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Iceland's selective default?

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Iceland's latest attempt to phase out its capital controls will soon entail what deserves to be characterized as a punitive, selective default on its obligations to the country's foreign creditors.

To be sure, the authorities in Reykjavík, on advice of their attorneys at Cleary, Gottlieb – the firm that has represented other default-prone governments in Argentina, Greece and Puerto Rico– have gone to great lengths to mask this impending default. Given that outright defaults sully an issuer's reputation and can invite protracted litigation, in the case of Iceland they have concocted a backdoor default they hope will pass unnoticed by the credit-rating agencies and be tolerated by investors.

The scheme is the following. Foreign investors who have been trapped by Iceland's capital controls imposed in the wake of the 2008 banking crisis – the owners of so-called offshore krona investments, mainly in government bonds – are being provided a one-time chance to exit their positions and access foreign exchange if they agree to a departure tax of between 37 and 58 percent on their holdings. At present, the controlled onshore market for the krona prices euros at around 139 ISK/EUR, but for the purposes of an exit, the authorities have set an arbitrary price range from 190 to 220 ISK/EUR, depending on the amount of bids received at an auction for euros to be held on Thursday, June 16, or bids received after the auction but before November.

To encourage foreign investors to swallow such a bitter pill after eight years of waiting, the authorities have 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 Central Bank of Iceland (CBI), paying a miserly interest rate of 0.5 percent per annum – a fraction of the 5.75 interest rate that the CBI has been paying on seven-day bank deposits. Foreign investors spurning the upcoming auction should expect to languish in these creditor prisons for "many years," the authorities have warned.

The government is shameless when defending this discriminatory scheme targeting the foreign investors they once actively courted. According to a recent address delivered in London by CBI Governor Már Guðmundsson, the scheme is not as bad as it sounds because participation in the auction "will be entirely voluntary," "some holders of offshore krona may wish to remain in Iceland," and "there is no forced or distressed debt exchange involved." He also revealed that the authorities had initially considered an offer to exchange trapped assets for long-term government bonds, but the idea was dropped because this "might be construed as a distressed debt exchange"

– thus the confiscatory and discriminatory scheme the advisors concocted to avoid the appearance of a sovereign default.

However, the scheme entails a distinction without a difference. Besides a distressed debt exchange, a default as per the rating agencies is triggered, in Moody's own words, whenever "a change in the payment terms of a credit agreement or indenture imposed by the sovereign results in a diminished financial obligation, such as a forced currency redenomination … or a forced change in some other aspect of the original promise, such as indexation or maturity." In Iceland's case, the confiscatory exit tax and reserve requirement surely qualify as a forced change in the original payment promise made to foreign investors.

Additionally, Iceland's economy and finances have recovered to the point where such an approach is hard to justify: it reflects unwillingness, rather than incapacity, to pay. Iceland has exhibited a more vigorous economic recovery than most Nordic countries, and most of its 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; and the exchange rate has been appreciating in both nominal and inflation-adjusted terms – despite the fact that the CBI has fully repaid the IMF and has been buying up foreign exchange to bolster its international reserves.

Indeed, the CBI's net foreign-asset position has more than tripled in both krona and euro terms since 2007. As of end-May, the CBI held net foreign assets of ISK 743bn (€5.35bn), more than double the officially estimated stock of offshore krona, which is ISK 319bn (€2.3bn). Given its investment-grade rating, the Reykjavík government could easily raise long-term funds abroad to start paying down its trapped foreign creditors if it did not want to draw from the CBI's ample international reserves. As the new government in Argentina has recently shown, in the manner in which it swiftly eliminated longstanding capital controls and cured its defaults to private and official creditors, where there is a (political) will, there is a (financial) way.

Furthermore, 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-account balances, the authorities would countenance. And yet, rather than welcoming them to Iceland, earlier this month 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 about to double down on capital controls – allegedly, for the sake of enhanced monetary independence.

All things considered, the government of Iceland, a member of both the European Free Trade Association (EFTA) and the European Economic Area (EEA), is likely to find it difficult to justify the measures it has recently enacted before the EFTA Surveillance Authority and the EFTA Court, which regulate the activities of EFTA members in respect of their EEA obligations. Indeed, the risks of protracted and disruptive litigation in Icelandic and European courts are real.

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