ICELANDIC ECONOMIC UPDATE

Arion Bank

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Stability Tax

According to the Minister of Finance we only have a few days to wait until a bill describing the removal of capital controls will be put forward. Reportedly the road ahead will entail a so-called „stability tax", a bond swap and the gradual removal of controls on the domestic market. Arion Research examines how much the government could possibly collect from the stability tax.

Capital controls: How relevant is the Malaysian experience?

When examining the effects of capital controls on the Icelandic economy there are not too many comparable situations throughout history to draw on. The Malaysian experience shares many characteristics of Iceland's while also having important distinctions. How relevant is it as a comparison?

An interest rate hike is around the corner

In its latest statement, the Monetary Policy of the Central Bank of Iceland was rather straightforward in its forward guidance when it stated that a rate hike in June was likely. Wage negotiations have come to a standstill in some industries and general strikes are planned throughout the country. The results from these negotiations will have a large influence on the MPC's decisions in the coming months.

Do capital controls have long term effects on investment?

Although Malaysia's experience with capital controls was not very long-lived compared to Iceland's could it have had a long term negative effect on investment levels in the country? As a percentage of GDP, investment in Malaysia fell more than in its peer countries after the Asian financial crisis. Is it due to an increased required rate of return due to higher country risk? Theoretically, that makes sense. Empirically, it's hard to say.

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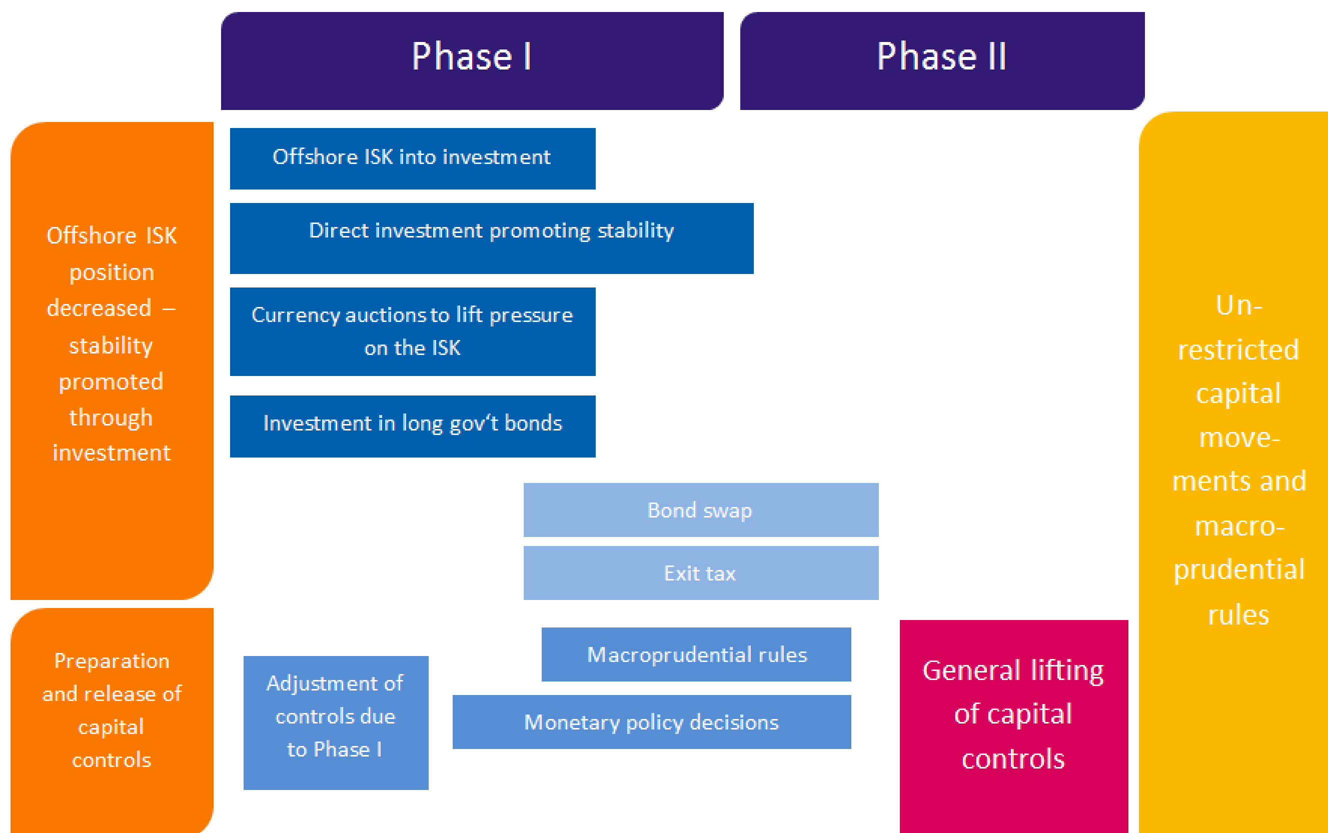
Stability tax

A bill describing the capital control lifting process will be presented to parliament in the coming days according to the Minister of Finance and Economic Affairs. The parliamentary session was originally scheduled to end on May 29, but has been extended indefinitely - members of parliament are well aware that they are not going on vacation anytime soon.

