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Research Update:

Republic of Iceland Ratings Affirmed At 'BBB-/A-3'; Outlook Remains Positive

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Overview

- We expect growth in the Republic of Iceland to average close to 3% over 2015-2018, supported by strong private consumption and rising investments.
- We expect the government's budgetary policies to result in net debt levels declining as a percentage of GDP through 2018.
- We are therefore affirming our 'BBB-/A-3' long- and short-term sovereign credit ratings on Iceland.
- The outlook remains positive, indicating that there is more than a one-in-three chance of an upgrade in the next two years.

Rating Action

On Jan. 16, 2015, Standard & Poor's Ratings Services affirmed its 'BBB-/A-3' long- and short-term foreign and local currency sovereign credit ratings on Iceland. The outlook remains positive.

Rationale

The ratings are supported by Iceland's high productivity and income levels and positive long-term growth prospects, as well as its strong institutional 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 2014 GDP at about \$17 billion) is characterized by high income levels, with GDP per capita exceeding \$55,000 in 2014. This is well above the median for other sovereigns we rate in the 'BBB' category. 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 abundant hydro and geothermal energy available on the island.

Following robust export-driven GDP growth of 3.5% in 2013, we estimate that the Icelandic economy expanded by only 1.3% in 2014. This is markedly less than we had forecast at the beginning of 2014, largely owing to weaker-than-projected growth in domestic demand as well as net exports making an unexpectedly large negative contribution. We nevertheless believe domestic demand-driven growth will strengthen to 3% in 2015, helped by wage increases, reducing unemployment, and household debt relief currently being implemented by the authorities.

We also view Iceland's long-term growth prospects as positive. We expect significant investment growth, averaging 10% in both 2015 and 2016, supported by several projects in the metals and energy sectors as well as modernization of the fishing fleet and capacity expansion in the tourism sector. In our view, these projects could boost Iceland's export performance by the end of our forecast horizon (2018). The Icelandic economy also benefits from a well-educated workforce, very high labor participation rates, and favorable demographics.

Our ratings on Iceland remain 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 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. The government is also committed to maintaining budgetary discipline and reducing public debt levels, which more than quadrupled between 2007 and 2011, as a percentage of GDP.

In our view, Iceland's fiscal position has improved considerably. For the first time in seven years, the general government balance was in surplus in 2014. We estimate the surplus amounted to 1.5% of GDP, supported by several one-off factors including a sizable dividend from the government-owned commercial bank, as well as higher-than-usual dividends from the Central Bank of Iceland. Even though such contributions will decrease this year, the 2015 budget targets a general government surplus, for a second consecutive year, of 0.2% of GDP.

Although we expect Iceland's budgetary performance to remain strong over 2015-2018, we forecast deficits to average 0.3% of GDP for the general government during this period, reflecting a number of downside risks. Uncertainties remain around the source of financing of the household debt relief currently being implemented.

Of the Icelandic krona (ISK) 160 billion package (8.2% of GDP), half is being financed directly by the government with the bulk of revenue coming from a bank tax that has been expanded to cover the old, defaulted Icelandic banks. The creditors of these institutions could mount a legal challenge to these measures, which could prevent the government from realizing some of the expected revenues. In our view, there is also a risk that the government could overshoot its spending target because of the pressure it faces to increase public-sector wages, as well as the need to support the government-owned Housing Financing Fund (HFF); the HFF could need more than the currently budgeted ISK2.9 billion in average annual contributions through 2018. Risks also remain from contingent liabilities stemming from government guarantees provided to the HFF and some other government-controlled companies, such as Landsvirkjun (see "Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System Proposals; Outlook Stable," July 22, 2014, and "Icelandic Power Company Landsvirkjun Outlook To Positive After Similar

Action On Iceland; 'BB/B' Ratings Affirmed," July 24, 2014).

Even so, we expect that government net debt levels will steadily decline to reach 52% of GDP by 2018. This is markedly less than the high 84% observed in 2011. We continue to include the Central Bank of Iceland's debt to the IMF (estimated at 2.2% of GDP as of end-2014) in our general government debt calculations. Following the financial crisis, Iceland has successfully regained international capital market access. More recently, it issued a €750 million bond in mid-2014 and used the proceeds to pay down official debt that had been extended during the crisis. We expect that over the 2015-2018 forecast horizon the remaining IMF and bilateral loans will be refinanced with market borrowing. We do not expect that these borrowings will significantly affect the government's interest expenditures; these will average nearly 10% of revenues over the next four years.

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

The authorities have, in the past year, taken some steps toward eventual capital account liberalization. In December 2014, Lansbankinn and LBI (the estate of old defaulted Landsbanki) reached an agreement by which an ISK196 billion (10% of 2014 GDP) Lansbankinn bond to LBI will be extended, with final maturity now in 2026 (2018 previously) in exchange for LBI getting exemptions from capital controls regarding distributing funds to priority creditors. In our view, this agreement notably eases one of Iceland's balance-of-payments pressure points.

