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Research Update:

Iceland Long-Term Ratings Raised To 'A-' On Stronger External Position; Outlook Stable

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Research Update:

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Overview

- Iceland's balance of payments performance has exceeded our forecasts. We estimate the current account surplus was more than 5% of GDP in 2016, predominantly supported by robust tourism growth.
- The Central Bank of Iceland's (CBI) foreign exchange reserves grew by over 40% last year, marking a visible strengthening in the economy's external position.
- We are therefore raising our long-term ratings on Iceland to 'A-' from 'BBB+'.
- The stable outlook primarily balances the potential for further improvement in Iceland's external and monetary profiles, as capital controls are fully lifted, against the risk of the domestic economy overheating over the next two years.

Rating Action

On Jan. 13, 2017, S&P Global Ratings raised its long-term foreign and local currency sovereign credit ratings on the Republic of Iceland to 'A-' from 'BBB+'. At the same time, we affirmed the 'A-2' short-term ratings. The outlook is stable.

Rationale

The upgrade largely stems from Iceland's stronger-than-anticipated external performance characterized by a sizable current account surplus and material growth in the CBI's foreign exchange reserves throughout 2016. We believe current account surpluses will persist over our 2017-2020 forecast horizon. The upgrade also reflects the Icelandic economy's robust growth dynamics and our expectation of a continued reduction in the general government debt level as a percentage of GDP.

Over the last six months, Iceland's balance of payments performance has exceeded our expectations. We estimate the current account posted a surplus of 5.4% of GDP in 2016, where we previously projected 4.0%. This is primarily due to strong tourism growth; tourists outnumbered the domestic population several times over. Large service export inflows have allowed the CBI to accumulate significant additional reserves. Coupled with a one-off impact from the settlement of the old defaulted banks, we estimate reserves were over 40% higher at the end of last year compared to end-2015. We estimate that the Icelandic economy is now in a net external creditor position of 2.5% of GDP.

We continue to forecast that the current account surpluses will gradually diminish over our four-year forecast horizon. This primarily emanates from:

- Expected strong consumption and investment performance, which will pull in imports; and
- Weaker terms of trade. We note that terms of trade improved significantly during the last two years, a trend that could reverse, particularly as oil prices rise,

but also if marine prices turn out to be less favorable.

That said, we anticipate the current account will nevertheless remain in surplus through 2020 and, consequently, Iceland's net international investment position will improve further.

Even though Iceland's external position has improved, risks still remain. These are primarily around the final stages of capital account liberalization. The government implemented the first round of loosening controls on domestic residents in October 2016, and the second round of measures came in on Jan. 1, 2017. Under the amended regulations, residents are allowed to purchase foreign real estate and foreign-exchange-denominated instruments, for example. We understand that the outflows so far have been very limited and the CBI reserves continued to grow in November and December 2016.

With further steps in the liberalization process for residents, outflows could pick up considerably. Any estimates are subject to a high degree of uncertainty, however. Our base case assumes that the CBI's foreign exchange reserves will remain steady throughout our forecast preiod, with the entire current account surpluses de facto allocated to meet residents' pent-up demand for foreign assets following years of exchange controls.

There are also risks stemming from the so-called offshore krona overhang. This overhang originated principally from bonds denominated in Icelandic krona (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). In June 2016, the government held a foreign currency auction to release this overhang. We understand that, at present, the overhang totals about ISK190 billion (about 8% of 2016 GDP). We see legal risks from the government's approach to remaining offshore ISK holders, who are likely to try to reach a better settlement either through continued negotiation or litigation. The timeframe for resolution remains uncertain.

Overall, however, we consider that enlarged net foreign exchange reserves afford the CBI more firepower to deal with unforeseen developments related to the aforementioned risks. We anticipate that capital account liberalization will proceed in orderly stages. In our view, were unforeseen pressures on the exchange rate, net foreign exchange reserves, or the financial system to emerge, the CBI would react by halting the liberalization process until these were resolved.

Our ratings on Iceland remain supported by the country's comparatively high per capita income levels and strong growth exhibited over the last four years. We estimate that the Icelandic economy grew by 5% in real terms in 2016, which is very high given the country's level of development.

We still believe there are risks of the economy overheating and we note that several signs of this have already emerged: the CBI estimates that there is now a positive output gap while private consumption is booming and wages are growing in double digits, year-on-year, across the country. Nevertheless, we believe the current high

pace of growth is taking place against much stronger fundamentals compared to the four years prior to the crash in 2008: private sector leverage is on a downward path while the current account is in surplus for the eighth consecutive year.