It looks like the authorities have been following their plan from 2011 and since no further currency auctions have been anounced on the CBI's part we are probably on the verge of Phase II (see below) in the capital control removal plan. A macroprudential framework has already been signed into law, albeit quite generally worded, giving the authorities some more tools to deal with potential systemic risks.

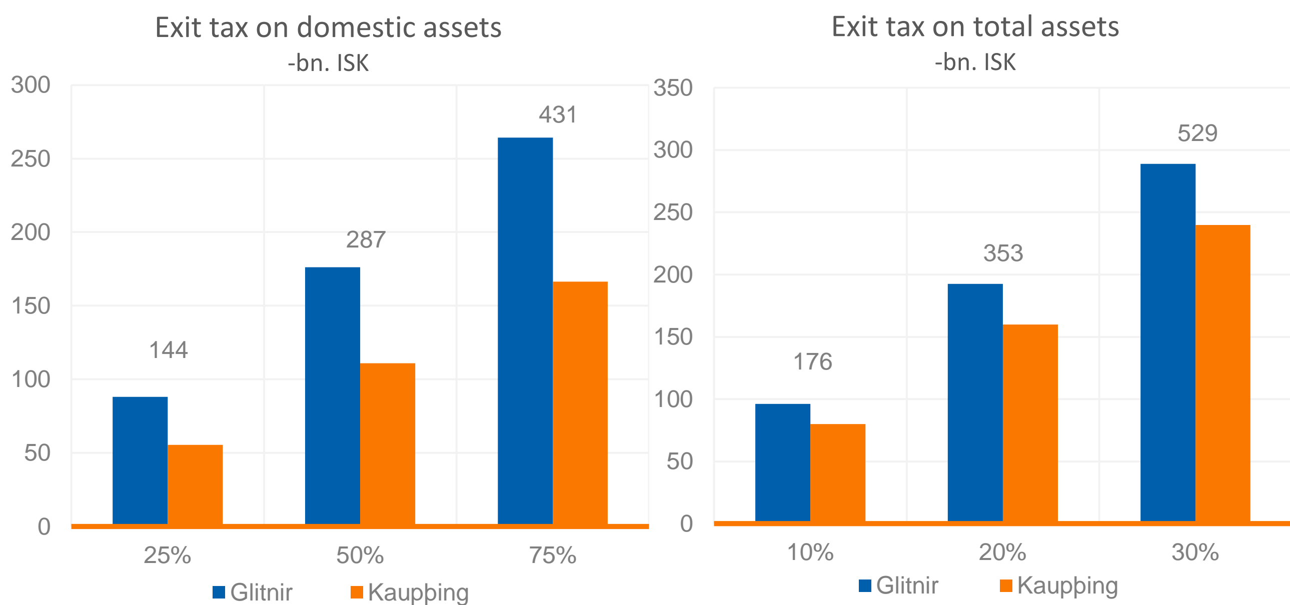


Source: Central Bank of Iceland

According to the Finance Minister in a recent radio interview the way forward will entail:

1) a so-called „stability tax" (exit tax) on the failed bank estates,
2) a bond swap (via auction) for the old overhang
3) and finally the lifting of controls on the domestic market in a few steps.

So far the authorities haven't published any details about the tax, such as who will be taxed, what kind of assets will be subject to it and what the tax rate will be. There is not a strong argument for taxing foreign assets since they do not pose a threat to Iceland's balance of payments. However, we decided to include that scenario in our analysis for comparison. In our analysis we focus only on Glitnir and Kaupþing when estimating the potential size of the tax, as when accounting for the Landsbanki bond and priority claims that have yet to be paid out from the LBI estate, the domestic assets of LBI are not as substantial as those of Glitnir and Kaupþing.

