Iceland's Retreat from Financial Markets

November 7, 2016
3:00PM to 4:30PM

Featuring **Arturo Porzecanski**, Distinguished Economist in Residence, American University; and **Ike Brannon**, Visiting Fellow, Cato Institute; moderated by **Mark A. Calabria**, Director of Financial Regulation Studies, Cato Institute.

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 eight years later in November 2016, and while partially liberalized this year, 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, virtually all of Iceland's vital statistics 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. The currency 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 hard-currency cash position. In fact, the level of reserves has more than been tripled in both krona and euro terms since 2007 – and it has never been stronger.

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 in the wake of the 2008 crisis. Of relevance to the balance of payments, and as a product of the banking system's harsh resolution, Iceland's gross external debt has been cut from the equivalent of 250 percent of GDP in 2013 to about 130 percent of GDP this year. Iceland's net international investment position has swung from a *negative* 200 percent of GDP in 2008 to just about zero at present.

Having more than met their own preconditions for liberalization, the authorities have begun to ease the capital control regime. This year, Icelandic pension funds are being allowed to invest abroad the equivalent of 570m euros, up from less than 100m euros in 2015. And in recent days, individuals and companies have been authorized to invest abroad up to the equivalent of a quarter-million euros through year-end, increasing to the equivalent of 810,000 euros in 2017. Furthermore, at the turn of the year, they will also be authorized for the first time to transfer deposits and securities to and from Iceland, to trade in securities abroad, and to purchase or withdraw foreign currency in cash – within the aforementioned ceiling, of course. It's a modest start, but a very welcome one for an island whose residents historically were very much connected to the international financial system.

In sharp contrast, the authorities came up with a coercive and punishing scheme for the so-called offshore krona investments, which have been trapped inside Iceland since 2008 by the capital controls. As of the end of May, these foreign investments were officially estimated at 319bn krona, equivalent to 2.3bn euros as of that date. To put the figure in context, this amount of trapped investments was equivalent to 45 percent of the CBI's net foreign assets of 704bn krona, or 5bn euros, as of end-May – so it's not like the authorities didn't have spare euros and dollars to sell to these investors in return for their krona holdings at the market exchange rate.

Nevertheless, foreign investors were given a chance to exit their positions and access foreign exchange only if they would agree 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 now 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 to the government. 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 were one-fourth of total offshore krona outstanding, and they suffered "haircuts" of 38 percent. Apparently, the owners of three-fourths of offshore krona funds – 236bn krona or 1.9bn euros – are digging in for a long fight. But 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. And sure enough, if you want to invest in Icelandic bonds or bank deposits right now, you must do so for a minimum of one year and 40 percent of your investment will be frozen upon arrival in a blocked account paying zero interest. In other words, the authorities in Reykjavík are phasing-in new controls on capital *in*flows while 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 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 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!

I sure hope that, in the wake of the recent parliamentary elections in Iceland, the new government will reconsider and embrace a more reasonable solution that will signal the country's reintegration, rather than its retreat, from financial markets.