Arnór Sighvatsson: Shedding the shackles of capital controls

Speech by Mr Arnór Sighvatsson, Deputy Governor of the Central Bank of Iceland, at the breakfast meeting of Icelandic Securities Ltd, Reykjavík, 7 October 2010.

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Restrictions on movement of capital to and from Iceland are in contravention of Iceland's international obligations, including the European Economic Area Agreement. Such controls distort economic incentives, lead to lost business opportunities, discourage foreign investment, are costly and inconvenient for the public and private sector alike, and are a breeding ground for illegal activity aimed at circumvention. There is also the risk that a capital controls regime will be progressively more difficult to enforce over time. Moreover, there is good reason to believe that, in the long run, Iceland's pension system would benefit from diversifying risk by investing abroad. Indeed, this has become abundantly clear in the current financial crisis. In sum, there are a host of reasons not to impose capital controls, and to lift them as soon as possible if they do exist.

In spite of these arguments to the contrary, capital controls were imposed after the Icelandic financial system collapsed, and removing them has taken longer than originally anticipated. It is useful to review the reasons for imposing the controls, as those reasons are the key to understanding what conditions must be met before the controls can be lifted.

Why capital controls?

In short, restrictions were placed on movement of capital because confidence in Iceland's banking system, currency, and Treasury – actually, in Iceland's entire economy and institutional framework – was in tatters after all of the country's major banks failed in one of the largest financial collapses in history. It was clear that the collapse of the banking sector would deal the Treasury a heavy blow, although the exact scope of the shock was unknown. It was also clear that the Treasury would require substantial funding to address temporary deficit operations. The collapse cut a wide swath in the foreign exchange reserves, and it proved necessary to use some reserves to stabilise the foreign exchange market while the reconstruction of the banking system was underway and solutions to private sector debt problems were being sought. Without enhanced reserves, refinancing of Treasury foreign debt could have proven elusive or even unavailable in coming years if efforts to restore confidence in the global markets in due time should prove unsuccessful. There were numerous indications that the global financial crisis could be protracted, as has proven to be the case. Thus it was far from assured that the global financial markets would become accessible to Iceland in time to refinance foreign loans maturing in 2011 and 2012.

The problem was exacerbated by the large króna positions accumulated by non-residents from 2005 onwards. It could be assumed that these investors would sell and, in some cases, would be forced to sell at distressed prices at the first opportunity. Had this happened, the króna would probably have plunged in the meantime and not recovered before prices and wages had adjusted. But the problem was not restricted to non-residents. Residents, including Iceland's pension funds, allocate substantial funds that must be invested on a continuous basis. With the economy paralysed and the Treasury's ability to fund a large deficit over the next few years uncertain, domestic institutional investors also became reluctant to invest in domestic assets. Under these conditions, central government financing would have been extremely challenging, which would have undermined exchange rate stability still further.

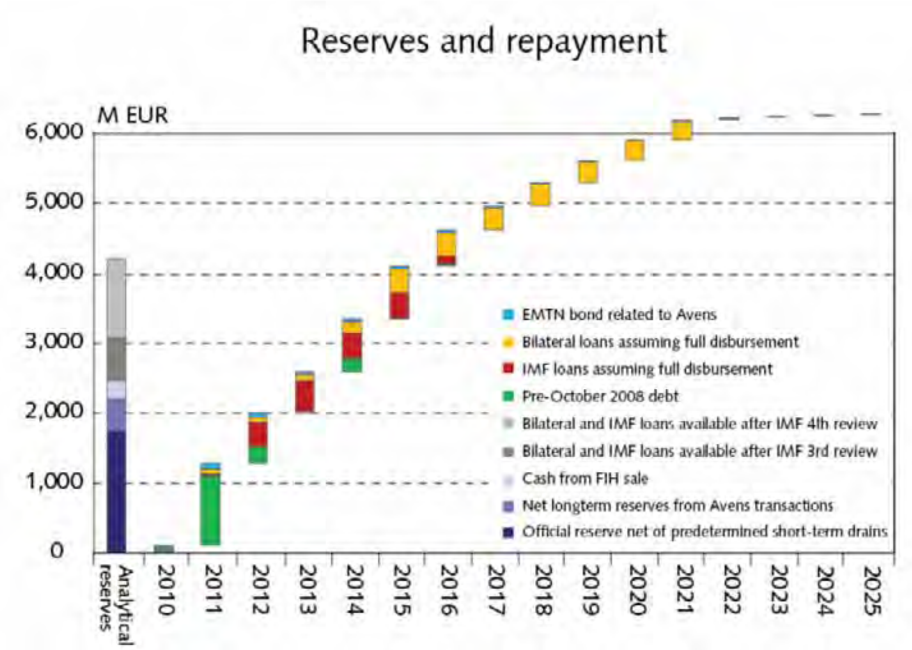
The third reason for the capital controls was the shaky balance sheets of the newly established financial institutions and the other financial firms that survived the onslaught, however briefly. Their balance sheets were fraught with uncertainty and potentially unstable.

