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FITCH: ICELAND REMOVES CAPITAL CONTROLS AS EXTERNALS STRENGTHEN

Fitch Ratings-London-20 March 2017: Iceland's removal of capital controls on residents reflects improved external resilience and strong buffers, limiting the risk of pressure on the balance of payments and the exchange rate, Fitch Ratings says. The risk of macroeconomic imbalances remains part of our sovereign rating assessment.

Iceland last week removed almost all capital controls on Icelandic households, businesses and pension funds (restrictions remain on some derivatives and foreign-exchange transactions and lending to non-residents). Capital controls had been significantly loosened over the preceding six months without triggering large capital outflows or pressures on the krona. Removing capital controls should also alleviate upward pressure on domestic asset prices.

The Icelandic authorities also agreed with some remaining holders of offshore krona assets still behind capital controls to exchange about ISK90 billion at an exchange rate of ISK137.5 to the euro, which is below the current market exchange rate, but above the range at which some holders exchanged in June last year. This has reduced the overhang of offshore ISK to about ISK100 billion, or 4% of GDP. Holders who did not take part can currently still do so at the same exchange rate.

These moves are consistent with the phased liberalisation strategy set out in June 2015. Current account surpluses (8% of GDP in 2016, according to the Central Bank of Iceland's preliminary estimate) and capital inflows have built up foreign-exchange reserves to ISK811 billion, or about a third of GDP, in February. This is a large buffer against the risk that pent-up demand for foreign assets leads to sharp outflows weakening the currency and the balance of payments. We think this risk is currently contained and has not materialised in response to this week's liberalisation - the krona fell by about 2.5% on the announcement but remains about 14% higher against the dollar than a year ago.

The stronger external position has been accompanied by strong growth in the domestic economy and improved public finances. Excluding the impact of the stability contributions of the estates of Iceland's failed banks, the government balance showed a surplus of 1.3% in 2016. Last year's GDP increase of 7.2% (according to preliminary figures from Statistics Iceland) was largely driven by a tourism boom, which has also supported exports and the current account.

Domestic cost pressures and high wage settlements have not translated into high inflation, which was unchanged at 1.9% in February, as the higher krona offsets domestic demand pressures, and real interest rates remain higher than other advanced economies. The special reserve requirement introduced last year has significantly slowed down the inflow of capital attracted by relatively high interest rates.

But above-trend growth and an appreciating real exchange rate could lead to domestic demand overheating and create risks to macroeconomic stability. Macro imbalances are an inherent risk for a small, open economy with a more open capital account.

Falling external vulnerability and public-sector debt, economic growth and progress in capital control liberalisation were the key drivers of our revision of the Outlook on Iceland's 'BBB+' Sovereign Rating to Positive in January.

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