EMTA SPECIAL SEMINAR:
ICELAND'S SELECTIVE DEFAULT?

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EMTA
360 Madison Avenue, 17th Floor
New York City

12:00 PM - 2:00 PM - Panel Discussion

James Glassman (American Enterprise Institute) – Moderator
Arturo Porzecanski (American University)
Lee Buchheit (Cleary Gottlieb Steen & Hamilton)
Magnus Arni Skulason (Reykjavik Economics)

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

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 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 put in their crosshairs the foreign financial investors who years ago were courted by the government and the private sector, to buy government and corporate bonds and acquire other financial assets, such as stocks and bank deposits. These are 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.

And I have been told that the leading investors, some of them members of EMTA, have expressed to the government their willingness to depart from Iceland in a gradual and orderly manner over a period of several years. They have also reportedly offered to exchange their krona for a government bond denominated in dollars, rather than insisting on cash up front.

The problem is that the government in Reykjavík is vindictive, and it wants to inflict heavy damage on these creditors too, as if they had been responsible for the country's banking crisis. Therefore, offshore krona investors were recently given a one-time chance to exit their positions and access foreign exchange by agreeing to a departure tax of between 35 and 60 percent on their holdings.

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 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, and a rate less than inflation. Foreign investors spurning the auction were warned by the authorities to expect to languish in these creditor prisons for "many years."

Now, I don't know about you, but this smells to me like the kind of coercive, punishing debt exchanges that we saw orchestrated by Argentina in 2005 and 2010, and in Greece in 2012. If I am a holder of Icelandic government bonds, instruments which figure heavily in the portfolios of offshore krona investors, and I'm offered a one-time, take-it-or-leave-it choice between accepting a huge haircut upfront or being bled by a thousand cuts over time, doesn't it smell the equivalent of having to choose between a Discount and a Par bond?

In fact, the authorities have admitted that they initially considered an offer to exchange trapped assets, mainly maturing 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 concocted to avoid the appearance of a distressed debt exchange that would be classified as a sovereign default. That's why I speak of Iceland being engaged in a Selective Default.

In the event, the auction, which took place a couple of weeks ago, 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 totaled a little more than one-fifth of total offshore krona outstanding, and as a result, it looks like the owners of four-fifths of offshore krona funds are digging in for a long fight.

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, 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 couple capital controls on outflows with new controls on inflows.

This is the situation we're here to discuss.