Last year, the authorities also appointed special advisors to work on removing capital controls. That said, we continue to believe that it will take years to fully remove the controls. Nonresidents' krona-denominated assets trapped in Iceland currently total about \$6.5 billion (39% of 2014 GDP). This figure combines with domestic residents' pent-up demand to diversify their asset holdings by investing abroad, following years of capital controls. IMF estimates suggest that these rebalancing preferences--largely stemming from Iceland's sizable pension funds--could amount to 20%-45% of GDP. The combined potential outflows well exceed the central bank's reserves, which at the end of 2014 amounted to about 24% of GDP.

The underlying current account surplus--adjusted for accrued domestic and foreign interest payments and receipts of the old banks--improved markedly to nearly 8.0% of GDP in 2013, from 1.5% in 2012. That said, this largely reflects a considerable improvement in the income deficit, partly due to weaker returns on direct investment in Iceland as well as low interest rates. We estimate that the surplus tightened to 4.6% of GDP last year owing to strong imports growth. Given high projected investment growth and strong domestic demand, we expect that the current account surplus will continue to

narrow and 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 a greater improvement in the services surplus than we currently expect. Tourism has been particularly strong over the last two years.

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. That said, financial supervision has improved in the last few years. 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 2008 bank defaults. The new commercial banks are well-capitalized and liquid; nonperforming loans have reduced significantly over the last few years and now amount to about 8% under the cross-default method. There are risks for the Icelandic financial system from potential adverse judicial rulings, such as the case on the legality of basing the calculation of borrowing costs for CPI-indexed consumer loans on 0% inflation at a time when inflation in Iceland was much higher. Should Icelandic courts rule that such an arrangement is incompatible with the law, and depending on the compensating mechanism put in place, the financial system could potentially sustain considerable losses. Uncertainties also remain around the potential impact of the removal of capital controls on the domestic financial system (see "Banking Industry Country Risk Assessment: Iceland," Dec. 10, 2014, for more details on the Icelandic banking sector).

Outlook

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

We could consider an upgrade if Iceland's forthcoming proposals to address the overhang on its external accounts and to lift capital controls appear sufficiently credible to benefit macroeconomic stability. Part of this analysis will also reflect our assessment of the impact that these proposals may have on Iceland's ability to attract net foreign direct investment, as well as on the Icelandic private sector's access to funding. We could also raise the ratings if Iceland's fiscal and growth performance strengthens more than we currently anticipate, leading to a faster-than-projected decline in net general government debt as a percentage of GDP.

On the other hand, if we observed fiscal slippage, say from unfinanced expenditures related to the household debt relief plan, the ratings could stabilize at the current level. We could consider lowering the ratings if lifting the capital controls saw reserves decline significantly, or if there

was renewed pressure on 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\$)	60,264	43,472	44,812	49,328	47,494	51,030	55,128	52,962	55,634	58,271	61,033
Real GDP growth (%)	1.1	(5.1)	(2.9)	2.1	1.1	3.5	1.3	3.0	2.8	2.5	2.5
Real GDP per capita growth (%)	0.1	(6.1)	(3.2)	1.7	0.7	2.8	0.6	2.3	2.1	1.8	1.8
Change in general government debt/GDP (%)	49.9	19.9	9.8	19.8	(9.9)	(3.0)	(1.2)	0.5	(2.7)	0.2	0.2
General government balance/GDP (%)	(13.1)	(9.7)	(9.7)	(5.6)	(3.7)	(1.7)	1.5	(0.5)	(0.2)	(0.2)	(0.2)
General government debt/GDP (%)	74.0	92.2	100.0	115.1	100.4	92.1	87.4	83.2	75.9	72.2	68.6
Net general government debt/GDP (%)	48.0	64.0	73.8	84.0	72.9	70.5	63.8	60.8	57.7	54.9	52.3
General government interest expenditure/revenues (%)	7.3	15.7	12.5	11.4	12.1	11.4	10.2	10.2	10.2	9.4	8.9
Other dc claims on resident nongovernment sector/GDP (%)	199.0	145.2	139.4	140.2	133.0	127.1	127.2	125.8	124.9	124.3	123.7
CPI growth (%)	12.4	12.0	5.4	4.0	5.2	3.9	2.0	2.0	2.5	3.4	3.4
Gross external financing needs/CARs plus usable reserves (%)	657.7	166.3	136.3	112.0	91.0	95.4	93.7	91.9	93.4	99.7	100.6
Current account balance/GDP (%)	(16.5)	1.4	0.6	0.9	1.5	7.7	4.6	2.5	0.7	(0.4)	(0.7)
Current account balance/CARs (%)	(33.5)	2.5	1.0	1.4	2.4	12.6	7.6	4.1	1.1	(0.7)	(1.0)
Narrow net external debt/CARs (%)	166.7	177.8	148.8	97.4	89.7	72.0	51.2	51.1	53.1	53.6	54.8
Net external liabilities/CARs (%)	115.9	150.2	149.1	112.0	45.2	20.4	9.3	11.0	16.6	19.3	22.2

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 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

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 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

- Sovereign Rating Methodology, Dec. 23, 2014
- 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

- Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed, July 18, 2014
- Supplementary Analysis: Iceland (Republic of), Aug. 19, 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 Iceland's debt burden 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 Affirmed

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

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