S&P Global
Ratings

RatingsDirect®

Research Update:

Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable

Primary Credit Analyst:
Maxim Rybnikov, London (44) 20-7176 7125; maxim.rybnikov@spglobal.com

Secondary Contact:
Felix Winnekens, Frankfurt (49) 69-33-999-245; felix.winnekens@spglobal.com

Table Of Contents

Iceland Ratings Affirmed At 'BBB+/A-2'; Outlook Stable

Overview

- We expect economic growth in Iceland will remain strong over the next few years, supported by the tourism sector and robust private consumption.
- Strong growth should help Iceland to continue to reduce general government debt as a percentage of GDP.
- We are affirming our ratings on Iceland at 'BBB+/A-2'.
- The stable outlook balances the potential for a faster-than-anticipated improvement in the country's fiscal and balance-of-payments profiles over the next two years against the remaining risks surrounding capital control liberalization and the prospect of the economy overheating.

Rating Action

On July 15, 2016, S&P Global Ratings affirmed its long and short-term foreign and local currency sovereign credit ratings on Iceland at 'BBB+/A-2'. The outlook is stable.

Rationale

Our ratings on Iceland remain supported by the sovereign's strong institutional effectiveness, high per-capita income levels, and the continued improvement in the government's fiscal position. The ratings are constrained by the remaining risks surrounding the final stages of the liberalization of the capital account, the prospect of the domestic economy overheating, and the limited effectiveness of monetary policy.

Iceland has seen several political changes in recent months, including the resignation of Prime Minister Sigmundur Gunnlaugsson of the Progressive Party, in the wake of public protests sparked by the "Panama Papers" leak. Although this increases uncertainty in the short term, we believe the development underlines Iceland's institutional strengths, including the free flow of information and the existence of generally effective checks and balances. The government has also announced that early general elections will be held in autumn 2016, but no specific date has been set yet. The next scheduled elections had been due in the spring of 2017.

Political commentators regard the outcome of the upcoming vote as uncertain. According to some opinion polls, the Pirate Party's share of support is around 30%, ahead of both incumbent coalition partners, the Progressive Party and Independence Party. The Pirate Party could therefore be a lead partner in the next government if its election performance matches its current polling. In our opinion, forming and running the government may prove challenging for the Party as it remains small, led by a handful of people, and has yet to articulate fully its goals and policy priorities.

That said, we don’t expect major policy shifts regardless of who wins the next election. Iceland benefits from a strong civil society, effective institutional checks and balances, and a highly educated and productive work force. Iceland has been governed effectively by parties across the political spectrum and our baseline scenario is that this will remain the case.

The ratings on Iceland remain supported by the country’s per-capita income levels. At close to $50,000 at the official exchange rate, these are high by international standards and significantly exceed the median for the sovereigns we rate in the 'BBB' category. That said, we believe GDP per capita is overestimated in U.S. dollar terms as it is calculated at an exchange rate propped up, possibly significantly, by capital controls.

The Icelandic economy grew strongly over 2013-2015, with output expanding by nearly 3.5% annually. Growth has been supported by the considerable expansion of the tourism industry, which has boosted exports. Arrivals have grown in double digits for several years in a row, in part due to interest in Iceland’s recent volcanic activity. It is estimated that, in 2015, the number of visitors exceeded the domestic population several times over. We expect that the tourism expansion will continue over 2016-2017--partly owing to the historic success of the country’s football team, which reached the quarter finals of the Euro 2016 championship, likely further raising awareness among potential travellers.

Even though Iceland has enjoyed consistently robust growth in the recent years, we believe--partly owing to its small size--the economy remains structurally volatile, as demonstrated by the boom-bust cycles in the past. Output is concentrated in the fishing, metals, and, more recently, tourism sectors. In our view, an unexpected tapering of tourism inflows or any development that hurts fish stocks or their migration patterns may have considerable influence on the country’s economic performance. In 2014, for example, a low capelin catch had a pronounced impact on Iceland's headline growth. Moreover, we believe that the Icelandic economy at present shows several signs of overheating.