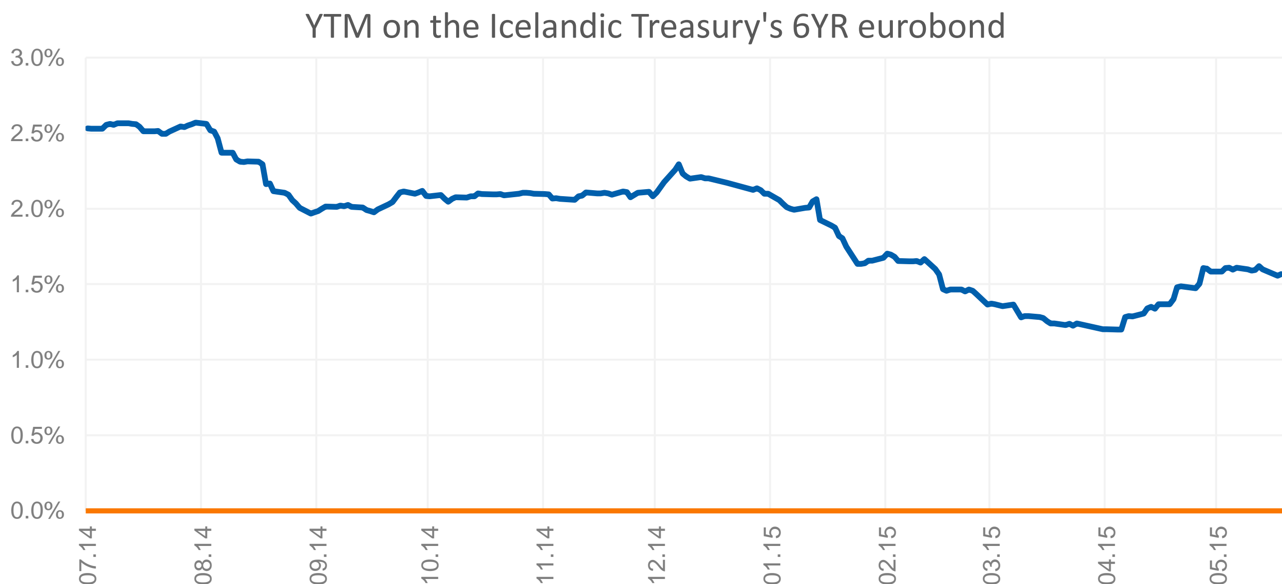


Sources: Glitnir and Kaupthing financial statements, Arion Research

Given a 25-75% tax on domestic assets the total tax collected could be in the range of 144-431 bn.ISK total for Glitnir and Kaupþing, but in the range of 176-529 bn.ISK when looking at the estates' total assets and a 10-30% tax rate. The Minister of Finance has specifically stated that the proceeds would not be used to finance the budget but would be used to pay down debt. Possibly this means that the government's debt to the CBI, which currently stands at approximately 180 bn.ISK, could be paid up.

A bond swap – at what terms?

If the government were to auction off a long eurobond now the terms would probably be rather favorable for the government. Interest rates in Europe are very low at the moment and, in addition, the credit default spread of the Icelandic government has been decreasing lately. The Treasury issued a 6-year eurobond in July of last year with a 2.5% coupon. The YTM of the bond currently stands at about 1.5%. The bond that would be issued in exchange for domestic government bonds would, however, in all likelihood be longer and would thus carry a higher interest rate.



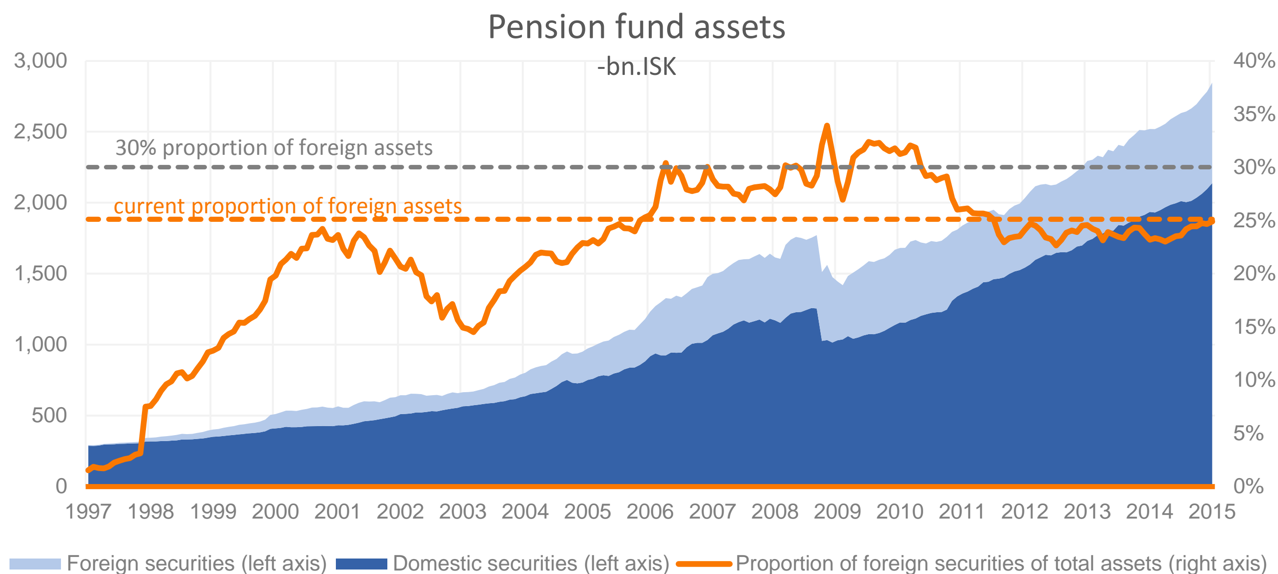
Source: Bloomberg

What about the rest?

According to the Finance Minister controls will be lifted on the domestic market in a few steps. It's difficult to guess what steps those will be exactly, but some speed limits will probably be imposed on the pension funds. One suggestion has been to allow them a certain percentage of the country's current account surplus as foreign investment.

Their foreign assets currently stand at approximately 25% of their total portfolios, which is a similar percentage as in 2006. According to a book recently published by the National Association of Pension Funds the appropriate proportion of foreign assets in the portfolios of the pension funds is closer to 40-50%, if you subscribe to modern portfolio theory. The pension funds have recently been in discussions with the Central Bank, requesting permission to invest further abroad in order to get closer to this optimal ratio.

Reportedly, the Central Bank has been quite positive towards the idea, as it should be if controls are really being lifted soon. Given the economic outlook in Iceland and current yields abroad it does seem unlikely, however, that these behemoths will all rush out with hundreds of billions of krónur at the same time, negatively affecting domestic asset markets and thus their own portfolios.