A considerable share of their deposits could prove unstable as well. The balance sheets of households and businesses were likewise in a state of disarray. In the absence of exchange rate stability, it would be extremely difficult to restructure the finances of Iceland's households, corporations, and banks.

Prerequisites for capital account liberalisation

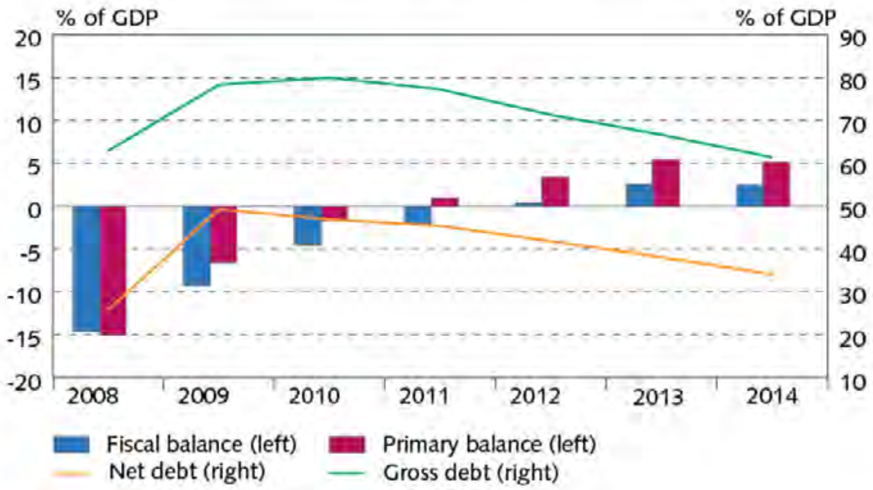
The foregoing discussion should make it clear that the capital controls will not be lifted in full until confidence has been restored to the extent that their removal will not cause prolonged instability. Let us consider the prerequisites for capital account liberalisation and Iceland's position on the path towards fulfilling them:

The IMF Stand-by Arrangement has ensured sufficient foreign exchange reserves to roll over Treasury debt in coming years and address potential outflows associated with the first stages of liberalisation. When the loan facilities have been drawn in full, Iceland will probably be in a better position than many European countries in terms of refinancing risk. This will place the Icelandic Government in a comfortable position when it seeks foreign market funding once again.



A central government budget aimed at ensuring a primary surplus in 2011 has now been drafted and, according to the medium-term fiscal programme, the Treasury will record an overall surplus in 2013. According to these estimates, public sector debt will peak in 2010. Fiscal consolidation is the cornerstone of the policy aimed at reviving Iceland's creditworthiness and creating the conditions necessary for capital account liberalisation and sustainable exchange rate stability. Thus it is vital to adhere to these objectives.

Treasury performance and debt 2008-2014[1]



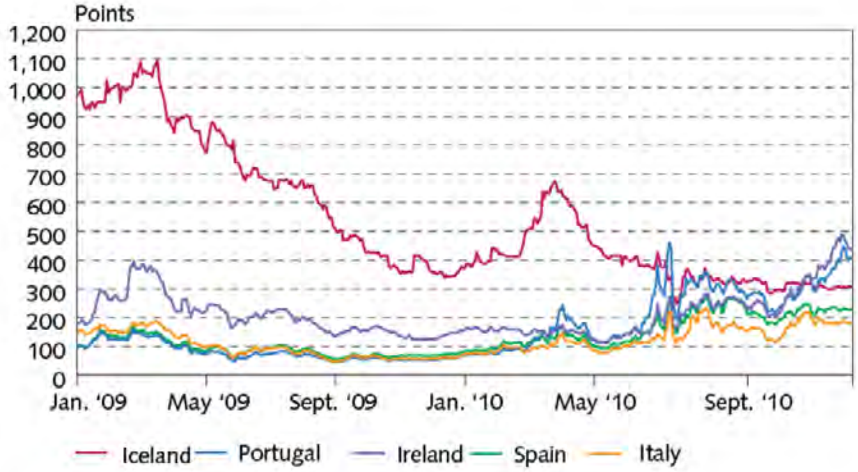
1. Debt excludes potential Icesave obligations.
Source: Ministry of Finance.

