FitchRatings

Fitch Upgrades Iceland to 'BBB-'; Stable Outlook

Ratings Endorsement Policy

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Fitch Ratings-London-17 February 2012: Fitch Ratings has upgraded Iceland's Long-term foreign currency Issuer Default Rating (IDR) to 'BBB-' from 'BB+' and affirmed its Long-term local currency IDR at 'BBB+'. Its Short-term foreign currency IDR has also been upgraded to 'F3' from 'B' and its Country Ceiling to 'BBB-' from 'BB+'. The Outlooks on the Long-term ratings are Stable.

'The restoration of Iceland's Long-term foreign currency rating to investment grade reflects the progress that has been made in restoring macroeconomic stability, pushing ahead with structural reform and rebuilding sovereign creditworthiness since the 2008 banking and currency crisis," says Paul Rawkins, Senior Director in Fitch's Sovereign Rating Group.

"Iceland has successfully exited its IMF programme and gained renewed access to international capital markets. A promising economic recovery is underway, financial sector restructuring is well-advanced, while public debt/GDP appears to be close to peaking on the back of a robust fiscal consolidation programme" added Rawkins.

As the first country to suffer the full force of the global financial crisis, Iceland successfully completed a three-year IMF-supported rescue programme in August 2011. Despite some setbacks along the way, the programme laid the foundations for renewed access to international capital markets in mid-2011 and an encouraging rebound in economic growth to 3% for 2011 as a whole. Flexible labour and product markets and a floating exchange rate have facilitated the correction of external imbalances and contained the rise in unemployment, while the financial system has shrunk to one fifth of its former size.

Iceland has been among the front runners on fiscal consolidation in advanced economies: the primary deficit has contracted from 6.5% of GDP in 2009 to 0.5% in 2011 and Iceland appears to be on track to attain primary fiscal surpluses from 2012 and headline surpluses from 2014.

Fitch believes that gross general government debt may have peaked at around 100% of GDP in 2011 (excluding potential Icesave liabilities); net debt is significantly lower at around 65% of GDP, reflecting appreciable deposits at the Central Bank (CBI). Barring further shocks, Iceland should see a sustained reduction in its public debt/GDP ratio from 2012, assuming economic recovery continues and the government adheres to its medium term fiscal targets. Ample general government deposits at the CBI and record foreign exchange reserves ameliorate near-term fiscal financing concerns. However, the risk of additional contingent liabilities migrating to the sovereign's balance sheet remains high.

Iceland's unorthodox crisis policy response has succeeded in preserving sovereign creditworthiness in the face of unprecedented financial sector distress. However, legacy issues remain, notably the protracted dispute over Icesave, an offshore branch of the failed Landsbanki that accepted foreign exchange deposits in the UK and the Netherlands, and the slow unwinding of capital controls imposed in 2008.

The impact of Icesave on Iceland's sovereign creditworthiness has diminished over time and Landsbanki has begun to remunerate deposit liabilities. Nonetheless, Fitch considers that Icesave still has the capacity to raise public debt by 6%-13% of GDP, should an EFTA Court ruling go against Iceland. Resolution of Icesave will be important for restoring normal relations with external creditors and removing this uncertainty for public finances.

Capital controls continue to block repatriation of USD3bn-USD4bn of non-resident investment in ISK-denominated public debt and deposit instruments. Fitch acknowledges that Iceland's exit from capital controls promises to be lengthy, given the underlying risks to macroeconomic stability, fiscal financing and the newly restructured commercial banks' deposit base.

So far, Iceland has been relatively unaffected by the eurozone sovereign debt crisis and, although growth is expected to slow to 2%-2.5% in 2012-13, Fitch does not expect Iceland to slip back into recession. However, the private sector remains heavily indebted - household debt exceeds 200% of disposable income and corporate debt 210% of GDP - highlighting the need for further domestic debt restructuring, while the key export sector has been held back by capacity constraints and a lack of investment exacerbated in part by the slow unwinding of capital controls.

Fitch says that future sovereign rating actions will take a broad range of factors into account including continued economic recovery and fiscal consolidation and progress towards 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 sovereign than low investment grade. 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 would help to further advance Iceland's investment grade status.

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Applicable criteria, "Sovereign Rating Methodology", dated 15 August 2011, are available on www.fitchratings.com.

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Applicable Criteria and Related Research:
Sovereign Rating Methodology