International
Special Report

Iceland: A Difficult Road Ahead

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Summary

On 19 November Iceland finally won IMF approval for a two-year USD2.1bn stand-by arrangement (SBA), supplemented by some USD3bn of bilateral official funding. This financial rescue package, which had been delayed by prolonged debate over whether the sovereign was liable for private deposit insurance obligations in overseas jurisdictions, followed the collapse of the banking system at the beginning of October. Multiple sovereign rating downgrades accompanied this credit event, taking Iceland's Foreign and Local Currency Long-Term Issuer Default Ratings (IDRs) from 'A+' and 'AA+' to 'BBB–' and 'A–' respectively; all the ratings remain on Rating Watch Negative.

IMF Executive Board approval of the SBA triggered an immediate disbursement of USD827m, allowing the authorities to take the first steps towards restoring confidence in the currency, restructuring the financial system and stabilising the economy. This Special Report examines the sequence of future policy steps as they are spelt out in the IMF's letter of intent (LOI), the execution risks of the programme, and the broader implications for sovereign creditworthiness. The main conclusions are these:

- The IMF programme addresses an urgent need for a credible macroeconomic stabilisation programme, backed by sizeable external financing to stabilise the ISK and restore investor confidence. Nevertheless, a deep recession looks unavoidable, accompanied by high inflation, further steep falls in asset prices and rising unemployment.
- The early stages of the programme will be characterised by a high degree of execution risk, reflecting the overriding need to stabilise the currency, lay the foundations for economic recovery, and normalise international financial flows. The potential for capital flight - non residents hold ISK400bn of liquid domestic assets - could pose a significant challenge to exchange rate stability initially, hence the need for tight liquidity, high interest rates and such unorthodox measures as the maintenance of temporary capital controls.
- General government debt, currently low at 29% of GDP, is set to rise sharply to over 100% of GDP as the government shoulders the cost of recapitalising the banking system and meeting the cost of overseas deposit insurance obligations. Double-digit fiscal deficits will add to the pressures on public finances in the near term; in the longer term, a medium-term fiscal consolidation programme will be essential to restore sovereign creditworthiness.
- Maintenance of investment-grade status reflects the authorities' proven commitment to prioritise sovereign debt service in the face of significant financial-sector distress. All sovereign external liabilities have been repaid on time and in full in 2008. External public debt service is negligible in 2009-2010, providing a vital breathing space as Iceland takes on significant new sovereign foreign-currency liabilities, albeit longer term.
- Iceland's debt tolerance is high, as evidenced by its elevated income per capita, notwithstanding the recent depreciation of the currency, and the nation's asset-rich pension funds, which should absorb most incremental public debt issuance. Euro area membership has gained in popularity as a potential path of external salvation for Iceland, but Fitch believes the timetable for such a move could be at least five years and offers no quick fix.

Macroeconomic Outlook

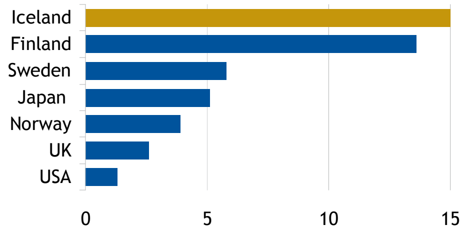
(% GDP)	2008	2009
Real GDP growth	1.6	-9.6
Inflation	13.0	14.5
General govt. balance	-0.2	-13.5
General govt. debt	99.9	118.9
Current acc. balance	-10.5	1.0
Int reserves (USDbn)	5.1	5.1
Gross public ext. debt	81.8	134.2
Net public ext. debt	50.0	89.6

Source: IMF, Fitch

Policy Priorities

The Icelandic authorities' LOI recognises that the speed with which the economy has collapsed poses unique challenges that will need to be addressed with a mix of orthodox and less orthodox measures. There can be little doubt that the economy is on course for a deep recession, accompanied by a sharp rise in the fiscal deficit and an escalation of public-sector debt, as the government shoulders a major part of the cost of adjustment. While the need to restore a fully functioning internationally integrated banking system is paramount, the authorities' first objective must be to stabilise the currency.

