

Case No:79250  
Document No: 821093  
Decision No: 207/16/COL



EFTA SURVEILLANCE  
AUTHORITY

## EFTA SURVEILLANCE AUTHORITY DECISION

of 23 November 2016

closing a complaint against Iceland in the field of free movement of capital (capital controls)

### 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:

On 9 June 2016, the EFTA Surveillance Authority (“the Authority”) received a complaint against Iceland concerning the treatment of holders of offshore króna assets.

The complaint regards the treatment of offshore króna assets as it is laid down in Act No 37/2016, on the Treatment of Króna-Denominated Assets Subject to Special Restrictions. The referred Act came into force on 23 May 2016.

The complaint also regards a foreign currency auction held by the Central Bank of Iceland in June 2016. The complaint maintains that the substantive criteria laid down in Article 43 of the EEA Agreement are not met in the current economic circumstances. The complaint maintains that the provisions of the legislation for the treatment of holders of offshore króna assets are discriminatory and the special restrictions imposed are neither necessary, reasonable nor proportionate.

### **1 Correspondence**

By letter of 9 June 2016, the Authority informed the Icelandic Government of the receipt of the complaint and requested the Government to comment on the substance of the complaint.<sup>1</sup>

The Icelandic Government provided the requested information by letter dated 8 July 2016.<sup>2</sup>

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<sup>1</sup> Document No 807620.

<sup>2</sup> Document No 811876.

By letter dated 23 August 2016 (Document No 814037), the Internal Market Affairs Directorate (“the Directorate”) informed the complainant that it intended to propose to the Authority that the case initiated on the basis of this complaint be closed.

On 23 August 2016, the complainant submitted observations to the Icelandic Government’s reply letter of 8 July 2016 (Document No 818977).

The Authority received observations from the complainant contesting the preliminary conclusion of the Directorate by letter dated 23 September 2016 (Document No 820084).

On 14 October 2016, the Authority received further observations from the complainant (Document No 822521).

## 2 Assessment

The Authority has considered the documentation received and has assessed the relevant issues of EEA law.

The Authority has already examined and dealt with a number of complaints relating to the Icelandic rules on capital controls and concluded that the measures were in line with EEA law.

### 2.1 The Authority’s role in relation to Article 43 EEA

Article 43(4) of the EEA Agreement 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. When it comes to the protective measures under Article 43 EEA, the prescribed procedures provide that the EFTA Standing Committee and the EEA Joint Committee are to be notified and consulted prior to the implementation of the measures.

Article 45 EEA sets out that decisions, opinions and recommendations related to the measures laid down in Article 43 EEA shall be notified to the EEA Joint Committee. Moreover, before being implemented, the measures shall be subject to prior consultations and exchange of information within the EEA Joint Committee. Protective measures in the field of capital movements may nevertheless be taken (i) in accordance with Article 45(3) and 43(2) on the grounds of secrecy and urgency, where this proves necessary, without prior consultations and exchange of information when movements of capital lead to disturbances in the functioning of the capital market in any EFTA State and (ii) in accordance with Article 45(4) and 43(4) where a sudden crisis in the balance of payments occurs and the regular procedure of notification cannot be followed, as a precaution and causing the least possible disturbance in the functioning of the EEA Agreement without exceeding in scope what is strictly necessary to remedy the sudden difficulties which have arisen when 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 the EEA Agreement. It follows from Article 45(5) EEA that in those cases notice of the protective measures must be given at the latest by the date of their entry into force, and the exchange of information and consultations must take place as soon as possible thereafter.

According to Article 44 EEA, the EU and the EFTA States are to apply their internal procedures for implementing Article 43 EEA, as provided for in Protocol 18 to the EEA Agreement. In the case of the EFTA States, this envisages the giving of notice “in good time” to the Standing Committee of the EFTA States, which is to examine the situation, deliver an opinion regarding the introduction of measures and keep the situation under review. Deciding by majority vote, the Standing Committee is empowered at any time to recommend amendments, suspension or abolition of the measures.

The 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. In this regard, Articles 43 and 45 EEA stipulate certain conditions which must be met before the protective measures may be invoked.

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 (“SCA”).

## **2.2 Assessment under Article 43 EEA**

### *2.2.1 The special features of Article 43 EEA*

The EEA Joint Committee brings together the EFTA and EU States party to the EEA Agreement, the latter being represented by the European Commission. The other Contracting Parties have an opportunity to make their views on the measures known through the procedure provided in Article 45 EEA, and the Standing Committee may, according to Article 2 of Protocol 2 to the Agreement on a Standing Committee of the EFTA States, make recommendations regarding amendments to the measures notified to it. The EEA Joint Committee has continuously put the issue of the capital controls on its agenda since early 2014.

