

## **In response to a letter regarding the capital controls.**

A reference is made to the Authority's letter dated 21 June 2013 (Case no. 73984) informing about a complaint regarding the capital controls. The Icelandic authorities welcome the opportunity to submit its observations and comments on the matter.

The complainant is a Danish company and an owner of 8.38% of the shares in Marel hf. It is stated in the complaint that the complainant wishes to sell his shares in return for the domestic currency (ISK). However, as a result of the relevant provisions in the Foreign Exchange Act the complainant argues that his right to dispose over the shares remains unjustifiably restricted within the contexts of the EEA free movement of capital (Article 40 EEA agreement). The complainant claims that the permission to exchange the proceeds of the sale into a foreign currency and to transfer the money out of the country remains limited and is dependent upon participation in special auctions set up by the Central Bank of Iceland. The complainant considers that the auction mechanism is unpredictable and only allows the exchange at an extremely disadvantageous rate.

The complaint refers to Article 13 (b) and Article 13 (c) of the Foreign Exchange Act, No. 87/1992, that form the basis of the capital controls in Iceland.<sup>1</sup> The former concerns restrictions on cross-border capital movements while the latter concerns restrictions on foreign exchange transactions between residents and non-residents. According to Article 13 (a) the referred provisions shall prevail over Article 9 of the Act No. 34/1991, on Investment by Non-residents in Business Enterprises, where it is stated that non-residents who invest in Icelandic enterprises shall have the right to convert into any currency, for which the Central Bank of Iceland maintains a regular exchange rate any dividends received or other profits and proceeds from sales of investments.

The complainant does not contest that the capital restrictions introduced by Iceland in the autumn 2008 were adopted in accordance with the appropriate procedural requirements set forth in the EEA agreement and that the restrictions may have been justified by the outbreak of the financial crises.<sup>2</sup> The complainant is however of the opinion that the restrictions can no longer be justified on the basis of the substantive criteria laid down in the second and the fourth paragraph of Article 43 EEA, assuming that the restrictions are not necessary with regard to Iceland's economic recovery and cannot be seen as proportional if they are to remain in place for an undefined period and without any kind of automatic review mechanism.<sup>3</sup>

The Icelandic authorities consider that the complaint is mainly based on general considerations concerning the current state of the Icelandic economy rather than individual circumstances of the

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<sup>1</sup> See paragraph 19 of the complaint.

<sup>2</sup> In that regard the complainant refers to the second and the fourth paragraph of Article 43, Article 44, Article 45 and Protocol 18 of the EEA agreement.

<sup>3</sup> The complainant is of the opinion that five years after entering into force the restrictions on capital movements and foreign exchange transactions cannot be justified as the disturbances caused by the financial crisis no longer pose a threat to the functioning of the Icelandic capital market and Iceland's balance of payments. The complainant observes that there is no time limit fixed for the capital restrictions and draws the conclusion that any capital restrictive measure, although justified, must be applied for the shortest possible period. The complainant assumes that after the sunset clause was removed from the Foreign Exchange Act by Act no. 16/2013 there is no longer a need to regularly review the need for keeping the capital restrictions in place and furthermore that the situation has not been properly kept under review by the EFTA Standing Committee according to protocol 18 of the EEA agreement.

complainant although he firmly points to the consequences of capital restrictions for market players.<sup>4</sup> In response the authorities recall that the EFTA Court has concluded that the substantive conditions set forth in Article 43(2) and (4) EEA entails a complex assessment of various economic factors and that the *"EFTA States must therefore enjoy a wide margin of discretion, both in determining whether the conditions are fulfilled, and the choice of measure taken, as those measures in many cases concern fundamental choices of economic policy."*<sup>5</sup> The Court's conclusion was supported by the Authority and the Commission.

The Central Bank of Iceland delivered an opinion on the complaint at hand 12 July 2013 on a request by the Ministry. The opinion is attached to this letter. The opinion points to the fact that in order for the capital controls to be lifted without causing severe economic instability certain conditions of economic nature have to be fulfilled. The opinion also draws the attention to problems that currently pose a risk to Iceland's balance of payments and have to be addressed before the removal of the capital controls. The main vulnerabilities relate to the liquid ISK assets held by non-residents, the winding up of failed banks and the refinancing risk on foreign loans carried by some Icelandic companies.

The Icelandic Government has declared that the liberalization of the capital controls is a priority matter that has to be dealt with in an orderly fashion. According to the circumstances these restrictions remain necessary for the time being and as stressed in the opinion the liberalization strategy has to be conditions-based as reflected in the parliamentary Act No. 16/2013 by which the fixed termination date was removed from the Foreign Exchange Act in line with recommendations of a cross-party committee and the IMF. Although it stands to reason that capital controls may lead to inconveniences for individual parties it should be observed that Icelandic authorities have duly respected their obligations resulting from the requirements laid down in Article 43 EEA, including the principle of proportionality.<sup>6</sup>

The Icelandic authorities are willing to provide the Authority with further information if requested in order to examine and assess the complaint further.

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<sup>4</sup> See paragraphs 39-41 of the complaint.

<sup>5</sup> E-3/11 Pálmi Sigmarsson. See paragraph 50. See also paragraph 24 of the Judgment where the Court notes that *"by its question the national court essentially seeks to establish whether restrictions on cross-border movements of capital implemented in Iceland are compatible with Article 43(2) and (4) of EEA, which provide for the adoption of derogations from the free movement of capital."*

<sup>6</sup> E-3/11 Pálmi Sigmarsson. In paragraph 25 the Court notes that it *"is common ground that Iceland has respected the relevant notification procedures"*.



