

Iceland (/gws/en/esp/issr/80442256)



Fitch Upgrades Iceland to 'A-'; Outlook Positive

Link to Fitch Ratings' Report: Iceland - Rating Action Report (<https://www.fitchratings.com/site/re/900735>)

Fitch Ratings-London-07 July 2017: Fitch Ratings has upgraded Iceland's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'A-' from 'BBB+'. The Outlooks are Positive. The issue ratings on Iceland's senior unsecured foreign- and local-currency bonds have been upgraded to 'A-' from 'BBB+'. The Country Ceiling has been revised up to 'A-' from 'BBB+'. The Short-Term Local-Currency Rating has been upgraded to 'F1' and the Short-Term Foreign-Currency IDR has been affirmed at 'F2'.

KEY RATING DRIVERS

The upgrade of Iceland's IDRs reflects the following key rating drivers and their relative weights:

MEDIUM

The Icelandic economy's external vulnerability has reduced considerably. Strong current account surpluses and capital inflows since 2013 have strengthened external finances. The krona has been strengthening, despite the virtually complete liberalisation of capital controls between October 2016 and March 2017, appreciating by 20.1% yoy against the USD, and 17.3% against the EUR at end-June 2017, allowing for a build-up of FX reserves to 8.8 months of current external payments at end-2016.

The current account surplus rose to 7.9% of GDP in 2016 (revised up from our previous estimate of 4.5% of GDP), due to a stronger than expected development in tourism receipts. We expect robust tourism activity to persist in the forecast horizon, supporting a large current account surplus, moderating to 6.5% of GDP by 2019. Net external debt decreased further to 28% of GDP at end-2016, down from 41% of GDP in 2015, and we expect Iceland to have a negative net external debt position by 2018 and in line with the 'A' median.

Liberalisation of capital controls has not resulted in strong outflows of capital and downward pressure on the exchange rate, which led to strong inflationary pressures and a sharp deterioration in private sector balance sheets during and after the 2008-2009 crisis.

The government has paid down debt at a fast pace, resulting in gross general government debt/GDP falling to 53.4% of GDP at end-2016 from 68.0% at end-2015, and 95.1% at its peak in 2011. Government debt/GDP is forecast to be 47.6% in 2017, lower than the 'A' median of 51.4%, and consistent with the 'BBB' median of 40.7%. Fitch forecasts Iceland's government debt/GDP to fall below the medians to 41.0% by 2019, driven by strong economic growth and in line with the government's strategy in its five-year fiscal policy statement.

Robust economic growth has supported the improvements in public indebtedness and external finances. Real GDP growth in 2016 was strong at 7.2% driven by solid growth in tourism, private investment and private consumption. Private investment growth was mainly driven by renewed growth in construction to meet the strong increase in tourism demand, while private consumption was supported by the strong wage increases (11% yoy) in 2016, lower unemployment (3.0% average in 2016), appreciating krona and a rise in house prices. Fitch has revised its growth forecast for 2017 up to 5.6%, but expects growth to moderate to 3.7% by 2019. However, domestic cost pressures resulting from the above-trend growth and wage rises, coupled with the appreciating real exchange rate could lead to overheating and exposes the economy to the risk of a contraction in tourism activity.

Iceland's IDRs also reflect the following key rating drivers:

Iceland has a very high income per capita, forecast to be USD68,899 in 2017, making it more aligned with the 'AAA' median of USD51,977. The country's performance on the measures of governance, human development and ease of doing business are also consistent with that of the 'AAA' and 'AA' rated countries.

The new coalition government consists of the Independence, Reform and Bright Future parties, with a slim majority in parliament of just one seat. It is led by the Independence party, which continues the commitment to debt reduction in the medium-term fiscal plans from the previous government coalition. Fitch forecasts the fiscal surplus to fall to 0.2% of GDP in 2017 from 12.9% in 2016, reflecting extraordinary stability contributions that were made by the old banks' estates in 2016. The new government plans a mild fiscal tightening by raising VAT on tourism-related activities, broadening the scope of the VAT standard rate, while reducing the VAT rate to 22.5% from 24% in the next two years. Along with a higher carbon tax, the measures are expected to raise tax

revenues by 0.6% of GDP in 2018 and 0.1% of GDP in 2019.

