

Capital Controls Abolished Before 2013?

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What will the 50/50 option achieve?

- We consider it very unlikely that the "Investment Program" will result in many investments in Iceland. Instead it is more likely to be a hindrance as the process is simply far too complex and foreign investors will rather wait for the Central Bank's next move and instead will continue to invest their offshore krónur in government bonds and deposits. If this happens, one has to question the Central Bank's most recent economic forecast which projects a 16.5% increase in investment next year. It is clear from the above that due to current format of the "Investment Program" investors, who wish to invest in something other than bonds in Iceland, need to decide whether they are prepared to a) count on the total lifting of the capital controls within five years or b) take the "New Investment Route" (available since Oct. '09) with the promise of an exit or c) just forget the about whole thing and invest somewhere else.

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Overall, it is rather difficult to assess the possible benefit of this step and its significance for the abolishment of the capital controls at a later date as numerous questions remain unanswered. One could also ask what the benefit is for investors in taking this route, instead of the so-called "New Investment Program" which has been available since the lifting of the controls on capital inflows. The "New Investment Program" made it available for investors to bring capital to Iceland for investment without any restrictions on the later outflow of that capital if the investor decided to sell the investment. According to the newly introduced "Investment Program" and 50/50 option investors now need to commit themselves to a 5 to 10-year investment in order to meet the terms of this new route. In addition, possible candidates who wish to take advantage of the newly introduced "Investment Program" route have to go through a rigorous application process. The Investment Program's various conditions might possibly scare investors off.

Arion Research believes that the legislator has put the Central Bank in a very tight spot by shortening the liberalization process by two years, as this spring the Central Bank had already officially stated that it would be suitable to lengthen the process by 4 years. By doing this the legislator is working against the goals set by the Central Bank this spring where the removal of the capital controls was contingent on certain targets being reached rather than following a specific timetable.

Many steps, little time

Today offshore krónur total ISK 450 billion and one of the key issues in the liberalization strategy is to free up owners of offshore krónur who have become impatient. If we simplify things, we could say that if the goal is to free up all of the offshore krónur with the "New Investment Program" and the "Investment Program" and put this money into long-term investments, foreign investors need to bring up to **€4 billion** into the Icelandic economy in long-term investments (if we assume that the offer exchange rate is ISK 230 to the euro). Two billion euros would go to Icelandic financial institutions and two billion would go into the Central Bank's auction where investors were given the chance to obtain offshore krónur ($2 \times 230 = 460$ billion "offshore" krónur) (see explanation graph on next page). It is clear that the channel for such sums in long-term investment, given the current outlook, is limited over the next 25 months. It is therefore obvious that more steps need to be taken in a relatively short time if the goal of lifting the controls is to be achieved before the end of 2013.

