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Research Update:

Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable

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Overview

- Over the next several months, we expect Iceland to address its sizable balance-of-payments overhang and start to gradually ease the capital controls.
- In our view, the government's proposed measures will be beneficial for investor sentiment and improve access to foreign capital markets for nonsovereign issuers. They could also yield material one-off fiscal revenues for the government.
- We are therefore raising our long- and short-term ratings on Iceland to 'BBB/A-2' from ‘BBB-/A-3’.
- The outlook is stable, indicating that the risks to the ratings are balanced, in our view.

Rating Action

On July 17, 2015, Standard & Poor's Ratings Services raised its long- and short-term foreign and local currency sovereign credit ratings on the Republic of Iceland to ‘BBB/A-2’ from 'BBB-/A-3'. The outlook is stable.

Rationale

The upgrade reflects what we view as credible government proposals that will enable the eventual lifting of capital controls, which have been in place since the 2008 banking crisis. We believe that the proposals will address the country’s sizable balance-of-payments vulnerability by relieving the latent pressure on the Icelandic krona (ISK) exchange rate. As a result, we expect that foreign investor sentiment will strengthen and nonsovereign borrowers' access to international capital markets will improve.

We anticipate that the measures will lead to sizable one-off fiscal revenues for the government. Our upgrade is premised on the assumption that any such proceeds will be used to pay down government debt, and therefore not spent in a way that could contribute to economic overheating.

On June 8, 2015, the Icelandic government announced a comprehensive strategy for capital account liberalization. The strategy addresses the three components of the country’s sizable balance-of-payments overhang. These are: the local and foreign currency-denominated claims of the banks that defaulted in the crisis (the old bank estates) against Icelandic residents (which amount to 45% of Iceland's 2015 GDP); the krona held by nonresidents (largely attributable to ISK-denominated bonds issued by nonresidents before the crisis, which are known as glacier bonds and equal about 15% of 2015 GDP); and domestic residents’ pent-up demand for foreign assets (estimated at about 25% of 2015 GDP by the International Monetary Fund).

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Under the proposals, the old bank estates will be taxed at 39% of their total assets unless they sign agreements by year-end on "composition," under which their assets will be liquidated without bankruptcy, and fulfil "stability conditions." For their part, the creditors of the old bank estates have presented proposals on how these stability conditions could be fulfilled. The creditor proposals involve a payment by each estate of a so-called stability contribution. This comprises a set of measures, tailored to each estate, broadly aimed at preventing any ISK-denominated assets originating from the sizable claims the estates hold against Icelandic residents from being sold and converted into foreign currency--thus destabilizing the Icelandic krona--over the next several years.

In the coming months, the government will also make an offer to nonresident holders of ISK to either sell their krona at a foreign currency auction (most likely at a discount to the onshore krona exchange rate), to invest their krona in long-term treasury bonds, or to deposit their krona in non-interest-bearing accounts for a number of years.

Not all creditors of the old bank estates have put forward the stability contributions approach. Even so, we expect the claimants to broadly adopt them in order to avoid the payment of the 39% asset tax. However, the risk remains that some creditors could postpone or derail the plan by challenging the government in court, potentially prolonging the capital controls. In our view, there is also a risk that nonresident holders of liquid ISK could undertake litigation.

Our baseline forecast, however, assumes that the proposals will succeed in relieving Iceland's overhang on the foreign exchange market and, consequently, enable the gradual easing of restrictions on cross-border financial flows. We have frequently cited external risks as being a key constraint on the sovereign credit ratings on Iceland. We now see these risks as lower than they were before.

In particular, we believe that as the restrictions on Iceland’s capital account are gradually relaxed, nonsovereign Icelandic entities will be able to tap foreign credit markets more readily, thereby relieving potential future pressure from servicing the nonsovereign external debt. The relaxation of capital controls is also likely to result in a gradual reduction of the administrative burden imposed on Icelandic companies with foreign currency revenues, like those in the fishing sector, which are currently obliged to repatriate all their foreign currency earnings. We also believe that foreign direct investors could increase their investments given the prospects for greater macroeconomic stability, although recent foreign direct investment has largely been exempted from the capital controls.

The stability contributions will also likely entail sizable one-off fiscal revenues for the government, albeit less than if the 39% asset tax is imposed across the board. We and other market observers estimate that these receipts could exceed 20% of 2015 GDP if the proposals are adopted. Given that this estimate is subject to significant uncertainty, both in terms of the amount and timing of the receipts, we do not currently include it in our fiscal forecasts.

Even without these one-off gains, Iceland's underlying fiscal position supports the ratings. We expect the general government deficits to average 0.8% of GDP over 2015-2018, significantly less than the 5% of GDP average deficits observed over the last six years. We expect general government debt, net of treasury deposits at the central bank, to decline to below 50% of GDP by 2018. Following the 2008 financial crisis, Iceland has regained capital market access and has issued instruments denominated in both euros and U.S. dollars on multiple occasions.

At the same time, we continue to see a number of risks for Iceland's underlying fiscal position. Spending pressures could emerge if public sector wage hikes exceed our current expectations. The government also incurs moderate contingent liabilities, mostly from government guarantees for the national power company Landsvirkjun and the lossmaking mortgage lender Housing Financing Fund (HFF). The government has had to inject over ISK50 billion (2.5% of 2015 GDP) in capital to HFF over the past several years, and future assistance could exceed current government estimates.

The ratings on Iceland continue to be supported by its 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 they agree on key issues. These include opposition to EU membership, promotion of large-scale investments, and the removal of capital controls.

