to-ISK conversion. To minimise possible circumventions, certain investments, such as leveraged derivative instruments, will not qualify for re-exit.

Stage 1 is expected to have a positive or limited effect on the reserves. Initial inflows should strengthen the króna, providing the CBI with an opportunity to intervene to limit volatility and build up reserves for possible outflows stemming from the new investment.

Stage 2: Liberalisation of foreign exchange outflows

Stage 2 is based on a distinction made between accounts, assets, and transactions that can be released without the risk of large capital outflows, on the one hand, and blocked accounts that must remain controlled for a longer period of time, on the other. As an example liberalisation of long-term holdings is not considered likely to generate a substantial outflow of capital. These holdings will therefore be liberalised, gradually, before short-term holdings. Such accounts are and will remain blocked.

The CBI stands ready to tighten administration of “blocked accounts” if the situation requires.

Batch A:

In Batch A, holdings that meet specific long term maturity criteria, to be determined by the CBI, can be sold and the investor can convert the proceeds from krónur to foreign currency. In general the liberalization process will gradually allow the convertibility of the longest term investments. All such conversion must be made with a financial institution supervised by the FME. To avoid churning by investors, the investor must provide documentation to verify a given holding period up to a specific cut-off date to be determined by the CBI. This will enable the CBI to monitor the outflow. The CBI will implement procedures for this process.

These holdings will gradually be made convertible and transferable according to a threshold schedule consistent with the availability of surplus reserves. The transferability of residents’ proceeds may initially be limited, according to current repatriation requirements, which stipulate that the proceeds must be deposited in specific accounts with domestic financial institutions. The use of these holdings will gradually be allowed for specified outward investments, sequenced from long-term to short-term AAA bonds and securities.

Stage 2 will be carefully managed and sequenced in line with the CB's reserve policy and the broader objective of exchange rate and price stability. The timing, conditions and thresholds for liberalization will be chosen in line with these objectives. Reserves will be available for intervention in the FX market to reduce excess volatility If a large number of investors choose to convert their assets, it will tend to lower the market value; that is, to a level that is not attractive for conversion. This will limit the total amount converted into FX.

Batch B:

Liberalization of asset categories as defined in Stage 2, Batch A can continue, gradually liberating the medium to short-term instruments. In addition, as sufficient reserves are accumulated, the Government will issue and auction short-term euro-denominated bills under its EMTN programme. In the auctions, successful bidders will be offered to convert krónur to euros at the CBI's official rate in order to purchase the bills. In essence, investors will be converting their ISK holdings into a transferable euro-denominated asset.

The price, amount, and timing of the procedure will be controlled by the CBI. It will provide all investors intending to exit with equal treatment, and the exit will be regulated by a price-based control. The decision to exit or not will be left to the investor; however, the total amount of foreign exchange used for this purpose will be subject to a predetermined limit. Since the auction mechanism will allow those who are willing to pay the highest amount to exit, it will permit the most impatient investors to leave first and immediately lessen the incentive to circumvent. This will allow for a flexible management of both reserve positions and exits, depending on balance of payments flows, yet without requiring long-term reliable balance of payments projections.

As the total amount of foreign exchange used is kept within a predetermined limit, reserves will remain within comfortable levels. The process will not have a direct effect on the interbank market. The cost effects of reserves used will be minimised, as the price is determined by the market.

All the above mechanisms are consistent with the international obligations of Iceland.

F. Administration and enforcement

Surveillance by the CBI

The administration of the strategy will be carefully designed to ensure compliance. The CBI is responsible for the surveillance of the capital controls, and it will devote to the task the resources and remedies necessary to carry it out successfully. The surveillance operation will cover the following three areas:

a) General surveillance

The CBI will have in place a general surveillance operation carried out on a daily, weekly and/or monthly basis, depending on the subject. The scope of such general surveillance will be extensive enough to enable the Capital Control Surveillance Unit (CCSU) to monitor and spot out possible violations of the Rules on Foreign Exchange. Such monitoring requires access to a range of data that will be obtained both within the CBI's systems and from other sources. Such data access must be continuous; i.e., it must not be dependent on the CBI's requesting it on a case-by-case basis. As a result, the CBI will need to establish collaboration with various sources from the public sector. As regards the private sector, the CBI will make general requests for the provision of specific data on a regular basis; e.g., in reports. The scope of the general surveillance operation will be as exhaustive as possible, and every data process will be described in as much detail as possible. This will allow the CCSU to determine certain references or benchmarks in its monitoring, which will give the general surveillance operation a sufficient overview. Such definitions, descriptions, and determinations will be reviewed regularly to ensure the best results possible.

b) Specific surveillance

In certain business sectors, companies and individuals have greater incentive and opportunities to circumvent the Rules on Foreign Exchange. The CCSU's surveillance will therefore target such high-risk sectors on regular basis. The specific surveillance operation will also target companies and individuals that have been granted exemptions from the Rules.

c) Case-by-case inspection

If the CCSU becomes aware of a possible violation of the Rules, either through its surveillance operations or through information provided by a third party, the CCSU will investigate such possible violations and may request additional data. Such inspections would be made on a case-by-case basis and, if applicable, would form the basis for the CBI's reporting of suspected violations to the FME.

CBI's resources and remedies

In order to fulfil its surveillance obligations, the CCSU will need additional staff. The CBI has already committed to recruit new members to the unit in response to the immediate need.

As regards data collection, the CBI will request clearer regulatory authority to request data pertaining to foreign exchange matters, and remedies at its disposal if such requests are ignored. In order to ensure adequate data collection, it is necessary to amend the Foreign Exchange Act and to adopt additional rules. Furthermore, the CBI will have to be able to oblige the financial sector to implement internal rules on observance of foreign exchange matters and to report any possible violation of the Rules on Foreign Exchange to the CBI. Therefore the CBI will request amendments to the Foreign Exchange Act to include such an obligation.

In addition to the surveillance operations described above, the CBI in collaboration with the FME enhance monitoring the commercial banks' compliance with the regular supervisory work of the FME. These steps are currently being prepared by the CBI and the FME.

Steps to increase voluntary compliance

The CBI will take measures to make the interpretation and implementation of the Rules on Foreign Exchange more transparent and accessible to interested market participants. The CBI's responses to questions and interpretations will be published regularly on its website. This should increase transparency and minimise the risk of unequal treatment.

In general, the CBI has begun to interact more frequently with the financial sector regarding the capital controls. The knowledge and actual overview that can be obtained through the financial institutions is vital to the efficient surveillance of the controls. Enhanced collaboration with the financial sector, including the Icelandic Financial Services Association, has commenced.