According to the estimates of the Central Bank of Iceland (CBI), the economy is now operating with a positive output gap, while wages have soared. As a result of a series of collective bargaining agreements, we expect national pay hikes may exceed 25% over 2015-2018. In our view, this could cause the real effective exchange rate of the krona (ISK) to appreciate, diminishing Iceland's competitiveness. While this is not our baseline expectation, wage hikes could pose material risks to Iceland’s external position, which has improved considerably over the last several years.

Iceland’s underlying external current account has posted sizable surpluses averaging over 6% of GDP over the last three years. We expect the surplus to gradually contract to 1% of GDP in 2019 from 5.1% in 2015 owing to strong growth in import volumes, a widening income account deficit, and deteriorating terms of trade.

However, in a downside scenario in which rapid wage growth undermines Iceland’s competitiveness, this decline could be more pronounced, leading to current account deficits. To confront this risk, the central bank has embarked on a cycle of tightening monetary policy, attempting to contain the consequences of large wage hikes on the domestic economy.

Overall, however, Iceland’s balance-of-payments risks have declined considerably over the last several years. The settlement via composition of the old defaulted Icelandic banks at the end of 2015 has effectively resolved the biggest obstacle standing in the way of further capital account liberalization (for more details, please see "Iceland Ratings Raised To 'BBB+' On Further Progress Toward Capital Account Liberalization And Declining Debt Levels," published on Jan. 15, 2016, on RatingsDirect). Iceland’s underlying net external liability position has improved to just 6.5% of GDP in 2015 from about 80% of GDP in 2009.

In May-June 2016, the government also announced and held a foreign currency auction to release the so-called offshore krona overhang. This overhang originated principally from bonds denominated in ISK issued by nonresident entities (known as glacier bonds) and from nonresident holdings of bonds of the government-owned mortgage lender, Housing Financing Fund (HFF; see "Ratings On Iceland's Housing Financing Fund Affirmed At 'BB-/B'; Outlook Stable," published on July 22, 2015). With the collapse of the Icelandic banking sector, the demand for ISK evaporated and the ensuing sudden selling pressure could have destabilized the country’s external position. Icelandic authorities thus introduced capital controls, successively tightened, for all financial account transactions, in order to husband reserves and ensure that monetary policy could be conducted independently. These controls included limiting instruments eligible for reinvestment by nonresidents. Through this latest auction, the government allowed nonresident investors to convert their offshore krona holdings into foreign currency at ISK190 to the euro, a weaker exchange rate than the official rate of about ISK135/€1 currently. Holders of krona can still exit at a weaker exchange rate (ISK220/€1) until November 2016. Following that, the investors deciding to stay will continue to only be allowed to reinvest the ISK proceeds of their domestic investments once they mature into a limited number of instruments.

We see legal risks from the government’s approach to remaining offshore ISK holders, which are likely to try to reach a better settlement either through continued negotiation or litigation. The timeframe for resolution remains uncertain, however. Following the offshore ISK auction, the government will increasingly focus on lifting the capital controls on domestic residents, including households and pension funds. In fact, the latter have already received small exemptions allowing them to purchase a limited amount of foreign instruments.

Our ratings on Iceland remain supported by the sovereign’s strong fiscal settings. As a byproduct of resolving the old defaulted banks, the Treasury has received one-off revenue in the form of so-called stability contributions worth about 15% of GDP. The majority of the contributions are not liquid (and constitute claims on Iceland’s commercial banks) but the government expects to pay down its debt as the contributions are converted to cash. We do not include this one-off windfall in our fiscal statistics.

Even excluding the stability contributions, we expect Iceland’s fiscal standing to improve over the four-year forecast horizon. Gross general government debt has declined by about 15% of GDP in 2015 as the sizable accumulation of non-borrowed CBI reserves has allowed the government to draw on its foreign exchange deposits at the central bank and prepay some of its obligations.

However, the underlying fiscal position, excluding the impact of the stability contributions, is still subject to a number of risks. These include costs associated with rising public sector wages and the potential for larger-than-expected contributions to HFF. In our view, this poses a material contingent liability to the government. Fiscal pressures could also intensify ahead of the upcoming general elections. Were it to happen, the fiscal expansion could be particularly detrimental as it would take place against a background of an already-overheating economy, increasing the burden placed on monetary policy.