12 July 2013

*Subject: ESA complaint against Iceland concerning the capital controls*

## I. Introduction

On 17 June 2013 the EFTA Surveillance authority received a complaint against Iceland concerning the capital controls (case no. 73984). The complainant claims that the capital account restrictions introduced by Iceland at the outbreak of the financial crisis in 2008 are no longer justified, as the balance of payments and the functioning of its capital markets of Iceland are no longer disturbed, and requests that the measures be lifted. Furthermore, the complainant states that Iceland is in breach of the requirement set forth in Article 43 of the EEA Agreement, as there is not a foreseeable termination date or any kind of automatic review mechanism.

The Central Bank of Iceland emphasises that the complainant's assessment does not reflect Iceland's balance of payments position accurately, as the risk of destabilizing capital flows stemming from non-resident claims on domestic assets trapped by the capital controls is not accounted for. In addition, the Central Bank of Iceland firmly believes that Iceland has fulfilled its duty to ensure that the restrictions meet the requirements under 43 EEA on a continuous basis.

## II. Capital controls in Iceland in November 2008: rationale and form

*In the autumn of 2008, the three largest banks in Iceland failed. In the aftermath, Iceland faced a severe external payments crisis, with net financial and capital outflows projected at approximately 120 per cent of GDP. On a trade-weighted basis, the effective exchange rate of the króna plummeted about 65 per cent, fuelling exchange rate-driven inflation. Given the low reserve levels, the large external liabilities, and a probable capital reversal by carry traders, capital controls were instated to stem massive additional flight of capital as confidence in the Icelandic economy tumbled.<sup>1</sup> The arrangement stabilised the exchange rate, which was vital to protect households and firms that*

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<sup>1</sup> International Monetary Fund. *Iceland: Ex Post Evaluation of Exceptional Access Under the 2008 Stand-by Arrangement*. IMF Country Report No. 12/91, Paragraph 18, page 10.

*were financed largely through either inflation-indexed loans or foreign currency loans.*

*Preventing further depreciation of the currency in order to provide some shelter while households and businesses restructured and rebuilt their balance sheets was the central goal of the economic programme drafted by the Government and the IMF in the early days of the crisis.*

<sup>2</sup>

### III. Changes to the capital controls November 2008-April 2013

In October 2008, the Central Bank issued guidelines that provided for reduced allowances for foreign currency withdrawals on credit cards and prioritisation of foreign currency requests for imports of goods and services. However, during the ensuing few months, it became evident that these arrangements were insufficient, and on 28 November 2008 the Foreign Exchange Act, no. 87/1992, was amended by Act no. 134/2008, allowing the Central Bank of Iceland to adopt rules restricting cross-border capital movement and foreign exchange transactions. The temporary provisions had a fixed termination date of 30 November 2010, which was set in accordance with Iceland's economic programme timeline according to the IMF Stand-By Agreement.

On 28 November 2008, when the Central Bank of Iceland adopted the Rules on Foreign Exchange, no. 1082/2008, which were subsequently replaced by Rules no. 1130/2008, all controls on current account foreign exchange transactions were lifted, but more stringent controls on cross-border movement of capital and related foreign exchange transactions were imposed.

In August 2009, the Central Bank of Iceland presented a capital account liberalisation strategy that it had prepared with technical assistance from the IMF. Following the publication of the liberalisation strategy, the Rules on Foreign Exchange were reviewed and amended. The amendments provided for the first step in liberalising the controls; i.e., lifting controls of new inflows of foreign capital and all future associated outflows.

Because it is important when easing controls to ensure that the controls are efficient, further amendments were made to close loopholes. One of the most important changes in this regard was made on 30 October 2009, with Rules no. 880/2009, later replaced by Rules no. 370/2010,

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<sup>2</sup> *International Monetary Fund. Iceland: Request for Stand-By Arrangement. 2008. IMF Country Report No. 08/362, page 1.*

which unequivocally prohibited the unilateral importation of offshore krónur.<sup>3</sup> Importation of offshore krónur had been a common means of circumventing the controls. Most likely, these actions played a role in stopping the virtually uninterrupted slide in the exchange rate of the króna, which had begun in March 2009.

In June 2010, the Foreign Exchange Act was amended by Act no. 78/2010 again to extend the expiry of the controls (the sunset clause) to 31 August 2011, and on 25 March 2011 a new capital account liberalisation strategy was approved by the Cabinet. Consequently, and following consultations with the IMF, Parliament further extended the sunset clause until year-end 2013.<sup>4</sup>

As it was foreseeable that the capital controls would be in effect longer than was originally intended, it was considered appropriate to incorporate the Central Bank of Iceland's Rules on Foreign Exchange into law. This was done by Act no. 127/2011 which added sixteen new articles, Articles 13(a) – 13(p), to the Foreign Exchange Act. The articles contained the substantive provisions previously found in the above-mentioned Central Bank Rules no. 370/2010, together with guidelines for the Rules and minor amendments. The provisions were to remain in force until 31 December 2013. Parallel changes were made to the Central Bank Act, no. 36/2001, to strengthen the Central Bank's tools to carry out the next liberalisation step; i.e., the Central Bank's foreign currency auctions, which were launched in February 2012. For further discussion on the foreign currency auctions, see Section VI of this document.

