Tagging Info

Fitch Affirms Iceland at 'BBB'; Outlook Stable

Ratings Endorsement Policy

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Fitch Ratings-London-01 August 2014: Fitch Ratings has affirmed Iceland's Long-term foreign and local currency Issue Default Ratings (IDR) at 'BBB' and 'BBB+', respectively. The issue ratings on Iceland's senior unsecured foreign and local currency bonds were also affirmed at 'BBB' and 'BBB+' respectively. The Outlooks on the Long-term IDRs are Stable. The Country Ceiling was affirmed at 'BBB' and the Short-term foreign currency IDR at 'F3'.

KEY RATING DRIVERS

Iceland's ratings are underpinned by its high level of income per capita, and indicators of governance and human development akin to the highest-rated sovereigns.

Iceland has a strong political consensus on the long-term objective of public debt reduction, the commitment of which would be reinforced by the approval of the proposed organic budget law. The Icelandic Treasury recently issued euro-denominated bonds amounting to EUR750m (around ISK116bn), the first euro-denominated issue since 2006. The Treasury has used the funds to prepay outstanding bilateral loans provided by Nordic countries in the aftermath of the financial crisis of 2008/2009.

Despite these developments, public finances remain a rating weakness. The government debt to GDP ratio at end-2013 was estimated at 94.7%, more than double the 'BBB' median of 40%. Iceland has run primary surpluses since 2012. Fitch expects further primary surpluses going forward, which will help bring the debt ratio down to 81.4% by 2016.

The legacy of the financial crisis weighs on Iceland's external position. External debt is much higher than that of rated peers, pending the resolution of the estates of failed banks. At end-2013 net external debt was over five times GDP. In comparison, the 'BBB' median was 8.6% of GDP. While the central bank's foreign exchange reserves (ISK480.5bn, around 26% of GDP) outweigh official foreign debt obligations, the private sector's foreign debt repayment schedule poses a risk to external sustainability.

Capital controls, which remain in place, also weigh on Iceland's credit profile. The authorities have reiterated that the removal of capital controls is contingent on ensuring that there will not be excessive balance-of-payments pressures arising either from the unwinding of 'locked-in' non-residents' krona assets (amounting to around EUR2.1bn, 18% of GDP) or from the mismatch between domestic/foreign claims and assets of failed banks' estates.

Economic activity picked up sharply last year. Real GDP growth in 2013 rose to 3.3% (from 1.5% in 2012), with net external demand - and especially tourism-related revenues - as the main driver of growth. We expect domestic demand to take over as the main growth driver over the forecast horizon, and expect GDP growth to be 2.8% this year, and rising to just over 3% in the following two years. Inflation has fallen back sharply in 1H14, to 2.4% in July from 4.2% in December. This will ease debt burdens in the economy, given the widespread use of index-linked debt.

RATING SENSITIVITIES

The Outlook is Stable. Consequently, Fitch's sensitivity analysis does not currently anticipate near-term

developments with a high likelihood of leading to a rating change. However, future developments that could, individually or collectively, result in a positive rating action include:

-Continued steady falls in the public debt and external debt ratios
-Greater clarity about the evolution of the process for lifting capital controls, for example in the context of negotiated agreements on repayments to the failed banks' estates
-A longer track record of monetary and exchange rate stability in the context of continued economic growth

The main factors that could lead, individually or collectively, to a negative rating action are:
-Weakening debt dynamics, either from a worse-than-expected economic performance, or from a weakened commitment to fiscal consolidation
-An increase in policy uncertainty, linked, for example, to policy actions that could adversely affect the business climate
-Crystallisation of significant contingent liabilities from the financial system, especially the Housing Finance Fund (HFF), above the amounts already assumed in Fitch's debt sensitivity analysis. State guarantees are sizeable, totalling ISK1,233bn (around 66% of GDP) at end-May 2014. The HFF accounts for about three-quarters of these guarantees.

KEY ASSUMPTIONS

The ratings and Outlooks are sensitive to a number of assumptions.

Fitch assumes that capital controls will ultimately be eased in an orderly manner. This is not incorporated into the agency's macroeconomic forecasts for up to 2016.

For its debt sensitivity analysis, Fitch assumes a nominal GDP growth rate of 5%, an average primary balance of 3.7% of GDP, an average effective interest rate of 5.4% and an annual nominal exchange rate depreciation of 2% over 2017-2023. Recapitalisations of HFF equivalent to 0.2% of GDP each year are assumed over the next five years.

Under these assumptions, gross government debt as a share of GDP would decline to 64% by 2023.

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Applicable criteria, 'Sovereign Rating Criteria' dated 13 August 2012 and 'Country Ceilings' dated 09 August 2013, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Sovereign Rating Criteria
Country Ceilings

Additional Disclosure
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