On 22 May 2016, the Icelandic Government notified the EEA Joint Committee, under Article 43 of the EEA Agreement, that it had, on 19 May 2016, presented a draft bill of legislation on the treatment of króna-denominated assets subject to special restrictions. Subsequently, on 23 May 2016, the Icelandic Government notified the EEA Joint Committee that it had adopted the Bill of Law as a protective measure under Article 43 EEA. The bill was introduced as a “*further measure for removing capital controls in Iceland*”.

The complainant’s letter of 23 September 2016 notes that “[t]he Icelandic Authorities did not give the Standing Committee notice in good time of Act 37/2016 concerning the introduction of these new measures. On this matter, the Authority notes that it has the role of assessing whether the notification was necessary under the circumstances of the case. In this regard, it should be observed that the notified amendments were discussed in the EEA Joint Committee on 3 June 2016. As far as the Authority is aware, the amendments did not give rise to any objections, either within the framework of the Standing Committee, or on the part of the other Contracting Parties. In the Authority’s opinion, the lack of objections from the other Contracting Parties regarding the timing of the notification is indicative of

that that they considered the notification delivered by Iceland to be sufficient to comply with the procedural obligation.

The principal grounds of the complaint are allegations that “[t]he Iceland Government is unable to demonstrate that the provisions of Article 43(2) and (4) as of the date of this complaint are met in the current economic circumstances and accordingly that a derogation from its obligations under Articles 40, 41 and 42 can be justified.”<sup>3</sup>

The complaint further states that “[i]t is for the derogating party to demonstrate that the appropriate grounds are met and that its response is non-discriminatory, necessary, reasonable and proportionate. It is also for the derogating party to demonstrate that the action that it has taken is transparent. Iceland has not met these requirements.”<sup>4</sup>

The Authority is of the opinion that Article 43(4) EEA cannot be equated with the Agreement-based derogations from the fundamental free freedoms (including the open-ended list of objective justifications or ‘overriding reasons in the public interest’).<sup>5</sup>

The safeguard clause provided for in Article 43(4) EEA provides a possibility for States to implement a national economic, and specifically monetary, policy aimed at restoring equilibrium in the balance of payments. It is the Authority’s opinion that the safeguard provision provided for in 43(4) EEA represents an extensive exception to the EEA Agreement’s provisions, albeit specifically restricted to cases of economic difficulty and crises, which provides a possibility for supporting national economic policy aimed at overcoming economic difficulties.

In the Authority’s opinion, in the context of an assessment conducted in the light of Article 43 EEA, it is of the utmost importance to not confuse the applicable legal tests and standards. As soon as it is clear that a case – such as the present one – concerns Article 43 EEA, it becomes both unnecessary and inappropriate to apply the rules created for the agreement-based derogations from the fundamental freedoms.

In case of application of Article 43 EEA – where a State faces difficulties with regard to the balance of payments – EEA law obligations are temporarily suspended. As a consequence, primary provisions (such as Articles 3, 4 40, 41 and 42 EEA) cannot be relied upon to challenge measures considered protective under Article 43 EEA.

Incidentally – on the matter of the applicable law – the Authority wishes to clarify that the *Fokus Bank* decision, upon which the complaint relies, is not a relevant precedent. Although the case dealt with restrictions upon movements of capital, it dealt neither with Article 43 EEA nor with the Norwegian balance of payments.

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<sup>3</sup> The complaint, p. 6.

<sup>4</sup> The complaint, p. 6-7.

<sup>5</sup> See the Agreement-based derogations from the free movement in Article 28(3) EEA (workers), Article 33 EEA (establishment) and Article 39 EEA (services). Similar general derogations apply in the field of capital movements, including express derogations listed in Article 65 TFEU. In the field of capital the same considerations apply in the EEA context. In Case E-10/04 *Piazza v Schurte* [2005] EFTA Ct. Rep. 76, the EFTA Court, in paragraph 39, stated that “[i]n light of the objective of the EEA Agreement to provide for a homogeneous European Economic Area, this must apply equally to rules prohibiting restrictions on the free movement of capital and rules governing any possible justification. Consequently, national rules restricting the free movement of capital in the EEA may, as in Community law, be justified on grounds such as those stipulated in Article 58 EC or on considerations of overriding public interest.”

In this context, the Icelandic Government thus enjoys a wide margin of discretion. Indeed, the EFTA Court confirmed in the *Sigmarsson* case that “[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.”<sup>6</sup> The margin of discretion accorded to the Government, thus extends to both the assessment of whether the substantive conditions are fulfilled and to the choice of measures.