The financial system is now in a better position than it was only a few months ago to withstand the volatility of short-term capital flows that could accompany the removal of capital controls. The most recent Supreme Court judgment eliminated a large source of risk that had made it extremely difficult to estimate the banks' liquidity. According to the Icelandic authorities' Letter of Intent, the Financial Supervisory Authority will review the banks' planned responses to the judgment by 15 November. The remaining risk is due primarily to foreign banks' króna deposits and the old banks' deposits. However, before the controls on these deposits can be lifted in full, it is necessary to channel as much of this capital as possible into long-term investments and structure the winding-up of the old banks so as not to jeopardise exchange rate stability.

Although conditions in the global financial markets are still difficult, they are better overall than they were a year ago, not to mention two years ago. But the fiscal problems faced by Greece, Ireland, Portugal, and Spain have contributed to investor flight to the relative safety of low-yielding markets. The Icelandic Government is faced with the intricate task of demonstrating that Iceland is a better target for investment than other indebted European countries. The progress made under the IMF programme is gradually laying the foundation for enhanced confidence, but the programme will only be successful if we adhere to its objectives. Funds lying in wait in the shelter of low-yielding markets will eventually seek more bountiful shores. When the flight to safety begins to subside and investors begin to seek out better returns, the Icelandic authorities must be ready to direct their attention to Iceland.

Developments in sovereign CDS spread in international context

Daily data 1 January 2009 - 5 October 2010



Source: Central bank of Iceland.

The existence of capital controls and their proposed removal represents a problem for both the Monetary Policy Committee and those who trade in the bond market. While the capital controls are being removed, the risk-adjusted interest rate differential between Iceland and its trading partners must be sufficient to make ISK assets attractive relative to foreign currency alternatives. On the other hand, there are strong arguments for a considerable reduction in interest rates, provided that the capital controls keep the króna stable. Whether the interest rate at any given time is appropriate depends in part on the timing of the phased capital account liberalisation. Both the market and the Monetary Policy Committee face uncertainty about when, and in what stages, it will be possible to lift the controls. In line with transparent monetary policy implementation, the Monetary Policy Committee has explained how this uncertainty affects its decisions. To that end, the Committee has given an account of various factors that affect the prospects of continuing the phased capital account liberalisation that began in November 2009. Uncertainty about key Supreme Court decisions and the third IMF review increased the likelihood that the next stage of liberalisation could be delayed quite a while. The bond market appeared to interpret this delay to be more fundamental in nature than the Monetary Policy Committee intended to convey in its statement, thus contributing to the decline in yields that had begun somewhat earlier. The uncertainty had abated by the time the Monetary Policy Committee met in September, and the Committee explained this in its statement. Furthermore, the Committee implied that it would inevitably consider this point in its next interest rate decisions. This shift represented not a change in policy but a response to changed circumstances.

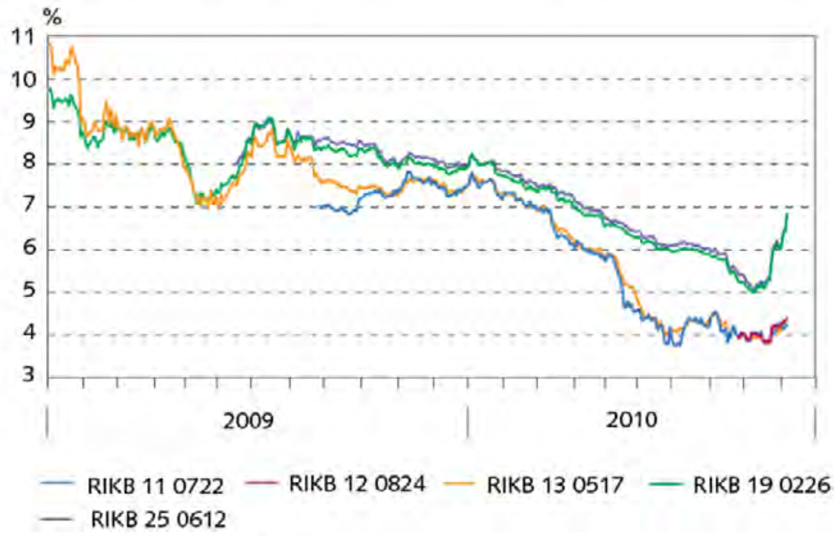
Yields on indexed long-term bonds

Daily data 2 January 2009 - 6 October 2010

Source: Central Bank of Iceland.

