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ISSUER COMMENT

Iceland's Prepayments on IMF and Nordic Government Loans are Credit Positive

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Last Monday, the Central Bank of Iceland announced that Iceland (Baa3 negative) would prepay ISK171 billion on its outstanding loans from the International Monetary Fund (IMF) and the Nordic governments, the second time this year that the country has made an early repayment on its substantial loans extended by official creditors.[1] The prepayment is credit positive as it improves Iceland's external debt maturity profile and will help limit the risk of excessive exchange rate volatility as the country gradually loosens its strict capital controls.

The original total loan from the IMF and the Nordic governments was €3.5 billion, or approximately ISK558 billion at current exchange rates. Including the first repayment, Iceland has now repaid 55.5% of the combined loans from the IMF and Nordic governments.[2] The early repayment to the IMF and the Nordic governments has only a limited impact on Iceland's overall public debt levels because the government has repaid official creditors with the proceeds of a recent Eurobond issue[3]. The transaction reduces Iceland's gross external debt by 2.6% of GDP to approximately 173% of GDP.

The early repayments cover principal that is due to the IMF in 2013 and 2014, and repayments that are due to the Nordic governments in 2016-18. The exhibit below shows the repayment profile for Iceland's Treasury and Central Bank combined, before the March and June pre-payments, and the new repayment profile. As the exhibit shows, the most substantial repayment on Iceland's public-sector external debt occurs in 2016, when the country's first post-crisis Eurobond matures. Until then, repayments on external debt by the government and central bank are comparatively moderate and fully covered by foreign-exchange reserves, which were at ISK 1,063 billion as of May 2012 (ISK895 billion, including the second prepayment).

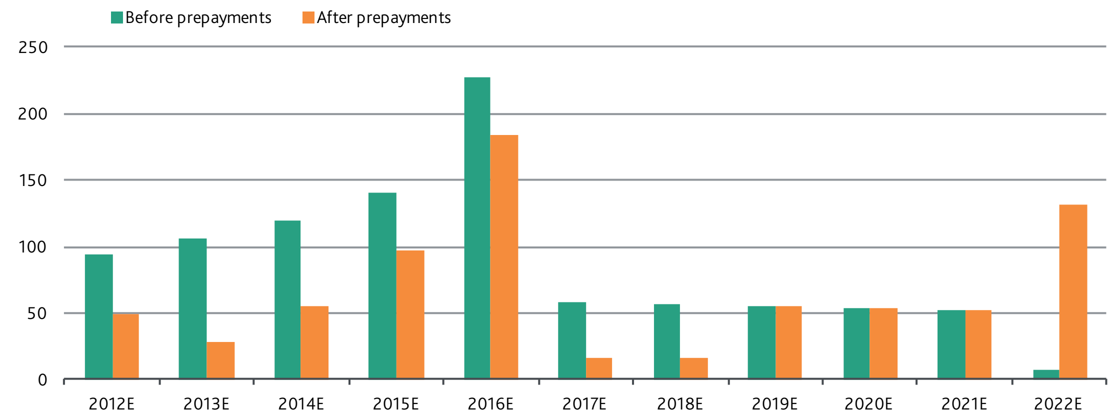
1 The first repayment in March 2012 was equal to €705 million, or nearly 21% of the total loans outstanding, and covered maturities of 2013 to the IMF and 2014-16 payments due to the Nordic governments. See Iceland: Early part-repayment of IMF and Nordic loans in positive, 22 March 2012.

2 The pari passu clause requires the Icelandic authorities to make proportional pre-payments to the IMF and the Nordic governments.

3 According to the Icelandic authorities the transaction leads to an increase in government gross debt by 2.6% of GDP. This is due to the fact that the IMF and Norway extended their loans directly to the Central Bank of Iceland. As a result, these liabilities do not appear under government debt. However, we include these loans in our calculations of general government debt.

FIGURE 1

Iceland's Combined Treasury and Central Bank Foreign Debt Payment Schedule (ISK bn)



Note: Includes projected interest due

Before Prepayments: As of the end of March 2012

Source: IMF, Icelandic Government Debt Management, Bloomberg, Moody's calculations

The early repayments are positive because they will help reduce the risk of excessive exchange rate volatility as Iceland's authorities ease the country's strict controls on capital outflows, which we expect to start in earnest in 2013-14[4]. Hence, it is positive that the authorities attempt to reduce capital outflows linked to their own debt maturities that would otherwise exert additional pressure on the exchange rate.

Still, even taking into account the reduced foreign-currency outflows linked to official payments, the size of potential capital outflows in the coming years remains substantial and properly sequencing the liberalization of capital outflows to maintain exchange rate and financial stability will be the major challenge for Icelandic policy-makers.

Foreign investors have been unable to withdraw approximately ISK425 billion (24% of 2012 GDP) of króna-denominated assets since the government imposed strict capital controls in late 2008. Most of those investors will want to exit the country as soon as the government lifts the restrictions on capital outflows.

Depreciation pressure on the króna will also likely arise from the settlement of the estates of the banks in winding-down process as well as foreign-currency debt payments by domestic companies. The Icelandic authorities estimate that foreign creditors of the failed banks are due to receive around ISK190 billion (11% of GDP) in foreign currencies out of the settlement of the failed banks' estates. In addition, they estimate foreign-currency debt payments due by Icelandic companies of up to ISK80 billion per year in 2012 and 2013, rising to more than ISK100 billion per year after that, assuming no change in income.[5]

4 The Central Bank has been conducting foreign-exchange auctions since February this year to allow the most "impatient" foreign investors to exit the country. While this is the first step in the capital account liberalization strategy of the Icelandic authorities, the amounts of capital outflows so far have been moderate.

5 See Central Bank of Iceland: Financial Stability Report, June 2012.

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