

18 September 2014

## **Progress of the Plan for Removal of Capital Controls**

A report as provided for in Act No. 16/2013 of the Icelandic parliament *Althingi*

This report is published by the Minister of Finance and Economic Affairs as provided for in Act No. 16/2013 of the *Althingi*:

[The Minister shall make public a report on the progress of plans to remove restrictions on cross-border capital movements and foreign currency trading at six-month intervals until such restrictions are finally removed. The report referred to in the first sentence shall be published for the first time within six months of the entry into force of this Act.]

The first of the reports provided for in the Act was published on the website of the Ministry of Finance and Economic Affairs on 17 September 2013<sup>1</sup>. A second report was published on 17 March 2014.<sup>2</sup> Reference is made to the previous reports for a general discussion of the background of the capital controls, their purpose and the main aspects of the plan for their removal.

### **New advisors and organisation of the programme**

At the beginning of July 2014 the Ministry of Finance and Economic Affairs, after consulting with the Ministerial Committee on Economic Affairs and the Steering Group on Removal of Capital Controls, concluded an agreement with the legal office Cleary Gottlieb Steen & Hamilton LLP, the consultants White Oak Advisory LLP, and economics professor and former IMF deputy managing director Anne Krueger of Johns Hopkins University, to work with the Icelandic authorities on removing capital controls. Attorney Lee Buchheit of Cleary Gottlieb Steen & Hamilton will direct the legal office's work on this project. The engagement of these foreign advisors is part of the government's work to relieve the economy of capital controls.

At the beginning of July the Minister of Finance and Economic Affairs furthermore engaged four experts to work with the above-mentioned advisors on behalf of the Steering Group. They are Benedikt Gíslason, advisor to the Minister of Finance and Economic Affairs on capital controls, Supreme Court attorney Eiríkur Svavarsson, Freyr Hermannsson, head of the Central Bank's treasury section, and Glenn V. Kim, who will lead the team. This four-man executive committee has worked closely with the foreign consultants for the past two months towards an overall solution which would include all aspects of the capital controls and will deliver specific proposals on options for their removal to the Steering Group. The work involves both legal and economic issues, and in particular the macroeconomic conditions for removal of controls and granting of exemptions.

---

<sup>1</sup> <http://eng.fjarmalaraduneyti.is/media/frettir/Progress-of-the-Plan-for-Removal-of-Capital-Controls.pdf>

<sup>2</sup> <http://www.fjarmalaraduneyti.is/frettir/nr/17803>

The consultation committee on removal of capital controls, comprised of representatives of parliamentary groups, has been kept informed of the progress of events. Its members are Árni Páll Árnason, of the Social Democratic Alliance; Bjarkey Gunnarsdóttir, of the Left-Green Movement; Frosti Sigurjónsson, of the Progressive Party; Guðmundur Steingrímsson, of Bright Future; Jóhann Haukur Gunnarsson, of the Pirate Party; and Vilhjálmur Bjarnason, of the Independence Party. Tómas Brynjólfsson, director general in the Ministry of Finance and Economic Affairs, chairs the committee while Steindór Grétar Jónsson, specialist in the same Ministry, is its secretary.