Yields on non-indexed long-term bonds

Daily data 2 January 2009 - 6 October 2010

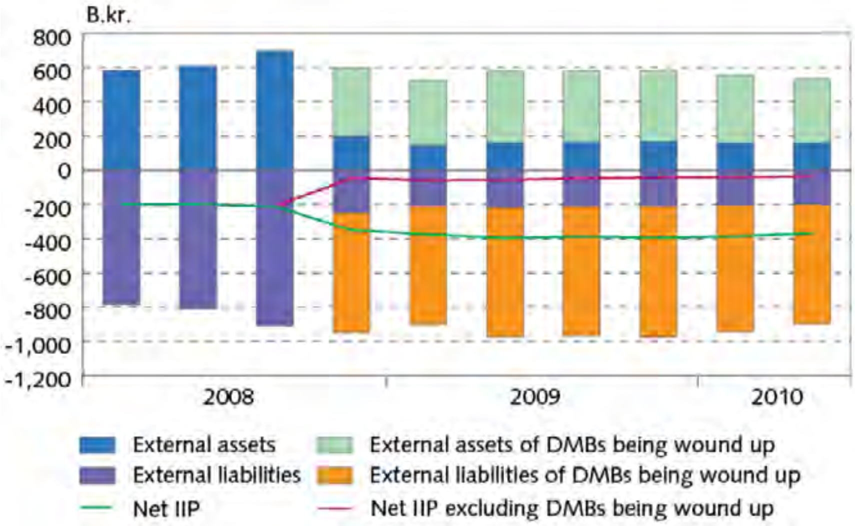


Source: Central Bank of Iceland.

One of the prerequisites for lifting the capital controls without causing exchange rate instability is a sufficiently strong external balance – preferably a surplus. That prerequisite has already been met to the extent that the Central Bank has initiated regular foreign exchange purchases in the market. Excluding the estates of the failed banks, there is a sizeable trade surplus. When winding-up proceedings conclude, there will be a net debt to non-residents; however, it will probably not be large enough to eliminate the underlying surplus. The fundamental problem lies not with the current account balance but with capital movements. Residents' payments on foreign loans will probably exceed inflows of new borrowed funds or other investments as long as Iceland's access to foreign credit markets is constrained and economic recovery is delayed. However, Landsvirkjun's recent bond issue indicates that foreign credit markets are not entirely closed, although few firms are in a position to obtain foreign credit and the terms are far from favourable.

External position of the Icelandic economy

Q1/2008 - Q2/2010

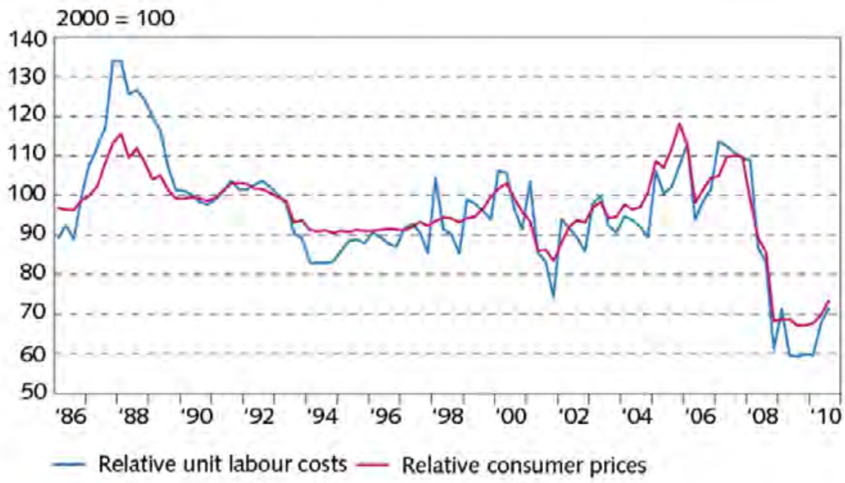


Source: Central Bank of Iceland.

