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Government of Iceland

Elimination of Capital Controls is Credit Positive for the Sovereign and the Financial Sector

On 14 March, Iceland (A3 stable) removed almost all remaining capital controls, signaling the country's return to economic normalcy more than eight years after the collapse of 90% of its banking system. The move is credit positive because we expect it to boost fixed direct investment (FDI), such as new investments that would take advantage of Iceland's competitive and green energy resources. While new FDI was not subject to the controls, companies were likely deterred from investing to some extent by the substantial administrative costs related to the restrictions.

The withdrawal of capital controls was made possible after the Central Bank of Iceland (CBI) concluded an agreement over the weekend to purchase a substantial portion of offshore króna assets. These are local currency-denominated assets mainly owned by non-residents that were trapped behind capital controls. There was an estimated ISK 200 billion (~8% of GDP) of such assets remaining after 22 central bank auctions over the past 5-1/2 years had whittled down the figure from over 42% of GDP at the time the controls were imposed in 2008. Nearly 99% of the remaining offshore króna asset holders participated in the latest auction in June 2016. Those few investors that did not participate were offered better terms, which most accepted.

Iceland's pace of growth is already buoyant, averaging more than 10% year-over-year in the second half of 2016. The speed and extent of the recovery following the resolution of its failed bank estates prompted us to upgrade the sovereign's ratings to A3 in September 2016. Still, the recent expansion depends heavily on tourism. Therefore, an increase in FDI in the energy sector, for example, would improve economic diversification. The removal of capital controls will also reduce the risks associated with the "hothouse effect" of forcing households, pension funds and other investors to keep their capital invested in Iceland. Such restrictions drove asset prices higher in the country and exposed investors to concentration risk.

Under the latest agreement with offshore investors, the CBI will use foreign exchange reserves to purchase about half of the remaining offshore assets (approximately ISK90 billion) at an exchange rate of ISK/EUR 137.5, an improved rate for investors compared to the ISK/EUR rate of 190 offered last June. By choosing to cancel the debt, most of which is held in ISK-denominated government bonds, the central bank avoids the disruption caused by the assets being converted all at once in the local foreign exchange market.

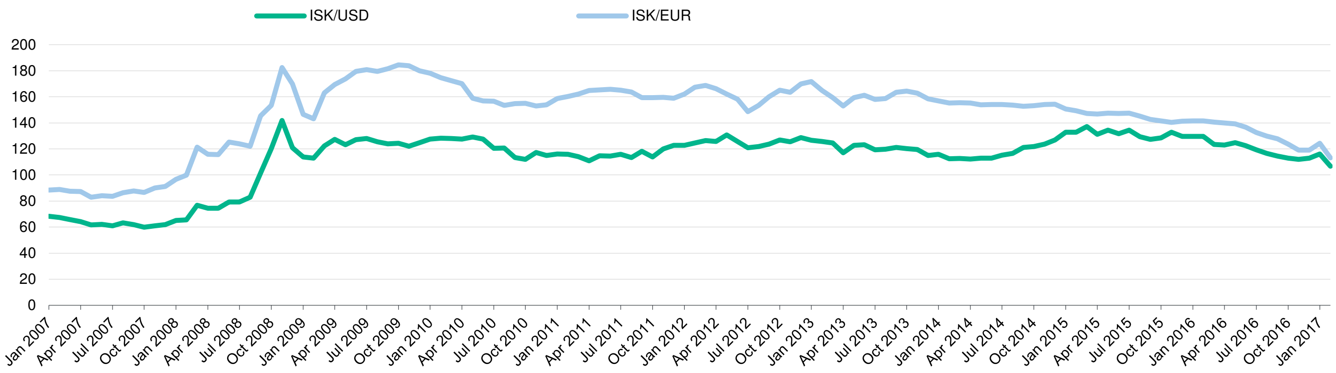
The agreement to buy back the offshore króna also brings an end to a controversial chapter in Iceland's investor relations. This is because after March 2015 offshore króna holders were prevented from reinvesting the principal when their bonds matured. Attempts by investors to seek legal redress in Icelandic and international courts were unsuccessful given past rulings that the imposition of capital controls was legal.

