Fitch: Iceland Eases Capital Controls; FX Reserves Reduce Risks

Fitch Ratings-London-30 August 2016: Iceland's latest move towards removing capital controls continues the steady progress made in implementing the liberalisation strategy set out in June 2015, Fitch Ratings says. This process has been credit positive for the Icelandic sovereign, and further capital control liberalisation would improve the business environment, allowing Icelandic households and businesses to diversify their investments. Moving towards unrestricted capital flows still presents risks, although there are mitigants.

The Icelandic government introduced a bill on 19 August that would phase in provisions for outward FDI (subject to Central Bank of Iceland approval) and let individuals invest up to ISK100m in securities outside Iceland and purchase one piece of real estate per year, among other measures. Other restrictions, such as those on transfers of bank deposits, will be eased from 1 January 2017.

The measures mean that "capital controls should not place substantial restrictions on most individuals" and requests for exemptions should fall by 50%-65%, Iceland's Ministry of Finance and Economic Affairs said. This step follows June's foreign currency auction where the CBI offered non-resident holders of ISK assets 'locked in' by capital controls the chance to unwind their positions by exchanging ISK assets for FX at a discount on the onshore exchange rate. The CBI said that total offers to buy ISK83bn were accepted.

The announcement of a detailed, credible policy for lifting capital controls, with implementation contingent on avoiding excessive balance-of-payments pressures, was an important driver of our upgrade of Iceland's sovereign rating to BBB+/Stable in July 2015. The authorities have adhered to the plan, for example securing agreements with the estates of the failed Icelandic banks. This greatly reduced potential balance-of-payments and exchange rate risks arising from currency mismatches between the estates' assets and creditor claims.

Risks associated with the potential acceleration in capital flows cannot be discounted, but we think these have eased as the liberalisation strategy has been implemented. Net external debt is still high compared to other 'BBB' category sovereigns, but current account surpluses (largely due to tourism and fish export earnings and low import prices), and central bank buying of FX to bolster reserves and in response to ISK appreciation mean reserves have risen to around 30% of GDP; this provides a substantial buffer. Stress tests published by the CBI indicate that in case of substantial outflows, up to ISK285bn (around 12% of GDP) of residents' assets may be invested overseas over the next two years.

In conjunction with the currency auction, the Icelandic authorities introduced a special reserve requirement on capital inflows, to deter excessive inflows driven by the interest rate differential between Iceland and other developed markets. Low import prices and an appreciating krona have contained inflation and the CBI's decision to cut interest rates by 50 bps to 5.25% on 24 August suggests that risks to macroeconomic stability from strong growth and high labour costs are lower than previously thought - although the central bank said that the "imbalances and the uncertainty associated with capital account liberalisation argue for caution in interest rate setting."

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