3 May 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].

Liberalisation of capital controls on offshore króna assets and increased flexibility of the special reserve requirement on capital inflows

On 7 December 2018, the Government agreed to present to Parliament a bill of legislation from the Minister of Finance and Economic Affairs, which provided for amendments to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no 27/2016, and the Foreign Exchange Act, no 87/1992. The amendments entered into force on 5 March 2019.

Treatment of Króna-Denominated Assets Subject to Special Restrictions

The amendments to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions provided the following expanded authorisations for withdrawals from accounts subject to special restrictions:

1. General authorisation for all holders of offshore króna assets to release their offshore króna assets in order to purchase foreign currency and export it to an account abroad;
2. Special authorisation for offshore króna holders that have owned offshore króna assets continuously since before 28 November 2008 to release those assets from the legal restrictions;
3. Authorisation for individuals to withdraw up to 100 m.kr. from accounts subject to special restrictions.

The amendments were designed so as to not undermine the efficacy of the special reserve requirement on capital inflows (SRR). Therefore, those offshore króna holders that have not owned their króna assets continuously since before the capital controls were introduced and wish to invest in Iceland, must exit through the foreign exchange market and then re-enter, subject to the SRR. This was to ensure uniform treatment of investors.[2]

The Foreign Exchange Act

The amendments to the Foreign Exchange Act allowed for increased flexibility of the SRR. Before the amendments took effect, the SRR could only be satisfied by depositing funds in a term deposit account with a deposit institution. There was evidence that this deterred investors interested in investing in Iceland, for instance if their own rules prohibited them from investing

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

[2] As explained below, the SRR‘s special reserve ratio has since then been reduced to 0%. Thus, this distinction serves little practical purpose as of now.

where investment positions cannot be closed at any time. In order to respond to this, it was made possible to satisfy the SRR via repo transactions with Central Bank certificates of deposit. Furthermore, the new arrangement allows investors to release funds during the holding period by settling with a financial institution.

The SRR‘s special reserve ratio lowered from 20% to 0%
New Rules on Special Reserve Requirements for New Foreign Currency Inflows and Rules on the Treatment of Króna-Denominated Assets Subject to Special Restrictions were published on 5 March 2019 and took effect the following day. The rules entailed necessary amendments due to the aforementioned amendments to the Act on Foreign Exchange and the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions.

Furthermore, the new Rules on the Special Reserve Requirements for New Foreign Currency Inflows lowered the SRR‘s ratio from 20% to 0%. This amendment rendered the SRR effectively innactive and investors can now invest foreign capital in bonds and high-yielding deposits without restrictions. The special reserve ratio had been lowered from 40% to 20% on 2 November 2018, as described in the last report on the progress of the plan to remove capital controls. The Central Bank of Iceland‘s press release noted that conditions had developed that permitted lowering the SRR to 0% as the likelihood of substantial inflows leading to an overshooting exchange rate and to severe disturbances in the monetary policy transmission mechanism had subsided significantly. Moreover, capital flows to and from Iceland were better balanced than they were at the time the SRR was introduced and in the recent past there had been outflows of new foreign investments in bonds.

Removal of restrictions on cross-border movement of capital pursuant to reduction in the special reserve ratio
Rules amending the Rules on Foreign Exchange, no. 200/2017, were published on 2 April 2019 and took effect the following day. The objective of the Rules was to lift restrictions on specific transactions as the SRR had been deactivated. The relevant restrictions, which had remained in place to support the SRR by reducing the likelihood of circumvention, were as follows:

- Exportation of securities issued in domestic currency that are comparable to those subject to the special reserve requirement, if investments in them have not been subject to the special reserve base pursuant to the Rules on Special Reserve Requirements for New Foreign Currency Inflows.
- Cross-border movement of domestic currency in relation to specified measures other than those that create a special reserve base, when payment is made directly or indirectly by withdrawal from an account owned by a foreign financial institution (Vostro account). The term specified measures refers to investment options comparable to those subject to the special reserve requirement.
- Loans in domestic or foreign currency, granted by resident entities to non-residents, and repayments of loans between these parties that are allocated to investment options comparable to those that are subject to the special reserve requirement;
- The settlement in foreign currency of transactions with bonds, bills, certain unit share certificates and equity issued in Icelandic króna.

Remaining restrictions
Restrictions on the following transactions remain in place:

1. Cross-border transfers of domestic currency due to transactions with offshore króna assets that are subject to special restrictions;
2. Foreign exchange transactions carried out between residents and non-residents without the intermediation of financial institution, if domestic currency is a constituent of the transaction;
3. Derivatives transactions involving domestic currency against foreign currency and undertaken for purposes, except if the derivative is related to trde o rif used for hedging against risk, provided that a foreign currency imbalance exists over the duration of the contract.

It is foreseen that these restrictions will be revised as a part of a holistic revision of the legal framework for foreign exchange in Iceland.

The foreign exchange market‘s reaction to the liberalisation
Early indications suggest that the liberalisation of offshore króna assets has not given rise to a burst of capital flights. The stock of offshore króna assets has declined by about 12 bn.ISK since 5 March 2019 and currently stands at around 72 bn.ISK, which corresponds to 2.6% of GDP. Furthermore, a part of the decline has been re-imported. As noted below, net registered new investment using foreign capital, especially in government bonds, increased after the SRR was deactivated.

Main determinants of balance of payments
Current Account
A large surplus on the service account, mainly due to tourism, has more than outweighed a deficit on the goods account and led to a sustained surplus on the current account in recent years, amounting to 81 bn.ISK in 2018. With a decline in tourism imminent this year, the outlook is for a reduced surplus on the current account which, other things equal, would be expected to put downward pressure on the real exchange rate. However, as the capital controls have been almost fully lifted and new investment using foreign capital is no longer subject to restrictions, the exchange rate will increasingly be determined by capital flows.

Pension funds
The pension funds‘ net foreign currency purchases amounted to 109 bn.ISK in 2018. Foreign assets make up close to 27% of the funds‘ total assets. With some funds not having reached their objectives of foreign assets, it is possible that the pension funds might invest abroad this year at levels similar to those in 2018. However, some funds have already met their target share for foreign assets, and with the exchange rate having depreciated from the mid rate of 2018, it is possible that the pension funds‘ net outflows could be somewhat less this year than in 2018.

New investment using foreign capital and offshore króna assets
Net registered new investments using foreign capital was 23 bn.ISK in 2018 and 11 bn.ISK in 2019Q1. It increased markedly following the deactivation of the SRR in early March 2019. As an example, net inflows into government bonds amounted to 10 bn.ISK in March, but only 1 bn.ISK in all 2018. In 2015, before the introduction of the SRR, net new investment using foreign capital amounted to 76 bn.ISK.

Offshore króna assets amount to 72 bn.ISK and a substantial part of them will exit through the foreign exchange market. It is roughly estimated that about half of the assets fall under either the authorisations of individuals or the special authorisations that apply to parties who have owned offshore króna assets continuously since November 2008. However, the Central Bank has declared that outflows of offshore króna assets will not impact the exchange rate of the króna. The Bank‘s foreign exchange reserves are large and can meet potential outflows if needed.

The liberalisation of offshore króna assets, the deactivation of the SRR, narrower interest rate differential with abroad and a changed economic outlook are among the factors that currently affect capital flows to and from Iceland. However, it is impossible to predict the extent and timing of capital flows.

Figure 1. Registered new investment using foreign capital (bn. ISK)