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Research Update:

Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed

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Overview

- We expect growth in the Republic of Iceland to average close to 3% during 2014-2017, supported by improving domestic demand.
- We project net general government debt to decline to 61% of GDP in 2017 from 71% in 2014.
- We are therefore revising our outlook on Iceland to positive from stable, and affirming the 'BBB-/A-3' long- and short-term sovereign credit ratings.
- The outlook revision reflects our view that there is a more than one-in-three likelihood that we could raise the ratings within the next 24 months if Iceland's growth performance remains strong and broad-based, while fiscal improvements continue.

Rating Action

On July 18, 2014, Standard & Poor's Ratings Services revised its outlook on the Republic of Iceland to positive from stable. At the same time, we affirmed our 'BBB-/A-3' long- and short-term foreign and local currency sovereign credit ratings on Iceland.

Rationale

The outlook revision reflects our view that Iceland's economic growth prospects have strengthened, while its fiscal position continues to improve with net general government debt on a downward path.

The ratings are supported by high productivity and income levels and positive long-term growth prospects, as well as Iceland's generally strong institutional and governance effectiveness. The ratings are constrained by high external and public-sector debt, weak monetary flexibility, and uncertainties and risks related to the eventual lifting of ongoing capital controls.

The small Icelandic economy (we estimate 2013 GDP at $15 billion) is characterized by high income levels, with GDP per capita exceeding $45,000 in 2013. Iceland's economy is export-oriented with marine products, tourism, and aluminium as the three main pillars. Despite the absence of bauxite reserves in Iceland, the energy-intensive aluminium smelting process benefits from

cheap hydro and geothermal energy widely available on the island. The economy expanded by 3.3% in 2013 and we expect continued strong growth averaging 3% over 2014-2017, supported by strong domestic demand against a background of rising wages, falling unemployment, and household debt relief.

In our view, Iceland's long-term prospects are positive. We expect investment levels will pick up in 2014-2016 as the fishing fleet is modernized and capacity in the tourism sector expands. Several projects in metals and energy will also support hitherto depressed investment levels--currently below 14% of GDP compared to 24% on average over 1998-2008. The Icelandic economy also benefits from a well-educated workforce, very high labor force participation rates, and favorable demographics.

The ratings are also supported by generally effective and predictable policymaking. The governing coalition of the center-right Independence Party and the centrist Progressive Party controls a majority in parliament and there is consensus on key issues. These include opposition to EU membership, promotion of large-scale investments, and the aim of lifting the capital controls that have been in place ever since the banking system collapsed in 2008.

Iceland's external vulnerabilities continue to constrain the ratings. When we analyze Iceland's balance of payments and the international investment position, we exclude the positions of banks in winding-up proceedings (the banks that collapsed in the financial crisis) from our calculations. Instead, we consider the underlying external position assuming that the liabilities of the failed banks will not be repaid in full. In our baseline projections we expect narrow net external debt to reduce to 56% of current account receipts in 2015 before stabilizing and then edging slightly upward. Even though commercial banks (as well as the government) have borrowed abroad over the last year, access to external financing for other Icelandic entities remains limited partly due to still-fragile confidence against a background of capital controls.

The pace and consequences of the removal of capital controls remain a key uncertainty. There are still very substantial foreign-creditor-held assets, denominated in Icelandic krona, trapped in Iceland due to capital controls. The lifting or easing of capital controls entails risk of significant capital outflows, the extent and speed of which are hard to predict.

Pent-up capital outflows come from a number of sources. The Central Bank of Iceland (CBI) estimates that short-term krona assets held by nonresidents are worth approximately 17% of GDP, even though this is markedly less than 35% at the beginning of 2009. This is largely due to CBI currency auctions, which have allowed the least patient foreign creditors to exit, albeit at a less attractive exchange rate. This combines with estimated net settlements of the claims of foreign creditors on the collapsed Icelandic banks (43% of GDP). We also believe that domestic residents--and specifically Iceland's sizable pension funds (with assets close to 140% of GDP)--would opt to diversify their asset holdings by investing abroad once the controls are lifted. Recent IMF

estimates suggest that these rebalancing preferences could result in a balance of payments outflow of 20%-45% of GDP. Combined, the aforementioned settlements amount to at least 80% of GDP, well in excess of the CBI's reserves of about 26% of GDP as of June 2014. Accordingly, while we believe that capital controls will be eased gradually--with some steps potentially taken in the near future--full capital account liberalization seems remote.

