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FITCH: ICELAND GETS SOLID IMF REPORT CARD, LEGACY ISSUES REMAIN

Fitch Ratings-London-21 November 2012: Moderate growth and fiscal consolidation show Iceland is on track to recovery but a number of legacy issues remain to be addressed before the process is complete, says Fitch Ratings.

Most importantly, capital controls still trap the equivalent of approximately 50% of GDP in the country; 23% of that is offshore kronas with a further 30%-40% of potential net foreign claims arising from the winding up of Iceland's failed banks, according to a recent IMF report.

If capital controls are unwound in line with the current legislative deadline of the end of 2013, it would probably expose Iceland to damaging capital flight (resident and non-resident), a collapse of the exchange rate, soaring inflation and renewed financial sector instability. However, the longer controls remain in place, the more detrimental they will become to investor sentiment and broader economic recovery.

We agree with the IMF that the 2013 deadline is likely to be extended. The slow progress so far shows that the authorities have a particularly cautious interpretation of their three conditions of: restoration of macroeconomic stability; an adequate level of international reserves and; a sound financial system, although considerable progress has been made on all three counts. This highlights the intractability of capital controls.

The macroeconomic position is good compared with other countries who have had support programmes. Iceland will post 2.6% growth in 2012, unchanged from last year, while gross public debt appears to have peaked at almost 100% of GDP in 2011. We expect debt to fall to 75%-80% of GDP by 2017 as Iceland continues its fiscal consolidation.

Monetary and exchange rate policy are more problematic. Inflation is still running some way above the Central Bank of Iceland's target of 2.5%, while the slow pace of capital account liberalisation means that the exchange rate has yet to attain a sustainable equilibrium.

The stability of the financial sector is dependent on how capital controls are removed. The banks are well capitalised and liquid at the moment, but are likely to see funding difficulties if controls were lifted too quickly.

Fitch upgraded Iceland's sovereign ratings from 'BB+' to 'BBB-' earlier this year in recognition of the progress that had been made in restoring macroeconomic stability, restructuring the financial sector and rebuilding sovereign creditworthiness. Iceland regained market access in 2011 and has used the proceeds from several sovereign bond issues to prepay near-term obligations to the IMF and official bilateral creditors.

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