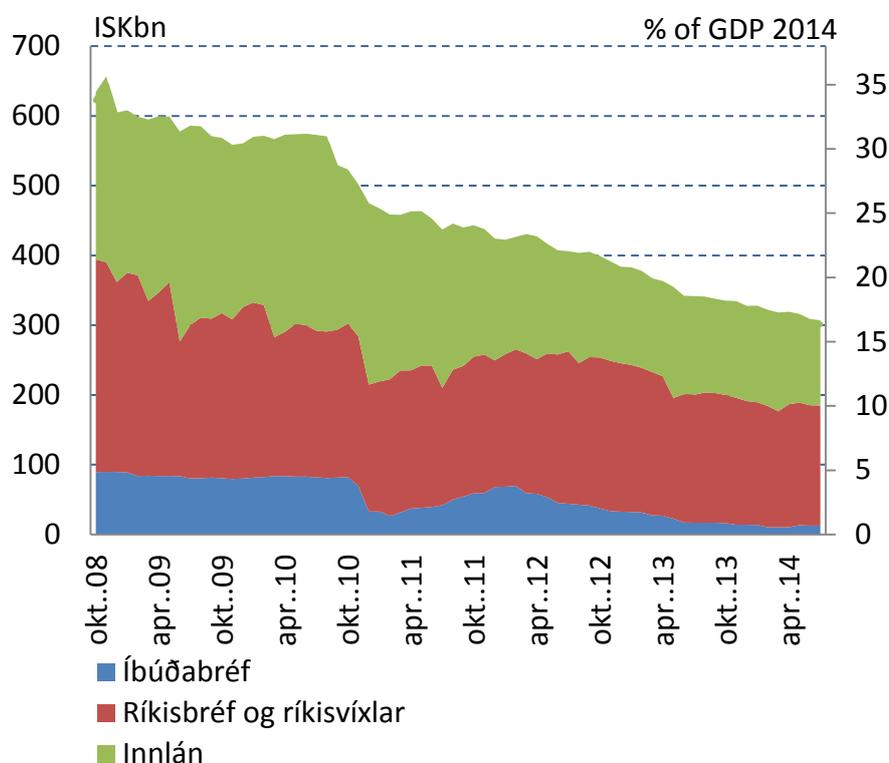
### **FX auctions of the Central Bank of Iceland**

The Central Bank of Iceland has continued its FX auctions in accordance with its programme for removal of capital controls published in March 2011. The auctions are intended to reduce the stock of ISK assets held by non-residents, so-called offshore ISK. Auctions of Treasury securities for foreign currency began in the summer of 2011, and the first auction of the Investment Programme was held in February 2012. A total of 22 auctions of Treasury securities have been held and 20 auctions have been held under the Investment Programme. In both cases investors oblige themselves to hold the investment for at least five years. When auction participants are divided into residents and non-residents it turns out that 36% of the total amount was from domestic and 64% from foreign investors. In this analysis, foreign companies owned by Icelandic residents were classified as domestic investors. During this same period an additional 21 auctions have been held inviting bids from non-residents wishing to sell their ISK assets in exchange for FX which is exempt from repatriation obligations. The most recent auction was held on 2 September 2014 and no further auctions have been announced.

Through these auctions and extraordinary transactions concluded by the Central Bank of Iceland it has been possible to reduce the amount of offshore ISK since the autumn of 2008 from over 40% of GDP in 2008 to 16% of GDP at mid-2014.

## Non-residents' short-term ISK assets

Octóber 2008 - July 2014



Sources: Statistics Iceland, Central Bank of Iceland

3

### Investment Programme

In the Investment Programme auctions investors can purchase ISK 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 FX market. To date investors have brought EUR 982 million, or ISK 186 billion, into the country through the Investment Programme, with over 2/5 of this amount passing through the domestic FX market. Total foreign investment under the Investment Programme amounts to over 10% of Iceland's 2013 GDP. Around 46% of this capital inflow through the Investment Programme has been invested in bonds, around 41.1% in equities, 12.2% in real estate and around 0.7% in UCITS.

### Treasury securities option

One of the objectives of the Treasury securities option was to ensure refinancing of Treasury debt and extend its repayment profile. When the Treasury securities option was established, it was

<sup>3</sup> Íbúðabréf = HFF bonds, Ríkisbréf og -vixlar = Treasury notes and bills, Innlán = Deposits

considered important to ensure the sale of Treasury paper to new investors to replace those non-residents wishing to transfer their capital out of the country. The Treasury securities option was directed primarily at pension funds, encouraging them to exchange foreign assets in return for long inflation-indexed Treasury bonds. In more recent auctions the pension funds have not been as interested in the Treasury securities option as they were in the beginning and have been replaced by other buyers. Investors have invested a total of EUR 261 million in Iceland through the Treasury securities option, or ISK 56.4 billion, based on the auction price in each instance. Of this amount, ISK 32.7 billion, equivalent to 58% of the total amount sold, was sold in two of the three first auctions.

