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Macroeconomic balances and capital account liberalisation in Iceland

John Eatwell

Summary

- Significant risks attend liberalisation of the Icelandic capital account.
  - Currency instability is a very significant risk for Iceland as around 55% of its GDP is traded.
  - Falls in ISK exchange rate cut real income, increase inflation, and increase FX denominated debt.

Summary

- Iceland chose not to default in 2008. It postponed the problem until a better day.
- But does the ISK debt overhang matter?
  - Casts a pall over economic and policy debate.
  - Prevents the development of normal market relationships in other aspects of the economy.
  - Reduces economic opportunities for Icelandic people.
  - Impact on FDI.
  - A persistent drain on confidence.

Summary

- Trying to pay down the ISK debt overhang out of a current account surplus would take an unpredictably long time.
  - But a deficit is damaging since it increases debt and erodes confidence.
- Since current account flows cannot pay off the debt in a reasonable time, a large capital account transaction will be required.
  - Sale of an asset for FX
  - Change in the structure of the debt
  - Major FDI projects supplying FX

Summary

- It is essential to maintain confidence in the Icelandic economy and the ISK exchange rate. Any solution must therefore be prudent, flexible and consensual.
  - An ideal would be a agreement between the creditors and the Icelandic government which the IMF endorses. The IMF is an interested party because it would have to deal with the consequences of a disorderly resolution. A contingent guarantee would be useful to bolster confidence.

Summary

- De-risking the process, as far as may be possible, is a key component of an orderly programme of relaxation and eventual removal of capital controls.
- Maintain confidence.

Significant risks attend liberalisation of the Icelandic capital account

- Capital controls leave a legacy of potentially severe imbalances in the allocation of stocks of financial assets.
  - Domestic asset creditor payments associated with the wind-up of the old banks,
  - the "escape" of assets of non-residents "trapped" in Icelandic Krona (ISK),
  - any latent desire of Icelandic residents to diversify their portfolios to include greater quantities of FX assets.
- Any disorderly stock adjustment permitted by liberalisation is likely to result in substantial flows out of ISK into FX, with potentially serious consequences for the stability of the ISK exchange rate.

Significant risks attend liberalisation of the Icelandic capital account

- The ISK debt overhang derives from the decision made in 2008 not to default on Iceland's FX liabilities.
- Instead the imposition of capital controls allowed the commitment to resolve those liabilities to be postponed to a (hopefully) better day.
- Capital controls were characterised as a temporary measure.

Significant risks attend liberalisation of the Icelandic capital account

- A fall in the **exchange rate** would sharply reduce real income, increase inflation, and increase FX indebtedness as a proportion of GDP. It would also have a negative impact on confidence.
- Overshooting.

Significant risks attend liberalisation of the Icelandic capital account

- **Current account** surpluses may, at least in small part, “pay for” stock adjustments and/or the cost of FX debt servicing, but would take many years to pay off the debt.
- **Inflation** is relevant both for its impact on the terms of trade and the current account, and because inflation erodes the real value of nominal debt.
- A high and sustainable **growth rate** is relevant because growth reduces the ratio of given debt to GDP, and provides uplift in fiscal revenues.

Significant risks attend liberalisation of the Icelandic capital account

- Estimates of macroeconomic performance are surrounded by considerable uncertainty:
  - Susceptible to events in the wider world.
  - Idiosyncratic events impinge more powerfully than would be the case in a large diversified economy.
  - External markets for Icelandic financial instruments are small, with the potential for considerable volatility given relatively low liquidity.

General reflections.

- The financial collapse of 2008 was managed with considerable success. But the ISK debt overhang derives from the decision made in 2008 not to default.
- Capital controls are now inhibiting future investment in Iceland. Uncertainty over the lifting of controls is undermining confidence.
- The IMF expressed concern that "Design of the macroprudential measures to support lifting restrictions is still at an early stage"

General reflections.