However, as was made clear in the EFTA Court’s *Sigmarsson* case, even though the State enjoys a wide margin of discretion with regard to such safeguard measures, given the complexity of the economic assessments involved, there is nevertheless a limit to the discretion accorded to the State in judging the circumstances which make this action necessary. Thus, the EEA States cannot derogate unilaterally and beyond the control of the EFTA Surveillance Authority, and ultimately the EFTA Court, from the obligations which result for them from the Agreement.

In summary, the Authority would only consider starting proceedings under Article 31 SCA 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. In the control of legality of those measures, the Authority must restrict itself to considering whether the exercise of that discretion contained a manifest error or constituted a misuse of power or whether the State clearly exceeded the bounds of its discretion.

#### 2.2.2 *The existence of balance of payment difficulties envisaged by Article 43(4) EEA*

In response to the Authority’s request for information, the Icelandic Government, in its letter of 8 July 2016, draws attention to problems which currently pose a risk to Iceland’s balance of payments and which must be addressed prior to the removal of the capital controls. The main vulnerabilities related to the offshore króna assets, which amounted to 319 billion króna at the time the auction was held. The Icelandic Government states that there is a substantial risk that, without the measures provided for in Act 37/2016, large scale capital flows would take place upon the removal of restrictions on offshore króna assets, with a significant impact on exchange rate stability and the foreign exchange reserves. In this context, it was noted that the stock of offshore króna assets equalled around 65% of the year 2015 turnover in the foreign exchange market and about 80% of the Central Bank’s domestically financed foreign exchange reserves.<sup>7</sup>

The complaint states that the economy is much stronger now than it has been for quite some time. In this regard, the complaint, for example, states: “*The underlying current account surplus was ISK 108 billion in 2015 (or 4.9% of GDP). Economic growth was just over 4% in 2015, and there was a surplus in the Treasury budget.*”

However, the Authority observes that the above does not mean that the balance of payment difficulties have been resolved to the degree of reducing the likelihood of destabilising capital flows in the aftermath of the liberalisation.

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<sup>6</sup> 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.

<sup>7</sup> The Icelandic Government’s letter of 8 July 2016, p. 3-4.

In its 2015 country report, the International Monetary Fund (IMF) stated: “*Faced with a large balance of payments overhang, Iceland needs many years of current account surpluses to release the locked in króna and lift capital controls.*”<sup>8</sup>

While the complainant’s letter of 27 September 2016 focuses on the material produced by the Central Bank of Iceland, which, according to the letter “plainly demonstrates that Iceland is not currently in difficulty as regards its balance of payments”, the Authority wishes to reiterate that, while a link between fiscal balance and capital account certainly exists, this in and of itself does not necessarily entail that Iceland’s balance of payment difficulties have already been solved due to a fiscal surplus. Although there is a link between the fiscal balance and the current account, the Authority is convinced by the argument brought forward by the Icelandic Government, namely that the Icelandic balance of payments problem stems principally from the private sector, and the problem therefore subsists, regardless of the status of the government’s fiscal balance.

Furthermore, the complaint suggests that Iceland could be threatened with difficulties as regards its balance of payments only if it were to end currency controls overnight. The Authority maintains a different position on the matter; it cannot be excluded that suspending the treatment of offshore króna assets, as provided for in Act No. 37/2016, could potentially have the effect of threatening the balance of payments.

Thus, the Authority observes that despite progress being made, a significant balance of payments problem would seem to remain unresolved. Domestic entities still have limited access to foreign credit markets. Further, it is not certain that the current account surplus will suffice to cover the outflow against which the controls provide temporary shelter.

Further, the IMF Staff Concluding Statement of the 2016 Article IV Mission stated that “[a] final effort to resolve the offshore króna overhang is appropriate before attention turns to residents. Prolonged capital controls are amplifying distortions, including undue risk taking by pension funds.”<sup>9</sup>

As follows from the above, Iceland is still experiencing difficulties as regards its balance of payments, which could jeopardize the functioning of the EEA Agreement. The Authority sees no reason to question the accuracy of this information. By way of consequence, the Authority considers that the Icelandic Government has not exceeded the margin of discretion it has when it comes to applying Article 43(4) EEA.

### 2.2.3 *The Authority’s assessment of the necessity of the measures*

The complaint states that Iceland has given no substantive reason as to why it is considered necessary that capital controls must be removed “*now, in such a short timeframe, or in the draconian fashion contemplated by the Legislation.*” Further, the complaint states that in light of the investment options currently available in Iceland, there is no reason to expect that holders of offshore króna will all seek to exit the country at once should the capital controls be relaxed.