Since then, the Foreign Exchange Act has been amended several times. First of all, amendments were made in March 2012 to withdraw certain exemptions for capital movements, including exemptions to the estates of the failed banks. It was foreseen that unless such exemptions were revoked, there was a substantial risk of disorderly capital movements, which could undermine the capital account liberalisation strategy. The resulting foreign exchange market instability could lead to a sizeable depreciation of the króna, which could upset household and corporate balance sheets and undermine financial stability. Any attempt to stabilise the króna with Central Bank intervention in the foreign exchange markets in the event of large disorderly flows would carve a large swathe out of the Central Bank's foreign exchange reserves, which are mostly borrowed.

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<sup>3</sup> *Offshore krónur are defined as valuables (or a certificate for such valuables) that are denominated in domestic currency but owned or held in custody by non-residents and are subject to particular restrictions according to the Rules on Foreign Exchange. Although most holders of offshore krónur are probably non-residents, residents hold some as well, either directly or indirectly.*

<sup>4</sup> *Before that the sunset clause was extended to 30 September 2011 by Act no. 81/2011.*

In April 2012, the IMF stated in its Article IV and Post-Program Report that in view of the uncertainty in the global environment, consideration should be given to a further extension of the capital controls, beyond end-2013.<sup>5</sup> This view of the IMF was reiterated in its second Post-Program report, dated November 2012<sup>6</sup>

In December 2012, a cross-party committee on the removal of the controls issued a joint letter to the political parties, emphasising the need to extend the time limit for the controls and to reach a comprehensive approach to lifting capital controls. Following this, in part due to unfavourable external conditions and the scope of the problem involved, the Foreign Exchange Act was amended again with Act no. 16/2013, to replace the sunset clause with a non-term authorisation. Shortly after the sunset clause was removed, further amendments were made to the Foreign Exchange Act with Act no. 35/2013, which aimed in particular at easing frequent small transactions. Such amendments involved raising non-residents' living expense authorisations, expanding reinvestment authorisations, expanding authorisations for foreign exchange transactions in connection with commercial activities, and expanding the authorisation for foreign borrowing. Finally, the Central Bank wishes to point out that, from the beginning of the current capital controls – i.e., 28 November 2008 – the Act on Foreign Exchange has authorised the Central Bank to grant exemptions from the restrictions imposed.

#### IV. EEA Agreement and other international obligations and cooperation

##### *EEA Agreement*

Article 40 of the EEA Agreement, cf. Act No. 2/1993, discusses the general principle of the free movement of capital. However, Article 43 of the EEA Agreement stipulates that EEA States may, under certain circumstances, take protective measures that restrict the free movement of capital. According to Article 43, Paragraph 2, an EEA State may take such measures if movements of capital lead to disturbances in the functioning of the capital markets. Also, Article 43, Paragraph 4 states that, where an EEA State is in difficulties or is seriously threatened with difficulties as regards its balance of payments, either as a result of

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<sup>5</sup> *International Monetary Fund. Iceland 2012 Article IV Consultation and First Program Monitoring Discussions. IMF Country Report No. 12/89, Paragraph 38, page 18.*

<sup>6</sup> *International Monetary Fund. Iceland 2012 Article IV Consultation and First Program Monitoring Discussions. IMF Country Report No. 12/309, Paragraph 14, page 8.*

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 jeopardise the functioning of the Agreement, the EEA State concerned may take protective measures. Moreover, the EFTA states must "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>7</sup>

On 28 November 2008, the Government of Iceland presented the Standing Committee of the EFTA States, as well as the Joint Committee of the EEA Agreement, with notifications of protective measures under Article 43 of the EEA. Neither committee discountenanced the protective measures. All amendments and developments regarding the protective measures have been duly notified by the Icelandic Government to the Standing Committee of the EFTA States, as well as the Joint Committee of the EEA Agreement. The notifications have been taken note of by the committees.

#### *IMF*

Iceland is a founding member of the IMF. In the Letter of Intent between the board of the IMF and Iceland, dated 15 November 2008, the IMF stated that currency restrictions, which were about to be adopted, were in line with the Fund's policy and were supported by the Fund, cf. Article VI, Section 3, as they were temporary, non-discriminatory, and driven by balance of payments problems. Article VI, Section 3 stipulates that members may exercise such controls as are necessary to regulate international capital movements, but that no member may exercise these controls in a manner that will restrict payments for current transactions or will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2. Article VII, Section 3(b) further stipulates that the member states shall have complete jurisdiction in determining the nature of such limitations, but they shall be no more restrictive than is necessary to limit the demand for scarce currency to the supply held by, or accruing to, the member in question, and they shall be relaxed and removed as rapidly as conditions permit. Furthermore, as the capital control regime marginally affects the conversion and transfer of a certain component of current payments, it gives rise to an exchange restriction subject to Fund jurisdiction under Article VIII, Section 2(a). This restriction arises from limitations imposed by the capital control regulations on the conversion and transfer of interest and indexation on bonds. The Icelandic authorities

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<sup>7</sup> Judgement of the EFTA Court, *Sigmarsson v. the Central Bank of Iceland*. Case E-3/2011.

requested an approval from the IMF's Executive Board of further retention of the measure on a regular basis, in accordance with the IMF Articles of agreement.<sup>8</sup>

#### *OECD*

Iceland is a member of the OECD Codes of Liberalization of Current Invisible Operations and Capital Movements. Article 7(b) stipulates that if any measures of liberalisation taken or maintained in accordance with the provisions of Article 2(a) result in serious economic disturbance in the member state concerned, that member may withdraw those measures. According to Article 13(a), any member invoking the provisions of Article 7 shall notify such actions to the OECD. The Council of the OECD has agreed that Iceland's invocation of the derogation clause under Article 7(b) of the Codes was justified. In accordance with OECD procedures, the Icelandic authorities continue to keep the OECD abreast of progress made towards lifting of the controls and of amendments to the controls and the liberalisation strategy.