It would arguably be wise to commence capital account liberalisation while the real exchange rate is relatively low. With a relatively low real exchange rate, owners of ISK assets en masse are less likely to view the removal of capital controls as a selling opportunity, and it is more likely that foreign investors will view it as an opportunity to acquire krónur from those wishing to sell. The real exchange rate of the króna is somewhat below its likely long-term average, although it has risen in the past year.

Real effective exchange rate of the króna

Quarterly data

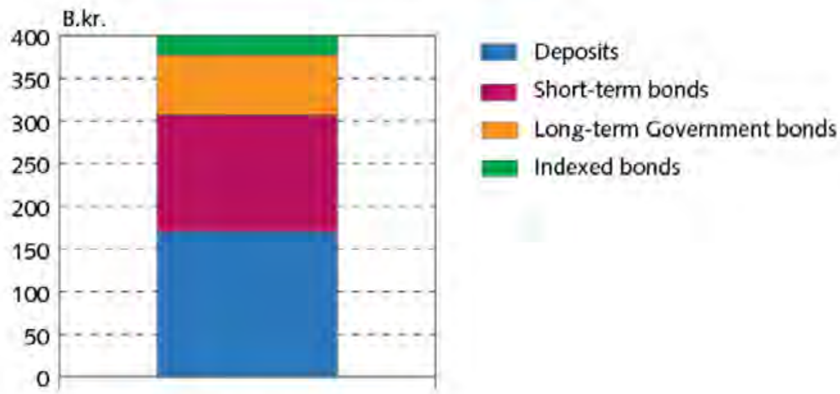


Source: Central Bank of Iceland.

As economic recovery gains pace, the outlook for capital account liberalisation improves. Recovery tends to be accompanied by increased inflow of foreign capital in the form of credit or direct investment. Significant inward foreign direct investment could set the stage for removal of the controls. Although suggestions that recovery began late in 2009 or in the first half of 2010 have proven to be a mirage, a number of indicators imply that Iceland has hit bottom or is close to it, and that growth will resume in the latter half of this year. But the pace of the recovery will depend greatly on our success in attracting foreign capital for export-generating investment.

The main objective of the IMF programme is to build confidence in Iceland's economy and economic policy. If that confidence existed now, it would be possible to lift the controls today. Considerable discussion has been devoted to the instability of foreign capital that could flee as soon as the controls that hold it in place are reduced or eliminated. Although the magnitude of foreigners' frozen ISK assets is broadly known, information on non-resident retail owners of ISK assets is largely hidden. The group referred to as impatient investors is probably not a fixed quantity; it may turn out to be quite variable, depending on expectations concerning Iceland's economic policy, on the one hand, and on global market conditions, on the other. The agreement concluded with the Banque centrale du Luxembourg, which transferred a significant amount of ISK assets to domestic long-term investors, facilitates the removal of capital controls. The agreement expands Iceland's foreign reserves and transfers assets into the hands of parties that are less likely to sell at the first opportunity.

Estimated ISK held by non-residents



Source: Central Bank of Iceland.

How to lift the controls?

In August 2009, the Central Bank presented a capital account liberalisation strategy based on sequenced removal of the controls upon fulfilment of stated conditions rather than on a specified timetable. That strategy was prepared under conditions that differ from the current ones and must therefore be reviewed in its entirety. The first phase of the existing strategy, the removal of restrictions on capital inflows, was implemented in early November 2009. The original intention was that, in Phase 2, restrictions on capital outflows would gradually be lifted, beginning with long-term securities transactions. That step has not yet been taken, and its implementation must be considered carefully with an eye to stability before it can be taken. While the stages of the strategy were not scheduled in terms of a precise timetable, its implementation has definitely been delayed with respect to original expectations, in part because of delays in the progress of the IMF programme and the uncertainty generated by recent Supreme Court judgments. The Letter of Intent connected with the second IMF review stated that the next stages of capital account liberalisation would be taken after the third review, at the earliest. The third review is now complete. When the associated loan facilities are disbursed over the next several months, and when the Financial Supervisory Authority has completed its assessment of financial institutions' plans in view of the last Supreme Court decision on FX loans (around mid-November, as is stated in the Letter of Intent accompanying the third IMF review), it will be timely to consider further steps towards lifting the controls.

