

Kaupthing and the Balance of Payments Problem

There have been frequent discussions in the media about the balance of payments difficulties faced by the Icelandic economy. To judge from the discussion, it could sometimes be concluded that forcing the estates of Kaupthing and Glitnir into bankruptcy would solve a major portion of the problem and thereafter the capital controls could be removed. At times this discussion has been imprecise and even misleading. The issues which need to be resolved in connection with the krona assets of Kaupthing and Glitnir do not disappear simply because the handling of the estates is changed from winding-up proceedings to bankruptcy proceedings. The issues would be even more extensive and complicated to deal with if the foreign assets of the estates were to be converted into kronur. In addition, the krona assets of the estates are only a part of the balance of payments difficulties.

Only a minor share

In essence, the balance of payments problem concerns three aspects. Firstly, a possible outflow resulting from krona assets of foreign parties, frequently referred to as "offshore kronur", who may wish to exchange these for other currencies. Secondly, around a settlement of the winding-up proceedings for the collapsed banks. This includes, on the one hand, a bond between the new and old Landsbankinn, under which the new bank is to make payments to the old bank's estate in foreign currencies, and on the other hand, a settlement of the estates of Kaupthing and Glitnir, i.e. the assets of these estates in Icelandic kronur. Thirdly, around the requirement for foreign currencies by domestic parties that do not have earnings in Icelandic kronur.

It is evident that the conversion of all of these funds to foreign currency at once, in an uncontrolled manner, would create enormous pressure on the exchange rate of the Icelandic krona and threaten financial stability in Iceland. The scope of the balance of payments problem has been estimated at around 1,000 to 1,400 billion kronur. That does not include a possible outflow in connection with krona assets of domestic parties who may wish to exchange these for other currencies following the removal of the capital controls.

By far the largest portion of Kaupthing's assets are outside of the Icelandic economy and therefore do not have an impact on financial stability in Iceland. At year-end 2013 Kaupthing's assets denominated in Icelandic krona amounted to close to 148 billion. Of this amount, the holding in Arion Bank was just under 122 billion kronur and other Icelandic krona assets amounted to around 26 billion kronur. Kaupthing's assets denominated in krona therefore amount to only around 10-15% of the extent of the balance of payments problem and are mostly linked to Kaupthing's ownership in Arion Bank. The greatest part of the balance of payments problem has nothing to do with Kaupthing. Despite its importance, resolving specific issues to Kaupthing's situation alone cannot create a basis for removing the capital controls.

Foreign investors' interest

As far as Kaupthing is concerned the most important issue is finding an acceptable solution regarding its holding in Arion Bank. If it can be sold for foreign currency and the winding-up proceedings can be concluded with a composition it would without a doubt have a positive impact on the Icelandic economy.

The Winding-up Committee engaged Morgan Stanley to study the possibility of selling Kaupthing's holding in Arion Bank for foreign currency. That study revealed interest of investors in looking at the possibility further. This interest, however, like any other large-scale foreign investment, depends upon support of the Icelandic authorities.

Among other things, the authorities will have to take a decision on whether it regards foreign investment in Iceland as desirable and whether special concerns apply to the banking system in this context.

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