Getting stuck in Iceland

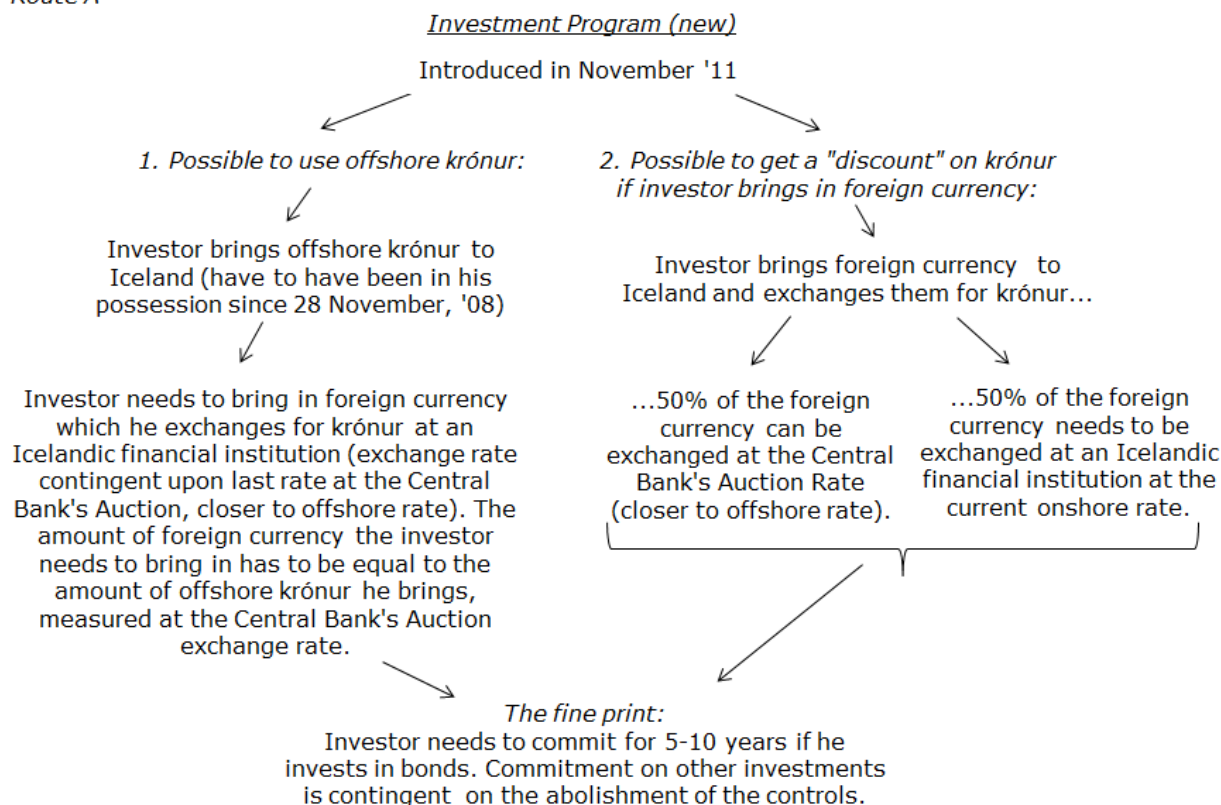
It is necessary at this point to distinguish between the plans of the authorities and the Central Bank to lift the capital controls in 25 months and the obligations assumed by investors by committing themselves for a minimum of five years. Firstly, we need to divide potential investors into two groups:

- Investors interested in buying bonds issued by Icelandic issuers. According to the Investment Program, these investors are allowed to receive interest for the first five years and then principal repayments for the next five. They can therefore be certain that they can exit with the value of their investment intact over **the next ten years**.
- Investors interested in other investment options than bonds (stocks, real estate, funds etc.) do not enjoy the same position, however. Such investors enjoy **no certainty** that they will get their money back at the end of the five years unless the capital controls have been lifted. They can sell their investments after 5 years, but will then be stuck in the same position as most Icelanders when it comes to transferring the money out of the country. According to the terms

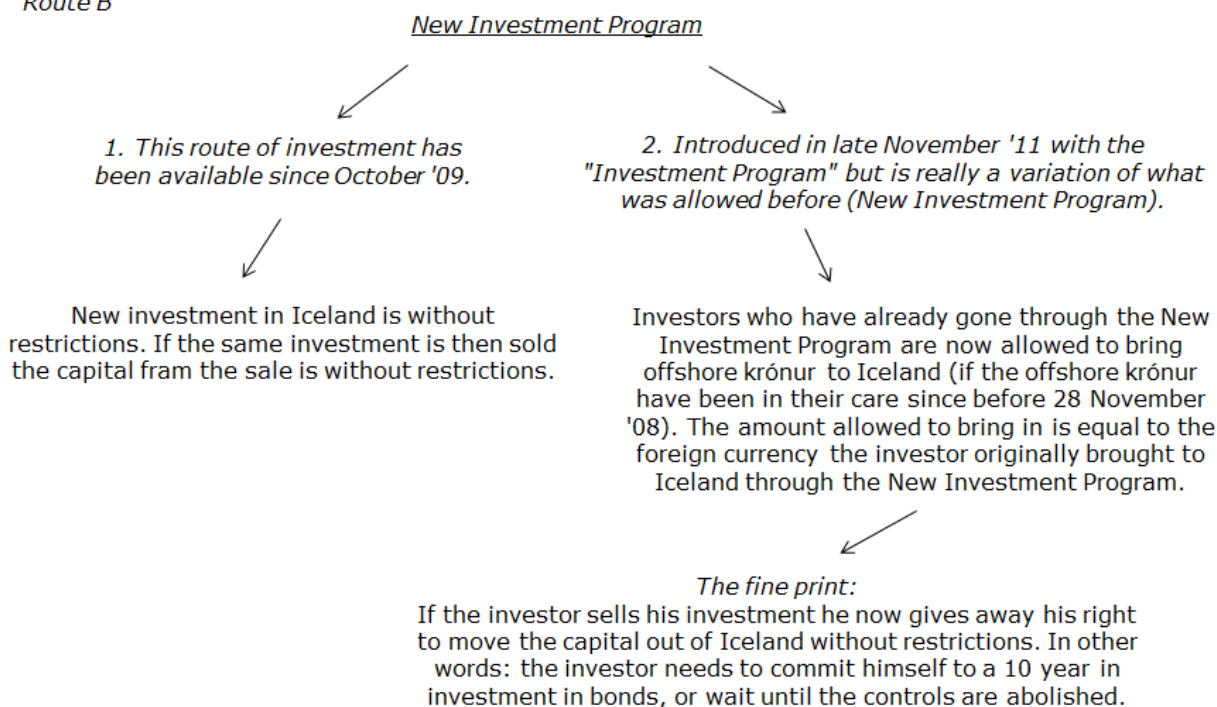
of the "Investment Program" investors may only sell their investments at the end of that period; there is no mention of a guaranteed exit. The terms only discuss the possibility of the investors' being paid a normal return, such as dividends paid by limited companies, rental income or interest payments. This is because the "Investment Program" assumes that the capital controls will be gone when the five-year provision is put to the test (in 25 months' time). These investors are therefore dependent on the capital controls' being lifted no later than in five years, until proven otherwise.