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<sup>8</sup> IMF Country Report No. 15/73, p. 16.

<sup>9</sup> IMF Staff Concluding Statement of the 2016 Article IV Mission. See: <https://www.imf.org/external/np/ms/2016/041216.htm>



In its response of 8 July 2016, the Icelandic Government explained that the rationale for the protective measures was to create the ideal conditions to liberalise the capital controls without significant risk of adverse effects on monetary and exchange rate stability, and without the need for vastly increased long term capital controls surveillance.

Further, the explanatory notes accompanying Act No 37/2016 state that there is a substantial risk that, without the measures provided for in the Act, large scale capital flows would take place upon the removal of restrictions on offshore króna assets – with a significant impact on exchange rate stability and the foreign exchange reserves.<sup>10</sup>

In the Authority's opinion, Iceland has not erred in considering that the economic conditions that must be met before the capital controls can be lifted are clearly – and logically – contingent upon the level of risk resulting from capital liberalisation.

The Icelandic Government has stated that setting aside the capital falling within the scope of Act No 37/2016 – i.e. focusing general liberalisation of capital controls first on other types of capital and then on the offshore króna assets for which an exit through the Central Bank foreign currency auction was not sought – enables the authorities to achieve the goal of lifting the capital controls without undermining economic and financial stability.<sup>11</sup>

The Authority recalls that in view of the wide margin of discretion granted to the EEA States under Article 43(4) EEA in determining the necessity of the measures, the Authority does not examine the choices of economic policy inherent in the measures. However, the Authority notes that Iceland's prioritisation seems fully consistent with the IMF's recommendations. The IMF's June 2016 Country report, for example states that the Icelandic Government works with regard to releasing offshore króna investments via an auction is consistent with the IMF's 2014 Article IV Recommendations.<sup>12</sup> The report further states that “[t]he final effort to resolve the offshore króna overhang is appropriate before attention turns to residents.”<sup>13</sup> The report also states that the prolonged use of capital controls “is increasingly amplifying distortions, including for instance commercial real estate lending by domestic pension funds via special purpose vehicles.”<sup>14</sup> Lastly, the

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<sup>10</sup> The explanatory notes accompanying the Act state: “In spite of these measures, it is clear that if all remaining offshore krona assets were granted unrestricted access to the domestic foreign exchange market, they would create the risk of a steep drop in the exchange rate unless the Central Bank sold large amounts of foreign currency from its reserves in order to counteract it. Such a depreciation would weaken households' and businesses' equity position, reduce their collateral capacity, cut into demand, and thereby reduce economic activity, which could lead to even further declines in the exchange rate and in asset prices. Owners of offshore krona assets would feel these negative effects to some extent, particularly those that did not have domestic assets after having closed out their positions through the foreign exchange market. Therefore, these transactions would also have a negative external effect on other parties not involved in them. This detrimental effect would emerge in the market where Iceland's most important asset price is determined - the foreign exchange market - and would thereby have a systemic impact. In spite of the authorities' attempts to solve the problem represented by the offshore krona assets, it is impossible to guarantee that it will be resolved in full with the voluntary measures that have been and will be offered to owners of offshore krona assets. In view of the foregoing, it appears inevitable that, other things being equal, lifting the capital controls without preventative measures vis-a-vis the offshore krona problem will lead to system-wide adverse effects that could pose a threat to economic stability. At the same time, it is clear that prolonged capital controls will tend to lead the domestic economy onto a path of weaker GDP growth than is desirable, owing to other negative effects that will be amplified as the controls remain longer in effect. For this reason, it is imperative to lift the controls, to do it efficiently, and to take measures that will ensure, as well as possible, predictability and economic stability.”

<sup>11</sup> The Icelandic Government's letter of 8 July 2016, p. 5.

<sup>12</sup> IMF 2016 Country Report No. 16/179, page 44.

<sup>13</sup> IMF 2016 Country Report No. 16/179, page 22.

<sup>14</sup> IMF 2016 Country Report No. 16/179, page 17.

IMF stated in its report that staff had “*advised that steps to unlock restricted offshore krónur are best kept simple.*”<sup>15</sup> The report then stated that “[a]greeing with staff on the merits of simplicity, [the authorities] shall hold a targeted foreign exchange auction on June 16, 2016, after which their attention will resolutely turn to easing capital controls on residents.”<sup>16</sup>

The Authority also notes that the Icelandic authorities have stressed that “*the intention is to ensure that it is possible to turn next to lifting capital controls on residents without mixing onshore and offshore krónur together in a disorderly manner, thereby undermining the objectives of the controls and undermining economic and financial stability. These are therefore temporary measures that enable the authorities to determine the sequence of liberalisation. When the controls are finally removed, however, controls on these assets and others will be lifted and the onshore and offshore markets will effectively merge.*”<sup>17</sup>

The complaint states that it is anticipated that the proposed auction will force non-resident holders of off-shore króna to accept a disproportionate discount.