- Net International Investment Position (NIIP).
  - fundamental issue is the stability of holdings of assets and liabilities;
  - a granular analysis is necessary.
- Balance of Payments (BoP)
  - the supply of and demand for FX (excluding compensatory financing)
  - the balance on current and capital account (lt and st)
    - decisions of the sovereign with respect to its foreign borrowing
    - speculative flows

General reflections.

- The scale and speed of the speculative flows are difficult to predict, and represent one of the major risks to be managed in the process of dismantling capital controls. They are essentially a function of confidence, and hence are exacerbated by uncertainty.
- De-risking the process, as far as may be possible, is a key component of an orderly programme of relaxation and eventual removal of capital controls.

IMF *2013 Article IV Consultation*

- "The outlook is for modest growth, declining inflation, and improving fiscal and external position."
- The highest risk facing the Icelandic economy is that there might be a disorderly unwinding of capital controls. "Slow progress in lifting capital controls could undermine confidence in an orderly liberalization while increasing the risk that prolonged controls will fuel asset bubbles, inhibit investment, and reduce productivity"

IMF *2013 Article IV Consultation*

- **“Iceland’s reserve position is comfortable.** The baseline balance of payments outlook—which incorporates gradual capital account liberalization and deleveraging of highly indebted companies—shows reserves as staying above 100 percent of short-term debt for the projection horizon. External debt is also projected to continue declining. …..Taking a comprehensive approach to lifting the capital controls will safeguard external and financial stability. Staying on course with fiscal consolidation will maintain market confidence and support continued market access. Buttressing non-borrowed reserves through foreign exchange purchases—taking advantage of seasonal krona appreciation—would help support reserve adequacy.”

The IMF's *External Debt Sustainability Analysis*

- The following roll-over assumptions are made:
  - 100% of sovereign debt (other than re-payments to official creditors);
  - 30% of the CBI's external debt falling due between 2012 and 2016;
  - central government corporations, local municipalities, and local government corporations, 40%;
  - corporations under financial stress, 0%.
- Eurobonds with a value of \$1.6bn (c. ISK194.5bn) are issued to be swapped for short-term krona assets held by non-residents. This arrangement will not increase the level of external debt, but will increase the government's FX exposure.

The IMF's *External Debt Sustainability Analysis*

- The IMF stress tests for interest rate shocks, growth shocks, current account shocks, and even a real depreciation shock of 30%. None of these, nor the combination of all of them, reverse the downward trend in the external debt ratio.
- The only stress test that results in an upward trend is that based on the historical experience of the past 10 years.

CBI: *Iceland's underlying external position and balance of payments.*

- A NIIP position of −60% of GDP.
  - The measures of March 2012 restricting transactions in some FX denominated capital limits netting possibilities.
- Balance of payments
  - If creditors have confidence in servicing of the debt, it can be rolled over and no balance of payments problem will arise.
  - Even if a country has no net debt, and yet the markets have no confidence in its future financial stability then a balance of payments problem can arise, created by speculative outflows.

CBI: *Iceland's underlying external position and balance of payments.*

- The repayment profile ….. becomes significantly heavier in 2015, when payment on the debt instruments between old and new Landsbanki begins in earnest.
- The estimate of developments in the balance of payments …… implies that either capital inflows from investment or borrowings abroad or extension of maturities will be required in order to service the debt according to this profile

CBI: *Iceland's underlying external position and balance of payments.*

- An external (FX) financing need in 2017 equivalent to ISK150bn, (c.7% GDP).
- A major part of this financing need arises from the forecast deterioration in the trade balance by ISK94bn between 2013 and 2017.
- The CBI concedes that this deterioration is "relatively pessimistic". It rests on a sharp deterioration in the balance of trade in services, a balance that in the past 3 years has benefitted from the sustained expansion of tourist receipts.

CBI: *Iceland's underlying external position and balance of payments.*

- Given the necessary relationship between the private sector, the public sector and the foreign balance as defined by the national accounting identities, the balance on current account predicted by the CBI would suggest the CBI expects increasing indebtedness of the private sector (households and firms) and/or a growing fiscal deficit .

