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Plan for lifting capital controls

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Unacceptable capital controls

The lifting of capital controls is the most pressing issue for the Icelandic economy. Foreign exchange controls were initially imposed with Act number 134/2008 subsequent to the Central Bank of Iceland having already, on 10 October 2008, issued recommendations for temporary restraint on the outflow of currency. Since then, controls have variously been tightened or extended, most recently with Act number 17/2012, where among other things, the bankruptcy estates of the old banks were brought within the scope of the Act. Now there is a new Bill (item number 731/2012) under debate in the Althingi where authorisation is relaxed, but penalties increased.

The capital controls are intended to keep up the value of the ISK as it is feared that foreign holders of monetary assets in ISK will exchange them in very large amounts over a short period of time, for foreign exchange. Capital controls have in reality quite the opposite effect in the long-term. They create persistent pressure for the reduction of the exchange rate of the ISK because of the limitations on supply of foreign exchange that they cause. This means that parties to the market will rather not exchange foreign currency for ISK except for the purposes of paying domestic costs and repayments of loans or to purchase assets. The returns from Icelandic companies' business with foreign parties thus gradually accumulates in assets in foreign currencies, while the general public seeks to buy and save foreign currency because they fear devaluation of the ISK. Ownership of ISK by foreign parties increases steadily as a result of their earnings on the domestic financial market.

Foreign exchange controls and their implementation create a variety of problems in the economy. Icelandic companies' access to foreign finance is limited. Parties that bring capital into the country in accordance with the Central Bank of Iceland exemptions, gain a certain competitive advantage over domestic parties on the market. The implementation of capital controls will inevitably develop into a manipulated system, characterised by discrimination and arbitrary decisions. The controls create a lack of confidence in the Icelandic economy and government, repel foreign investors from the country and limit the growth of domestic companies, e.g. on foreign markets. The greatest damage caused by the controls is however by nature hidden, being embodied in investments and growth that never come to fruition. Continuous reduction of the exchange rate as a result of the controls, and the attendant inflation and wage increases, result in a situation where the competitive position of Icelandic companies becomes dire.

The controls need to be continuously tightened as the ISK is avoided by parties to the market and as its exchange rate continues to fall. The most recent tightening of the controls was where foreign parties were no longer authorised to exchange domestic indexation earnings for foreign currency. The next steps will possibly be to impose controls on the possibilities for exchanging interest income and to introduce an obligation for exporters to exchange their foreign currency income, which they are currently authorised to keep in Icelandic foreign currency accounts.

The current Central Bank of Iceland plan is to lift the controls in cautious, unscheduled steps, with the objective of avoiding the collapse of the ISK when they are lifted. This plan is not credible and will not return the intended results. This is demonstrated by the experience of the banks' foreign-exchange calls for tenders and investment channels. The amounts in question there are only a fraction of the problem that remains to be solved.

The necessity for a credible plan

The key pre-requisite for a credible plan for the lifting of capital controls is to follow a strict timeline where the risk of a fall in the currency rate is taken. The fact that foreign owners of ISK expect a drop in the currency rate and resulting depreciation of their assets in foreign currency, are the main catalyst for their desire to sell ISK fairly rapidly and at a discount. The greater the expectation of a drop in the ISK exchange rate, the easier and less expensive it will be to release the frozen ISK assets of foreign parties.

Potential reduction in the exchange rate increases inflation and erodes purchasing power, but this has to be weighed against the previously mentioned damage resulting from the controls and the cost to the national economy from paying foreign parties their ISK assets at a higher rate than with this method, given that the controls will be lifted in the coming years.

Then one must keep in mind the fact that the ISK exchange rate will probably correct itself fairly rapidly should it fall with the lifting of capital controls. The reason is that the frozen ISK assets of foreign parties are a one-off problem and after these assets have been bought and sold the exchange rate of the ISK will be decided first and foremost by the flows of imports and exports and by capital flows (given that monetary policy will be formulated in a manner that does not bring the return of carry trade).

Timing

The Althingi passed legislation on the lifting of capital controls at the beginning of October 2012 that will come into force on 1 January 2013. It provides for authorisation for domestic parties to buy ISK assets abroad, the issue by the state of Eurobonds in return for government guaranteed bonds held by foreign parties, bank authorisation to issue Eurobonds in return for deposits in bank accounts, exit levy and mitigating measures.

Measures for lifting controls

Before the controls can be lifted, trades with frozen ISK assets held by foreign parties need to be mostly completed. This considerably lessens the likelihood of a pressure build-up for the reduction of the ISK exchange rate.

The methodology for lifting controls would involve the issue of government guaranteed bonds and the bank bonds in foreign currency, increased authorisation for domestic parties to purchase ISK assets located abroad, mitigating measures for indebted households to weigh up against a possible increase in inflation resulting from the fall of the ISK, and taxation measures to fund such mitigating measures.

Market actions

1. Domestic owners of assets in foreign currency will be authorised to buy the ISK assets of foreign parties. These trades will be specially registered by the Central Bank of Iceland and will be taxed with 2% to 5% turnover tax. Foreign exchange trades will be made at the Central Bank exchange rate and assets will change hands with a discount of for example, the proportional difference between the registered exchange rate and the offshore exchange rate. (The Central Bank needs to give an exemption from Article 13 of Act 87/1992 on foreign exchange, see Article 7 of the Act, for such trades to be authorised.)

2. The government shall issue bonds in foreign currency for a term of 10 to 20 years, which will be registered on the bond markets and which shall be offered to foreign owners of government guaranteed bonds in ISK. The Icelandic government guaranteed bonds are to be available with the above specified discount and 2% to 5% turnover tax will be imposed on the trades.

3. The banks will be authorised to convert deposits of foreign parties to term deposits in foreign currencies for a term of 5 to 10 years or to bonds in foreign currencies for an analogous term with a specified discount on the ISK deposits. These trades will be taxed with a 2% to 5% turnover tax.

4. Negotiation should be started with the winding up committees of the old banks for the purchase of their 75% holding in the new banks against payment in foreign currency.

5. Agreements will be made between government and the pension funds that they only make modest foreign investments in the first instance or until equilibrium has been reached on the foreign exchange market.

6. After unrestricted trading in foreign exchange has been authorised anew there will be a temporary imposition of an exit levy on the purchase of foreign exchange by foreign owners of government guaranteed bonds and on deposits amounting to at least the proportional difference between the registered exchange rate of the ISK and its offshore rate, in order to inhibit the outflow of foreign exchange. The level of taxation necessary, and for how long it has to be imposed, will depend on the level of success in achieving equilibrium on the foreign exchange market. In a best case scenario the tax will not be necessary at all.

Mitigating measures

Indebted households will be protected against an increase in indexation payments on indexed loans with special interest subsidies that will be funded with the above-mentioned turnover tax. ("Special interest subsidies to weigh up against a possible increase in inflation resulting from the fall of the ISK in connection with the lifting of capital controls"). Interest subsidies will be decided on the basis of income and net assets in the same manner as the interest subsidy system. The households in the most difficult situation will receive a full subsidy for the increase in indexation payments and in interest payments in excess of a specific reference, which will be based on inflation that one could normally have allowed for. The methodology would in the first instance be based on tax returns from the preceding year and the final settlement on the basis of tax returns for the current year taking into account price increases and salaries increases.