Case No:79283
Document No: 853287
Decision No: 106/17/COL

EFTA SURVEILLANCE AUTHORITY DECISION

of 26 June 2017

closing a complaint case against the Icelandic Government concerning rules which cover new inflows of foreign currency

THE EFTA SURVEILLANCE AUTHORITY

Having regard to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice, in particular Article 31 thereof,

Whereas:

1 Introduction

On 10 June 2016, the EFTA Surveillance Authority ("the Authority") received a complaint against Iceland.[1] This complaint alleged breach of Article 40 EEA resulting from Rules no. 490/2016 on special reserve requirements for new currency inflows, issued by the Central Bank on 4 June 2016 in accordance with the new temporary provision of the Foreign Exchange Act, no. 87/1992.

According to the complaint, the aforementioned rules amount to a restriction on the movement of capital between the member states and entail discrimination based on nationality and on the place of residence. The complaint not only submitted that Article 40 EEA has been breached but also that none of the derogations provided by Article 43 EEA were available to – or correctly applied by – Iceland.

2 The Authority's action

By letter of 4 July 2016 the Authority informed the Icelandic Government of the receipt of the complaint and requested the Government to comment on the complaint.[2] In its communication, the Authority asked the Icelandic Government to specifically comment on both the view taken by the International Monetary Fund (IMF) and the question of

[1] Document No 808490.
2 Document No 810763.

whether the measures were necessary in order to counter difficulties as regards its balance of payments, as required by Article 43 EEA.

3 Iceland's reaction

The Icelandic Government, on 6 July 2016, requested the Central Bank of Iceland to provide a statement on the issues raised in the complaint. On 11 August 2016, the Central Bank of Iceland provided its response to the Icelandic Government. The latter transmitted to the Authority a letter – together with the communication of the Central Bank of Iceland – on 25 August 2016.[3]

4 Assessment

At the outset, it is worth recalling that the Authority has already examined and dealt with a number of complaints relating to the Icelandic rules on capital controls – the most recent being the Authority's closure decision 207/16/COL of 23 November 2016.[4]

4.1 Rules 490/2016

Act no. 42/2016, which amended the Foreign Exchange Act and other legislation and entered into force on 4 June 2016, authorised the Central Bank of Iceland, upon receiving approval from the Minister of Finance and Economic Affairs, to adopt rules providing for special reserve requirements on new inflows of foreign currency in connection with further described instances – so-called capital flow management measures. On 4 June 2016, the Central Bank of Iceland issued Rules no. 490/2016 on special reserve requirements for new currency.[5]

Article 1 of Rules 490/2016 defines any special reserve account as "[a]n account with a deposit institution in Iceland that is identified with ledger code 24 in the Icelandic Banks' Data Centre hf. system."[6] Simultaneously, the special reserve requirement is defined as "[t]he obligation of an entity subject to special reserve requirements to hold a special reserve amount in a special reserve account with a deposit institution in Iceland over the holding period."[7] Holding period is defined as "[t]he term during which the special reserve amount shall be held in a special reserve account with a deposit institution."[8]

Under Article 4 of Rules 490/2016 (combined with Article 2 of Rules 490/2016), a special reserve ratio of 40% applies to the following types of capital: (i) registered owners of bonds or bills and registered owners of deposits with regard to "[n]ew investments and reinvestment of such new investments according to Article 13(m) of the Foreign Exchange Act, in bonds or bills issued in domestic currency that are electronically registered in accordance with the Act on Electronic Registration of Title to Securities, or in domestic currency deposits" and "[n]ew investments and reinvestment of such new investments according to Article 13(m) of the Foreign Exchange Act, in the equity of a company that is established for the purpose of investing, directly or indirectly, in bonds or bills issued in

[3] Documents 815721 and 815723.
[4] Document No: 821093.
[5] Rules 490/2016, available at http://www.cb.is/library/Skraarsafn---EN/Rules/Rules%20490_2016.pdf
[6] Rules 490/2016, Article 1
[7] Id.
[8] Id.