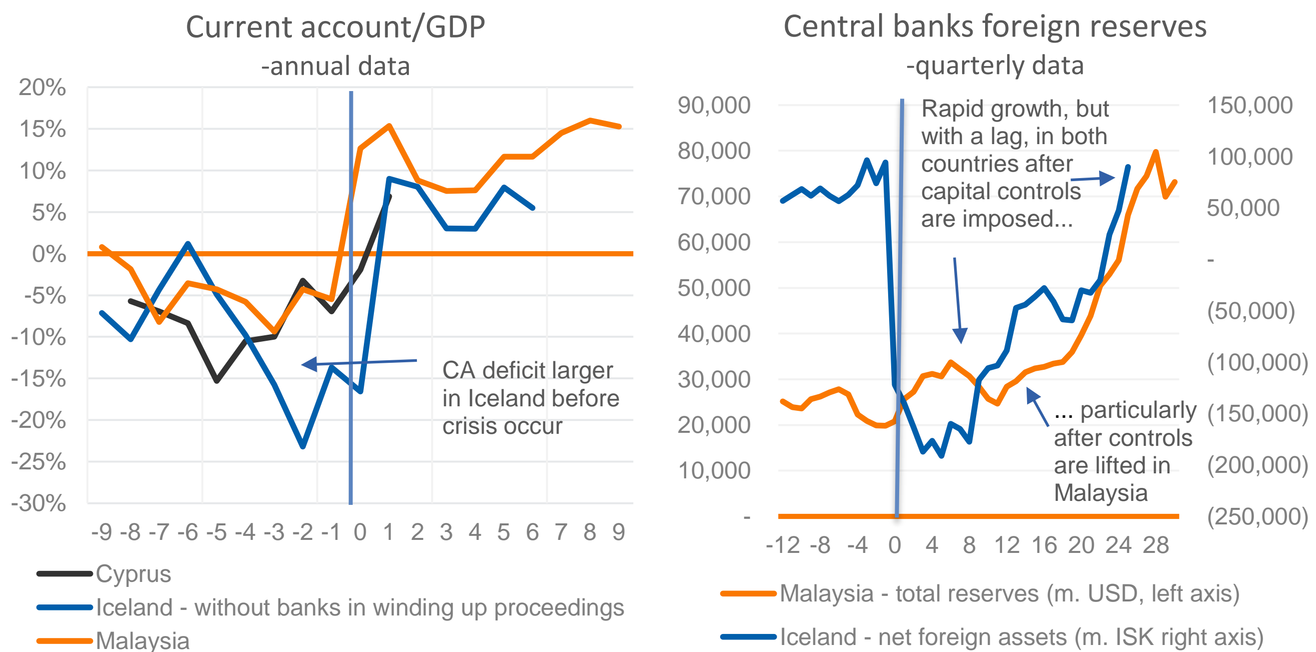
Sources: Central Bank of Iceland, Arion Research

Capital controls: How relevant is the Malaysian experience?

When trying to evaluate what kind of effect the capital controls and their ultimate abolition could have on the exchange rate of the króna and the Icelandic economy in general, there are not many comparisons to draw on from history. The Malaysian experience has often been used as a comparison, but how relevant is it to Iceland's current situation?

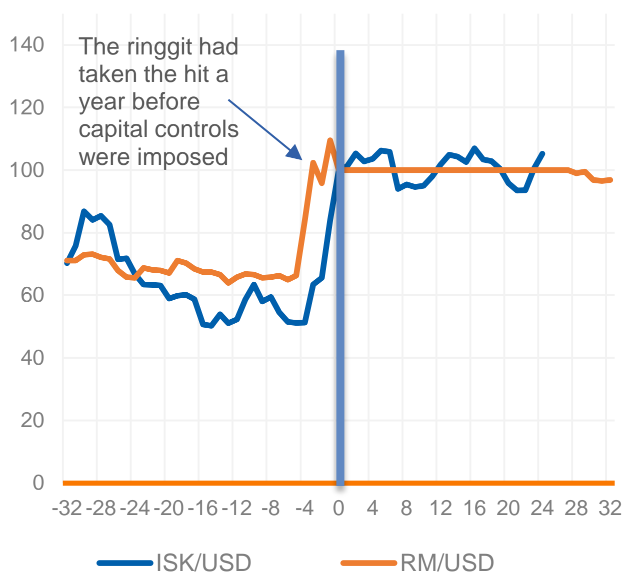
Even though there are many similarities between the currency crises of the two nations there are also important distinctions. When capital controls were instated in Malaysia the economic situation was quite different from that in Iceland. The political environment was also quite different and the restrictions were a part of a political power play at the time. The relative timing of the controls was also different – in Iceland controls were introduced approximately two months after capital started fleeing the country while in Malaysia controls weren't implemented until a year after capital outflows began and the exchange rate had already fallen substantially. The aim therefore was to create a stable environment for the lowering of interest rates and the turnaround of the economy rather than to restrict flows per se. The comparison with Cyprus is also difficult – Cyprus uses the euro and therefore did not see a large drop in its exchange rate. However, these are effectively the only comparable instances to Iceland's since they are the only capital controls instated in developed economies during a financial crisis in recent times.