#### *GATT*

Iceland is a member of the WTO and the General Agreement on Tariffs and Trade (GATT agreement). It is believed that the actions of laws and regulations on foreign exchange are in compliance with Iceland's obligations under the GATT agreement, as they impose no restrictions on trade in goods and services, cf. Article XI. The measures were introduced to the WTO.

#### *Negotiations for membership to the EU*

The removal of the capital controls has been considered a prerequisite for membership to the European Union. The Government has announced that the membership negotiations will remain on hold and not to continue them without a prior referendum. The next step is to prepare an assessment of the status of the negotiations as well as of developments within the EU since Iceland applied. The assessment will be debated by the Althingi. As a member of the EEA and the internal market, however, Iceland is under the same obligations as all Member States in ensuring the free movement of capital. Furthermore, Iceland has from the onset maintained that economic and financial conditions will determine the pace of the liberalisation process, rather than other developments as relates to the accession process. In light of

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<sup>8</sup> *International Monetary Fund. Iceland 2010 Article IV Consultation and The Third Review under Stand-By Arrangement and Request for Modification of Performance Criteria. IMF Country Report No. 10/305, Paragraph 26, page 14.*



this, and Iceland's current international obligations, it is not considered that there is "significantly less outside pressure to review the justification of the capital restrictions with the aim of restoring the free movement of capital" following the Government's decision.

## V. Significant balance of payments risks persist despite improved economic conditions

### *Economic conditions for lifting capital controls*

Certain economic conditions must be in place before the capital controls can be lifted without jeopardising financial stability, exchange rate stability, and the real economy.<sup>9</sup>

(1) The medium-term balance of payments position must be strong enough to withstand potential drains on reserves. This condition has not been met, as the potential drain due to the two legacy vulnerabilities, liquid offshore krónur and the old banks' estates, is still very large.

(2) The financial sector must be able to withstand volatile flows. The banks' resilience has improved significantly in recent years as regards both capital and liquidity. In addition, the banks have become less reliant on deposit financing from distressed foreign investors.

(3) Fiscal surplus. This is a necessary condition for lifting the capital controls. Although progress has been made since 2009, more needs to be done. As the IMF pointed out in June 2013, the fiscal targets remain appropriate but will require additional measures.<sup>10</sup> A new organic budget law will be presented to Parliament in the fall to further strengthen the fiscal policy framework. Furthermore, the maturity profile of sovereign debt should be lengthened.

(4) Access to foreign financial markets. Iceland faces significant refinancing risk in foreign currency in coming years. At present, the interaction between relaxation of the controls and substantial refinancing risk is the greatest risk to the stability of the financial system. Access for the sovereign has been established with two billion-dollar bond issues in the past three years. Other entities in Iceland have very limited access to foreign financial markets.

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<sup>9</sup> These conditions are in part listed in Central Bank of Iceland "Capital Account Liberalisation Strategy", Report to the Minister of Economic Affairs, 25 March 2011, and in IMF "Iceland—Concluding Statement of an IMF Mission for the Second Post-Program Monitoring Discussion" Reykjavik, 28 September 2012.

<sup>10</sup> IMF, "Iceland—Concluding Statement of an IMF mission for the 2013 Article IV Consultation and the Third Post-Program Monitoring Discussion" Reykjavik, 14 June 2013.

(5) Prudential rules must be in place before the controls are lifted. Work on this is now proceeding at a good pace. It is expected that new liquidity rules will be introduced in the autumn, and a review of the rules on financial institutions' foreign exchange balance is underway. Furthermore, a draft bill on a macro-prudential structure for Iceland is currently under public consultations and will be presented to Parliament in the fall.

In all, the preconditions set by the Central Bank and recommended by the IMF<sup>12</sup> for the removal of the capital controls have not yet been fulfilled.

There is no doubt that Iceland has made significant progress in its efforts to stabilise the economy. As is stated in the Concluding Statement of the IMF mission in June 2013, *"Iceland's economy is on a path to recovery and the outlook is for continued gradual expansion."*<sup>13</sup> Domestic output growth is forecasted at 1.7%-1.8% in 2013, which compares reasonably well with other developed countries.<sup>14</sup>

However, this relatively benign economic picture does not imply that there is not a significant risk of disorderly capital flows should the capital controls be lifted abruptly. Moreover, it obscures the fact that Iceland's economic recovery so far, as well as fiscal and financial stability, is partly dependent on the existence of capital controls.

While strong overall economic conditions are among the prerequisites for lifting the capital controls, the most important problem that must be addressed before controls can be lifted in a safe manner is the extent of non-residents' highly volatile short-term claims on domestic assets. If controls are lifted prematurely, before measures to stabilise those claims have had the desired impact, massive capital outflows are likely to occur immediately after the controls are lifted.

These legacy vulnerabilities must be addressed before major steps towards liberalisation can be taken. Otherwise, financial stability and hence the stability of the real economy in Iceland would be at risk. Significant progress has been made towards stabilising non-resident

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<sup>12</sup> IMF "Iceland—Concluding Statement of an IMF mission for the Second Post-Program Monitoring Discussion" Reykjavik, 28 September 2012.

