Arnór Sighvatsson: The logic behind the capital account liberalisation strategy

Speech by Mr Arnór Sighvatsson, Deputy Governor of the Central Bank of Iceland, at a meeting of the Iceland Chamber of Commerce, Reykjavík, 15 December 2011.

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Ladies and gentlemen

On 25 March 2011, the Central Bank published a capital account liberalisation strategy allowing for removal of the capital controls in two phases. Phase I would focus on channelling unstable króna assets, particularly those held by non-residents, into the hands of investors willing to take a long-term exposure on the króna. In Phase II, other controls would be lifted. The strategy is relatively terse as regards Phase II, as a number of things could change before it can be launched. As a consequence, Phase II will be drafted in greater detail at a later stage. Therefore, in my presentation today, I will focus on Phase I and attempt to explain why the individual steps within it are being taken in the order specified in the strategy.

The main problem the strategy is attempting to solve is lack of confidence: in the domestic economy, the currency, and the Government's capacity to service its debt. Confidence between individuals and between firms, domestic and foreign alike, is a precious commodity whose true value is only realised when lost.

The reason confidence plays such a vital role in the mechanics of the economy is that each party's confidence depends on the confidence of all the others. Recent runs on short-term bank liabilities and the fiscal crisis in the euro area are a clear example of this. No one wants to be the last one to withdraw his deposits from a tottering bank, sell bonds issued by a country heading for insolvency, or rid himself of the currency of a country facing an imminent balance of payments crisis and potentially unsustainable debt burden, even though it may only be unsustainable provided that other investors *think* it is. The capital controls stopped a run on Iceland's currency. In a sense, they also undermined confidence for the long term – that is, investors' confidence that Iceland's economy and public sector finances could achieve balance and sustainability in the absence of controls, knowing that the fragile balance created by the controls is based on coercing many investors to hold króna assets. Ultimately, confidence can be established only under conditions of free trade, not through coerced transactions.

Fortunately, however, investors' view on the Icelandic economy is diverse. Some understand quite well that behind the cloud of dust swirling in the wake of Iceland's financial collapse is a country fraught with opportunity. When the dust has settled, Iceland's net international investment position may turn out to be lower than it has been in decades, and in spite of sizeable gross debt, the Treasury's net debt position indicates that it will be possible to reduce gross debt rapidly, if the programme of fiscal consolidation set forth is followed strictly. The country's natural resources are untouched by the financial crisis, and its human resources are relatively unscathed.

The problem we face is not primarily a debt problem; it is a payment flows problem, which can be attributed in part to the fact that owners of frozen ISK assets either do not want to own them because they lack confidence in the Icelandic economy or are barred from owning them by regulatory provisions or investment strategies.

If this, and not an underlying debt problem, is at the core of the issue, there are two main ways to restore balance in the foreign exchange market and lift the capital controls: the Central Bank could use its limited foreign exchange reserves to buy up unstable assets, or it could render unstable assets more stable by creating a forum for long-term investors to buy them with foreign currency.

The problem with the former of these options is that it transfers private sector debt to the public sector, at least temporarily. The foreign exchange reserves are leveraged, and this option requires reducing reserve assets although the debts remain. The Treasury's net debt position deteriorates as a result.

The problem with the latter option is that, for the short term, the supply of krónur is too large in comparison with long-term investors' capacity to invest. If it is executed too rapidly, the exchange rate of the króna could fall sharply, at least temporarily, or the foreign exchange reserves could be depleted excessively. In addition, a number of investment projects are extremely foreign exchange-intensive because of imports. The króna could depreciate as a result, with heavy outflows of foreign currency, even if there were ample opportunities for investment.

This is the problem the liberalisation strategy is attempting to solve. Emphasis is placed on protecting the foreign exchange reserves by converting short-term claims against domestic entities to long-term investments to the extent possible. The Central Bank acts as an intermediary, and the auction format ensures that only a small portion of the foreign exchange reserves are in play at any given time. The auction format also ensures that transfers of banking system liquidity will not be large enough to jeopardise the system's stability. The foreign exchange reserves are protected as well by the requirement that investors bring foreign currency into the country and exchange it for krónur in the domestic market. This will offset the foreign exchange outflows that often accompany new investment.

Another important aim of the strategy is to ensure short-term Treasury financing. Even though significant progress has been made in controlling the fiscal deficit after the crash and halting the accumulation of unsustainable debt, it is important not to underestimate the current dependency of Treasury financing on the capital controls. More than half – and, in some instances, as much as ¾ – of the stock of short-term Treasury bonds is held by non-residents. The yield on Icelandic Treasury debt is now a bit lower than in the euro area countries that are facing severe sovereign debt crises, and real yields are considerably lower. It is not a given that this would be so without the capital controls. If the controls were lifted today, interest rates would probably rise sharply, even though a large proportion of the investors that own these bonds are relatively at ease within the capital controls regime. Without the controls, the authorities would have to take further action in order to achieve the objectives set for the coming year.