(THM) *Project Close – considerations on Iceland's macroeconomic position and the impact of the Glitnir and Kaupthing compositions.*

- Accept the methodology of the CBI in the calculation of the NIIP and the BoP.
- Identify a number of funding streams which mitigate any deterioration of the Balance of Payments.
- An "illustrative solution", significantly reduces the ISK element of the Overhang to such an extent that not only are the ISK assets of Kaupthing and Glitnir susceptible to a reasonable level of bond funding, but so also are the "Trapped 2008 ISK".

(THM) *Project Close*

- THM point out that the CBI assessment of the problem assumes:
  - No capital inflows or outflows associated with assets of Glitnir and Kaupthing (FX in to domestic creditors, ISK out (and then exchanged) to foreign creditors).
  - The forecast contains FX yield outflows estimated by THM to be ISK50bn, comprising 21bn on 2008 trapped ISK (a 5.5% return), and 29bn related to ISK assets in Glitnir and Kaupthing post compositions assumed to occur in 2013 (a 7.9% return).
  - No movement in FX assets of so-called Deposit Money Banks, the new, post-crisis banks.
  - No inflow of FX from FX assets of the pension funds.
  - 100% rollover of sovereign debt.
  - No rollover of FX debt by corporates.
  - Scheduled payments on the LBI bond.
  - ISK238bn of capital inflows, with consequential outflows accounted in the trade account.

(THM) *Project Close*

- THM consider potential sources of FX to fund the deficit including:
  - Rollover of other FX debt due to non-residents.
  - The unwinding of the foreign FX assets of Landsbankinn dedicated to funding LBI bond
  - The potential restructuring of the Landsbankinn's FX bonds due to LBI
  - Reducing the negative carry on CBI FX reserves.

THM "illustrative solution" to the ISK overhang

- the sale for FX of either one or both of Islandsbanki and Arion Bank;
- the use of domestic ISK assets of the Glitnir and Kaupthing to settle Icelandic domestic claims on the estates;
- the issue, if necessary, of a long-term FX sovereign bond to settle any residual domestic claims.

Confidence

- The key issue is confidence
- Avoidance of speculative overshoot
- A prudent approach
- A clear, secure path to resolution
- Financial guarantees
- Convertibility

A prudent approach

- The role of the balance of trade and FDI should not be exaggerated. There is only limited possibility of earnings on these accounts financing an outflow equal to the scale of current indebtedness.
- A solution should be informed by a common data base. It is imperative that all parties – the winding up boards and the Icelandic authorities, and the IMF – share the methodologies, assumptions, data and other information used in their estimates of what are inevitably uncertain forecasts.

A prudent approach

1. The liberalisation strategy should be phased, with contingencies built into the phasing. Contingencies may include the ability to vary the timing of permitted FX flow, other speed-limits associated with debt structures and maturities, and a variable levy on ISK exits. In order for the contingencies to be effective FX should be pre-ordered from or through the CBI. The CBI will then know what is going to happen in, say, 1 month's time.

A prudent approach

2. After asset sales and auctions, any remaining resources issued to manage the funding of FX outflows associated with liberalisation should be placed in a special fund to be used for future contingencies. Whilst this measure is essentially an accounting device, it would enhance transparency and boost confidence.

A prudent approach

3. A guarantee in the form of contingent funding would be useful to cement confidence in the liberalisation strategy. (The experience with contingent funding has not, in the past, been notably successful. It is generally believed that this has been because countries have proved unwilling to apply for contingent funds for fear of raising expectations of forthcoming difficulties. But in the case of Iceland, the "difficulties" have already occurred, and the availability of a contingent fund will increase confidence.)

A prudent approach

4. An important element of a confidence boosting approach should be that the liberalisation strategy emanates from an agreement between the major parties: the Icelandic government and the estates of the old banks, perhaps endorsed by the IMF.