<sup>13</sup> IMF, "Iceland—Concluding Statement of an IMF mission for the 2013 Article IV Consultation and the Third Post-Program Monitoring Discussion" Reykjavik, 14 June 2013.

<sup>14</sup> Statistics Iceland, *Economic Forecast, summer 2013* and Central Bank of Iceland, *Monetary Bulletin 2013/2*.

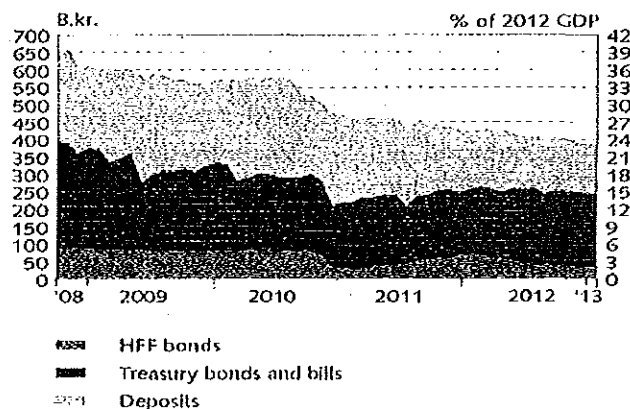
claims, in line with the liberalisation strategy, but several remaining problems must be solved.

### *Iceland's balance of payments problem*

Notwithstanding the small current account surplus, Iceland's balance of payments situation remains highly vulnerable. There are three types of vulnerabilities that must be addressed. First, liquid króna assets held by non-residents amounted to 367 b.kr. in Q1/2013, or 22% of GDP (see Figure 1). Although these short-term claims on domestic assets have declined by almost half since the onset of the crisis, they are still sizeable compared to Iceland's current account surplus, which amounted to 3.5% of GDP in 2012. These assets are liquid and could therefore be sold and converted into foreign currency in the absence of capital controls. Second, the failed banks' estates hold liquid ISK assets that could potentially add to the capital outflows in the absence of capital controls. These claims currently amount to about 80 b.kr. and could increase to as much as 420 b.kr. in the coming years (see the first two columns in Figure 2). Third, unlike the sovereign, Iceland's banks and corporations have extremely limited access to foreign credit markets. At the same time, some Icelandic companies face substantial refinancing risk on foreign loans, which may cause balance of payments problems, even in the presence of capital controls.

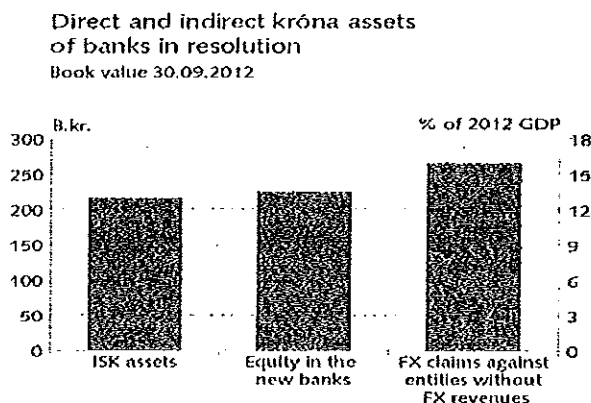
Figure 1.

Liquid ISK assets held by non-residents  
October 2008 - January 2013



Source: Central Bank of Iceland.

Figure 2.



Source: Central Bank of Iceland.

The main objective of Phase 1 of the capital account liberalisation strategy is to reduce distressed investors' króna holdings and channel them into long-term Treasury bonds and long-term investment in the Icelandic economy. This is done through auctions that facilitate transactions between long-term investors and distressed investors that want to sell their króna holdings.<sup>15</sup>

The winding up of the failed banks' estates entails significant risk to the balance of payments. A third of the assets held by the banks' estates are domestic, while only about five per cent of the claims are domestic. Consequently, in the worst-case scenario, the winding up could result in the distribution of 770 b.kr. in domestic assets to foreign claimants (see Figure 2), which amounts to 45% of GDP (see Figure 3).<sup>16</sup>

It is imperative that the winding up of the failed banks be done in an orderly manner, so as to prevent severely destabilising capital flows. It should be borne in mind that non-resident creditors' net claims on domestic assets amount to 45% of GDP. This is a problem that must be addressed before major steps towards lifting capital controls can be taken, preferably in the context of a composition agreement with creditors. A majority of creditors would probably prefer to reach such an agreement. To be effective, a composition agreement would require an exemption, granted by the Central Bank, from capital account restrictions. The exemption would be granted on the condition that asset sales and payments to creditors be carried out in a manner that is non-disruptive to the balance of payments.

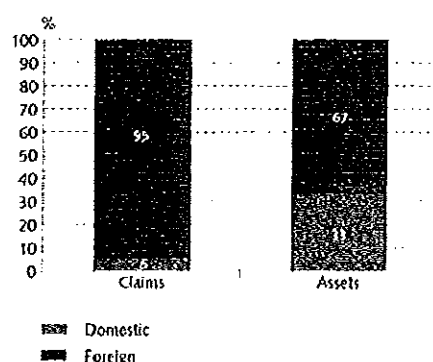
<sup>15</sup> Central Bank of Iceland "Capital Account Liberalisation Strategy", Report to the Minister of Economic Affairs, 25 March 2011.

