

30 January 2012

# **Draft Screening Report**

## **Iceland**

### **Chapter 17 – Economic and Monetary Policy**

**Date of screening meetings:**

Explanatory meeting: 17-18 March 2011

Bilateral meeting: 17 May 2011

## **I. CHAPTER CONTENT**

The *acquis* in the area of economic and monetary policy contains specific rules requiring the independence of central banks in Member States, prohibiting direct financing of the public sector by the central banks and prohibiting privileged access of the public sector to financial institutions. Member States are expected to co-ordinate their economic policies and are subject to fiscal and broader economic and financial surveillance. New Member States are also committed to complying with the criteria laid down in the Treaty in order to be able to adopt the euro in due course after accession. Until then, they will participate in the Economic and Monetary Union as a Member State with a derogation from the use of the euro and shall treat their exchange rates as a matter of common concern.

The *acquis* in the area of economic and monetary policy is governed by Title VIII (Art. 119 to 144) of the Treaty on Functioning of the European Union (TFUE), and by relevant implementing legislation. Treaty provisions related to the adoption of the euro do not apply to Member States with a temporary derogation as defined in Art. 139 of the TFUE.

The *acquis* consists mainly of Treaty provisions and protocols, regulations and decisions that do not require transposition into national legislation. Nonetheless, as indicated in Article 131 of the TFUE, each Member State shall ensure that its national legislation, including the statutes of its central bank, is compatible with the TFUE and the Statute of the European System of Central Banks (ESCB).

## **II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY**

This part summarises the information provided by Iceland on its legislation and administrative capacity as well as the discussion at the screening meeting held on 17 May 2011 and additional information provided by the country in the process of assessment.

Iceland indicates that it can accept the *acquis* regarding Chapter 17, Economic and monetary union. It indicates that it does not expect any difficulties to implement the *acquis* by the time of accession.

### **II.a. Monetary policy**

#### *(i) Functional independence*

Iceland stated that the primary objective of the Central Bank of Iceland (CBI), as defined in Article 3 of the 36/2001 Act on the Central Bank of Iceland (CBI Act), is to achieve and maintain price stability. It is provided with the necessary means and instruments for achieving this objective independently of any other authority. The CBI also supports the Icelandic government's economic policy without prejudice to its primary objective. According to the Icelandic authorities pursuant to article 22, the CBI Act the direction of the CBI rests with the Minister of Economic affairs, and the Supervisory Board. According to the Icelandic Authorities the Supervisory Board is a surveillance body. It is elected by the Parliament and there are no provisions that guarantee that it not accountable to the Parliament for its performance of tasks..

Iceland stated that their authorities are aware of the existence of a gap with the *acquis* concerning functional independence and are prepared to amend the relevant legislation in order to achieve compliance with the requirements.

(ii) *Institutional independence.*

Although the CBI Act provides that the CBI is an independent, state-owned institution, Iceland acknowledged that it does not ensure the general prohibition of giving instructions by third parties to the CBI and its decision making bodies, and also that there is a lack of provisions on prohibition of approving, suspending annulling or deferring decisions.

Iceland stated that there is no provision on participation by representatives of third parties in a CBI decision-making body with a right to vote on matters concerning the performance by the CBI of ESCB-related tasks. There is no statutory obligation for CBI to consult third parties ex ante that results in interference with the independence of the members of the CBI's decision-making bodies, that does not respect the special status of Governors in their capacity as members of the ECB's General Council, and that does not observe the confidentiality requirements resulting from the Statute.

No provisions exist in the CBI Act regarding the discharge provided by third parties (e.g. government) regarding the duties of members of the CBI's decision-making bodies.

Iceland stated that they were prepared to amend the relevant legislation in order to achieve compliance with the requirements of institutional independence of the Central Bank.

*Personal independence*

Article 23(1) of the Act on the CBI provides for a five-year term of office for a Governor. It allows the Minister of Economic affairs to appoint temporary replacements in case the Governor or Deputy Governor is unable to perform his/her duties. Article 26 of the CBI Act does not provide for any minimum period of tenure of office for the members of the Supervisory Board. It derives its mandate from the Parliament and is appointed following each election (normally every 4 years). The CBI Act remains silent on the grounds for dismissal of Governor. The Government Employees Act, however, spells out the rights and duties of government employees, including grounds and conditions for dismissal of heads of state agencies. It applies to the Governor and Deputy Governor and the executive from within the CBI who is a member of the Monetary Policy committee. It does not apply however to the members of the Supervisory Board who can be dismissed only by Parliament decision to repeal their mandate.

Iceland stated that it was aware of the existence of a gap with the *acquis* requirements of personal independence and is prepared to amend the relevant legislation in order to achieve compliance with it.