Nevertheless, our baseline forecast assumes that Iceland's underlying fiscal performance will remain strong and that deficits will average a modest 0.3% of GDP through 2019. As a result, we expect net general government debt to decline to about 35% of GDP by 2019 and interest expenditures to average 8% of government revenues in 2016-2019, down from nearly 11% of revenues over the preceding four years.

The ratings on Iceland continue to be constrained by the limited flexibility of monetary policy. In our assessment, Iceland's monetary policy has not historically been effective at keeping inflation near the target of the Central Bank of Iceland (CBI). More recently, inflation has been somewhat contained, mostly reflecting imported deflation owing to lower foreign oil and commodity prices and a stable exchange rate. Against that background, measured inflation expectations appear to have aligned more closely with the central bank's target. The CBI has also introduced new tools aimed at supporting the implementation of monetary policy. Nevertheless, we expect inflation to increase due to the sizable wage hikes over the next three years.

The financial sector has been substantially rehabilitated since the 2008 bank defaults. The new commercial banks are well-capitalized and nonperforming loans have declined significantly over the past few years. (For more details on the Icelandic banking sector, see "Banking Industry Country Risk Assessment: Iceland," published on Jan. 28, 2016.) We also do not expect the government's approach toward gradually lifting the capital controls to put Iceland's financial stability at risk.

Outlook

The stable outlook indicates our view of balanced risks to the ratings on Iceland over the next two years. We could raise the ratings if capital controls are fully lifted without putting the balance of payments or financial stability at risk. We could also raise the ratings if the ratio of net general government debt to GDP declines materially faster that we presently anticipate.

We could lower the ratings if we perceived that the sizable wage hikes led to a significant overheating of the domestic economy with heightened risks for the country's monetary, fiscal, or external stability. We could also lower the ratings if further liberalization of capital controls led to a significant decline in net reserves, placing renewed pressure on the Icelandic krona exchange rate and the financial system.

Key Statistics

Table 1

Republic of Iceland Selected Indicators										
Balance Sheet Date Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. ISK)	1,618	1,701	1,777	1,889	2,004	2,205	2,367	2,528	2,677	2,826
Nominal GDP (bil. $)	13	15	14	15	17	17	18	19	19	19
GDP per capita (000s $)	41.7	46.1	44.5	48.0	52.7	50.8	54.8	56.4	56.2	55.8
Real GDP growth	(3.6)	2.0	1.2	4.4	2.0	4.0	4.2	3.5	2.8	2.5
Real GDP per capita growth	(3.1)	1.7	0.9	3.6	0.8	2.9	3.1	2.3	1.6	1.2
Real investment growth	(8.6)	11.6	5.3	2.2	16.0	18.6	14.0	4.0	7.0	2.5
Investment/GDP	13.9	15.6	16.1	15.5	17.4	19.2	21.3	21.6	22.7	22.8
Savings/GDP	14.2	16.3	17.6	23.3	22.9	24.4	25.3	24.7	23.9	23.8
Exports/GDP	53.7	56.6	57.0	55.5	53.3	53.3	54.4	55.6	57.2	59.1
Real exports growth	1.0	3.4	3.6	6.7	3.1	8.2	7.0	4.5	4.2	4.0
Unemployment rate	7.6	7.1	6.0	5.4	5.0	4.0	3.5	3.5	3.5	3.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.4	0.7	1.4	7.9	5.5	5.1	4.0	3.2	1.2	1.0
Current account balance/CARs	0.7	1.2	2.3	12.8	9.5	8.9	6.9	5.3	2.0	1.6
Trade balance/GDP	3.9	2.1	0.7	0.4	(0.5)	(1.6)	(2.8)	(3.3)	(4.7)	(5.0)
Net FDI/GDP	19.7	7.4	29.8	(0.3)	4.3	3.1	2.5	1.5	1.5	1.5
Net portfolio equity inflow/GDP	7.6	0.6	0.5	0.1	0.0	(2.3)	(2.0)	(2.5)	(3.5)	(3.5)
Gross external financing needs/CARs plus usable reserves	136.5	111.9	94.7	95.3	99.2	94.3	94.5	86.8	90.4	93.3
Narrow net external debt/CARs	148.1	96.3	88.7	71.2	58.5	145.2	71.5	65.8	60.9	57.2
Net external liabilities/CARs	148.4	110.8	44.6	19.2	10.0	11.5	2.9	(2.4)	(8.7)	(13.1)
Short-term external debt by remaining maturity/CARs	86.8	65.0	60.2	48.4	48.9	42.1	44.8	34.0	34.4	36.6
Reserves/CAPs (months)	4.4	5.6	8.2	5.8	5.4	5.4	5.9	6.1	5.7	5.5
FISCAL INDICATORS (%, General government)										
Balance/GDP	(9.8)	(5.6)	(3.7)	(1.8)	(0.1)	(0.5)	(0.5)	(0.5)	0.0	0.0
Change in debt/GDP	9.8	19.8	(9.9)	(3.0)	(1.4)	(8.5)	(5.5)	0.0	0.0	0.0
Primary balance/GDP	(5.0)	(1.4)	1.0	2.7	4.7	3.9	3.6	2.9	3.1	2.8
Revenue/GDP	39.6	40.1	41.7	42.1	45.3	42.2	42.0	41.8	41.5	41.5
Expenditures/GDP	49.4	45.7	45.4	44.0	45.3	42.7	42.5	42.3	41.5	41.5