### **Sales of ISK for EUR**

Auctions of EUR in exchange for ISK are intended to provide a route for non-residents wishing to exit the country. In 21 auctions a total of ISK 401.7 billion have been offered for sale, of which the Central Bank has purchased ISK 145.9 billion or just over 36% of the total amount offered. The amount of ISK acquired by the Central Bank for FX in each instance is determined by the quantity of the foreign currency offered for sale through the Treasury securities option and Investment Programme. In this manner the impact of the auctions on the currency reserves is kept to a minimum. The auction price is determined following the three auctions on the auction date. In 2011 two such auctions were held, with the exchange rate ISK 210 per euro. The price remained fairly steady in 2012, at ISK 240 per euro, but has decreased since then. In 2013 the price fluctuated between ISK 210 and 230 per euro, while this year it has fallen still further. In the most recent auction, on 2 September this year, the auction price was ISK 181 per EUR.

### **Amendments to the Foreign Currency Act**

In May, the Icelandic parliament *Althingi* passed amendments to Act No. 87/1992, on Foreign Currency. The objective of the amendment was to remove all doubt that legal entities could be penalised for violations of the Act or Rules adopted by virtue of it. The definition of the concept of dividend, in the understanding of the Foreign Currency Act, was also amended.

The authorities are examining possible further amendments to the Act on Foreign Currency with a view to relaxing and simplifying its implementation for the benefit of individuals.

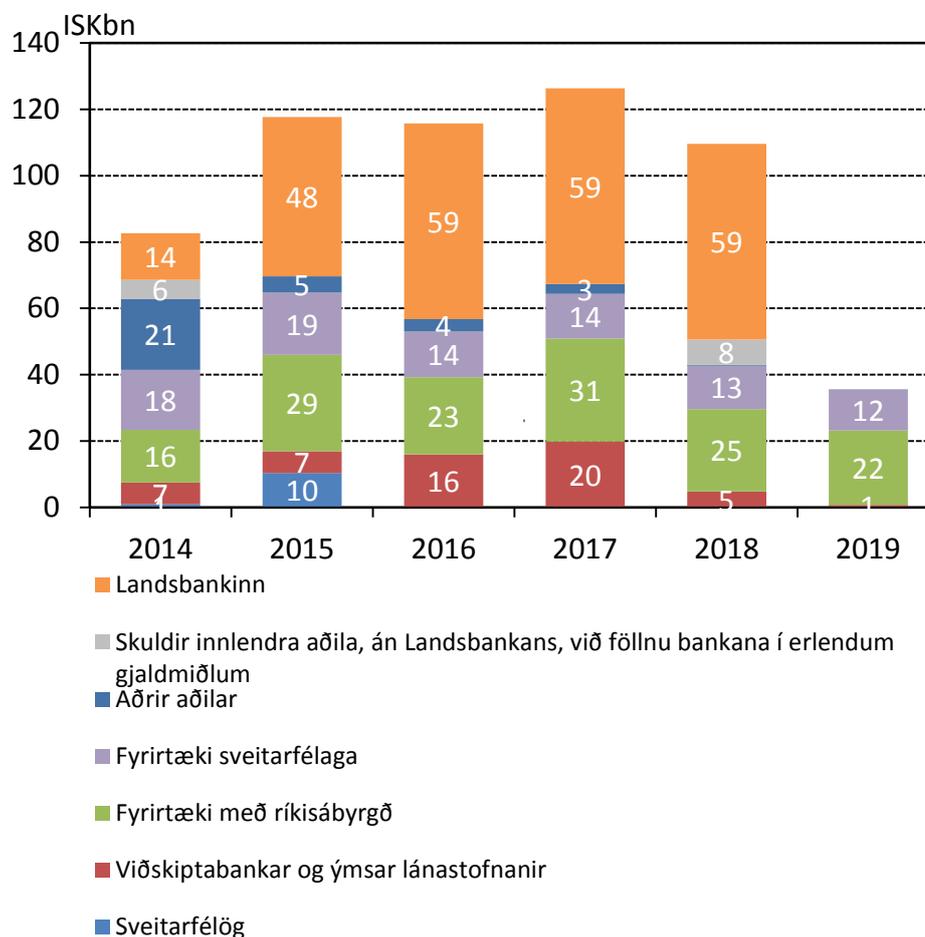
### **Pension funds' investments abroad**

Pension funds' investment authorisations are currently being examined in the Ministry. Before the controls are fully removed the question of setting "speed limits" on the increase in pension funds' foreign assets will be examined, as the Central Bank has requested. In this respect, however, concerns to limit the outflow from Iceland conflict with the rationality of allowing the funds to once more build up an international asset portfolio with diversified risk, as these funds hold the lion's share of the savings of the Icelandic public.