Since October 2016, the authorities took steps to lift capital controls on residents set in place during the crisis. In March 2017, remaining capital controls on residents were lifted. At the same time the central bank invited offers for the purchase of offshore krona assets held in restricted accounts at an exchange rate of 137.5EUR/ISK. The central bank agreed a purchase of ISK 112.4 billion (4.2% of GDP) from March to June 2017, leaving a remaining ISK88 billion (3.3% of GDP) in the stock of offshore krona assets that are restricted from free convertibility into foreign currency.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Iceland a score equivalent to a rating of 'AA-' on the Long-Term FC IDR scale.

In accordance with its rating criteria, Fitch's sovereign rating committee decided not to adopt the score indicated by the SRM as the starting point for its analysis because the SRM output has migrated to 'AA-', but in our view this is a temporary improvement due to the impact of the extraordinarily large fiscal surplus in 2016 on the SRM output. The committee has hence used a rating of 'A+' on the Long-Term FC IDR scale as the starting point for its analysis.

Assuming an SRM output of 'A+', Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- External finances: -1 notch, to reflect the fact that the small size of the economy makes it vulnerable to external shocks and balance of payments risks.
- Structural: -1 notch, to reflect the recent presence of capital controls on both residents and non-residents.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to an upgrade are:

- Resilience of the economy to external shocks, in the context of a more open capital account.
- Continued economic growth without excessive macroeconomic imbalances.
- Continued falls in the public debt ratio, supported by prudent fiscal policy.

The Outlook is Positive. Consequently, Fitch does not currently anticipate developments with a high likelihood of leading to a downgrade. However, future developments that may, individually or collectively, lead to negative rating action include:

- Evidence of overheating in the domestic economy, for example through wage-price spirals, inflation overshoots, and adverse effects on household and corporate balance sheets.
- A weakened commitment to fiscal consolidation in the medium term.
- Excessive capital outflows leading to external imbalances and pressures on the exchange rate.

KEY ASSUMPTIONS

The ratings and Outlooks are subject to the following assumption.

In its debt sensitivity analysis, Fitch assumes medium term nominal GDP growth will moderate to an annual average of 4.5%, government primary balance of 2.0% of GDP, and a nominal effective interest rate gradually rising to 7.0% by 2026. Under these assumptions, Fitch projects that government debt as a share of GDP will decline to 27.2% by 2026.

Contact:

Primary Analyst
Eugene Chiam
Director
+44 20 3530 1512
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Alex Muscatelli

Director
+44 20 3530 1695

Committee Chairperson
James McCormack
Managing Director
+44 20 3530 1286

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

Additional information is available on www.fitchratings.com

Applicable Criteria

Country Ceilings (pub. 16 Aug 2016) (<https://www.fitchratings.com/site/re/885997>)
Sovereign Rating Criteria (pub. 18 Jul 2016) (<https://www.fitchratings.com/site/re/885219>)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form (<https://www.fitchratings.com/site/dodd-frank-disclosure/1026227>)
Solicitation Status (<https://www.fitchratings.com/site/pr/1026227#solicitation>)
Endorsement Policy (<https://www.fitchratings.com/regulatory>)

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK:

[HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings)

(<https://www.fitchratings.com/understandingcreditratings>). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM (<https://www.fitchratings.com>). PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory) (<https://www.fitchratings.com/site/regulatory>). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2017 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of

loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Solicitation Status

Fitch Ratings was paid to determine each credit rating announced in this Rating Action Commentary (RAC) by the obligator being rated or the issuer, underwriter, depositor, or sponsor of the security or money market instrument being rated, except for the following:

Endorsement Policy - Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures (<https://www.fitchratings.com/regulatory>) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.