Output Losses: Episodes of Major Financial Stress in 1990s[a] (Peak to Trough, % of GDP)



[a] For countries other than Iceland
Source: IMF, Central Bank of Iceland

Having lost 50%-55% of its value against the USD and the EUR in January-October, the authorities are anxious to avoid a further steep depreciation of the ISK that would inflict severe financial distress on households and corporates, given these sectors' high concentrations of foreign-exchange and inflation-indexed debt. Re-floating the currency has been fraught with difficulties. While the current account is set to swing into surplus in 2009, lending some much needed support to the ISK, the behaviour of non-resident investors, who hold some ISK400bn (USD3.5bn at current exchange rates) of liquid domestic assets, presented the authorities with the bigger headache. Faced with a potential rush to close these positions and repatriate foreign exchange, the Central Bank (CBI) has raised policy rates to 18% and put in place capital controls for up to two years. Nonetheless, the risk that the CBI will have to intervene to support the ISK in the early stages remains, and the size of the IMF programme speaks to this.

New rules governing the trading of the ISK took effect on 4 December, since when the currency has appreciated by close to 30% against the USD and the EUR, albeit from very low levels. Stabilisation of the ISK will be a prerequisite for reducing inflation and interest rates and recalibrating monetary policy. Inflation targeting was steadily undermined by Iceland's unsustainable macroeconomic imbalances and had ceased to have any real credibility in the lead-up to the crisis. In the absence of a credible monetary policy anchor, the exchange rate will remain the key reference price for the economy, effectively determining the length and depth of the recession. Based on current policy settings, the authorities envisages a deep recession — real GDP will contract by 10% in 2009 — accompanied by a spike in inflation to over 20% in Q109 and peak unemployment of 10% by end-2009.

Much has been made of Iceland's impressive track record of adjusting to external shocks. However, Fitch considers that tight liquidity, coupled with the deep indebtedness of the household and corporate sectors and the prospect of steep falls in asset prices, all point to a longer and more painful period of adjustment this time. Moreover, while the authorities have set considerable store by a sharp reversal in the current account deficit, albeit driven mostly by a decline in imports, this adjustment could be complicated by an adverse global economic environment. Fitch expects the advanced economies, the destination of most of Iceland's exports, to experience their worst recession since World War II in 2009. While it is a misnomer that the real economy remains heavily dependent on fish production, much new aluminium smelting capacity — the second string to Iceland's export bow — has started to come on stream at the very point when world market prices are falling and production is being subject to steep cutbacks.

Fiscal Costs of Bank Crises (% of GDP)

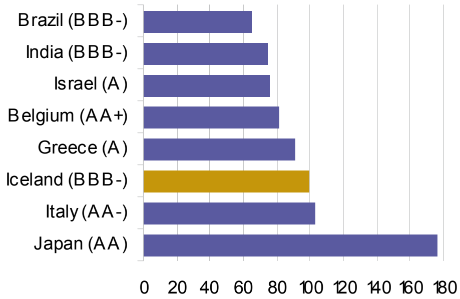
Country	Crisis period	Gross outlay
Chile	1981-1983	52.7
Finland	1991-1993	12.8
Indonesia	1997-2003	56.8
Korea	1997-2000	31.2
Norway	1987-1989	2.5
Sweden	1991-1993	4.4
Thailand	1997-2000	43.8
Turkey	2000-2003	29.7
USA	1984-1991	3.7
Venezuela	1994-1995	15.0

Source: IMF

Counting the Fiscal Costs of Adjustment

General Government Debt

% of GDP, 2008f



Source: Fitch

Financial crises of the magnitude that Iceland has experienced are more commonly associated with emerging markets and have invariably inflicted a heavy burden on ailing countries' public finances; Iceland promises to be no exception. Preliminary IMF estimates put the combined fiscal cost of recapitalising the banking system and meeting overseas deposit insurance obligations at 80% of GDP. Gross outlays on this scale would put the cost of the Icelandic financial crisis far ahead of the worst emerging-market banking crises (Indonesia spent close to 60% of GDP recapitalising its banking system in the wake of the Asia crisis).

Factoring in higher interest payments on public debt and steep falls in revenue — arising from the loss of income from financial-sector corporate income taxes and withholding taxes — the general government balance is forecast to swing from a surplus of 5.5% of GDP in 2007 to a deficit of 13.5% in 2009. Fitch expects general government debt to rise from 29% of GDP at end-2007 to 100% at end-2008 and 119% of GDP by end-2009. Few Fitch-rated sovereigns rival this level of public indebtedness: Italy (AA-) and Jamaica (B+), sovereigns at the opposite end of the rating spectrum, come closest at 103% and 110% of GDP respectively. An important mitigating factor in Iceland's case is its high GDP per capita, which speaks to an elevated degree of debt tolerance: even at its current, highly depreciated exchange rate, Iceland's 2009 GDP per capita at market exchange rates would still be on a par with the 2007 'AA' median (USD34,000).