Iceland has however stated that:

*“Act No. 37/2016, with subsequent amendments, did not change anything regarding offshore krona owners’ right to dispose of their assets: owners will still be authorised to withdraw interest payments on their investments, and in addition, their investment authorisations have been expanded. In this sense, nothing changes as regards the owners’ legal position; they will simply continue to be restricted by the capital controls, just as other owners of capital are.*

*It should be noted that, in the Central Bank’s recent foreign currency auction, an auction exchange rate was approved that reflected the Bank’s willingness to reduce its foreign exchange reserves to a level considerably below both the Bank’s and the IMF’s criteria for reserve adequacy during the prelude to liberalisation of controls on residents. This was done to enhance the probability of participation in the auction, and it took account of the likelihood that foreign currency inflows during the summer would enable the Central Bank to return the reserves to the desirable size. This was uncertain, however, and the Bank took a risk in doing so. The Bank was therefore making an effort to meet offshore krona owners halfway. In the auction, the Central Bank decided to accept all offers at an exchange rate of 190 kronur per euro, but in the interest of comparison, it is worth noting that there have been indications of trades with offshore kronur taking place a few weeks earlier at a lower exchange rate. Furthermore, 190 kronur per euro is at the low end of the outcome of the 20 auctions of offshore kronur that had taken place before this one.”*<sup>18</sup>

The Authority observes that the complaint does not provide the Authority with any documents supporting the assertion that the auction exchange rate provided constitutes a “disproportionate discount”.

In this regard, the Authority notes that the fact that the Icelandic króna’s exchange rate in the auction process is far lower than on the official onshore market does not constitute

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<sup>15</sup> IMF 2016 Country Report No. 16/179, page 17.

<sup>16</sup> IMF 2016 Country Report No. 16/179, page 21.

<sup>17</sup> The Icelandic Government’s letter of 8 July 2016, p. 5.

<sup>18</sup> The Icelandic Government’s letter of 8 July 2016, p. 4-5.



proof of a disadvantageous rate *per se*. Reports from the IMF indicate that abolishing capital controls could potentially trigger large capital outflows, to the significant detriment of the exchange rate of the Icelandic króna. The Authority would add that the significantly lower exchange rate of the offshore market when compared with the official onshore market precisely serves to illustrate this point. As a result, the Authority is of the opinion that it is not correct to contend that the exchange rate offered is, in and of itself, necessarily disadvantageous, since any calculation of the exchange rate as it would emerge in the event of capital controls being entirely lifted is necessarily speculative in nature, and could quite plausibly be lower than that offered at the auctions. A request for a valuation at face value with full liquidity is therefore deeply unrealistic in the context of the current underlying market conditions.

Moreover, in the Central Bank of Iceland's recent foreign currency auction (transaction date 16 June 2016) and the offer to buy offshore krónur at the exchange rate until 27 June 2016, a total of 1,715 offers to sell offshore króna assets were submitted by approximately 1,437 participants, all of them seeking to exit, albeit at differing prices. The total amount of capital offered in the auction equalled 58.9% of the total stock of offshore króna assets, which amounted to 319 b.kr. at the time the auction was held.<sup>19</sup> As a result, it is clear that some investors were prepared to engage in the process at the set price.

The Authority also notes that the auction serves as a *secure* means of trading in króna. This security is *not* representative of the current market as it would likely emerge, were capital controls to be completely relaxed, i.e. free market conditions.

The above 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(4) EEA. The Authority notes that this is an approach which is broadly consistent with the IMF's own preferred strategy. There are, therefore, no grounds for pursuing this case further.

### 3 Summary of conclusion

It follows from the assessment set out above that an EEA State enjoys a wide margin of discretion as regards the adoption of protective measures as long as they comply with the substantive and procedural requirements of Articles 43(4) and 45 EEA. Once compliance with these requirements has been established, the exercise of the powers conferred on an EEA State pursuant to Article 43 EEA precludes the application of primary provisions in the sector concerned (such as Article 40 EEA).

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 erred in its application of Article 43 EEA.

There are, therefore, no grounds for pursuing this case further.

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<sup>19</sup> The Icelandic Government's letter of 8 July 2016, p. 3.

HAS ADOPTED THIS DECISION:

The complaint case arising from an alleged failure by Iceland to comply with Article 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 on 23/11/2016*