<sup>16</sup> Central Bank of Iceland. Financial Stability 2013/1.

The “overarching challenge is to create a foundation for durable growth by resolving legacy problems”<sup>17</sup> and simultaneously lay the groundwork for lifting the capital controls.

Figure 3.

Estimated domestic/foreign breakdown  
of assets and claims of DMBs in winding-up  
proceedings  
Book value 31/12 2012



Sources: Clóinn Ísly and Financial Information Öðna, Kaupthing, and LBL, Central Bank of Iceland.

#### *IMF and rating agencies' support assessment*

The above assessment by the Icelandic authorities is supported by the IMF. In a report from November 2012, the IMF states as follows: “In the unlikely event that capital controls are lifted prematurely—before significantly reducing the liquid overhang of offshore krona—disorderly capital outflows could ensue and the krona could come under pressure. This would fuel inflation and—with most loans indexed to the CPI—increase private sector debt, with adverse implications for growth and lenders’ balance sheets. [...] Disorderly exit of the large stock of liquid offshore krona, combined with resident capital flight, would put significant pressure on reserves. Market access could be less than under the baseline. And payouts by the old banks from their liquid domestic assets could come sooner than in the baseline. These risks could be mutually reinforcing (by undermining confidence), giving rise to substantial financing needs in the coming years. The authorities viewed the possibility of a premature lifting of capital controls as a distant tail risk.”<sup>18</sup>

<sup>17</sup> IMF, “Iceland—Concluding Statement of an IMF mission for the 2013 Article IV Consultation and the Third Post-Program Monitoring Discussion” Reykjavik, June 14, 2013.

<sup>18</sup> IMF Country Report No. 12/309, Iceland Second Post-Program Monitoring Discussions, November 2012.

In a report issued by Moody's on 17 July 2013, it is stated: *"We assess susceptibility to event risk as 'moderate', mainly reflecting the risks emanating from the process of capital control liberalisation. As the size of potential capital outflows is substantial, the risk of too rapid a loosening in capital controls remains the key event risk for Iceland in our view. At the same time, we acknowledge that the authorities are well aware of these risks."*<sup>19</sup>

Furthermore, in a report from 1 March 2013, Fitch Ratings states that: *"Fitch acknowledges that Iceland's exit from capital controls will be a lengthy process, given the underlying risks to macroeconomic stability, fiscal financing and the newly restructured commercial banks' deposit base. In the short term, capital account liberalisation could undermine the krona, drive up inflation and weaken balance sheets; in the longer term, however, it should play to improved business confidence and higher investment and growth. On balance, therefore, an orderly unwinding of capital controls should be viewed as rating positive for Iceland, but it is likely to remain a medium-term objective. Fitch recognises that capital controls have cushioned Iceland from the eurozone crisis, while providing the sovereign with a captive funding pool at lower interest rates than it might otherwise had to pay. However, the longer capital controls remain in place, the greater the risk that they will begin to fuel asset price bubbles, as non-residents abandon government stock for other asset classes."*<sup>20</sup>

The Ministry of Finance and Economic Affairs and the Central Bank of Iceland share the views of the IMF and the rating agencies.

## VI. Central Bank of Iceland foreign currency auctions

In view of the balance of payments problems discussed above, the Central Bank and other authorities are working according to a strategy that aims to reduce the risk of disruptive capital outflows once the controls are lifted. On 25 March 2011, the Government approved a capital account liberalisation strategy presented by the Central Bank of Iceland, after having consulted with other authorities and the IMF. The strategy did not include a specific timetable; however, it contained a general description of the conditions that must be met in order for the capital controls to be lifted without causing severe instability, and it broadly described the measures that will be applied during the first phase of the strategy in order to reduce the risk of disorderly capital flows once controls are lifted.

<sup>19</sup> Moody's Investor Service. *Credit Analysis. Iceland, Government, July 16, 2013.*

<sup>20</sup> Fitch Ratings. *Iceland. Full Rating Report, 1 March 2013, page 7.*

The 2011 strategy is divided into two main phases. The first phase is characterised by measures intended primarily to stabilise “volatile” krónur (mainly krónur held by non-resident investors as deposits in domestic banks or short-term Treasury securities). The second phase involves the general removal of restrictions on movement of capital. Steps within the second phase were not described in detail, however, as the option of lifting the controls in full immediately upon completion of the first phase was left open.

*Central Bank auctions under Phase I of the strategy*

Deposits held by non-residents in domestic banks are deemed to be the most volatile króna holdings trapped behind capital controls. Reducing the stock of highly liquid and potentially volatile króna holdings before the capital controls are lifted is of paramount importance.

In accordance with the first phase of the capital account liberalisation strategy, the Central Bank of Iceland has held a series of foreign currency auctions that are particularly intended to allow unwilling holders of liquid króna assets to exit. Non-residents wishing to close their króna positions are invited to participate in auctions in which they offer krónur for sale in exchange for foreign currency. Parallel auctions provide owners of foreign currency not subject to repatriation requirements the opportunity to sell foreign currency at the auction rate and purchase long-term inflation-indexed Treasury bonds or undertake investments through the Central Bank Investment Programme. The Central Bank therefore serves as an intermediary in matching investors wishing to invest in Iceland for the long term and parties who wish to dispose of their krónur.

Through the latter auctions, investors can purchase krónur at the auction exchange rate for the equivalent of 50% of the amount to be invested, while the other 50% is converted on the domestic foreign exchange market. In both instances, investors pledge to hold the investment for at least five years if they avail themselves of these options.