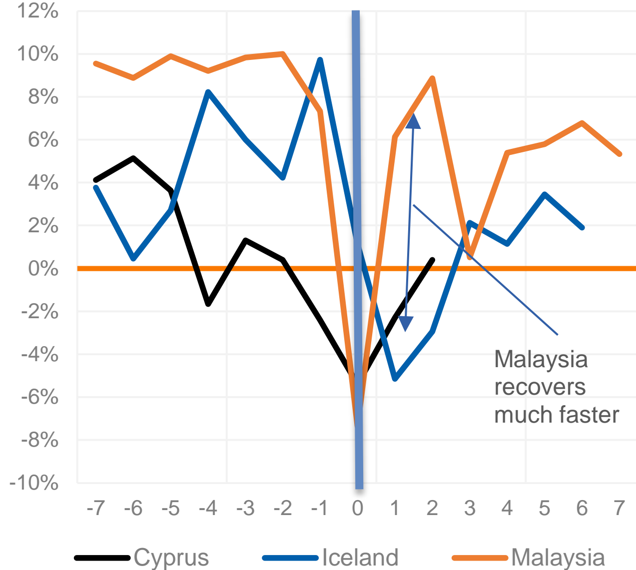
Several economic indicators have nevertheless developed similarly in these countries around the time of crisis. Part of the problem in all of these countries was that large amounts of foreign capital had accumulated and wanted out when the going got tough. This is demonstrated by the current account balance – when it is negative it means that the country is increasing its foreign debt and vice versa. Malaysia, Cyprus and Iceland all had a sizeable current account deficit in the years before capital controls were imposed.



Sources: IMF, CBI, Arion Research

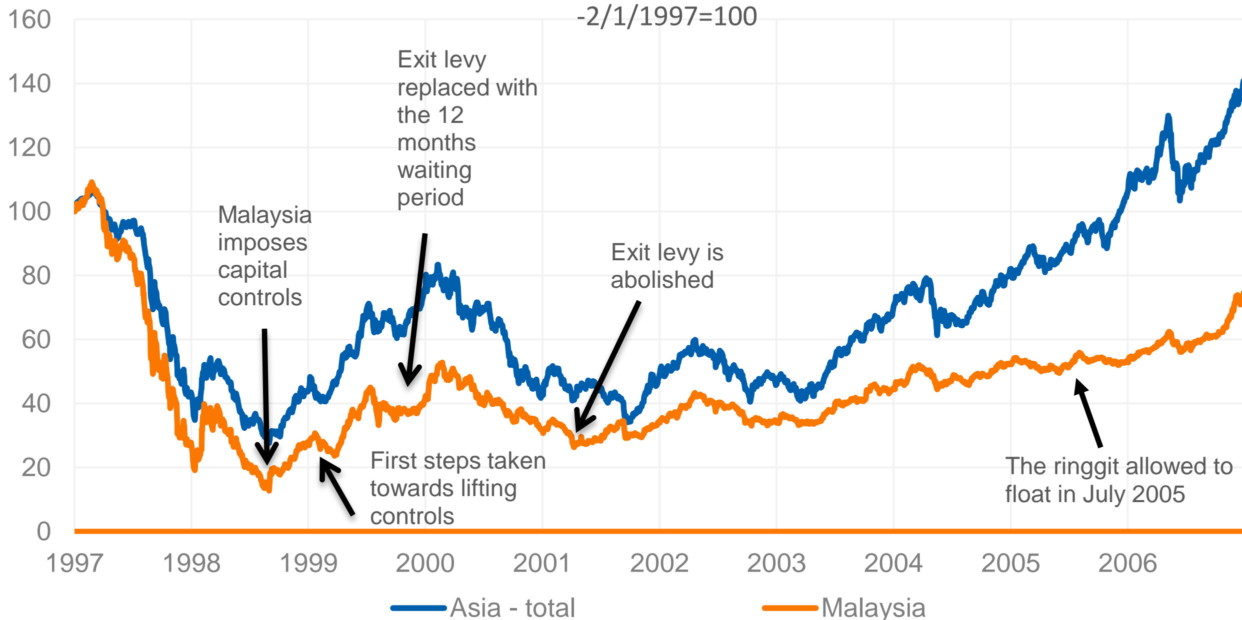
The post-crisis current account surplus allowed the Central Banks of Malaysia and Iceland to accumulate reserves, starting about 2-3 years after controls were imposed, growing at a similar pace after that. The speed and magnitude of the exchange rate drop was similar between these two countries. However, as can be seen in the graph below on the left, capital controls were not imposed in Malaysia until quite some time after the ringgit depreciated. Measured by economic growth, both Malaysia and Cyprus recovered quite quickly under the protection of capital controls, while Iceland was technically in a recession for three years after controls were imposed.





Sources: IMF, Cyprus Ministry of Finance (growth forecast for 2015), Arion Research

Malaysia lifted controls relatively quickly – the first steps were taken only months after the controls were instated. Although the economic indicators previously examined do not seem to have been too negatively affected by capital controls the Malaysian stock market underperformed noticeably in the years following the lifting of controls when compared to other Asian countries. Interestingly, the Malaysian stock market did not underperform as much while controls were in place as in the years following their abolition.