*Financial independence*

Iceland informed that according to the CBI Act the operational budget of the Central Bank is proposed by the Governor and endorsed by the Supervisory Board. Iceland stated it is aware that the accounting rules (Article 32 of the CBI Act) and the financial provisions on distribution of profit under Article 34 should be amended to ensure compliance with Article 27.1 of the ESCB/ECB Statute.

Concerning autonomy in staff matters, there is no legal provision that may impair the CBI's ability to employ and retain the qualified staff necessary to independently perform its ESCB-related tasks. Concerning ownership and property rights, third parties have no rights to intervene or to issue instructions to the CBI in relation to property held by the CBI.

Iceland stated it is aware of the gap with the *acquis* and are prepared to amend the relevant legislation in order to achieve compliance with the requirements of financial independence.

(iii) With regard to the *prohibition of monetary financing* of the public sector, Article 7 of the CBI Act allows the CBI to extend guarantees or loans to credit institutions in exceptional circumstances. Iceland considers that the current Article 7 complies with the requirements under Article 123 of the TFUE. An explanatory note to the CBI Act explicitly states that the Bank can not provide credit to insolvent credit institutions. Iceland pointed out that the requirement for such loans to be short-term is not explicitly specified.

Iceland stated that the Pension Act does not contain any provisions that give rise to privileged access of the public sector to financial institutions. According to the detailed rules on required investment policy of the pensions, the board of a pension fund shall formulate its investment policy and invest the assets of the fund according to the best terms available as regards return and risk on the basis of the stipulated investment rules. Article 36 enumerates assets that Pension Funds may invest, but it does not provide incentives or impose requirements on Pensions Funds to specifically acquire and hold public sector liabilities.

Article 16 of the regulation on Deposit Guarantees Fund requires a minimum of one-fourth of the Fund's capital to be invested in securities carrying a Treasury guarantee. Iceland noted that this requirement is not compatible with the EU *acquis*.

(iv) Iceland acknowledged that it is necessary to complement the CBI Act with the necessary provisions to ensure the integration of the CBI into the ESCB and notably reflecting its subordination to the guidelines and instructions of the ESCB and ECB as from the date of euro adoption.

## **II.b Economic policy**

According to Iceland, its legislation does not contain any provision that is non-compliant with the economic policy *acquis*. Iceland started participating in the pre-accession fiscal surveillance in 2011, when it submitted its first Pre-accession Economic Programme. Iceland has been submitting fiscal notifications since 2007. The economic policy of the country is shaped by the Ministry of Economic Affairs. The Government adopts and updates annually a four-year rolling fiscal framework. However, in view of the traditional legal independence of the different stakeholder institutions, the economic policy coordination remains a challenge.

Iceland informed that it has been implementing an economic policy aimed at stabilising the economy after the severe recession, while preserving the market economy and the welfare state. While public debt and deficit levels remain above the *acquis* reference values (government deficit no higher than 3% of GDP and public debt not higher than 60% of GDP), the fiscal programme of the Government is committed to continued fiscal consolidation which is an appropriate response to the vulnerabilities arising from a high public debt. Capital controls have been extended to end-2013, and in March 2011 the government adopted a strategy for the gradual lifting of capital restrictions and started its implementation (see Screening Report on Chapter 4

Free Movement of Capital). An important part of public expenditure is incurred at local level. In view of this, comprehensive legislation to strengthen local government fiscal frameworks and finances has been approved by Parliament. The Act stipulates strict limits on municipal borrowing, rolling three-year balanced budgets at local level and the introduction of a new data-based and more effective monitoring system. The new framework is set to become fully operational in budget year 2012.

The statistics on economic and monetary policy are compiled on the basis of the European System of Accounts ESA 95, however the frequency and detail of data do not fully meet, according to Iceland, the *acquis* requirements. Iceland stated that the Central Bank and the Statistical Office are aware of these gaps.

### **III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTATION CAPACITY**

Iceland has reached a satisfactory level of alignment with the *acquis*. The basic requirements are in place and the country is well advanced in this area and should therefore be able to take on the obligations of membership by the time of accession. However, in the field of monetary policy further alignment of the CBI Act with the Treaty provisions and the ESCB/ECB Statute is necessary. The administrative capacity in the field of monetary policy is sufficient. In the field of economic policy, the country needs to further develop its capacity for economic policy coordination as well as its participation in the fiscal and broader economic and financial surveillance in the EU.

