The changing face of capital controls in Iceland

- Recent comments by Icelandic political leaders have suggested that limits to capital flows might be retained indefinitely to prevent build-ups of external imbalances and stem future hot-money inflows from currency speculation and carry trading. The goal of such controls will be to strengthen the monetary policy framework and reduce financial- and macroeconomic stability risks. Such prudential capital flows management measures will most likely be sharply distinct from the strict controls now in place. Based on CBI publications and research, we try to envisage the currency regime that will come to replace capital controls, providing details to the rather vague descriptions already given by politicians.

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In a recent Bloomberg interview[1], newly appointed Minister of Finance Bjarni Benediktsson was quoted as saying:

> *"It's possible that Icelanders will, in the same way as other countries are contemplating, impose limits on derivative trades with the currency. [The nation may also] place a limit on Icelandic banks gathering foreign exchange in foreign branches. This can be considered as some kind of restriction on capital flows, but we can also view this as a normal part of managing the currency."*

This is partly synonymous with views[2] expressed publicly by former Minister of Finance Katrin Juliusdottir (albeit slightly more delicately put):

> *"There's a risk that while Iceland continues to use the krona we'll always have capital controls."*

Naturally, vague comments like these have sparked interest in what exactly is meant, and what to expect of the Icelandic currency regime as controls are eased – however long until that might happen. Luckily, there is a range of recent domestic and international research detailing the position of both the authorities and international institutions overseeing cross-border capital flows, enabling us to paint a relatively detailed picture of things to come.

IMF view

The view of the IMF on capital flows management measures (CFMs) has undergone extensive revision since the Southeast Asian currency crisis in the late 1990's, culminating in an update to the Fund's institutional view last November[3] which encompasses a softer stance towards imposing limits on cross-border capital flows.

First off, it should be noted that the Fund clearly distinguishes between capital controls as a crisis response tool, i.e. to stem disruptive outflows of capital, and as a tool to safeguard systemic financial stability, i.e. to stem rapid large inflows, counter balance sheet mismatches in foreign currencies etc.

In our view, statements by Icelandic authorities such as the ones above should not be viewed as reduced commitment to lifting the stringent capital controls in place (on the contrary, the Prime Minister of the new center-right government has recently pledged to propose an updated plan to liberalize capital accounts as soon as this fall), but rather as statements of intent to introduce a set of macroprudential measures to influence capital flows once controls are eased.

The institutional view is that such permanent measures should: (a) not be used as a substitute for necessary macroeconomic adjustment; (b) be the most effective, efficient, and direct, and the least distortive, in addressing the policy objective; and (c) seek to treat residents and nonresidents in an even-handed manner.

Overall, we believe the measures proposed by the CBI (see below) more or less meet the criteria suggested by the IMF.

CBI view

The Central Bank of Iceland has been advocating the implementation of more tools than just the policy rate since 2010, as interest rate setting can prove inadequate to maintain financial- and macroeconomic stability in addition to price stability. The Ministers of Finance's comments should therefore come as no surprise, as The Bank has released two reports proposing that macro-prudential tools be added to its toolkit as a part of more extensive changes to the monetary policy framework dubbed *Inflation Targeting Plus*[4].

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[1] See Derivatives Traders Targeted in Iceland Currency Experiment
[2] See Iceland Sees End of Krona Days as Joining Euro Only Option
[3] See THE LIBERALIZATION AND MANAGEMENT OF CAPITAL FLOWS: AN INSTITUTIONAL VIEW
[4] See Monetary policy in Iceland after capital controls and Prudential rules following capital controls

These proposals include:

1. **Increased FX market intervention.** This obviously doesn't quite count as a CFM measure, but nevertheless influences capital flows, in part due to interventions' effect on exchange rate expectations. The CBI has already implemented this pillar of the new monetary policy framework, and is currently operating a sort of "managed float" regime akin to that of the Central Bank of Singapore, with the goal of reducing ISK fluctuations. One prong of the interventions includes using large capital inflows to strengthen reserves, rather than letting the ISK appreciate unsustainably.

2. **Stringent FX liquidity requirements and mismatch constraints.** FX mismatch constraints have already been tightened, with open FX positions being limited to 15% of the capital base. Further changes might include changes to the definitions of FX assets and liabilities to incorporate risks from lending to unhedged parties, as well as requiring financial institutions to seek long term financing of their long term assets to reduce maturity mismatches and fulfill liquidity requirements in each currency seperately.

3. **Limits to deposit taking by foreign branches of domestic financial institutions.** This will further serve to reduce maturity mismatches in foreign currency and underline that the CBI will act as a lender of last resort in ISK only. Regulation might include several measures to reduce the attractiveness of such foreign financing by imposing high liquidity- or reserve requirements on foreign deposits, by allowing the Icelandic Depositors' Guarantee Fund to settle claims solely in ISK, or by simply banning deposit taking abroad.

4. **Limits to FX lending to unhedged parties, including municipalities, firms and households.** Because of the increased default risk in the event of exchange rate fluctuations, FX lending to parties with revenue and/or assets mostly denominated in ISK might be limited by regulation, even though the originator of the loan can hedge its exchange rate risk. These limits could manifest themselves as higher loan to value or debt to income ratio requirements, or simply barring unhedged parties from FX borrowing completely.

5. **Specific tools to stem rapid inflows of hot money.** These might include a Tobin-tax or a similar tariff to widen the bid-ask spread on FX trading (one idea is to make the amount of such a tax/tariff linear to the international interest rate differential), or a cash reserve ratio against foreign investment for given periods of time. By reducing the profitability of speculating, the authorities hope to reduce stability risks from carry trading without hampering long term investment.

6. **Temporary limits to the pace of domestic pension funds' foreign investment.** To alleviate the risk of pension funds' portfolio realignment threatening exchange rate stability, some limits will probably be imposed on how fast they can build up foreign assets when capital controls are eased (this is essentially what was done when they were first authorized to invest abroad).

Our view

Although these measures reduce freedoms of domestic agents and might impose costs by impeding efficient choices and distorting outcomes, there is reason to suggest that the policy trade-off is favourable if these costs are outweighed by stability benefits. Whether that will be the case is contingent on the management and application of the tools described above.

At any rate, we find it to be almost self-evident that the above CFM proposals will be a huge improvement from the comprehensive controls now in place, not least because of their hampering effect on investment (which, in our view, bears more witness to the stigma they carry and possibly some political risk associated with conceivable changes to the controls, than their direct effect since they do not constrain new investment).

In addition, we see few risks stemming from most of these CFM proposals to international investors, since they mostly concern domestic entities and financial institutions (with the notable exception of no. 5). Although speculators might find profitable short term trades harder to find than during the carry trading boom of 2003-2007, investors with longer horizons should welcome any steps that might ease capital controls into the prudential measures described here without too much worry.

Contacts

Ásdís Kristjánsdóttir
Head of Research
Research, Investment Banking
Tel: +354 444 6968
asdis.kristjansdottir@arionbanki.is

Hafsteinn Hauksson
Analyst
Research, Investment Banking
Tel: +354 444 6993
hafsteinn.hauksson@arionbanki.is

Stefán Guðjónsson
Senior Analyst
Research, Investment Banking
Tel: +354 444 6959
stefan.gudjonsson@arionbanki.is

Fannar Jónsson
Analyst
Research, Investment Banking
Tel: +354 444 6962
fannar.jonsson@arionbanki.is

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