The underlying current account surplus--corrected for accrued domestic and foreign interest payments and receipts of the old banks--improved markedly rising from 0.6% of GDP in 2012 to over 6% in 2013. That said, the development largely reflects a considerable improvement in the income deficit, which has been partly due to weaker returns on direct investment in Iceland as well as low interest rates. We currently expect these temporary effects to disappear as profitability strengthens and foreign interest rates gradually rise. Given high projected investment growth and strong domestic demand, we expect that the current account surplus will turn into a deficit in 2017. At the same time, we note that the current account performance could be stronger than we anticipate: this may happen, for instance, if new capacity in the tourism sector leads to material improvements in the services surplus, more than we currently expect. Tourism performance has been strong in recent years and this trend continues in 2014.

In our view, Iceland has improved its fiscal position considerably following the average general government deficits of 11% of GDP over 2008-2010. We estimate that the deficit measured 2.1% of GDP last year and expect it to move close to balance in the forecast period. This year's fiscal performance is supported by some expenditure restraint as well as one-off sizable dividends from the majority government-owned Landsbankinn. We also think that the organic budget law--currently being considered in parliament--has the potential to improve the fiscal framework and could contribute to less pro-cyclical budgetary policies in the future.

At the same time, our fiscal forecasts factor in a number of downside risks. These stem primarily from the proposed household debt relief plan, which provides for an Icelandic krona (ISK) 160 billion (approximately 8.5% of GDP) debt reduction. The plan comprises a direct write-off of ISK80 billion for households with index-linked mortgages and ISK80 billion from redirecting private pension contributions (through tax incentives) to loan repayment. We understand that the design of the scheme is fiscally neutral, with the lion's share of financing to come from the bank levy expanded to cover the old failed Icelandic banks. The creditors of these defaulted Icelandic banks could mount a legal challenge to these measures, leading to some of the expenditures crystallizing on the government's balance sheet. Debt relief could also increase prepayments and therefore reinvestment risk for the government-owned Housing Financing Fund (HFF), leading to further recapitalization needs from the government. HFF's government-guaranteed debt accounts for a sizable portion of the sovereign's moderate contingent liabilities.

Even though it remains substantial, we expect public-sector debt to steadily decline over the 2014-2017 forecast horizon. We forecast net general

government debt to decline to 61% of GDP in 2017, from 71% in 2014. This compares with a high of 88% in 2011. We include the CBI's debt to the IMF (7% of GDP at end-2013) in our general government debt calculations and expect it will be replaced by market borrowing. Iceland's regained international capital market access should contribute to maturities lengthening as well as more-favorable interest expenditures, which we expect to average 10% of general government revenues over 2014-2017, lower than the 13% of 2009-2013.

Iceland is one of the world's smallest economies with an independent monetary policy. In our view, Iceland's monetary policy and macroprudential settings have historically been ineffective in managing inflation and securing financial stability, demonstrated by significant deviations of inflation levels from the target and the collapse of the banking system in 2008. In general, the authorities heavily intervene in the foreign exchange market by restricting certain cross-border financial transactions via capital controls.

The financial sector has been significantly restructured since the bank defaults of 2008. New commercial banks have made notable progress in restructuring their balance sheets. Loan-loss provisions have declined steadily and we expect restructuring will continue in 2014. However, nonperforming loans remain significant; concentration risk--given the economy's dependence on the marine products sector--is still high; and further meaningful losses cannot be ruled out.

Outlook

The positive outlook reflects our view that there is a more than one-in-three likelihood that we could raise the ratings within the next 24 months.

Specifically, we could raise the ratings on Iceland if sustainable growth, significant fiscal improvements, and external balance sheet repairs continue while international capital market access gradually improves for Icelandic entities and financial stability remains secure.

We could revise the outlook back to stable if we observed sustained fiscal slippage, resulting, for instance, from unfinanced expenditures related to the household debt relief plan. We could also revise the outlook or lower the ratings if the lifting of the capital controls resulted in a significant decline in reserves or renewed pressure on the Icelandic financial system.