domestic currency that are electronically registered in accordance with the Act on Electronic Registration of Title to Securities, or in domestic currency deposits"; (ii) registered owners of deposits with regard to "[d]omestic currency deposits with deposit institutions in Iceland, other than those deriving from capital that is eligible for reinvestment according to Article 13(e) or Article 13(f) of the Foreign Exchange Act, or that falls under Article 13(l) or Article 13(m) of the Foreign Exchange Act, but not those deriving from capital according to Item 5 of this Paragraph";[9] (iii) unit share certificates with regard to "[n]ew investments and reinvestment of such new investments according to Article 13(m) of the Foreign Exchange Act, in unit share certificates of funds that invest in bonds or bills issued in domestic currency that are electronically registered in accordance with the Act on Electronic Registration of Title to Securities, or that own domestic currency deposits"; and finally (iv) bonds or bills, deposits, and unit share certificates with regard to "[l]oans granted to resident entities that are used for investments in domestic currency, for the benefit of the lender, in bonds or bills issued in domestic currency that are electronically registered in accordance with the Act on Electronic Registration of Title to Securities, or deposited to domestic currency deposit accounts. The same applies to such loans that are used for investments in unit share certificates of funds or in the equity of a company that is invested or disposed of, directly or indirectly, in the manner described in the first sentence."

According to Article 6 of Rules 490/2016, the holding period is 12 months and generally begins on the business day that the special reserve amount is deposited to a special reserve account.

It is worth noting that Rules no. 490/2016 on special reserve requirements for new foreign currency inflows have undergone amendments.[10] However, these changes are not of substantive significance for present purposes.

4.2 EEA Law: Article 43 EEA

Article 43(2) EEA allows States to derogate from the standard set in the EEA Agreement *"[i]f movements of capital lead to disturbances in the functioning of the capital market in any EC Member State or EFTA State, the Contracting Party concerned may take protective measures in the field of capital movements.*" Moreover, Article 43(4) EEA, allows States to derogate from the standard set in the EEA Agreement *"[w]here an EC Member State or an EFTA State is in difficulties, or is seriously threatened with difficulties, as regards its balance of payments either as a result of an overall disequilibrium in its balance of payments, or as a result of the type of currency at its disposal, and where such difficulties are liable in particular to jeopardize the functioning of this Agreement, the Contracting Party concerned may take protective measures*."

[9] Item 5 of the paragraph refers to "Loans granted to resident entities that are used for investments in domestic currency, for the benefit of the lender, in bonds or bills issued in domestic currency that are electronically registered in accordance with the Act on Electronic Registration of Title to Securities, or deposited to domestic currency deposit accounts. The same applies to such loans that are used for investments in unit share certificates of funds or in the equity of a company that is invested or disposed of, directly or indirectly, in the manner described in the first sentence."

[10] Regulation 537/2016 (http://www.stjornartidindi.is/Advert.aspx?RecordID=97fc97d5-8b5f-4d20-acdf-eb54fce396aa), Regulation 892/2016 (http://www.stjornartidindi.is/Advert.aspx?RecordID=2901dba6-c3c3-4fd4-8f1e-7c87887a52ce) and Regulation 201/2017 (http://www.stjornartidindi.is/Advert.aspx?RecordID=f43df867-5f68-4a9a-b37c-c0b3fba535a8).

4.3 Introduction

The role of the Authority in assessing Iceland's compliance with Article 43 EEA Agreement has been defined in previous decisions. In the closure decision 207/16/COL[11] in Case 79250 it was stated that "*[t]he scope of the Authority's powers under Article 43 EEA is not defined. However, in the Authority's view, there is, in principle, no legal barrier to ex post scrutiny by the Authority of a measure taken by an EFTA State under Article 43 EEA. (…)*

The Authority is competent to assess whether the substantive conditions for the application of this safeguard clause are fulfilled. If they are not, the measure lies outside Article 43 EEA and the Authority may bring an action against an EFTA State under Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (…)"[12]

The core issues raised in the complaint are:

(1) Rules 490/2016 are not an integral part of the capital control measures that have been considered legitimate under Article 43 EEA by the EFTA Court in Case E-3/11 *Pálmi Sigmarsson.*
(2) In any event, Rules 490/2016 are not implemented to respond to disturbances in capital markets or serious difficulties as regards Iceland's balance of payments.
(3) In implementing the rules, Iceland has disregarded the principle of proportionality.

4.3.1 The Role of Rules 490/2016

The complaint suggests that Rules 490/2016 are not an integral part of the capital control measures that have been considered legitimate under Article 43 EEA Agreement by the EFTA Court in Case E-3/11 (and were introduced by Iceland in 2008).

The Authority disagrees and considers that the measures have to be seen in the context of those introduced in 2008.