Before those steps can be taken, however, we must engage in a great deal of preparatory work aimed at reducing the likelihood of exchange rate and bond market instability. In the next few months, the Central Bank will consult with the International Monetary Fund, other advisors, and the Government concerning the next steps and will thoroughly review the capital account liberalisation strategy of August 2009. Because liberalisation has been delayed, circumstances differ to an extent from those expected at the time the original strategy was prepared. For example, both inflation and interest rates are considerably lower. The outlook for fortification of the foreign exchange reserves is far less uncertain than before. As a result, there is good reason to re-think the sequencing in the liberalisation strategy with an eye to changed circumstances and market developments, as the Monetary Policy Committee indicated in its August statement. One possibility might be to change the order of events and adopt measures to release pressure from owners of frozen deposits and glacier bonds before lifting controls on long-term obligations. The August 2009 strategy assumed that this particular step would not be taken until after restrictions on long-term obligations had been lifted, at least to some degree. The presence of unstable short-term capital creates a certain risk, however, when the first steps are taken. Another possibility is to hold auctions where non-residents with ISK holdings can exchange them for foreign-denominated bonds that can be traded without restrictions earlier in the timeline than was previously assumed. Still another possibility is the imposition of a gradually declining exit tax, either concurrently or later. One way of releasing frozen ISK assets is to direct them towards domestic long-term investments.

Unfortunately, it is difficult at this stage to say with assurance whether, when, how, and in what order these solutions will be adopted. That will be determined in part by the results of the preparatory work currently underway.

Foreign owners of frozen short-term assets are not the only parties that must be considered when the capital controls are lifted. Domestic institutional investors – particularly the pension funds – will play an important role in bringing about sustainable stability. As of the end of July, Iceland's pension funds owned over 500 b.kr., or 3.3 billion euros, in foreign assets, but their liabilities are entirely in Icelandic krónur, and their ability to hedge against foreign exchange risk is limited. As such, given the historically low real exchange rate, it is reasonable to expect that there might be an opportunity to reduce their exchange rate risk. Some pension fund executives, however, have stressed that the dearth of domestic investment opportunities with an acceptable risk-return balance makes a shift to domestic assets problematic. The Icelandic economy is still fettered by a debt crisis, and for a while Government-guaranteed bond yields fell below levels that many pension funds considered acceptable. But domestic investment opportunities will grow in number as corporate debt problems are solved. It may also be the case that the pension funds' required yield for the lowest-risk domestic bonds is simply too high. Although the actuarial assessment of their position is based on a given yield, it appears unrealistic to demand this yield on assets with the lowest-risk with respect to the pension funds' liabilities.

The capital controls – and more particularly, it seems, some parties' expectations that they will remain in effect for a very long period of time – have played a role in generating relatively low yields. The bond market instability that may be associated with market expectations about when capital account liberalisation will begin highlights the role of the capital controls in price formation. Domestic investors are in the same position as foreign investors in that awareness of impatient investors with frozen ISK assets erodes their confidence in the króna. It is important to open up an exit route for the most impatient among the impatient investors and create a framework within which the others can divert their liquid króna assets into long-term investment.

Conclusion

Is it possible to lift the capital controls without causing significant exchange rate instability? Yes, it is – if sufficient confidence has been built. At present, confidence is not present to a sufficient degree to support large steps in this direction. On the other hand, it is perfectly appropriate to begin preparatory work. The Icelandic authorities have made excellent progress in building confidence, although there is still much to be done. Investors' concerns about the Treasury's ability to fulfil its commitments should dissipate if the authorities adhere to the fiscal consolidation plans in the 2011 national budget and the estimates for the years to come. Soon it should emerge that Iceland is in many respects on a firmer footing than a number of other developed countries, many of which are faced with sizeable pension obligations in addition to large fiscal deficits and a heavy debt burden. Iceland now has access to enough foreign currency reserves to pay all Treasury debt falling due from now through 2013 – and through 2015, if it draws in full on the loan facilities associated with the IMF Stand-By Arrangement. There is an underlying current account surplus. The real exchange rate is still at a low level, which indicates that investments in krónur should be appealing for the long term. If efforts to attract direct investment in export sectors are successful over the medium term, the conditions for gradual removal of the capital controls will improve. The Central Bank emphasises lifting the controls in a way that minimises exchange rate and bond market instability to the maximum extent possible. Careful preparation will take place before the next steps are taken. However, the Bank cannot create greater certainty in the markets than it faces itself.