It is therefore of pivotal importance to lengthen the maturity profile of Treasury financing before the controls are lifted. Marked progress has already been made in this area. The average duration of domestic Treasury bonds has increased from 3 to 7 years. Last spring, domestic pension funds and other investors purchased a sizeable supply of indexed long-term Treasury bonds by participating in the first auctions under the liberalisation strategy, which were dedicated solely to investment in long Treasury bonds. The aim was to lengthen the maturity profile of Treasury financing and thereby reduce risk.

Although there has been a hiatus in the auctions and the pension funds lost interest in them after foreign stock markets fell this past summer, non-residents are growing interested in this investment option, which will continue to be available alongside the Investment Programme. The Programme gives investors the option of buying Icelandic krónur at the auction exchange rate (near the offshore rate) in order to invest in the domestic economy, provided they sell a corresponding amount of foreign currency in the domestic foreign exchange market.

The Investment Programme, which was introduced in detail on 18 November, has been described elsewhere; therefore, I will not go into the fine print here. It is designed to be neutral vis-à-vis the foreign exchange reserves in the short term and positive in the long run. This is achieved by requiring that half of the currency used for the investment be converted in the domestic FX market and by stipulating a minimum holding period of five years for the investment.

It is hoped that this will tie up a sizeable share of the most volatile offshore krónur. How large a share that is will depend primarily on the scope of the investment projects on offer and the actual amount of volatile krónur, both of which are quite uncertain. It is hoped that the Investment Programme will attract significant foreign investment.

It is a misunderstanding, however, to assume that the Programme aims at releasing almost the entire stock of offshore krónur through foreign investment. This would require an investment that it is unrealistic to plan on in the next two years. On the other hand, it is realistic to expect to release the most volatile krónur in this way. This is extremely important, although no one knows exactly how large a share of these assets are volatile. It is clear that a small group of non-residents are ready to sell their assets at the current offshore exchange rate. This spring's auctions did not tempt owners of short-term Treasury bonds. Many will turn out to be long-term investors in the sense that they will not unwind their positions at an auction price approaching the official exchange rate, but will continue to reinvest as long as the interest rate differential exceeds the assessed risk. The auctions will reveal whether this is the case.

Because it is unrealistic to expect more than a limited portion of the offshore krónur to be released through auctions, the Investment Programme does not stop there. When the incentive to participate in the investments diminishes – for example, because investors consider the auction exchange rate not favourable enough to justify a five-year commitment, or because the investment projects are not sufficiently large in scope – an exit tax will be levied on short-term capital movements. This step will not be taken, however, unless the offshore exchange rate moves close to the onshore rate, which would be a clear indication of enhanced stability of these assets.

A number of critics have found fault with this sequence of events and suggested that the exit tax be levied immediately. In their opinion, this would generate significant income for the Treasury and facilitate the full removal of the capital controls much sooner than is currently projected. But the danger is that foreign exchange reserves would be depleted commensurate with the rise in Government revenue. It is not as easy to control the scope of transactions in this way so as to prevent undue strain on the reserves, the banks' liquidity, and the Treasury's short-term financing.

The main problem, however, is that the incentive for long-term investors to purchase krónur from distressed investors will disappear as soon as the exit tax is imposed. The difference between the onshore and offshore exchange rates, which is the incentive for the transaction, would revert to the Treasury. This reduces the likelihood that the problem can be solved within the private sector, without tapping the nation's foreign exchange reserves. Those most concerned about the harmfulness of the capital controls must also realise that substantial revenues from the exit tax could provide an incentive for the authorities to maintain the controls for as long as possible.

I mentioned just now that non-resident owners of Treasury bonds did not participate significantly in the auctions held earlier in the year, and that some of them may continue to invest in Treasury bonds for the long term. This does not mean that they will not want to sell when the capital controls are removed, given the foreign exchange risk that may be perceived at that time.

In order to reduce such selling pressure and build confidence in the process, it is planned to offer owners of short-term Treasury bonds the opportunity to exchange them for foreign-denominated bonds. This will allow investors to avoid the foreign exchange risk temporarily, although creditor risk vis-à-vis the Treasury will still exist. It is too early to speculate on the duration of the bonds that would be offered. That would be determined by the conditions prevailing at the time. The more successful the authorities are in reversing the trend in public sector debt, the more likely investors will be to buy long-term bonds and the better protected the Treasury will be against the short-term exchange rate volatility that could accompany capital account liberalisation. Implementation of precautionary rules is also an important part of the preparation for ultimate removal of the controls.

Ladies and gentlemen

The capital controls are harmful. No one knows that better than those who must enforce them. They are even more harmful if they are not enforced. There are those who want precisely dated schedules for more rapid liberalisation than is currently planned, and their impatience is understandable. But a precisely dated schedule would not necessarily speed up the removal of the controls – not without correspondingly greater willingness to take on risk. I welcome the constructive criticism and exchange of opinions that come to the fore at meetings such as this one, however, and I urge others to air their views. In my opinion, the capital account liberalisation strategy is based on sensible arguments, which I have described briefly in my presentation today. On the other hand, it is not etched in stone, and in the final analysis, experience will reveal the truth. The liberalisation strategy can be implemented in various ways and adapted to actual developments. Sound ideas on this subject are most welcome. But at this juncture, I believe it is best that we follow the path already mapped out, with strong emphasis on safeguarding the foreign exchange reserves, financial stability, and Treasury financing.