Sources: Bloomberg

Despite similarities it is rather clear that the Icelandic situation has no precedent, which makes it understandable to some extent how careful the authorities have been in preparing for removing controls. However, one can ask whether the saying that “you can never be too careful” really applies here. It can easily be argued that having had controls in place for such a long time has already caused the economy harm in the long run due to their distortionary effects on asset markets, decreased investment and the inability of Icelandic citizens to diversify their portfolios. Even though volatility in Icelandic markets might increase in the short run after controls are lifted the long run costs of keeping them will only get higher.

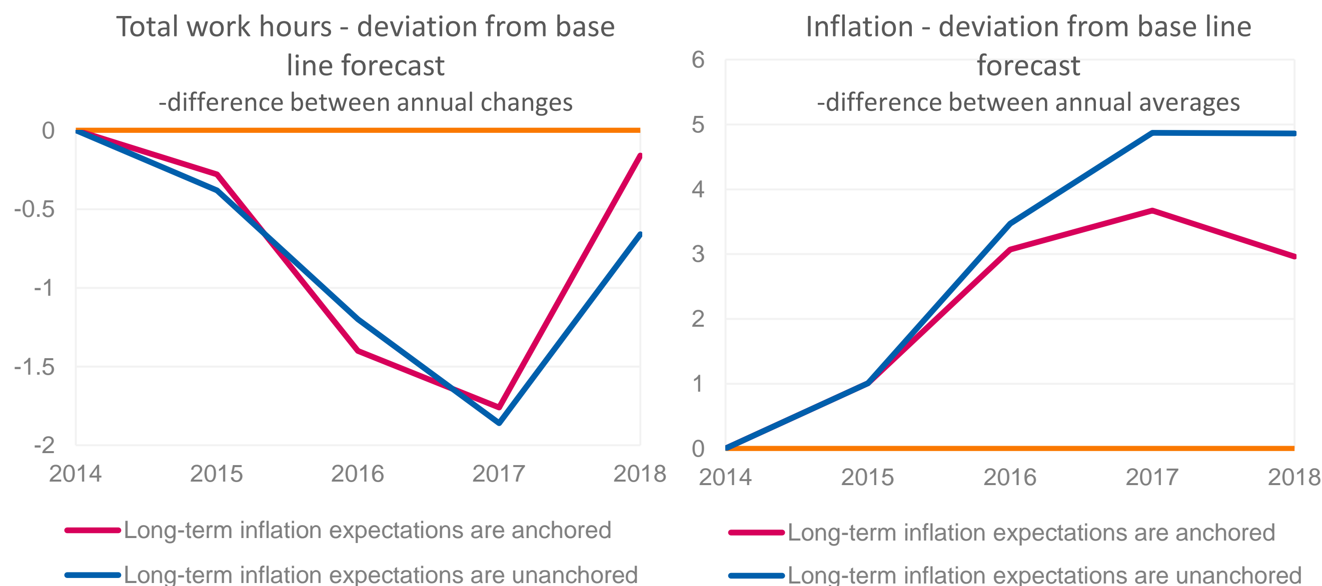
An interest rate hike is around the corner

On May 13th the CBI's Monetary Policy Committee announced it would keep interest rates unchanged. However, the committee's forward guidance was quite clear – rates will be hiked in June if wage negotiations proceed as expected. But even though inflation can possibly be contained high wage increases could cause major damage.

In the minutes from the MPC meeting, the members of the committee were clearly worried about the real effects of high wage increases on the Icelandic economy. Historically the exchange rate would adjust following such agreements, inflation would pick up and the banking sector would finance the losses of some companies, at least for some time. The situation today is different; the industrial environment has changed, there are many more small to medium sized companies (in tourism for example) and monetary policy has changed - the exchange rate would not be allowed to fall as much. Therefore, the real economy could be more adversely affected through more bankruptcies and higher unemployment.

According to a survey conducted in May most participants expected a 50 bp rate hike by the Central bank in Q3 2015, but the committee's statement indicates that it will in all likelihood react as early as Q2. One member of the committee even voted for a 50 bp rate hike in May already. The committee cited recent developments in wage negotiations, increasing inflation expectations and indicators of growing domestic demand as reasons for the explicit guidance. The MPC's guidance has seldom been as straightforward and it's quite clear that in order to prevent a rate hike results from wage negotiations will need to be more conservative than current indications suggest – an unlikely scenario.

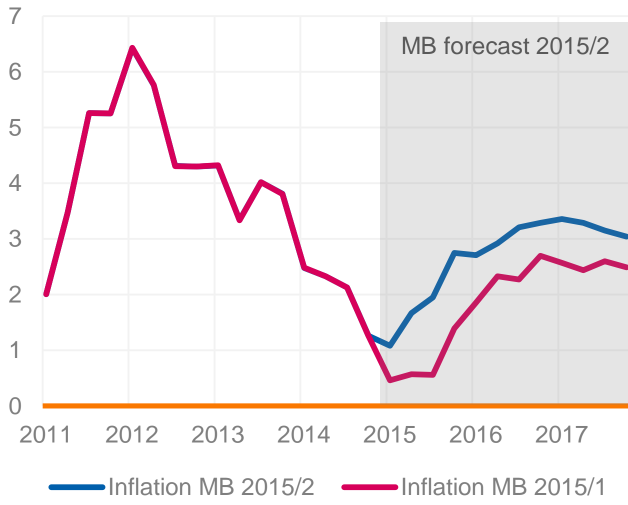
In the Central Bank's *Monetary Bulletin*, published concurrently with the MPC's statement, a scenario is presented where wages increase by 11% per year on average over the next three years, which is in line with some of the demands that have been made by the coalition of workers with university degrees for instance. In one scenario long-term inflation expectations are anchored, but in the other scenario long-term inflation expectations become unanchored, in which case the effects of wage increases on inflation become more persistent and restraining price increases becomes more difficult and costly. In the scenario where long-term inflation expectations are unanchored inflation will be up to 5% higher than in the base line forecast.