Treasury bond foreign currency auctions began in the summer of 2011, while the first auction under the Investment Programme was held in February 2012. A total of fourteen Treasury bond auctions have been held, and twelve auctions have been held in connection with the Investment Programme. Based on the auction price in each instance and the Central Bank's quoted mid-rate of the same date, investors have brought a total of around 50 b.kr. into the country through the Treasury bond option and over 118 b.kr. through the Investment Programme. Around one-third of this amount has gone through the domestic foreign exchange market, as 50% of the amount to be invested under the Investment Programme must be converted on the

domestic foreign exchange market. As of end-June 2013, the foreign currency auctions had brought into Iceland foreign investments equivalent to roughly 9% of 2012 GDP.

Another thirteen auctions have been held inviting bids from parties wishing to sell their króna assets in exchange for foreign currency exempt from repatriation requirements. In 2011, two such auctions were held, with the exchange rate set at 210 krónur per euro. In 2012 the price held fairly steady at around 240 krónur per euro, but it has fallen in 2013. In the most recent auction, held in June 2013, the auction price was 210 krónur per euro. In the thirteen auctions, a total of 303 b.kr. have been offered for sale, and the Central Bank has purchased around 100 b.kr. of that total. The price expectations of parties offering their króna assets for sale are not always in line with the price expectations of investors taking advantage of the foreign exchange auctions to make long-term investments in Iceland. It is important to realise that the Central Bank serves as an intermediary in matching investors wishing to invest in Iceland for the long term and parties who wish to dispose of their krónur.

#### *Auction price and amount*

The auction price is determined after the three auctions have taken place on the auction day. The total accepted amount of krónur depends on the amount of foreign currency offered to purchase long-term inflation-indexed Treasury bonds or undertake investments through the Central Bank Investment Programme. These amounts must match if the impact of the auctions on the foreign exchange reserves is to be minimised. All decisions regarding the auction process, auction price, and amounts are made by the Governor of the Central Bank of Iceland based on proposals by Director of the Treasury and Market Operations Department, the Head of Reserve Management in the Treasury and Market Operations Department, and the project manager of the auction process.

#### *Auctions intervals and predictability*

The auction dates are publicised well in advance, and the terms of the auctions are announced approximately 5 to 6 weeks in advance. The auction dates for the remainder of 2013 have been announced and are as follows: 3 September, 15 October, 19 November, and 17 December 2013. The Governor and Deputy Governor of the Central Bank have stated clearly that decisions regarding the termination of the auction process will be announced several auctions in advance.

So far, it can be concluded that the auctions have been modestly successful in reducing the most volatile part of the offshore overhang.



For example, deposits held by non-residents in Icelandic banks have been declining, from more than 200 b.kr. at the time the controls were introduced to the current balance of approximately 50 b.kr. This gradual process reduces the risk of liquidity problems in the banking system once capital controls are lifted. If the level of participation in the auctions is similar to that in the past few years, it may take up to few years to absorb most of the remaining non-resident deposits, provided that the problem of the failed banks' estates is solved satisfactorily.

*Parties are not severely restricted from transferring their capital.*

In light of the above, the Icelandic authorities cannot agree with the assertion in the complaint, that legal entities or individuals are "massively restricted" from transferring their capital, as both are permitted to participate in the auction process if they wish to close their króna positions. In addition, it should be mentioned that, according to the Foreign Exchange Act, non-resident individuals are authorised to purchase and transfer foreign currency for the equivalent of up to 6,000,000 krónur per calendar year for their living expenses abroad. In many instances, the Central Bank has granted exemptions increasing this limit.

## VII. Obligation to review the restrictions on a continuing basis

As is described in Section II of this document, the capital controls were based on a fixed-term authorisation that was extended three times before the so-called sunset clause was removed. Parliament, based on recommendations from both the cross-party committee and the IMF, replaced the sunset clause with a non-term authorisation along with a reporting obligation.

This change was made because fixed dates were thought to reduce the incentive to participate in auctions and hence delay the process of reducing the offshore overhang. Although the expiry date has been removed from the legislation, this does not imply that the restrictions on cross-border movement of capital and foreign exchange transactions will remain in effect for a longer time. On the contrary, the objective is to contribute to the success of the liberalisation strategy so that the controls can be lifted earlier, as economic conditions permit.

In view of the fact that the liberalisation strategy has been conditions-based from the beginning, the sunset clause of the legislation has limited relevance. It does not affect the criteria for safely lifting capital controls and hence the actual date of removal, nor does it imply that the need for capital controls will be reviewed less frequently. On the

contrary, the Minister of Finance and Economic Affairs is now required to publish a report on the progress of the liberalisation strategy at six-month intervals until the controls are finally lifted, with the first such report to appear within six months after the Act no. 16/2013 entered into force (March 2013). Assessing the need for the capital controls is an inseparable part of assessing the progress of the liberalisation strategy. This requirement is also intended to guarantee that Iceland complies with its obligations under the international agreements into which it has entered and that the capital controls do not remain in force longer than absolutely necessary. As the need for the controls is reviewed more frequently, the time between mandatory reviews of the controls has shortened with the removal of the sunset clause.

The Icelandic authorities are fully aware of the importance of the proportionality principle. The proportionality test should be an assessment based on current circumstances and the scope of the problems in existence. Reviews at fixed time intervals do not necessarily guarantee proportionality. The Commission, the IMF and the Cypriot authorities clearly state in their communications that the protective measures should be lifted as conditions allow.<sup>21</sup> A gradual lifting of capital controls must be conditions-based so as not to erode the stability achieved by controls. This is also the view of the IMF and the OECD.