Options to Invest in Iceland: The transfer of offshore krónur to Iceland now "allowed"

Route A



Route B



In theory but not in practice

Arion Research believes that it is unrealistic to lift the capital controls over the next two years; the Central Bank announced this spring that it deemed it necessary to lengthen the controls for approximately four more years. Thus the Central Bank clearly believed at the time that it could not afford to lift the controls any earlier. If the authorities' strategy of lifting the controls in the course of the next two years is to be credible, it seems strange that those investors who are interested in investing in Iceland with their offshore krónur are faced with an uncertain process, lasting many months, before they can get going. If this is the only move in an attempt to lift the controls over the next year or two, then it is going to be a long road until the goal is achieved. On top of this there are numerous aspects of the liberalization process which raise questions; e.g. how to free up those krónur which foreign investors receive in payment from the bankruptcy estates of the banks. In our opinion the authorities have seriously undermined the liberalization strategy by imposing such a tight timeframe on the Central Bank. If the objectives on exchange rate stability and the lifting of the controls before the end of 2013 are to be compatible, then it is clear that a substantial amount of Iceland's foreign currency reserves need to be used in the next two years, which in turn will seriously affect the treasury's liquidity in foreign currency. At the moment there are no plans to spend valuable currency reserves to loosen the capital controls. It could therefore be argued that the process of lifting capital controls is in complete disarray, as given the current targets, there is no way it will be achieved within the appointed timeframe.

What Will the 50/50 Option Achieve?

In the Central Bank's liberalization strategy published this spring it says:

*The first phase of the strategy aims to authorize the transfer of all legally acquired offshore krónur to Iceland in several steps according to the terms described below. **Legally acquired offshore krónur** means krónur owned by:*

- *A foreign or domestic investor who can prove continuous ownership of offshore krónur since before the rules on foreign exchange came into effect on 28 November 2008.*
- *A foreign investor who acquired offshore krónur after the rules came into effect.*

Furthermore:

"...it is proposed that the current legal authority [for capital restrictions] be extended to approximately 4 years..."

The liberalization strategy also spells out the "Investment Program" which was supposed to be launched at the end of the currency auctions which commenced this summer to buy offshore krónur in order to invest in long-term government bonds. This program designed to provide an exit for desperate owners of offshore krónur and at the same time stimulate investment in the business sector, particularly the export sector. This was also termed the 50/50 option as investors provided foreign currency for 50% of the investment (see explanation graphs above).

The original strategy introduced in March '11 did not specify what kind of investment would be permitted or the terms, except that investments should focus on the Icelandic business sector. Subsequently, the transfer back to Iceland of offshore krónur owned by investors willing to invest in Iceland was to be authorized - this included krónur owned both before and after the introduction of the capital controls (i.e. before and after 28 November 2008). According to the Central Bank's strategy, the intention was to direct these offshore krónur into investments "*after one or more auctions have been completed.*"

What does the Central Bank say now?

