Iceland (/gws/en/esp/issr/80442256)

FitchRatings

Fitch: Iceland Capital Controls Removal Positive; Execution Key

Fitch Ratings-London-12 June 2015: Iceland's announced strategy for the removal of capital controls is positive for the country's credit profile, Fitch Ratings says. The impact on Iceland's sovereign rating (BBB/Positive) will depend on the effective implementation of the strategy over the months ahead, in a context of monetary and exchange rate stability.

Capital controls were introduced in November 2008, following the collapse of Iceland's major banks. The presence of capital controls weighs on Iceland's credit profile. At the same time, the Icelandic authorities have been adamant that the removal of capital controls is contingent on avoiding excessive balance of payments pressures arising from the currency mismatch between domestic claims and assets of the failed bank estates (LBI, Kaupthing, and Glitnir) and the unwinding of 'locked-in' ISK assets owned by non-residents.

The strategy announced by Iceland's Ministry of Finance and Economic Affairs on Monday appears to take account of these pressures. The estates of the failed banks have a six-month window to propose a composition agreement consistent with a series of 'stability conditions' set by the ministerial Task Force on capital account liberalisation. Composition agreements would pave the way for payments to creditors outside Iceland. If the bank estates and the authorities do not reach a composition agreement, the former will be subject to a one-off 39% 'stability tax' on their assets at year-end.
Early indications suggest, however, that all three estates will abide by the stability conditions and seek a composition agreement.

A second plank of the authorities' strategy is the intention to unwind the controls on remaining non-resident ISK assets. Holders of ISK assets will be able to obtain FX at a premium through a currency auction, invest in government bonds, or lock in their investment for the long term.

The process of capital control liberalisation - even if the strategy is well thought out - inevitably carries some risks. Sudden and large capital outflows may lead to short-term uncertainty and exchange rate volatility, putting pressure on import prices, and the balance of payments. Over the past six years, Icelandic firms and pension funds have had very limited opportunities to invest abroad. A sudden portfolio shift by Icelandic pension funds, for example, could also put downward pressure on the exchange rate. That said, the Icelandic authorities have in the past indicated that limits on foreign investment by domestic investors would probably form part of the post-controls landscape.

At the same time, the removal of controls would improve the business environment. Moreover, composition agreements with the failed bank estates would dramatically improve Iceland's external metrics, as a sizeable share of the country's external liabilities would drop out of estimates of the Net International Investment Position.

Also, the implementation of the strategy - either through compositions or the stability tax - would substantially improve the government's fiscal position. The Ministry of Finance has indicated that revenues from the stability tax may amount to around a third of GDP, and more importantly, that the windfalls from the resolution of the old banks would be used to pay down debt.

We revised the Outlook on Iceland's 'BBB' sovereign rating to Positive from Stable in January. The revision was partly driven by the agreement to extend maturities on bonds issued to failed bank creditors which will cut Iceland's private foreign-debt service burden over the next three years.

This week's announcements confirm our view that the bond renegotiation and associated capital control exemptions were important steps in the removal of the capital controls, which heralded further measures in 2015-2016. Our assessment of their likely impact will form part of our next scheduled sovereign review, due on 24 July.

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