We also expect Iceland's economy to grow robustly over the forecast horizon, averaging close to 3% through 2018. Growth will be primarily supported by private consumption aided by wage increases and household debt relief implemented by the authorities. Perhaps more sustainably, it will also be boosted by large investments in the metals industry, tourism, and fishing. These investments could boost Iceland's export performance by the end of our forecast horizon in 2018. The Icelandic economy also benefits from a well-educated workforce, very high labor participation rates, and favorable demographics.

At the same time, we see considerable risks from this year's private and public sector wage settlements. In our view, national wage hikes could exceed 20% over the next three years. We fear that this could lead to a marked appreciation of the real effective exchange rate of the krona, diminishing Iceland's competitiveness and leading to a deteriorating current account position, ultimately complicating the task of liberalizing cross-border financial flows.

These risks are exacerbated by the uncertainties that remain around how this or a future government could use the potential fiscal receipts from the stability contributions. Although it is not our base case, we consider that there is a possibility that they could be used for public expenditures as opposed to debt reduction, thus contributing to the domestic economy overheating.

Iceland is the world's smallest economy with an independent monetary policy. In our assessment, Iceland's monetary policy has historically not been effective at keeping inflation near the central bank target. More recently, inflation has been somewhat contained, mostly reflecting imported deflation owing to lower foreign oil and commodity prices. That said, we have revised our inflation forecasts significantly upward because of the sizable wage hikes we expect 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 last few years. (See "Banking Industry Country Risk Assessment: Iceland," Dec. 10, 2014, for more details on the Icelandic banking sector.)

Outlook

The stable outlook reflects our view that the risks to our ratings on Iceland are balanced. We could raise the ratings if Iceland's fiscal position were to improve faster than we currently anticipate or capital controls are lifted sooner than we expect, without putting the krona exchange rate or financial stability at risk.

We could lower the ratings if we perceived that sizable wage hikes pose a material risk for the country's monetary, fiscal, or external stability. We could also lower the ratings if progress on lifting capital controls is significantly delayed or if it leads to a significant decline in net reserves, placing renewed pressure on the exchange rate or the Icelandic financial system.

Key Statistics

Table 1

Republic of Iceland Selected Indicators

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Nominal GDP (bil. US$)	18	13	13	15	14	15	17	16	17	18	19
GDP per capita (US$)	55,790	40,154	41,750	46,124	44,536	47,830	52,418	49,483	51,109	54,263	57,057
Real GDP growth (%)	1.2	(5.1)	(3.1)	2.4	1.3	3.6	1.9	3.4	3.0	2.7	2.5
Real GDP per capita growth (%)	(1.3)	(6.3)	(2.5)	2.1	1.0	2.8	0.7	2.8	2.4	2.1	1.9
Change in general government debt/GDP (%)	49.9	19.9	9.8	19.8	(9.9)	(3.0)	(2.0)	0.3	(2.2)	0.5	0.5
General government balance/GDP (%)	(13.1)	(9.7)	(9.7)	(5.6)	(3.7)	(1.7)	(0.2)	(1.2)	(0.8)	(0.5)	(0.5)
General government debt/GDP (%)	74.0	92.2	100.0	115.0	100.1	91.7	84.6	79.7	72.2	68.1	64.9
Net general government	48.0	64.0	73.8	83.9	72.6	70.2	57.5	55.2	52.4	49.5	47.3

Table 1

Republic of Iceland Selected Indicators (cont.)											
	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
debt/GDP (%)											
General government interest expenditure/revenues (%)	7.3	15.7	12.5	10.8	11.8	11.1	10.4	10.1	10.0	9.4	9.2
Other dc claims on resident nongovernment sector/GDP (%)	199.0	145.2	139.4	140.0	132.5	126.6	113.1	110.8	108.0	106.0	105.4
CPI growth (%)	12.4	12.0	5.4	4.0	5.2	3.9	2.0	2.3	4.0	4.0	3.2
Gross external financing needs/CARs plus usable reserves (%)	657.7	166.3	136.3	112.2	94.8	95.4	98.1	93.2	92.3	93.5	93.2
Current account balance/GDP (%)*	(16.5)	1.4	0.6	0.7	1.3	8.0	6.1	4.7	2.1	2.1	1.7
Current account balance/CARs (%)*	(33.5)	2.5	1.0	1.1	2.1	12.9	10.4	8.2	3.7	3.7	2.9
Narrow net external debt/CARs (%)	166.7	177.8	148.8	96.8	89.2	71.6	59.3	56.3	57.1	54.4	53.5
Net external liabilities/CARs (%)	115.9	150.2	149.1	111.3	44.8	19.5	10.6	7.6	9.5	9.8	11.4

*The current account statistics presented exclude the impact of the old bank estates on the income account. Note: 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 Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor'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 assessment	Strength
Economic assessment	Strength
External assessment	Neutral
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Weakness
Monetary assessment	Weakness

Standard & Poor's 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 Standard & Poor's "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 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

- 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: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015
- Republic of Iceland Ratings Affirmed At 'BBB-/A-3'; Outlook Remains Positive, Jan. 16, 2015
- Banking Industry Country Risk Assessment: Iceland, Dec. 10, 2014
- Icelandic Power Company Landsvirkjun Outlook To Positive After Similar Action On Iceland; 'BB/B' Ratings Affirmed, July 24, 2014
- Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System Proposals; Outlook Stable, July 22, 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 assessment had improved. 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	
	To	From
Iceland (Republic of)		
Sovereign credit rating		
Foreign and Local Currency	BBB/Stable/A-2	BBB-/Positive/A-3
Transfer & Convertibility Assessment		
T&C Assessment	BBB	BBB-
Senior Unsecured		
Foreign and Local Currency	BBB	BBB-
Short-Term Debt		
Local Currency	A-2	A-3
Commercial Paper		
Foreign Currency	A-2	A-3

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 Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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.