FitchRatings

FITCH: EFTA ICELAND RULING POSITIVE; CAPITAL CONTROLS STILL KEY

Fitch Ratings-London-29 January 2013: The European Free Trade Association (EFTA) Court's dismissal of alleged claims that Iceland failed to comply with obligations to Icesave depositors is positive for Iceland's sovereign credit profile, but the continuing presence of capital controls still weighs on the sovereign rating, Fitch Ratings says.

Monday's ruling removes a potential threat to Iceland's public finances. A significant contingent liability for the state would have been crystallised had the government been required to fund the interest-servicing costs associated with the loans incurred by the UK and Dutch governments when they reimbursed Icesave depositors (up to the Icelandic deposit insurance scheme amount of EUR20,000 per depositor). The Icelandic authorities estimated that this liability could have been as high as 6.5% of GDP, while IMF estimates were considerably higher.

The EFTA Court's dismissal of the application is consistent with our baseline scenario that general government debt-to-GDP peaked at 101% at end-2011, and will fall to below 70% by 2020 - assuming a primary surplus of 4% of GDP (in line with the average for 1998-2007), average nominal GDP growth of 5.4%, and average nominal interest rates of 4.8%. An unfavourable ruling would have slowed the fall in the public debt/GDP ratio.

More broadly for Iceland, the ruling appears to draw a line under the protracted dispute, and removes the risk of the potentially damaging fall-out for the economy and the exchange rate which an adverse ruling might have had. The Icelandic authorities have confirmed that payments from the estate of the failed Landsbanki will continue regardless of the EFTA Court ruling.

The ruling marks a step towards normalising relations with external creditors, but capital controls remain a major stumbling block. These support the currency and limit the risk caused by currency mismatches, but they also hold back investment and constrain economic growth. The Icelandic authorities continue to adhere to a conditions-based policy for lifting capital controls, and are exploring new avenues to accelerate the reduction in the overhang of non-resident holdings of krona-denominated instruments.

As we noted when we upgraded Iceland to 'BBB-' from 'BB+' in February last year, future sovereign rating actions will take a range of factors into account - including accelerated private sector domestic debt restructuring, a progressive unwinding of capital controls, normalisation of relations with external creditors, and enduring monetary and exchange-rate stability.

The Outlook on the rating is Stable.

Contact:

Paul Rawkins
Senior Director
Sovereigns
+44 20 3530 1046
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Michele Napolitano
Director
Sovereigns

+44 20 3530 1536

Mark Brown
Senior Director
Fitch Wire
+44 203 530 1588

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.