FitchRatings

FITCH AFFIRMS ICELAND; REVISES OUTLOOKS TO STABLE FROM NEGATIVE

Fitch Ratings-London-16 May 2011: Fitch Ratings has affirmed Iceland's Long-term Foreign and Local Currency Issuer Default Ratings (IDRs) of 'BB+' and 'BBB+' and revised the Outlooks to Stable from Negative. The Foreign Currency Short-Term IDR is affirmed at 'B' and the Country Ceiling at 'BB+'.

Fitch says that this positive rating action on Iceland, its first since 2006, reflects a reassessment of the near-term impact on sovereign creditworthiness of the popular rejection of the 'Icesave' agreement in a national referendum on 9 April.

"Fitch continues to regard the resolution of 'Icesave', a bilateral agreement with the UK and Dutch governments to finance the compensation of 'Icesave' depositors, as an important step towards the normalisation of relations with international creditors. However, the capacity of this dispute to close off access to multilateral and bilateral funding for Iceland's IMF financial rescue programme and put Iceland's economic recovery at risk has clearly diminished," says Paul Rawkins, Senior Director in Fitch's Sovereign Rating Group.

On 5 May the Icelandic authorities and the IMF mission reached agreement-subject to approval by the IMF Management and Executive Board-on completion of the fifth review of the standby arrangement. Nordic governments have since confirmed that access to the remaining bilateral funding to support the programme will not be impaired by the referendum result. Fitch also notes that the Icelandic authorities are confident that asset recoveries from failed Landsbanki will cover 90-100% of deposit liabilities. Payments to British and Dutch deposit insurance funds are scheduled to begin later this year, leaving the associated interest payment liabilities to be settled through a potentially protracted legal process.

Having experienced a steep contraction in output in 2009-10, Fitch believes that Iceland's economy is close to stabilising and could post growth of around 2% in 2011. Disinflation has been rapid: headline inflation has fallen to around 2% currently from a peak of 19% y-o-y in early 2009, allowing interest rates to come down to an historic low of 4.5%. Fiscal consolidation is on track: the primary balance is budgeted to be in slight surplus in 2011, even as general government debt (including accrued interest on Icesave) peaks at around 100%. Net debt is significantly lower, reflecting large deposits with the central bank, some of which are the counterpart of the increase in international reserves under the IMF programme.

Sovereign debt service is secure: recent prepayments have reduced sovereign foreign bond maturities to around EUR500m in 2011-13 compared to international reserves of EUR4.6bn, while the Treasury holds sufficient ISK deposits to meet 12 months of domestic debt service. However, simultaneous banking and currency crises have inflicted severe pain on private sector balance sheets, while capital controls continue to trap EUR2.8bn of non-resident investments in ISK instruments. Extensive private sector domestic debt restructuring will be necessary to sustain economic recovery and secure financial sector stability. Maintenance of underlying trade and current account surpluses and appreciable international reserves will be essential preconditions for lifting capital controls and establishing a credible market-determined exchange rate.

Fitch says that future sovereign rating actions will take a broad range of factors into account including successful completion of the IMF programme, clear signs of economic recovery and continued progress towards fiscal consolidation and public and external debt reduction. Iceland is still a relatively high income country with standards of governance, human development and ease of doing business more akin to a high grade than a 'BB+' sovereign. However, accelerated private sector domestic debt restructuring, an orderly unwinding of capital controls, normalisation of relations with external creditors and enduring monetary and exchange rate stability will be key to the restoration of investment grade status.

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Applicable criteria, "Sovereign Rating Methodology", dated 13 August 2010, are available on www.fitchratings.com.

Applicable Criteria and Related Research:
Sovereign Rating Methodology
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=547765