The opinion of the Central Bank of Iceland has confirmed this approach, when it answered to the Authority's questions. According to the Central Bank, *"[t]he introduction of the capital controls was an inseparable part of the Icelandic authorities' response to the collapse of the financial system, under the Stand-By Arrangement prepared and executed in cooperation with the IMF. Work on strategies to lift the capital controls has been underway ever since the controls were introduced in 2008 (…) The Central Bank is of the view that under the current condition there is a material risk that investment undertaken in Iceland using new inflows of foreign currency, authorised pursuant to the Foreign Exchange Act. no. 87/1992, could entail destabilising short term speculative investments, often referred to as carry trade. The Central Bank's Rules no. 490/2016 are intended primarily to discourage excessive short term speculative capital flows and thereby reduce the risk to economic and financial stability.*"[13]

[11] http://www.eftasurv.int/media/esa-docs/physical/Decision---Complaint-against-Iceland-concerning-the-treatment-of-holders-of-offshore-kronur.pdf
[12] Document No 821093.
[13] Document 815723.

In the Authority's opinion, this statement of the Central Bank of Iceland confirms that – contrary to the submission included in the complaint – Rules 490/2016 were precisely implemented as part of the set of measures introduced starting from 2008. In its closure decision in Case 79250, the Authority concluded that the conditions for reliance on Article 43 EEA were fulfilled, in particular that Iceland was still faced with a balance of payments problem. In the Authority's view this is still valid and there is nothing to suggest that Rules 490/2016 are not a part of the Icelandic Government's capital control strategy.

4.3.2 Iceland's conduct in the light of Article 43 EEA

The complaint suggests that, in any event, Rules 490/2016 would not have been implemented to respond to disturbances in capital markets or serious difficulties as regards Iceland's balance of payments.

The Authority will, first, assess what the applicable standard of review is when it comes to the analysis of a State's conduct in the light of Article 43 EEA; and, second, focus on the specific circumstances of the case concerning Rules 490/2016.

(i) Standard of Review

In the Authority's view, the standard that should be applied in order to assess the compliance of a State with Article 43 EEA is the one of a manifest error of assessment. This view is consistent with the Authority's previous decision making practice.[14]

The use of the manifest error standard is also consistent with the findings of the EFTA Court confirmed in the *Sigmarsson* case: *"[t]he substantive conditions laid down in Article 43(2) and (4) EEA call for a complex assessment of various macroeconomic factors. EFTA States must therefore enjoy a wide margin of discretion, both in determining whether the conditions are fulfilled, and the choice of measures taken, as those measures in many cases concern fundamental choices of economic policy.*"[15] Importantly, the discretion extends to both a determination of whether the conditions are fulfilled and deciding on the appropriate measures.

Consequently, the Authority will consider measures to not fall under the derogation provided by Article 43 EEA only when e.g. the State which implemented the measures relying on Article 43 EEA Agreement is evidently no longer experiencing difficulties as regards its balance of payments, or where the protective measures taken clearly exceed what is necessary.[16]

[14] See also the judgment delivered in joined Cases C-111/88, C-112/88 and C-20/89, *Crete Citron Producers Association v Commission*, where the Court of Justice established that the Commission had, in the application of Article 108(3) EEC, a wide discretion in determining whether the circumstances justified granting a Member State, which is experiencing difficulties in its balance of payments, authorisation to adopt protective measures. The Court further stated that in cases involving such discretion, it had to restrict itself to considering whether the exercise of that discretion contained a manifest error or constituted a misuse of power or whether the Commission clearly exceeded the bounds of its discretion.

15 See Case E-3/11 *Pálmi Sigmarsson* v *Seðlabanki Íslands* [2011] EFTA Ct. Rep. p. 430, paragraph 50. See also case E-16/11 *EFTA Surveillance Authority* v *Iceland* [2013], EFTA Ct. Rep. p. 4, paragraph 227.

[16] Cf. the Authority's decision in Case No 79250, Decision No: 207/16/COL.

(ii) Application of the Standard to Rules 490/2016

Article 43(4) EEA expressly permits a Contracting Party to undertake *"protective measures"* in cases when it is in difficulties as regards its balance of payments, liable in particular to jeopardize the functioning of the EEA Agreement.