Table 1

Republic of Iceland Selected Indicators (cont.)										
Interest /revenues	12.0	10.3	11.4	10.9	10.4	10.5	9.7	8.1	7.4	6.8
Debt/GDP	100.2	115.1	100.2	91.3	84.7	68.5	58.3	54.6	51.5	48.8
Debt/Revenue	252.8	286.9	240.5	216.8	187.1	162.2	138.8	130.5	124.2	117.6
Net debt/GDP	72.4	82.8	71.6	68.6	53.7	48.7	42.5	39.8	37.6	35.6
Liquid assets/GDP	27.8	32.3	28.7	22.7	30.9	19.8	15.8	14.8	14.0	13.2
MONETARY INDICATORS (%)										
CPI growth	5.4	4.0	5.2	3.9	2.0	1.6	2.5	3.8	3.5	3.5
GDP deflator growth	5.6	3.0	3.2	1.8	4.0	5.9	3.0	3.2	3.0	3.0
Exchange rate, year-end (ISK/$)	115.1	122.7	129.0	115.6	126.9	129.6	130.0	136.5	143.3	150.5
Banks' claims on resident non-gov't sector growth	(10.8)	(15.4)	(5.3)	(2.1)	5.5	2.0	5.0	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	194.9	156.9	142.2	131.0	130.3	120.8	118.1	116.1	115.2	114.5
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	12.9	11.6	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	12.4	14.0	14.1	18.5	18.0	16.5	N/A	N/A	N/A	N/A
Real effective exchange rate growth	5.2	1.4	(0.3)	4.6	6.6	2.4	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository 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. ISK--Icelandic krona. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' 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 assessment	Strength
Economic assessment	Strength
External assessment	Neutral
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Neutral
Monetary assessment	Weakness

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, 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 ratings score 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 S&P Global Ratings' 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

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Iceland Ratings Raised To 'BBB+' On Further Progress Toward Capital Account Liberalization And Declining Debt Level - January 15, 2016
- 2015 Annual Sovereign Default Study And Rating Transitions - May 24, 2016

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 all 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

	Rating	
	To	From
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	BBB+/Stable/A-2	BBB+/Stable/A-2
Transfer & Convertibility Assessment	BBB+	BBB+
Senior Unsecured		
Foreign and Local Currency	BBB+	BBB+
Short-Term Debt		
Local Currency	A-2	A-2
Commercial Paper		
Foreign Currency	A-2	A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Additional Contact:
SovereignEurope; SovereignEurope@standardandpoors.com