27 April 2018

Progress of the Plan for Removal of Capital Controls

This report is published by the Minister of Finance and Economic Affairs as provided for in Paragraph 2 of the Temporary Provision I in Act No. 87/1992 on Foreign Exchange, which reads as follows:

> The Minister shall make public a report on the progress of plans to remove restrictions on cross-border capital movements and foreign currency trading at six-month intervals until such restrictions are finally removed. The report referred to in the first sentence shall be published for the first time within six months of the entry into force of this act.

Former reports are available at the website of the Ministry of Finance and Economic Affairs[1].

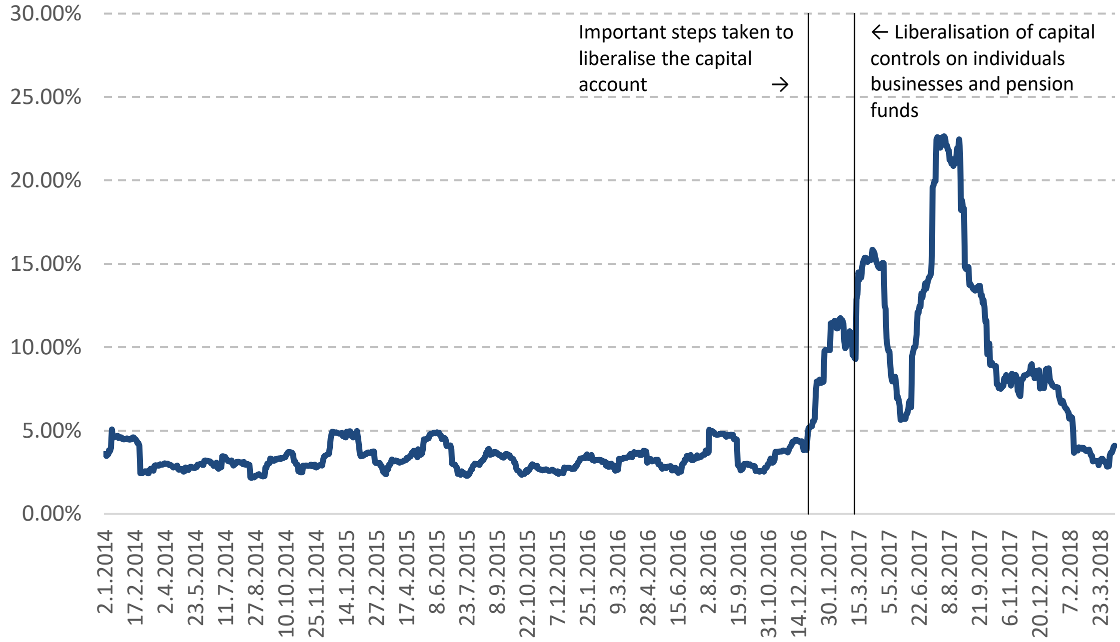
Successful liberalisation of capital controls in March 2017

Short-term exchange rate volatility increased temporarily following the liberalisation of capital controls on individuals, businesses and pension funds in March 2017. Such volatility was anticipated to an extent, as investors increased the share of foreign assets in their portfolios after a long period of capital controls. The short-term volatility receded in the autumn of 2017 and 30-day volatility in the króna is currently at a similar level as in 2014-2016 before the capital controls were lifted, as can be seen in the figure below. Since the liberalisation of capital controls in March 2017, there have been moderate outflows of securities investments abroad, but they have stemmed mainly from foreign investment by the pension funds, which amounted to around 120 b.kr. in 2017.

Standard and Poor‘s (S&P) raised the credit rating on Iceland to A on March 17 2017 on lifting of capital controls. As a sovereign rating, the ratings on Iceland are subject to certain publication restrictions, including the publication in accordance with a pre-established calendar. March 17 2017 was not on S&P‘s pre-established calendar, however, under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the reason for the deviation was that Iceland‘s move to lift capital account restrictions and the conclusion of agreements with the owners of the liquid krona overhang reduced balance of payments risks for the Icelandic economy and strengthened its external profile, with an immediate positive effect on the sovereign‘s creditworthiness. S&P had previously raised Iceland‘s credit rating in January 2017. Sovereigns‘ credit rating are rarely revised upwards twice in such a short time span, and the fact that Iceland‘s rating went from BBB+ to A in only two months supports the conclusion that the liberalisation of capital controls in March 2017 was successful.

[1] https://www.government.is/topics/economic-affairs-and-public-finances/progress-of-plans-to-remove-capital-controls/

Figure 1. 30 day exchange rate volatility



Improved credit rating following the liberalisation of capital controls

Fitch raised the credit rating on the Icelandic Treasury from BBB+ to A- on 7 July 2017 and then again from A- to A on 8 December 2017. The agency‘s news release from December stated that the Icelandic economy has been resilient to the lifting of capital controls between October 2016 and March 2017 and that international investor demand for Icelandic krona assets has resulted in capital inflows, which more than offset portfolio rebalancing capital outflows. Among factors that could lead to a positive rating action is a build-up of a track record in resilience of the economy to external shocks, in the context of a more open capital account. However, excessive capital outflows leading to external imbalances and pressures on the exchange rate could put a downward pressure on Iceland‘s credit rating.

On 30 June 2017 and again on 22 December 2017, S&P affirmed its credit rating of the Icelandic Treasury. Following the liberalisation of capital controls in March 2017, the agency had raised the Treasury‘s credit rating to A. S&P‘s news release from December stated that Iceland‘s monetary policy flexibility had improved following the March 2017 lifting of capital controls and given the adherence to a broadly flexible exchange rate arrangement.

Full liberalisation of capital controls

Despite the lifting of capital controls on individual, businesses and pension funds just over a year ago, the capital account has still not been fully liberalised and the remaining restrictions on capital movements and foreign exchange transactions are mainly twofold:

1. Offshore króna assets, which remain subject to special restrictions according to Act no. 37/2016. Remaining offshore króna assets amount to 87 b.kr., i.e. 3.4% of Iceland‘s 2017 GDP.
2. Restrictions that are necessary in order for the Central Bank‘s special reserve requirement to achieve its objective, including restrictions on derivatives trading for purposes other than hedging.

Restrictions on hedging-related derivatives trading in connection with foreign issuance of króna-denominated bonds are among those that fall under the second item above. The issuance of such bonds led to an accumulation of non-residents‘ short-term króna positions a decade ago with the associated macroeconomic and financial risks and, thus, it was considered appropriate to take action before such positions accumulated again. Therefore, Rules no. 200/2017 on Foreign Exchange were amended on 27 June 2017 so the exemption for hedging-related derivatives trading does not apply to derivatives trading in connection with foreign issuance of króna-denominated bonds. If such trading were not restricted, then investors could conduct carry trade without their investment being subject to the special reserve requirement according to Rules on Special Reserve Requirements for New Currency Inflows, no. 490/2016. Further discussions on the amendments to the Rules on Foreign Exchange can be found in the report on the progress of the plan for removal of capital controls from October 2017.

The appointment of a working group, which will be tasked with making proposals for a holistic revision of Act no. 87/1992 on Foreign Exchange, is being prepared. Proposals concerning how offshore króna assets will be liberalised will be a part of that review.