The Icelandic Government has submitted that Rules 490/2016 "*are closely related to the ongoing liberalisation of capital controls and must be assessed in light of those circumstances. The most recent milestone in the liberalisation plan was recently introduced (...)".*[17] In particular, the measures have been implemented on the basis of the idea that *"balance of payments stability could be jeopardised by the combined effect of outflows as a result of pent up demand for foreign assets from resident investors following liberalisation and the reversal of capital inflows in the period leading up to liberalisation. By curtailing the expansion of the stock of potential volatile capital, the capital flow management measure will contain the risk associated with strong speculative inflows during the prelude to the next steps in the liberalisation process*."[18] In these circumstances, Iceland relied on Article 43 EEA to the question raised in the complaint about the possible coexistence of capital outflows and capital inflows.

Furthermore, the Central Bank of Iceland considers the measure necessary and is of the opinion that it fulfils the requirements laid down in Article 43 EEA concerning protective measures, as it safeguards critical public interests.[19]

Also, the *travaux préparatoires* to Act no. 42/2016 made clear that "*policy instruments to contain excessive capital inflows were necessary, both because of the risk of imbalances in the real economy and the financial system and in order to support successful capital account liberalisation.*"[20]

In light of the above, the Authority considers that there has been no manifest breach of Article 43 EEA in implementing Rules 490/2016..

4.3.3 The proportionality of Rules 490/2016

The complaint also claims that Rules 490/2016 are disproportionate.

The Authority has previously decided that it would only consider initiating proceedings "*where the circumstances do not permit reliance on Article 43 EEA, such as for example where the EFTA State is no longer experiencing difficulties as regards its balance of payments, or where the protective measures taken manifestly exceed what is necessary*."[21] Given that, as explained above, in the Authority's opinion this is not the case concerning Rules 490/2016, there is in principle no need to assess the proportionality of the measures implemented.

In any event, however, it is worth acknowledging that, in order to respect the principle of proportionality, the Icelandic Government has made clear that "*amendments will be needed and have been implemented*" and that this statement has been confirmed by the

[17] Document 815721.
[18] Document 815723.
[19] Id.
[20] Id.
[21] Document No: 821093, Decision No: 207/16/COL

implementation of amendments to Rules 490/2016 after their introduction. Following the Authority's request for information, the Central Bank of Iceland confirmed that it "*can scale back the measure by changing the rules once the problems associated with inflows abate*."[22] Moreover, according to the Central Bank of Iceland, the provisions of Act no. 42/2016 – that served as one of the basis for the implementation of rules 490/2016 – entail that "*in applying the policy instruments entrusted to it, the Central Bank will not go further than is necessary to achieve the aforementioned objectives*."[23]

Consequently, the Authority notes that the Icelandic Government has indicated that it might amend Rules 490/2016 to ensure that they will remain appropriate and not go beyond what is necessary.

In view of the above, the Authority does not share the complainant's view that Rules 490/2016 are in manifest breach of the principle of proportionality.

5 Conclusion

An EEA State enjoys a wide margin of discretion as regards the adoption of protective measures as long as they comply with the requirements of Article 43 EEA Agreement.

Having taken account of the information on the facts of this case and the applicable EEA law, the Authority cannot conclude that the Icelandic Government has manifestly erred in its application of Article 43 EEA.

However, it should be observed that what is at stake in the case at hand is the question of whether or not the conditions laid down in Article 43 EEA were fulfilled at the time of the Rules' adoption to date. The above therefore reflects the fact that the *present policy* of the Icelandic Government, as regards lifting of the capital controls, is within the margin of discretion that Iceland is accorded under Article 43 EEA. The Authority notes however that at a certain point, Iceland will no longer be able to rely on the derogation in Article 43 EEA. Then, the measures at stake and/or similar ones would have to be assessed under Article 40 EEA, which would require a different examination in law.

By letter of 22 February 2017, the Internal Market Affairs Directorate informed the complainant of its intention to propose to the Authority that the case be closed. The complainant was invited to submit any observations on the Internal Market Affairs Directorate's assessment of the complaint or present any new information by 27 March 2017.

The complainant did not reply to that letter.

There are, therefore, no grounds for pursuing this case further. The Authority may, however, revert to the matter should any relevant developments occur in EEA or EU law.

HAS ADOPTED THIS DECISION:

[22] Document 815723.
[23] Id.

The complaint case arising from an alleged failure by Iceland to comply with Articles 40 and 43 EEA is hereby closed.

For the EFTA Surveillance Authority

Sven Erik Svedman
President

Frank J. Büchel
College Member

This document has been electronically signed by Sven Erik Svedman, Frank J. Buechel.