EMTA SPECIAL SEMINAR: ICELAND'S GLOBAL OUTLOOK AFTER CAPITAL CONTROLS

Thursday, September 15, 2016
Grand Hotel Reykjavik
Sigtún 38, 105 Reykjavík, Iceland

<u>9:00 a.m. - 11:00 a.m. Panel Discussion</u>

Aviva Werner (EMTA) – Moderator
Arturo Porzecanski (American University)
Daniel Gros (Centre for European Policy Studies)
Aldo Abram (Liberty & Progress Foundation)

Text of prepared remarks as delivered by Arturo C. Porzecanski:

The Icelandic economy has more than fully recovered from the financial crisis of 2008, but the normalization of its international financial relations has been needlessly delayed, and recent policy decisions are taking the country down a path of counter-productive confrontation with foreign investors.

Stringent capital controls were imposed in Iceland in late 2008 in order to prevent large-scale capital flight and a complete collapse of the exchange rate. They were intended as a short-term measure to be removed as soon as possible, and as part of Iceland's first program with the IMF, the authorities committed to abolishing them before the two-year program would be over in November 2010. The IMF approved of the capital controls and the EFTA institutions did not object because, although the European Economic Area Agreement guarantees the free movement of capital, it envisages that protective measures may be taken during major economic or financial disturbances.

But here we are almost eight years later in September 2016, and the stringent capital controls are still in place, despite the fact that the banking crisis has been resolved to the government's satisfaction and Iceland has exhibited a more vigorous economic recovery than most Nordic countries. Indeed, most of Iceland's vital indicators are looking healthier today than they did before the crisis of 2008. Real GDP stands higher while inflation is running lower. Exports have boomed, such that current account deficits have turned into surpluses. The post-crisis fiscal deficits have been eliminated. Official external assets are higher than ever and official external liabilities are lower than ever. And the exchange rate has been appreciating in both nominal and inflation-adjusted terms – this despite the fact that the Central Bank of Iceland (the CBI) has been intervening to buy foreign exchange to pay off the IMF, which it has done, and to bolster its own international reserves. In fact, the level of reserves has more than been tripled in both krona and euro terms since 2007.

The government had been unwilling to dismantle the capital controls until the banking system was recapitalized, their assets and liabilities were dealt with, and enormous losses were imposed on non-priority creditors. But by now that mission has also been accomplished. Direct state support to the financial sector during the crisis had amounted to some 34 percentage points of GDP, but after asset recoveries and transfers and debt forgiveness, the government is estimated by the IMF to have made a net *gain* in excess of 9 percent of GDP out of the banking crisis – a radically different outcome from the experience of all other European countries, which came out substantially more indebted. Of relevance to the balance of payments, and as a result of the banking system's resolution, Iceland's gross external debt has been cut from the equivalent of nearly 200 percent of GDP to about 130 percent of GDP by the start of this year.

As the supposedly last precondition for relaxing the capital controls, the authorities have come up with a coercive and punishing scheme for the so-called offshore krona investments, which have been trapped inside Iceland by the rationing of access to foreign exchange. We're talking about an officially estimated 319bn krona, equivalent to 2.3bn euros. To put this figure in context, this amount of trapped investments is equivalent to 42 percent of the CBI's net foreign assets of 743bn krona, or 5.35bn euros – so it's not like the authorities don't have spare euros and dollars to sell to these investors in exchange for their krona.

Foreign investors were recently given a one-time chance to exit their positions and access foreign exchange by agreeing to a stiff departure tax on their holdings, to be determined at an auction of CBI international reserves earmarked for this purpose. To encourage foreign investors to swallow such a bitter pill after eight years of waiting, the authorities announced their intent to imprison any remaining funds and to bleed them slowly over time. As per legislation passed in late May, all residual offshore krona funds are to be segregated into accounts subject to a 100 percent compulsory requirement to purchase krona-denominated deposit certificates, issued by the CBI, paying a miserly interest rate of 0.5 percent per annum – a fraction of the 5¼ percent interest rate that the CBI currently pays on seven-day bank deposits. Foreign investors spurning the auction were warned by the authorities to expect to languish in these creditor prisons for "many years."