The latter consideration is likely to manifest itself most clearly in the increased uptake of government paper by Icelandic asset-rich (122% of GDP and end-2007) pension funds, which are expected to absorb most incremental public debt issuance, thereby relieving pressure on domestic financial markets. As these funds are heavily weighted towards external assets at present, this projected switch into domestic assets should also support the exchange rate as capital is repatriated to Iceland. Nonetheless, there is no denying the fact that there has been a material erosion of sovereign creditworthiness and Iceland's sovereign ratings have been subject to multiple downgrades since 30 September. Maintenance of investment-grade status — Fitch rates Iceland 'BBB–' on the foreign-currency scale — reflects the authorities' proven commitment to prioritising sovereign debt service in the face of unprecedented financial-sector distress. Even so, the ratings remain on Rating Watch Negative, pending the highly uncertain outcomes of the financial crisis.

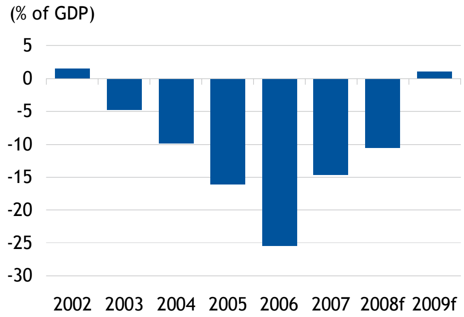
A key risk for the public finances is that the economy suffers a deeper and more prolonged recession, leading to double-digit fiscal deficits beyond 2010 and a further escalation of public debt. Such an outcome could also be expected to have an adverse impact on bank asset quality, holding out the prospect of a second round of bank recapitalisations. Indeed, the CBI is already forecasting that the decline in real estate values will be on a par with that experienced by Finland (40% in real terms from peak to trough) in the wake of its banking crisis in the early 1990s. Such potential downside risks point to the need for the early formulation of a medium-term fiscal consolidation programme to rebuild sovereign creditworthiness as the economy starts to recover.

The authorities plan to address this issue in the 2010 budget. The task of public debt reduction should be facilitated by some degree of asset recovery. Privatisation proceeds from the sale of the "good" (officially referred to as the new/domestic) banks should allow the government to claw back some of the costs of recapitalisation, while foreign asset recoveries from the "bad" (old/foreign) banks could help to defray public-sector outlays linked to overseas deposit insurance obligations. As a rule, the net cost to the sovereign of systemic banking crises has been much less in advanced countries than emerging markets; however, this seems unlikely to hold true in Iceland's case, given the sheer scale of the projected initial outlays.

The External Dimension

Iceland was always going to be vulnerable to a less benign global credit environment, given the magnitude of its external imbalances — the current account deficit had been running at more than 15% of GDP since 2005 — and its soaring net external indebtedness. With the "sudden stop" in external capital inflows, an abrupt external adjustment is in prospect. Severe import compression, coupled with non-payment of interest due (pending expected write downs of bank debt), is expected to generate a swing in the current account balance from a deficit of 11% of GDP in 2008 to a surplus of 1% in 2009.

Current Account Balance



Source: Fitch

Estimates of Iceland's external financing requirement have been necessarily fluid on account of the uncertainty surrounding the magnitude of the country's overseas deposit insurance obligations. Latest estimates point to a financing need of USD21bn-22bn between now and the end of 2010, down from an earlier IMF figure of USD23.5bn, reflecting a potential over estimation of deposit insurance obligations, although there is no official confirmation of this at the time of writing.

External Financing Needs

(USDbn)	2008-10
Gross external financing requirement	23.5
Financing:	
IMF Stand By Arrangement	2.1
Bilateral contributions[a]	2.9
Accumulated arrears owed by Icelandic banks	10.3
Bilateral loans to cover deposit insurance	8.2

[a] Finland, Sweden, Denmark and Norway (USD2.5bn), Poland (USD200m) and the Faroe Islands (USD50m) plus others
Source: IMF

Immediate disbursement of USD827m under the IMF programme has helped to stabilise liquid international reserves at USD3.6bn (end-November), while Norway, Sweden and Denmark have extended a EUR1.5bn swap arrangement until end-2009. Nonetheless, the authorities are erring on the side of caution: exporters are required to surrender foreign exchange in short order and tight capital controls have been announced that could remain in place for up to two years. Domestic and non-resident investors are forbidden to convert the proceeds of ISK investment into foreign exchange for the foreseeable future. Dividends and foreign-currency debt service should return to normal. However, a sizeable backlog of private non-bank external payment arrears has accumulated, while private non-bank external amortisation payments rise to over USD2bn a year in 2009-2010.