Key Statistics

Table 1

Republic of Iceland - Selected Indicators											
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Nominal GDP (US$ bil)	20	17	12	13	14	14	15	16	16	17	18
GDP per capita (US$)	66,396	53,357	37,936	39,558	44,097	42,513	45,424	48,892	50,196	52,933	55,820

Table 1

Republic of Iceland - Selected Indicators (cont.)											
Real GDP growth (%)	6.0	1.2	(6.6)	(4.1)	2.7	1.5	3.3	3.0	3.3	2.8	2.8
Real GDP per capita growth (%)	3.3	(1.3)	(7.7)	(3.6)	2.4	1.1	2.5	2.3	2.6	2.1	2.1
Change in general government debt/GDP (%)	1.7	52.2	21.1	10.4	20.7	(10.4)	(3.0)	0.8	0.8	0.4	0.4
General government balance/GDP (%)	5.4	(13.5)	(9.9)	(10.1)	(5.6)	(3.8)	(2.1)	(0.5)	(0.5)	(0.2)	(0.2)
General government debt/GDP (%)	28.5	77.4	97.6	105.5	120.2	104.8	96.7	92.6	87.9	83.2	78.8
Net general government debt/GDP (%)	12.4	50.2	67.8	77.9	87.8	76.1	74.1	71.1	67.7	64.2	60.8
General government interest expenditure/revenues (%)	5.4	7.6	16.1	13.3	12.4	12.9	12.0	11.1	10.8	10.3	9.7
Oth dc claims on resident non-govt. sector/GDP (%)	311.2	208.1	153.7	147.1	146.4	138.8	133.3	130.3	126.4	122.6	118.9
CPI growth (%)	5.0	12.4	12.0	5.4	4.0	5.2	3.9	2.6	3.1	3.3	3.4
Gross external financing needs/CARs +use. res (%)	317.7	653.9	157.6	139.5	113.1	90.9	96.3	95.8	93.8	94.2	96.5
Current account balance/GDP (%)	(15.7)	(18.0)	(0.2)	(2.1)	(0.5)	0.6	6.2	1.8	0.5	0.0	(0.3)
Current account balance/CARs (%)	(28.0)	(35.1)	(0.4)	(3.7)	(0.8)	0.9	10.1	3.0	0.7	(0.1)	(0.5)
Narrow net external debt/CARs (%)	433.4	158.1	175.4	145.8	92.5	84.3	69.2	59.8	56.2	56.5	56.7
Net external liabilities/CARs (%)*	205.6	111.9	145.9	153.3	113.3	45.2	22.3	19.6	21.6	27.0	34.1

*In our calculations, we exclude the external assets and liabilities of deposit money banks in winding up proceedings. Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Iceland - Ratings Score Snapshot	
Key Rating Factors	
Institutional and Governance Effectiveness	Strength
Economic Structure and Growth	Strength
External Liquidity and International Investment Position	Weakness
Fiscal Flexibility and Performance	Strength
Debt Burden	Weakness
Monetary Flexibility	Weakness

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Table 2

Republic of Iceland - Ratings Score Snapshot (cont.)
Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional and governance effectiveness; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) the average of government debt burden and fiscal flexibility and fiscal performance; and (v) monetary flexibility. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Government Rating Methodology And Assumptions," published on June 24, 2013, summarizes how the various factors are combined to derive the sovereign foreign-currency rating, while section V.C details how the scores are derived. The rating assessment snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral" or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Republic Of Iceland Outlook Revised To Stable From Negative On Receding Fiscal Risk; 'BBB-/A-3' Ratings Affirmed, Jan. 24, 2014
- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 2014
- Outlooks: The Sovereign Credit Weathervane, Year-End 2013 Update, Feb. 4, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that external liquidity and international investment position had improved and that monetary flexibility had deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate

his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Iceland (Republic of)		
Sovereign Credit Rating	BBB-/Positive/A-3	BBB-/Stable/A-3
Transfer & Convertibility Assessment	BBB-	
Senior Unsecured	BBB-	
Short-Term Debt	A-3	
Commercial Paper	A-3	

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