#### **III.a. Monetary policy**

(i) *Functional independence* requires the primary objective of the national central bank (NCB) to be stated in a clear and legally certain way and to be fully in line with the primary objective of price stability set out in Articles 127(1) and 282(2) of the TFUE. The NCB needs to be equipped with the necessary means to independently pursue this objective. Article 3 of the CBI Act provides that the principal objective of the CBI is to achieve and maintain price stability. Moreover, the CBI shall support the Icelandic government's economic policy without prejudice to its primary objective. However, from the date of the introduction of the euro in Iceland, the secondary objective need to refer to the general economic policies in the EU and take precedence over the current national economic policy objective. Clear allocation of roles and responsibilities between the decision-making bodies of the CBI needs to be ensured. Supervisory Board competences need to be clarified concerning its role to endorse rules adopted by the Monetary Policy Committee on the preparation of, rationale for, and presentation of its monetary policy decisions.

In addition, Article 24 of the CBI Act provides that the decisions of the Monetary Policy Committee must be based on the CBI objectives, which are not clearly and comprehensively indicated in the Act. Consequently, in order to ensure the *functional independence* of the CBI, the CBI Act needs to clearly state the objectives - other than the main objective deriving from Article 3 - and define precisely the tasks listed under Article 4, in line with the TFUE requirements.

(ii) *Institutional independence* involves a prohibition on national central banks from seeking or taking instructions from public authorities and a prohibition on the latter from seeking to influence the members of the NCB's decision-making bodies, whose decisions may affect the fulfilment of the NCB's ESCB related tasks. Although the CBI Act provides that the CBI is

an independent, state-owned institution, it does not ensure the general prohibition of third parties giving instructions to the CBI and its decision making bodies, including the supervisory board, which is incompatible with the central bank *institutional independence* set out in Article 130 of the TFUE. Those incompatibilities with regard to the prohibition on giving instructions, but also with regard to approving, suspending, annulling or deferring decisions are found in the following articles which need to be amended in order to ensure compliance with the *acquis*:

- Article 3 (approval of the Minister of Economic affairs on quantitative target inflation);
- Article 5 (the Minister of Economic affairs shall determine the form, appearance and denominations of the notes and coins issued by the CBI);
- Article 18 (approval by the Minister of Economic affairs of policy decisions of the CBI by which the value of the Icelandic króna against the foreign currencies is determined);
- Article 22 (the direction of the CBI, except from the Supervisory Board, rests also with the Minister of Economic Affairs).
- Article 25 of CBI Act provides for safeguards against the conflict of interest. However, the involvement of the Minister of Economic affairs to decide on conflict of interest matters could undermine the central bank independence.

The Act remains silent on the prohibition for bodies other than independent courts to censor, on legal grounds, decisions related to the performance of the CBI related tasks. Thus, Article 37 (decisions of the CBI to levy fines on credit institutions and unit trusts - in case they fail to comply with the rules on required reserves, liquid funds and foreign balance requirements - may be appealed to the Minister of Economic affairs) is incompatible with the TFUE and the Statute of the ESCB/ECB and should be amended.

Finally, the Act does not provide for any rules on prohibition on the participation by third parties in the CBI's decision making bodies with a right to vote and on discharge provided for the duties of the members of the CBI's decision making bodies.

Moreover, following Article 1 of the CBI Act, the CBI is organised as a state-owned institution, administratively falling under the Ministry of Economic Affairs, which can affect the CBI's independence. This will therefore have to be clearly limited by law.

*Personal independence* aims at ensuring security of tenure for members of the NCB's decision-making bodies (e.g. minimum term of office, rules on grounds for dismissal, rights of judicial review). All decision making bodies of the CBI (Governor, Monetary Policy Committee, Supervisory Board) need to be guaranteed the same level of protection with regard to their independence.

Article 23(1) of the Act on the CBI complies with the general requirement under Article 14.2 of the ESCB/ECB Statute as regards the minimum five years period for the term of office of a Governor. It nonetheless allows the Minister of Economic affairs to appoint temporary replacements in cases when the Governor or the Deputy Governor is unable to perform his/her duties. This runs against the principle of personal independence and is not in line with Article 3(3) of the ECB Decision 2004/12. With regard to the requirement of Article 14.2 of the ESCB/ECB Statute, Article 26 of the CBI Act needs to be amended in order to provide for at least five year terms of office for the members of the Supervisory Board. The CBI Act

remains silent on the grounds for dismissal of Governor, as required under Article 14.2 of the ECB/ESCB Statute. The members of the Supervisory Board and the Monetary Policy Committee (other than the Governor and the Deputy Governor) do not benefit from the same safeguards of personal independence as the Governor and the Deputy Governor. The CBI Act needs to provide for clear rules on the security of tenure and grounds for dismissal of members of the central bank decision making bodies in order to have sufficient safeguards of personal independence in place.

