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

Fitch Ratings

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.

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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)

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