Foreign investors directed towards long-term investments in Iceland: The Central Bank now intends to attract investors to Iceland who are willing to make long-term commitments. The conditions are, however, far more restricted than they were in the Central Bank's original liberalization strategy; although it was widely expected that stricter terms would be imposed on investments. According to the new terms, it is only permitted to invest in:

- Dematerialized securities (shares issued by a limited company registered in Iceland, bonds issued by Icelandic legal entities and the securities must be denominated in ISK)
- Real estate in Iceland
- Unit shares, or shares, in UCITS and investment funds.

Offshore krónur directed into long-term investments in Iceland: The terms issued by the Central Bank concerning the "Investment Program" do not seem to take into account plans to direct offshore krónur which have been owned by foreign **investors since after the economic collapse** into long-term investments in Iceland. For example, only owners of offshore krónur from before 28 November 2008 are allowed to transfer their offshore krónur and plough them into investments in Iceland as long as they bring in the same amount in foreign currency. Those investors who got hold of offshore krónur after this date, which many analysts believe is the majority, are not included in this definition. The liberalization strategy specified that those foreign investors who acquired krónur after the introduction of the capital controls **and up until the publication of the liberalization strategy** (in March '11) would be categorized alongside those who were allowed to participate in the transfer of offshore krónur to Iceland. The same would apply to those investors who had acquired offshore krónur in the Central Bank auctions. It is actually noted in the liberalization strategy from March '11 that it will be permitted to bring offshore krónur back to Iceland "after one or more auctions" and that those investors who

acquired krónur before the collapse will “be given priority.” However, nowhere does it state in the terms of the “Investment Program” which were published last November, when it will be permitted to transfer back to Iceland offshore krónur which were acquired after the collapse. These investors were originally (or according to the Central Bank’s plan this spring) supposed to fall into the so-called “transfer back to Iceland of offshore krónur” and “Investment Program” categories but the terms issued by the Central Bank last November make no mention of this group.

What will the Investment Program achieve?

We consider it very unlikely that the “Investment Program” will result in many investments in Iceland. Instead it is more likely to be a hindrance as the process is simply far too complex and foreign investors will rather wait for the Central Bank’s next move and instead continue to invest their offshore krónur in government bonds and deposits. If this happens, one has to question the Central Bank’s most recent economic forecast which projects a 16.5% increase in investment next year.

The implementation of the “Investment Program” is also dependent on there being demand to invest in Iceland and on foreign investors thinking it likely that long-term investments will be profitable. The bargain price available for part of the króna’s needed for investment in Iceland might not be very appealing if investors do not believe that the investment will eventually generate good returns. In this context it is worth noting a recent IMF report where the IMF expresses its concerns over the lack of investors’ interests in long-term investments. The prevailing uncertainty in international markets means that investors are increasingly seeking safe short-term investments. However, if they do seek long-term investments, then they tend to look towards Asia where economic growth has been great in past years as the growth outlook in Europe is rather bleak. The latest forecasts from analysts seem to indicate that Iceland belongs in this second group.

It is clear that investors, the Central Bank, the authorities, research departments and others have differing views of the removal of the capital controls. It would be possible to lift the capital controls in just one go, with certain side effects of course. It would also be possible to take the current course of action, in which there is a strong focus on taking a cautious approach so that the liberalization process does not result in the collapse of the ISK and thus jeopardize the economy, but again this has certain side effects.

It is clear from the above that due to the current format of the “Investment Program” investors, who wish to invest in something other than bonds in Iceland, need to decide whether they are prepared to a) count on the total lifting of the capital controls within five years or b) take the “New Investment Option” with the promise of an exit or c) just forget the whole thing and invest somewhere else.

Contacts

Ásdís Kristjánsdóttir

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

Dauid Stefánsson

Analyst
Research, Investment Banking
Tel: +354 444 6965
davidst@arionbanki.is

Thorbjörn Sveinsson

Senior Analyst
Research, Investment Banking
Tel: +354 444 6973
thorbjorn.sveinsson@arionbanki.is

Fannar Jónsson

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

Hallgrímur Björnsson

Senior Analyst
Research, Investment Banking
Tel: +354 444 6818
hallgrimur.bjornsson@arionbanki.is

Kristrún Frostadóttir

Analyst
Research, Investment Banking
Tel: +354 444 6911
kristrun.frostadottir@arionbanki.is

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