According to information from The Icelandic Pension Funds Association, at year-end 2013 the foreign assets of Icelandic pension funds as a ratio of their net funds for payment of pensions was around 22.4%. During the past four years (2010-2013) net contributions to the funds, i.e. contributions net of pension payments, have totalled over ISK 40 billion. If it is assumed that the funds fully avail themselves of their authorisations to re-invest abroad, that the ISK exchange rate remains steady, and that returns on domestic and foreign assets will be the same, the funds would have to invest 22.4% of their net contributions, or around ISK 9 billion, annually in foreign assets to maintain their current proportion of foreign assets.

In the Association's estimation, it is unacceptable for the long term for the pension funds' proportion of foreign assets to be less than 40% and it would be desirable to have it higher, or close to 50%. For it to be possible to increase the share of pension funds' foreign assets substantially in coming years, therefore, it is important to create as soon as possible the conditions for an active FX market and the removal of capital controls is a key step towards this end. Under current circumstances, purchases by pension funds or other parties of FX for additional tens of billions of ISK each year would be added to instalments by domestic parties on foreign loans (see the figure below) and would therefore put significant pressure on the ISK exchange rate, thereby eroding possible gains on foreign investment.

### Estimated instalments on foreign loans and debt in foreign currencies owed to the failed banks, other than those of the Treasury and Central Bank<sup>1</sup>



1. Based on the situation and exchange rates as of 26/02/2014

Source: Central Bank of Iceland

4

### More robust financial stability framework

A more robust financial stability framework is one of the premises for removing capital controls successfully. In this connection it is worth mentioning that the first meeting of the newly established Financial Stability Council was held in the Ministry of Finance and Economic Affairs on Wednesday, 10 September 2014. The Financial Stability Council is a formal co-operation forum of public authorities for financial stability. The Council serves as venue for consultation, exchange of information and policy formulation on financial stability and co-ordinates the preparedness of public

<sup>4</sup> Landsbankinn – Debts of other domestic parties owed to the failed banks in FX – Other parties – Municipal corporations – Enterprises with state guarantees – Commercial banks and various credit institutions – Municipalities

authorities for financial crises. The Financial Stability Council is comprised of the Minister of Finance and Economic Affairs, who acts as chairman, the Central Bank Governor and the Director General of the Financial Supervisory Authority.

The principal tasks of the Financial Stability Council are the following:

1. to formulate public policy on financial stability;
2. to assess economic imbalances, financial system risks, undesirable incentives and other circumstances liable to jeopardise financial stability;
3. to define those actions, other than implementing the Central Bank's monetary policy management tools, which are considered necessary at any given time to influence the financial system with the objective of reinforcing and safeguarding financial stability;
4. to confirm definitions of systemically important regulated entities, infrastructure and markets of such nature that their activities can impact financial stability.

Apart from its regular meetings, the Council convenes to provide a formal governmental consultation body when a financial crisis is seen to be imminent or has struck, or when there is a risk of events which could result in major contagion effects.

#### **Outlook for removal of controls**

Conditions have become more favourable for taking the next steps towards removal of capital controls since the last report in March 2014. The Treasury currently has ready access to foreign credit markets, as the issue of euro-denominated Treasury notes in July this year has confirmed. Credit terms have continued to improve as the year progressed. The Central Bank's regular FX purchases have been successful and were stepped up further in the summer months. Since the beginning of this year the Central Bank's net FX purchases are equivalent to ISK 73.9 billion. A budget surplus in 2014, no further increase in debt and a continuing reduction of Treasury debt relative to GDP in coming years, for instance, in accordance with the 2015 budget bill and the state's Medium-term Fiscal Programme, are important steps towards removal of capital controls.