While both Cyprus and Iceland had to implement capital controls, there is significant difference in the situation the controls aimed to stabilise; for example, Iceland has its own independent currency and Cyprus uses the euro. Consequently, the design is fundamentally different. Both controls were reviewed and adjusted in the initial stages, but adjustments and reviews became less frequent as policy goals were achieved. The overarching prerequisite for lifting controls in Cyprus is that liquidity have been stabilised in the banking system and "restrictions will be lifted as soon as funding conditions normalize".<sup>22</sup> The process of normalising markets is based on economic conditions in Cyprus but also on developments in international financial markets, and as this process cannot be timed, the lifting of controls will have to be conditions-based. The same applies to the liberalisation process in Iceland. Further elaboration on the capital controls can be found in Section II.

Finally, it should be noted that, to the Central Bank's knowledge, Iceland has not received formal complaints from any international supervisory body on its reviewing policy, although the term has never

<sup>21</sup> [http://europa.eu/rapid/press-release\\_IP-13-298\\_en.htm](http://europa.eu/rapid/press-release_IP-13-298_en.htm),  
<http://www.imf.org/external/pubs/ft/survey/so/2013/car051713a.htm>.

<sup>22</sup> Cyprus Letter Of Intent to the IMF, 29 April 2013.  
<http://www.imf.org/external/pubs/ft/scr/2013/cr13125.pdf>

been shorter than it is now; i.e., six months. More frequent reviews seem to have limited relevance. Iceland frequently consults with the IMF on the implementation and strategy for lifting the controls. Moreover, the *Ad Hoc Group on the Removal of Iceland's Capital Controls*, which is composed of officials from the European Commission, ECB, and the IMF, has also provided a forum for consultation with EU institutions.

In view of the above, it can be concluded that the capital controls fulfil fundamental EEA principles such as proportionality. The Icelandic authorities are fulfilling their duty to ensure on a continuing basis that the restrictions meet the requirements under 43 EEA.

## VIII. Other issues raised in the complaint

### *Effects on real estate prices in Iceland*

One of the risks associated with prolonged capital controls is asset price appreciation. Another risk is distortion in investment, due to the evaluation of investment options based on potential returns within the capital controls.<sup>23</sup> In the complaint, it is mentioned that there has been an "enormous increase in real estate investment in Iceland".<sup>24</sup> In 2009 and 2010, real house prices declined almost 30%; in 2011, they were virtually unchanged; and in 2012 there was a 1.5% real price increase. In May 2013, real house prices were at par with the level prevailing in mid-2004. Capital area house prices have risen at a faster pace, or about 5% in real terms in the past 12 months, which is in line with growth in disposable income. While the Central Bank shares the complainant's concern about possible distortions in the real estate market as a result of the controls, it takes the view that changes in house prices are not out of line with fundamentals. Real estate investment continues to be subdued. In real terms, it is about half of what it was in 2004 and a quarter of what it was in 2007. Housing market turnover has risen in the past two years, totalling about 183 b.kr. last year.

## IX. Conclusions

The Icelandic authorities are of the view that Iceland still faces unacceptable risks to its balance of payments that could disrupt the functioning of foreign exchange and capital markets in Iceland. Temporary restrictions on capital movement are therefore necessary. While the current account remains favourable, unresolved problems on

<sup>23</sup> Central Bank of Iceland, *Financial Stability 2012/1*

<sup>24</sup> *Complaint against Iceland concerning the currency controls.*

the capital account pose significant risk to the medium-term balance of payments outlook if capital controls should be lifted abruptly. Further improvements must be made in order to prevent wide fluctuations in the exchange rate or a drain on reserves. This involves winding up the failed banks' estates in a non-disruptive manner and further reducing volatile offshore króna holdings through auctions and other measures, broadly in line with the 2011 liberalisation strategy. Iceland has already made significant progress on this front, but it may take up to few more years to achieve a significant further reduction in risk, provided that the problem of the failed banks' estates is solved satisfactorily.

To create appropriate incentives to participate in Central Bank auctions and thereby ensure the success of the liberalisation strategy, the termination date of the capital controls legislation, or sunset clause, was replaced with a non-term authorisation with stricter reporting obligations. Assessing the need for the capital controls is an inseparable part of assessing the progress of the liberalisation strategy. Because the strategy for lifting capital controls has been conditions-based from the beginning, this has no relevance for the actual timing of lifting capital controls.

In view of the above, the Icelandic authorities are of the opinion that the capital controls fulfil the fundamental EEA principle of proportionality. The authorities are fulfilling their duty to ensure on a continuous basis that the restrictions meet the requirements under 43 EEA.

As is stated above, non-residents wishing to close their króna positions are invited to participate in auctions in which they offer to sell krónur in exchange for foreign currency. Non-resident individuals are authorised to purchase and transfer foreign currency for the equivalent of up to 6,000,000 krónur per calendar year for their living expenses abroad. Further exemptions are provided from imposed restrictions. Therefore, legal entities and individuals are not prevented from transferring their capital if needed, provided that the scale of the transaction does not constitute a serious threat to financial stability.

*Annexes:*

- 1) Capital Account Liberalisation Strategy, dated [August] 2009
- 2) Capital Account Liberalisation Strategy, dated 25 March 2011