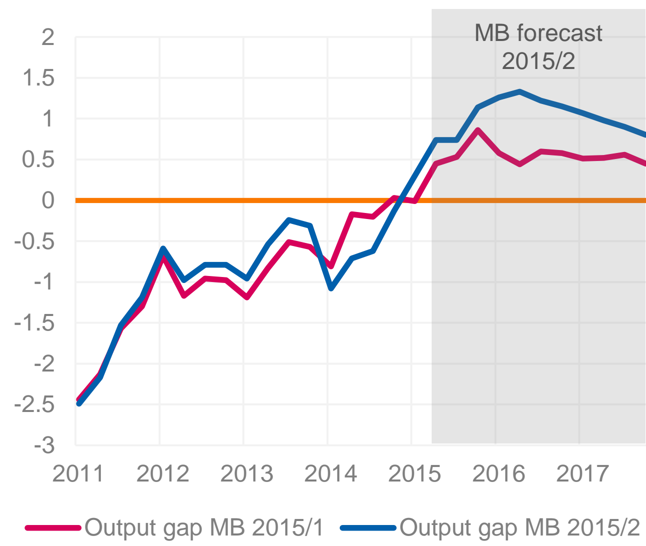
Source: Central Bank of Iceland, Monetary Bulletin 2015/2

The CBI's base line inflation forecast changed markedly from the February bulletin. In February, The CBI predicted that inflation would remain below target until Q3 2016 and that it would remain around target after that throughout the forecast horizon. Now, the CBI is forecasting that inflation will have risen above target in Q1 2016. In addition, the MPC specifically stated that inflation was more likely to be higher than lower than predicted.

The CBI's inflation forecast revised upwards



A positive output gap ahead



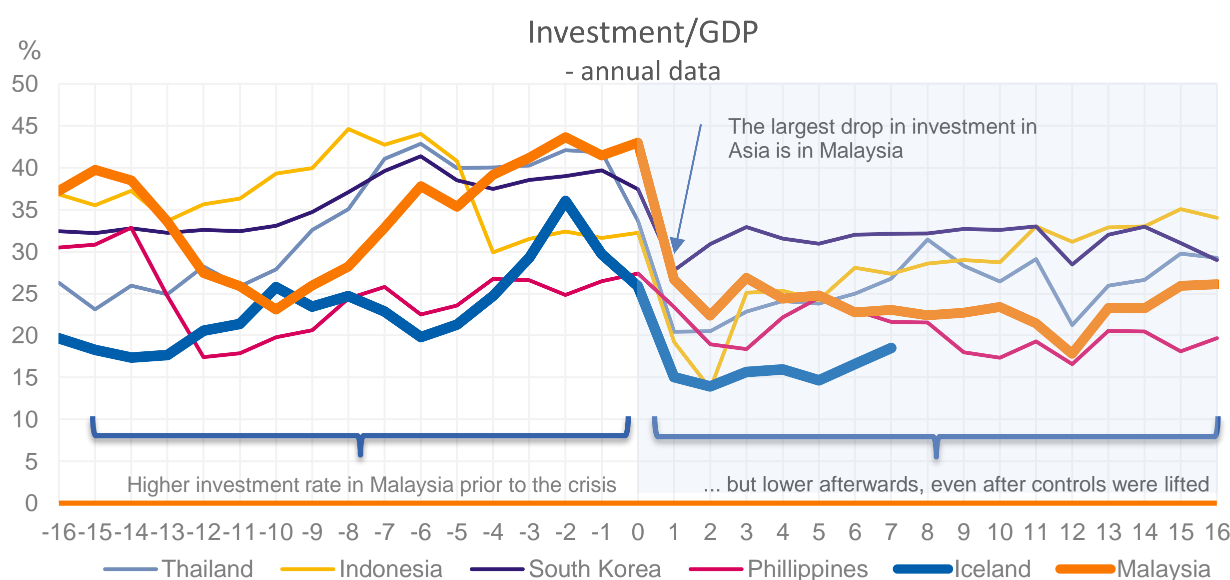
Sources: Central Bank of Iceland, Monetary Bulletin 2015/2

Given recent economic developments a rate hike in June has to be considered the most likely outcome. The main question is: will it be 25 bps or more?

Do capital controls have long term effects on investment?

Arion Research has been quite focused on matters relating to capital controls recently. Among other things, we examined some of their effects on the Malaysian economy, one of the few historical examples somewhat comparable to the Icelandic situation. Investment as a percentage of GDP has never quite picked up in Malaysia after capital controls were in effect. Is it possible that the simple fact that they were instated has increased the premium investors demand for investments there and thus have lowered overall investment in Malaysia in the long run?

