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Iceland's economy

The flows resume

Iceland lifts capital controls—sort of

Afloat again

HAVING nearly capsized in the stormy seas of international capital flows, Iceland is now making a cautious foray back into the water. On June 8th the government announced the lifting of the controls the country imposed in 2008—with one big caveat.

Investors with money tied up in Icelandic assets will soon be able to move it out of the country, and Icelanders will be free to buy foreign currencies. The hitch is that those who are owed money by the estates of Iceland's failed banks, worth about 500 billion kronur ($3.8 billion), or 30% of GDP, must agree to haircuts and maturity extensions on the debts involved before they can sell them and transfer the proceeds out of the country. Alternatively, they must pay a tax of 39% before doing so.

There will also be auctions to drain foreign investors' offshore holdings of kronur, preventing uncontrolled sales that might send the currency tumbling. Foreigners with kronur stuck abroad will now be able to put them in term-deposit accounts, swap them for bonds, or buy euros at a discount. All of these measures are designed to slow the inevitable rush to sell and so prop up the krona.

This is the right kind of innovation, following the wrong kind. The curbs on the convertibility of the krona were the result of Iceland's disastrous pre-crisis switch from fishing to finance. Amid a striking lack of supervision, the three biggest banks, Glitnir, Kaupthing and Landsbanki, amassed assets 14 times larger than Iceland's GDP. When the central bank raised interest rates to discourage this, the result was perverse: lots of foreign capital flowed in, to invest in high-yielding Icelandic assets. Meanwhile, Icelandic firms were piling on cheap foreign debt, which amounted to 170% of GDP by 2009. Households merrily borrowed abroad too.

These debts were manageable so long as the krona was strong and inflation was low. But in 2008, when short-term financing for banks started to dry up around the world and capital began rushing out of the country, the currency tanked and inflation soared. The krona lost over 50% of its value in a matter of months. Iceland had little choice but to impose capital controls. The aim was not to prevent people from withdrawing money from banks, as in Cyprus (and as now mooted for Greece). Rather, the controls were supposed to prevent foreigners selling krona-denominated investments and to stop offshore kronur—those owned by foreigners—from flowing in. The new regime trapped foreign-owned assets worth about 40% of GDP.

Though Iceland’s GDP fell by 10% from 2009 to 2010, the capital controls prevented a complete meltdown, and the economy has recovered faster than many expected. Growth in the past three years has been around 2% a year, faster than in crisis-hit countries in the euro zone; this year’s figure is expected to be even higher. The number of tourists has doubled since 2007. Downtown Reykjavik is bursting with backpackers and Chinese tour groups, drawn by the island’s thermal springs and seething volcanoes. Cranes dot the city as once-abandoned buildings are spruced up.

Yet Icelandic firms have struggled to attract foreign investors. The country’s Chamber of Commerce calculates that between 1993 and 2008, when capital flowed freely, export revenues generated by local firms with foreign operations grew at an annual rate of 8%. Since then they have shrunk at an annual rate of 2%. The curbs on sending money abroad may also have stoked a property bubble at home—by the beginning of last year nominal house prices were increasing at an annualised rate of 9%.

Icelanders are keen on foreign holidays, and will be glad to see the back of the hassles created by capital controls. Locals will no longer need to produce plane tickets to buy foreign currency. Students studying abroad will escape similar difficulties. Now the economy is looking stronger, says Sigmundur Gunnlaugsson, the prime minister, the people can have what they want. Bank