In the event, the auction, which took place in mid-June, was a disappointment. Most holders of offshore krona did not participate, preferring to stay invested in Iceland and preparing themselves for a battle in the courts of the island and in the relevant European courts. The accepted offers totaled a little more than one-fifth of total offshore krona outstanding and they entailed "haircuts" of 38 percent. As a result, it appears that the owners of four-fifths of offshore krona funds are digging in for a long fight. And such a fight is not in the long-term interest of Iceland, and specifically not for the pricing of krona assets, because future foreign investors will want to include a risk premium for the potential return of capital controls and also for the potential imposition of similar expropriations.

The irony is that the government has recently admitted that there *are* foreign investors wanting to come into Iceland. These potential investors could generate the foreign exchange inflows to compensate for whatever outflows, on account of liberated offshore-krona balances, the authorities would countenance. And yet, rather than welcoming them to Iceland, in June the government requested, and the Icelandic parliament readily agreed, to pass a law authorizing the CBI to impose a reserve requirement of up to 75 percent, for a period as long as five years, to discourage such capital inflows into domestic bonds and bank deposits. In other words, instead of making progress on capital liberalization, the authorities in Reykjavík are phasing-in new controls on capital *in*flows ahead of phasing out the capital controls on *out*flows.

The mistreatment of offshore krona investors appears to violate several of Iceland's obligations under the European Economic Area Agreement. According to its Article 4, "any discrimination on grounds of nationality shall be prohibited," and yet the Icelandic legislation knowingly targets foreign investors, who according to the government's own estimates account for at least 85 percent of the total funds in question.

Further, as per the Agreement's Article 43, protective measures in the field of capital movements may be taken "[i]f movements of capital lead to disturbances in the functioning of the capital market." But the punishment of offshore krona investors is being applied in the absence of any such market disturbance. The leading investors, including members of EMTA, have expressed to the government their willingness to depart from Iceland in a gradual, orderly and agreed manner over a period of several years. They have also reportedly offered to exchange their krona holdings for a new government bond denominated in dollars, rather than insisting on cash up front. In other words, while the offshore krona investors have offered to make concessions that have the potential to prevent market disturbances, the authorities have spurned them.

Article 43 also contemplates the adoption of protective measures in the event a government faces, or is seriously threatened with, balance-of-payments difficulties – but Iceland is not at all in this situation. As mentioned previously, current account deficits have turned into surpluses, gross external indebtedness has greatly diminished, and the krona has been appreciating even while the CBI has been building up its official international reserves.

So why are the authorities here in Reykjavík so hostile toward offshore krona investors? The stated reason has been that the foreign exchange market and economy could not possibly cope with a liberalization of capital controls which was not preceded by a reduction of the overhang of offshore krona trapped inside Iceland. That reason may have been valid years ago, but it is not valid now, so one must look to political or other explanations, especially since the government is now taking litigation and reputational risks which it avoided when dealing with the estates of the failed banks.

The hypothesis I have heard is that the authorities, as part of a political shift towards greater nationalism and populism, want to punish these offshore creditors because they view them as having contributed to the country's banking crisis of 2008. Such an attitude would be based on prejudice or ideology rather than facts, however. Before 2008, the offshore krona investors were courted by the government and the private sector: they were solicited to buy government and corporate bonds and to acquire other Icelandic financial assets, such as stocks and bank deposits. There is no evidence that they were directly or indirectly responsible for the banking crisis. In the exhaustive 2010 report of the Icelandic Parliament's Special Investigation Commission, which analyzed (in 23 chapters and 12 appendices) all the factors and individuals who contributed to the bankruptcy of the country's 3 main banks, plenty of failings were identified – but the offshore krona investors were not among them. Indeed, these investors became, and ought to be regarded as, victims of the negligence of the Icelandic private banks, regulatory institutions, technocrats, policymakers, and elected officials responsible for the crisis. They should not be held for ransom!