Gross sovereign external indebtedness will rise sharply as Iceland draws down IMF and associated bilateral funding to bolster its reserves, stabilise the currency and meet overseas deposit insurance obligations. Whereas Iceland was in the fortunate position of having low gross public external debt (20% of GDP) prior to the crisis, Fitch estimates point to a seven-fold increase to over 138% of GDP by end-2010. Iceland's capacity to shoulder this increased debt burden will be aided in the near term by a very modest public external debt repayment schedule. Having met all of its' scheduled sovereign debt service obligations for 2008, the government faces negligible external maturities until 2011, when a EUR1bn bond falls due.

Because a significant proportion of external disbursements are effectively earmarked for rebuilding the reserves, net public external debt may settle in the region of 90% of GDP by 2010. This would be the highest of any Fitch-rated investment grade sovereign: Greece, rated 'A' on the foreign-currency scale, comes

Banks' External Assets and Liabilities

(USDbn)	Dec 2007	June 2008
Assets		
Portfolio equity	4.6	4.0
Debt securities	6.7	8.2
Loans	33.8	38.5
Currency + deposits	11.1	14.7
Liabilities		
Portfolio equity	3.4	2.2
Debt securities	47.5	48.2
Loans	28.4	38.4
O/w: Short term	18.1	27.2
Currency + deposits	20.8	15.3

Source: IMF

closest at 73%, but it enjoys the crucial advantage of euro area membership, which shields it from external shocks.

Given that the scale of deposit insurance obligations could be scaled back, the public and public external debt ratios referred to in this report could prove to be a worst case scenario. Sovereign recovery of banks' foreign assets in respect of deposit insurance obligations could also help to ameliorate the public debt burden over time. Nonetheless, based on current trends and drawdown assumptions, the public sector could be looking at a heavy external debt repayment schedule towards the middle of the next decade. By that time, the IMF programme should have served its purpose and laid the foundation for the restoration of market access, widening Iceland's external financing options; but external public debt sustainability will remain a cause for concern in the interim.

A protracted workout of failed Icelandic banks' external liabilities that entailed extensive sovereign burden sharing could severely impair sovereign creditworthiness. Cognisant of this, the government has consistently sought to distance itself from external debt claims on the banks amounting to over USD100bn. International pressure has forced the government to concede the point on overseas deposit insurance obligations, but the LOI clearly states that "the pubic sector will not take on additional obligations with regard to the banking crisis". However, having put the failed banks into administration, the authorities cannot afford to be indifferent to their fate: an orderly workout of banks' external liabilities will be desirable for a variety of reasons, not least the restoration of an internationally viable banking system and renewed capital market access. To this end, the Icelandic authorities are committed to putting in place a transparent institutional framework for processing external creditors' claims and maximising asset recovery.

Euro Membership: An Exit Strategy?

- Euro-area membership would not offer a short cut to renewed economic stability and prosperity

Recent events have reopened the debate about the merits of joining the euro area: euro membership would have rendered Iceland's external imbalances less dominant, eliminated currency risk and allowed Iceland's fiscal policy strengths to better assert themselves. Public support for EU membership and the adoption of the euro has gained growing traction since the crisis broke and a failure to stabilise the krona over time could give rise to extensive de facto use of the euro both as a unit of exchange and a store of value in Iceland. However, unilateral adoption of the euro would have little to commend it, since it would deny Iceland the advantages that formal membership of the euro area brings. Thus, in the context of the current crisis, the CBI would have been denied access to ECB reserves and "lender of last resort" support that could have proved invaluable in Iceland's case.

Iceland is not a member of the EU. In theory, an application to join the EU could be fast-tracked, the more so given that as a member of the European Economic Area Iceland's legislative framework is already closely aligned with the "acquis communautaire", the body of EU laws that all prospective members are required to conform with. However, Iceland would still have to pass through the Commission's complex bureaucratic procedures, while EU accession would require ratification by all 27 of the current member states at a time when some member states have started to question the wisdom of further expansion. At best, Iceland could be looking at a wait of perhaps two years following compliance with the acquis.

Following EU accession, the Maastricht Treaty requires that a country submit itself to assessment for suitability for euro area membership on the basis of five tests relating to inflation, interest rates, public finances and the exchange rate. While most of these tests are based on an observation period of one year, the exchange rate criterion requires a minimum of two years, suggesting that the earliest date for euro adoption following EU entry would probably be three years. Slovenia, the most recent EU entrant to adopt the euro, conformed to this timetable and it would be unrealistic at this stage for Iceland to assume that it could leap-frog this experience.