Additionally, for legal certainty reasons, the CBI Act needs also to specify the right of judicial review on the decision dismissing the Governor from his/her function, as laid down in Article 14.2 of the ECB/ESCB Statute.

*Financial independence* needs to be assessed from the perspective of whether any third party is able to exercise either direct or indirect influence not only over the NCB's tasks, but also over its ability to fulfil its mandate. Member States need to notably not impair an NCB's ability to employ and retain the qualified staff necessary for the NCB to perform independently the tasks conferred on it by the TFUE and the Statute. A Government of a Member State cannot be in a position to influence the NCB's policy on staff matters.

The CBI Act is silent on the process of determination of the budget. Article 28(1) refers only to the operating budget presented by the Governor to the Supervisory Board for approval. For legal certainty reasons and in order to ensure the financial independence of the CBI, the Act needs to provide for clear rules on the determination of the budget.

The accounting rules, the laws, other rules (including those specified by the Minister of Economic affairs) and good practices, as laid down in Article 32 of the CBI Act, need to take into account *ex ante* the proposal of the CBI. Those rules need to be determined by the CBI decision making bodies and only *ex post* approved by the Minister. Similarly, Article 33 of the CBI Act need to guarantee that the audited financial statements endorsed by the Governor and the Supervisory Board are approved only *ex-post* by the relevant Minister. Article 33 need to be amended to ensure that the scope of the audit is clearly defined and that the accounts of the CBI are audited by an independent auditor, as required under Article 27.1 of the ESCB/ECB Statute.

Regarding the provisions on distribution of profit under Article 34 of the CBI Act, it is necessary to stipulate in the Act that the decisions on profit allocation are taken by the CBI's decision making bodies independently. Furthermore, the Act needs to provide for financial provisions with respect to the CBI's capital, assets and reserves management.

Finally, Article 5 of Act on Iceland's currency (and consequently, Article 4) needs to be amended; the right of the Minister of Economic affairs to decide on the distribution of profit from the sale of commemorative coins runs against the financial independence of the CBI.

(iii) With regard to the *prohibition of monetary financing of the public sector*, Article 7 of the CBI Act allows the CBI to extend guarantees or loans to credit institutions in exceptional circumstances. In order to comply with the prohibition on monetary financing of Article 123 of the TFUE and to be considered as 'emergency liquidity assistance', a loan needs to only be allowed under the following conditions: the credit institution should be solvent; the loan should be short-term, cover urgent and unforeseen liquidity needs, and be sufficiently secured by adequate collateral. A penalty rate is preferably required. All these conditions have not

been taken fully into account and thus, Article 7, in order to be in line with the TFUE, needs to clearly integrate those conditions.

Regarding the fiscal agent function, the CBI Act is aligned with the *acquis* and the monetary financing prohibition. However, the Act should provide that the remuneration margin on deposits/current account balances are at or below market rates.

Regarding the compliance with Article 124 of the TFUE, the CBI Act does not contain provisions establishing privileged access by the public sector to financial institutions, which is in line with the *acquis*. However, art. 16 of the Regulation on deposit guarantees requires that a minimum, one-fourth of the Deposit Guarantee Fund capital shall be invested in securities carrying a Treasury guarantee. This provision has to be amended so as not to provide specific requirements for investment in the Icelandic Government Treasury Bonds, or will need to be clarified to cover all securities carrying a treasury guarantee.

Additionally, Iceland needs to ensure that any act which may provide specific incentives for, or requirements imposed on, the financial sector to acquire and hold liabilities of the public sector is removed.

(iv) With a view to *integrating the central bank into the ESCB*, Iceland needs to complement the Act on the CBI with the necessary provisions ensuring integration of the CBI into the ESCB and notably reflecting its subordination to the guidelines and instructions of the ESCB and ECB as from the date of euro adoption.

### **III.b. Economic policy**

The legislation of Iceland does not contain any provision that is non-compliant with the economic policy *acquis*. Iceland participates in the pre-accession fiscal surveillance and is regularly submitting fiscal notifications. This contributes to developing the administrative capacity of the country for participation in the economic policy coordination and fiscal and broader economic and financial surveillance. However, further efforts will be needed to improve the capacity for economic policy formulation and coordination.

The statistics on economic and monetary policy are compiled on the basis of the European System of Accounts ESA 95, however further efforts will be needed in order to produce the full range economic and fiscal statistics required by the *acquis*.

## **IV. CONCLUSIONS AND RECOMMENDATIONS**

In view of the above, in particular the findings presented in Part III, Iceland can be considered to be sufficiently prepared for negotiations on this chapter. The Commission therefore recommends the opening of accession negotiations with Iceland on the chapter on Economic and Monetary Union.