

ISSUER COMMENT

Iceland: Early part-repayment of IMF and Nordic loans is positive

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We believe that the recently announced early repayment of part of Iceland's debt owed to the IMF and Nordic governments is credit-positive.

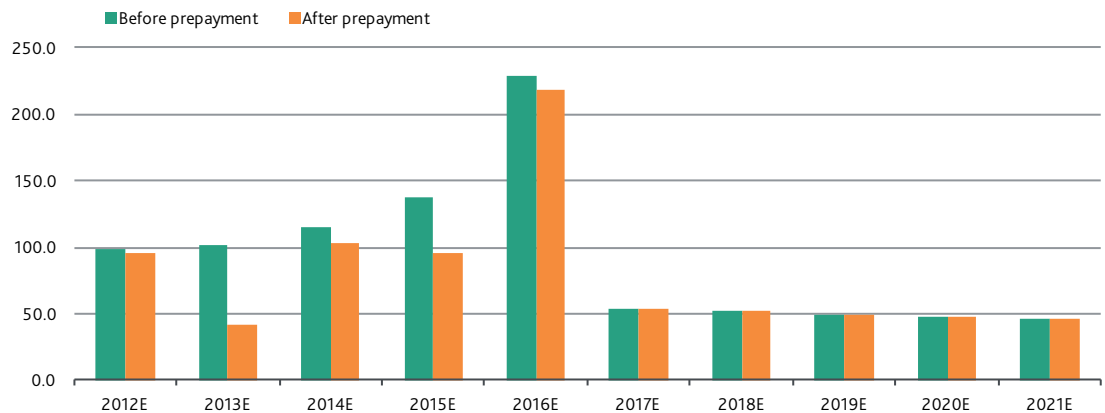
Iceland's early repayment of a significant part of the total outstanding loans of €3.4 billion (ISK567 billion at current exchange rates), as announced on 15 March, smoothes Iceland's external payment profile and generates interest savings for the government and the central bank (of approximately ISK10 billion or 7% of interest payments due on the loans). In fact, a key aim of this transaction was the reduction of the significant net interest expense associated with holding large amounts of "borrowed" reserves against short- to medium-term debt maturities.

Specifically, Iceland has prepaid the equivalent of €705 million (close to 21% of the total outstanding), covering the 2013 payment that is due to the IMF as well as the 2014-2015 payments and part-payment for 2016 maturities that are due to the Nordic governments.¹ The transaction also reduces Iceland's very high external debt burden, albeit only marginally (by 7.2% of GDP to 201% of GDP if the banks in winding-up process and short-term deposits are excluded). The transaction reduces gross government debt by 2.7% of GDP.²

¹ The payment to the IMF amounts to SDR 289 million (the equivalent of ISK 55.6 billion). The Nordic governments receive €366 million (ISK 60.5 billion). Repayments to the Nordic governments were scheduled to start only in December 2014.

² The IMF and Norway extended its loans directly to the central bank, hence these liabilities do not appear under government debt. In net terms, both the external and government debt position remains unchanged.

Exhibit 1

Maturity profile: Treasury and Central Bank Debt (ISK bn) *

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

* includes projected interest due

But capital account liberalisation will remain challenging

The transaction, albeit positive, is not sufficient in itself to trigger a positive rating action. It is clear that Iceland will need to maintain a high level of foreign-currency reserves during the capital account liberalisation process. Reserve coverage is currently adequate with total reserves of approximately ISK 978 billion (after pre-payment) amply covering the foreign-currency outflows in the next 12 months, which the central bank estimates at ISK 460 billion. Also, the central bank has announced further foreign-exchange auctions for the coming months, which should strengthen reserve adequacy further. Still, the level of borrowed reserves remains high at around 46% (after prepayment) and the large amount of non-resident ISK holdings – trapped in the country when the capital controls were imposed in late 2008 – continues to constitute a risk to the smooth operation of the liberalisation strategy.

The complexity of enforcing capital controls was demonstrated earlier in the month when the Icelandic government closed several loopholes in the capital control regime by revoking general exemptions from the controls for the estates of the collapsed banks as well as for payment flows related to amortising bonds. According to the government, these exemptions could have a significant negative effect on Iceland's balance of payments, as the outflows related to the estates of the failed banks alone are estimated by the government at 32% of GDP.³ With these changes the Icelandic authorities intend to better control the timing of external capital flows and to limit their impact on the balance of payments and the exchange rate. The closure of the loopholes gives some comfort that the authorities will indeed be able to manage the ongoing gradual relaxation of the controls in an orderly fashion. But capital account liberalisation is still in the early stages and managing the liberalization of the controls without endangering exchange rate and financial stability will remain a major challenge.

³ See Ministry of Finance website at <http://eng.fjarmalaraduneyti.is> for more detail.

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