Although decisions about investments are forward looking they are always partly based on experiences from the past. It seems likely that countries that have imposed restrictions on the flow of capital would be punished for that in the required rate of return of investors. Many research papers indicate that the short-term effects of capital controls in developing countries or countries dealing with a financial crisis can be positive, but they often fail to examine the long-run effects, which can indeed be difficult to determine as there are not too many examples. In the case of capital controls imposed during a financial crisis Malaysia is one of very few examples where long-run effects can be examined. One of the few researchers to have done that is Goh (2005) who determined that private long-term capital flows did indeed decrease following the capital controls in Malaysia. This can be seen in the graph below where Malaysia has been lagging other countries in Asia besides the Philippines when it comes to investment as a percentage of GDP.

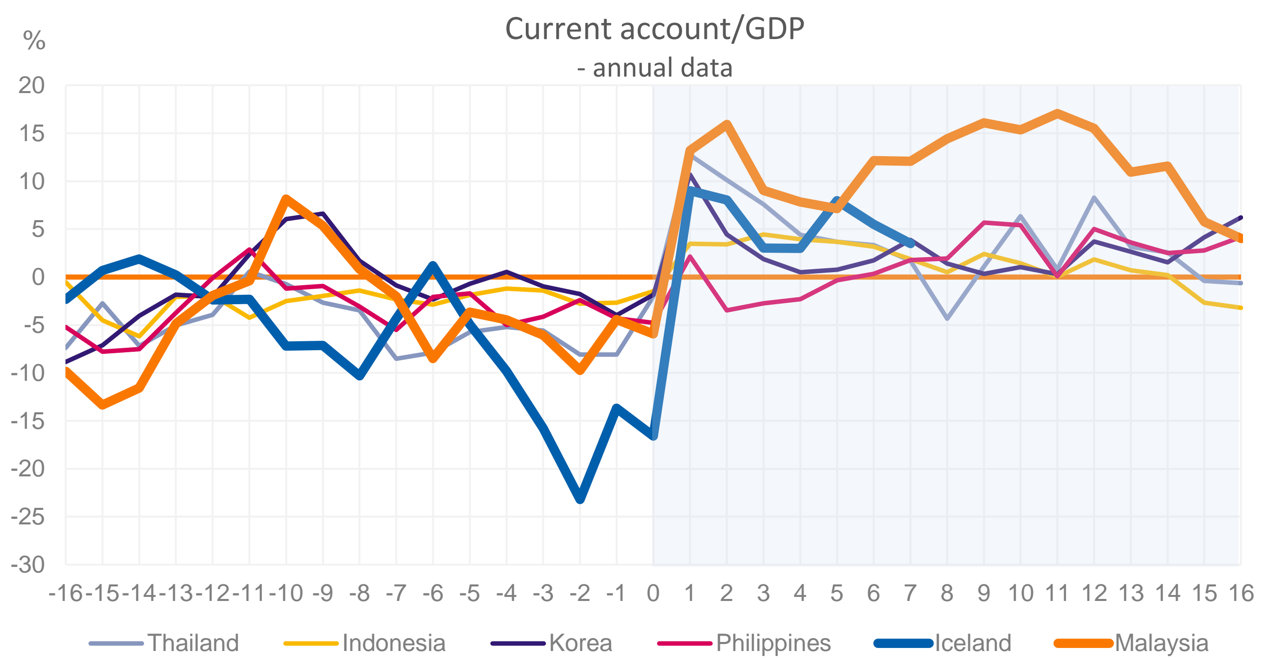


Sources: IMF-WEO. Year=0 is 2008 in Iceland and 1997 for Asian countries.

In the 90's investment in East-Asia was very high as a percentage of GDP, especially in Malaysia where investment reached close to 45% of GDP. After the financial crisis investment contracted rapidly, even more so than in other Asian countries that were hit hard by the crisis and had to seek financial assistance from the International Monetary Fund. Malaysia has been a laggard in Asia as far as investments goes since 1998 despite the fact that controls were lifted relatively quickly in Malaysia and were almost completely gone within three years. Since the crisis, investment in Malaysia has been hovering around 20-25% of GDP.

Does a persistent current account surplus reflect the deterring power of capital controls?

The current account balance can be defined as national savings minus domestic investment. After the Malaysian crisis, national savings came to a standstill while investment contracted rapidly. This is reflected in the current account surplus over the last 15 years or so. This means that the country's currency reserves have been increasing or that capital has been flowing out of the country. Malaysia's reserves have been growing, but capital has also been flowing out – investors who previously wanted to invest in Malaysia have been exiting the Malaysian economy over the last years. The current account surplus in Malaysia has been larger than that of most of its peer countries and the same can be said for Iceland.



Source: IMF-WEO. Year=0 is 2008 in Iceland and 1997 for Asian countries.

Of course the above analysis has many faults and limitations. Other factors than a history of capital controls determine investment levels in any given economy, which makes it possible that the investment level in Malaysia over the past years has been optimal after all. We also don't know exactly what was being invested in in all of these countries and why.

However, it can quite easily be surmised that a history of governmental interventions in capital markets, such as nationalizations or capital controls, increase the country risk of any country, resulting in a higher required rate of return for the average investor. One would think that the longer controls are in place the higher the required premium would be. The message is simple: the possible negative long-term effects on investment are just one more reason to call for the immediate removal of capital controls in Iceland.