The CBI's updated foreign exchange rules remove nearly all remaining restrictions on the cross-border movement of currencies, enabling residents to participate in foreign exchange transactions, hedging and lending activities abroad, as well as to make foreign investments. Requirements for residents and exporters to repatriate foreign currency have also been removed. Controls will remain on non-hedging-related derivatives trades and offshore króna holders who do not participate in the latest agreement. Restrictions aiming to limit the carry trade will also remain in place to reduce speculative capital flows.

The termination of capital controls comes amid an improvement in macroeconomic and financial conditions. The ongoing improvements in the current account (8% of GDP surplus in 2016) and the net international investment position (1.1% of GDP at year-end 2016) have reduced the risk of balance of payments pressures, making capital controls no longer necessary. The easing of capital controls for domestic residents in late 2016 and in January 2017 generated no discernable pressure on foreign exchange markets. This was because capital flight was extremely subdued given the favorable domestic economic conditions. Indeed, the currency has appreciated since the beginning of the year (see Exhibit 1). The currency dipped by 4% against the dollar the day after Sunday's announcement about the controls' removal, but has since recovered to be only 1.4% down.

Exhibit 1

Iceland's Currency Appreciation Continued in January 2017



Source: Haver Analytics/Central Bank of Iceland, Moody's Investors Service

Another element that was key to the timing of eliminating controls was the sufficiency of the central bank's foreign exchange reserves. The current level of liquid foreign exchange reserves ($7.24 billion at the end of February) are ample to both buy back the offshore króna and in case of renewed balance of payment pressures. The rapid growth of reserves (see Exhibit 2) has been accelerated by large current account surpluses and the CBI's intervention in the local foreign exchange market. Furthermore, the CBI put in place a capital flow management mechanism (CFM) - namely reserve requirements on foreign portfolio investment - that aims to limit short-term speculative inflows that are attracted to higher local interest rates. Such inflows contributed to the 2008 financial collapse.

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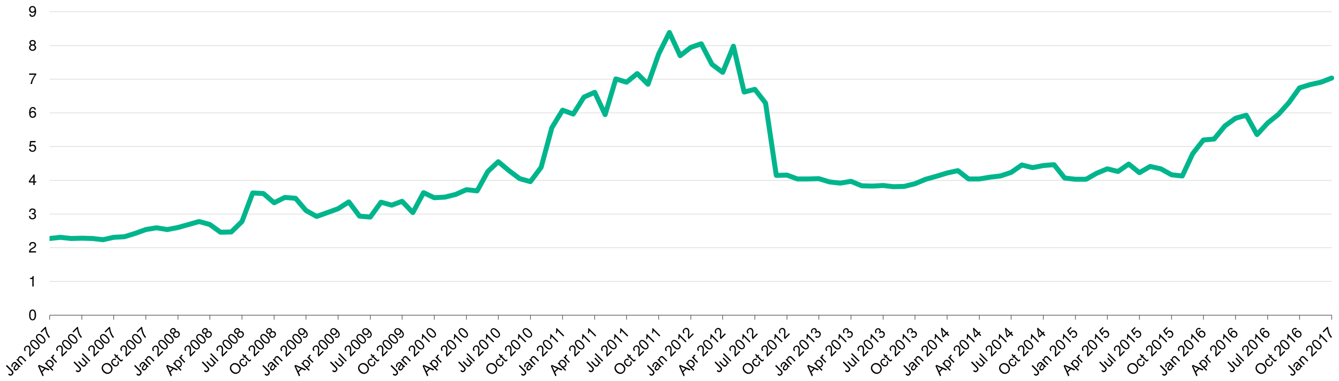
Exhibit 2

Iceland's Foreign Exchange Reserves
(US$ Billions)



Source: Haver Analytics/Central Bank of Iceland, Moody's Investors Service

The lifting of restrictions on capital flows to and from Iceland will also benefit the financial sector, allowing institutions to invest abroad to diversify risk. That said, pension funds had already been given progressively more freedom to invest abroad in recent years such that by now, the restrictions were no longer binding. Still, the opening of the economy will support demand for bank credit, which had already increased in 2016. Meanwhile, the CFM should shield banks' balance sheets from unsustainable growth due to attempted carry trades. We also expect the government and monetary authorities are prepared to introduce additional macro-prudential measures should they be needed to help contain the risks of over-exposure to the booming tourism sector.

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