

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

[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 Affairs¹.

Central Bank purchase of offshore króna assets

On 12 March, the Central Bank announced an agreement for the purchase of offshore króna assets in the amount of approximately 90 b.kr. at an exchange rate of 137.5 krónur per euro. It was also announced that the Bank would offer other owners of offshore króna assets the same terms, with the deadline for participation set at 28 April 2017. A number of interested parties were unable to finalise their trades within that timeframe and the Bank, therefore, extended the period deadline for participation until 15 June 2017.

Final settlement of the transactions took place on 22 June 2017 and the Central Bank announced the day after that it had bought offshore króna assets in two stages for a total of 112.4 b.kr. since 12 March 2017 at an exchange rate of 137.5 krónur per euro. The offshore króna assets bought by the Central Bank fall into categories as follows:

Cash and CDs:	46,5 b.kr.
Treasury bonds and bills:	62,0 b.kr.
Housing Financing Fund bonds:	3,9 b.kr.
Samtals	112,4 b.kr.

Offshore króna assets amounted to approximately 40% of GDP at their peak in 2009. With actions such as the Avens agreement, foreign currency auctions in exchange for payment in Treasury bonds or investment according to the Bank's Investment Programme, the foreign exchange auction in June 2016 and the abovementioned transactions, the stock of offshore króna assets has been lowered to around 3,5% of GDP, or 88 b.kr.

Amendments to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions

On 27 May 2017 an Act amending the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions came into force. With the Act, the authorisation to make withdrawals from accounts subject to special restrictions was changed. As a result, individuals are authorised to withdraw up to 100 m.kr. per calendar year from accounts subject to special restrictions if they can demonstrate continuous ownership of the offshore króna assets since 28 November 2008. Furthermore, withdrawals from accounts subject to special restrictions due to contractual instalments on the principal of loan obligations and

¹ <https://www.ministryoffinance.is/news/nr/20084/>

indexation of such contractual instalments became permissible. Those amendments were made to ensure that provisions of the Act do not contravene provisions of IMF's Articles of Agreement.

Amendments to the Rules on Foreign Exchange

With Rules no. 200/2017, which took effect on 14 March 2017, capital controls on individuals, firms, and pension funds were lifted. Restrictions on specified transactions have remained in place with the aim of reducing the likelihood of carry trade in connection with investments not subject to the special reserve requirement under the Central Bank's capital flow management measure (CFM).

On 24 February 2017, the Central Bank declared it was willing to grant exemptions from the Foreign Exchange Act, no 87/1992, for derivatives trading for long-term hedging purposes. The objective was to assess firms' need for and interest in hedging and to prepare for full liberalisation of capital controls. This framework was later incorporated into Rules no. 200/2017.

Non-residents could take advantage of those exemptions to conduct carry trade by issuing bonds in Icelandic krónur and entering into derivatives contracts with domestic banks. Credit rating upgrades and foreign investors' bolstered interest in carry trade following the liberalisation of capital controls in March and the Central Bank's purchase of offshore króna assets made such transactions both more appealing and more probable. The Central Bank therefore considered it appropriate to take action before non-residents' short-term króna positions accumulated again, with the associated risks to exchange rate, monetary and financial stability.

Therefore, in order to ensure the effectiveness of the Bank's CFM in the wake of liberalisation, the Rules on Foreign Exchange were amended on 27 June 2017 so as to exclude hedging-related derivatives trading in connection with foreign issuance of krónur denominated bonds from the exemption for hedging-related derivatives trading with financial undertakings in Iceland, granted in February.

Furthermore, it was necessary to remove exemptions for cross-border movement of Icelandic krónur when they are related to i) exports of specified securities issued in Icelandic krónur; and ii) specified measures involving payment remitted, directly or indirectly, by withdrawal from an account owned by a foreign financial undertaking (Vostro account). In both instances, reference is made to securities and measures that are comparable to the investment options that form a special reserve base under the Central Bank's CFM. Exemptions for settlement of transactions with financial instruments comparable to those that form a special reserve base under the Central Bank's CFM also needed to be removed, if the Icelandic króna was one of the currencies of the transactions. In addition, exemptions for króna-denominated lending by non-residents to residents were removed when the proceeds of the loan are used, directly or indirectly, for investment options comparable to those that form a special reserve base under the Central Bank's CFM.

The objective of the abovementioned amendments was to reduce the risk that carry trade will increase in the form of investments that do not form a special reserve base under the CFM, thereby reducing the efficacy of the measure. Therefore, the amendments have very limited impacts on households and businesses, which were the main beneficiaries of the liberalisation of capital controls in March.

Improved credit rating

On 30 June 2017, S&P affirmed its A rating of Iceland's sovereign long-term credit rating. The rating agency had raised the rating from A- to A in March 2017 as the lifting of capital controls and the conclusion of an agreement with owners of offshore króna assets were suited to immediately improve Iceland's credit quality.

On 7 July 2017, Fitch raised its rating on Iceland's sovereign long-term credit rating from BBB+ to A-. According to the agency's press release, the lifting of capital controls had not resulted in strong outflows of capital and downward pressure on the exchange rate. Furthermore, resilience of the economy to external shocks, in the context of a more open capital account could result in further upgrades of Iceland's credit rating, while excessive capital outflows leading to external imbalances and pressure on the exchange rate could have a negative effect.