Even though Iceland has enjoyed consistently robust growth in recent years, we believe--partly owing to its small size--the economy remains structurally volatile, as demonstrated by previous boom-bust cycles. 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.

Our ratings on Iceland remain supported by the sovereign's strong fiscal settings. As a by-product 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. We estimate that net general government debt declined to 42% of GDP in 2016, from 57% in 2014, and anticipate it will further reduce to 34% by 2020. We also understand that legislation has been passed to explicitly address the funding shortfall in the public part of the pension system. This would not, however, have a material impact on the fiscal indicators we use.

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 contingent liabilities stemming from various government entities.

The ratings on Iceland continue to be constrained by the limited flexibility of monetary policy. In our opinion, historically Iceland's monetary policy has not been effective at keeping inflation near the CBI target. More recently, inflation has been below the CBI target, mostly reflecting imported deflation owing to lower foreign oil and commodity prices and a stronger 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 over the next three years due to sizable wage hikes.

The resilience of the Icelandic financial sector continues to improve. The new commercial banks are well-capitalized and nonperforming loans have declined significantly over the past few years (see "Banking Industry Country Risk Assessment: Iceland," published Nov. 18, 2016).

We also do not expect the government's approach toward lifting the capital controls to put Iceland's financial stability at risk.

Our ratings on Iceland remain supported by the country's strong institutional arrangements. A narrow majority coalition government between the Independence Party, Bright Future, and the Reform Party has been formed following lengthy talks after the early general elections in October 2016. Our upgrade of Iceland reflects our view that the new government will maintain a prudent economic focus, particularly when it comes to fiscal policy.

Outlook

The stable outlook primarily balances the potential for improvement in Iceland's external and monetary profiles, as capital controls are fully lifted, against the risk of the domestic economy overheating 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 recent sizable wage hikes led to a significant overheating of the domestic economy, with heightened risks for the country's monetary, fiscal, or external stability. This could also be the case if further liberalization of capital controls proceeded in a disorderly fashion, placing renewed pressure on the Icelandic krona exchange rate and the financial system.

Key Statistics

Table 1

Republic of Iceland Selected Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	1,702	1,778	1,891	2,006	2,214	2,385	2,535	2,684	2,834	2,992
Nominal GDP (bil. $)	15	14	15	17	17	20	22	22	23	23
GDP per capita (000s $)	46.1	44.5	48.1	52.8	51.0	59.3	65.4	65.7	65.9	66.0
Real GDP growth	2.0	1.2	4.4	1.9	4.1	5.0	3.0	2.8	2.5	2.5
Real GDP per capita growth	1.7	0.9	3.7	0.7	3.1	3.9	1.8	1.6	1.2	1.2
Real investment growth	11.6	5.3	2.2	16.0	18.2	20.0	4.0	3.0	2.4	2.4
Investment/GDP	15.6	16.1	15.4	17.3	19.1	21.7	21.9	22.2	22.4	22.6
Savings/GDP	16.3	17.8	23.6	23.2	25.1	27.1	25.7	24.5	24.1	23.9
Exports/GDP	56.6	57.0	55.4	53.3	53.7	48.9	50.0	51.3	53.0	54.7
Real exports growth	3.4	3.6	6.7	3.2	9.2	9.0	4.0	4.0	4.0	4.0
Unemployment rate	7.1	6.0	5.4	5.0	4.0	3.2	3.0	3.0	3.2	3.5

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Table 1

Republic of Iceland Selected Indicators (cont.)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.7	1.7	8.2	5.8	6.0	5.4	3.8	2.3	1.7	1.3
Current account balance/CARs	1.2	2.6	13.3	10.0	10.2	10.2	7.0	4.2	2.9	2.2
CARs/GDP	61.6	63.3	61.7	58.3	58.3	53.5	54.2	55.6	57.5	59.3
Trade balance/GDP	2.1	0.7	0.4	(0.5)	(1.6)	(2.5)	(3.2)	(3.9)	(4.5)	(4.8)
Net FDI/GDP	7.4	29.8	(0.3)	4.3	3.7	3.0	0.5	0.5	0.5	0.5
Net portfolio equity inflow/GDP	0.6	0.6	(0.0)	(0.0)	(2.3)	(2.0)	(2.5)	(2.5)	(2.5)	(2.5)
Gross external financing needs/CARs plus usable reserves	112.0	95.5	96.5	99.9	93.6	93.1	83.9	88.0	91.2	92.9
Narrow net external debt/CARs	96.5	88.5	71.0	58.2	143.6	62.5	50.0	47.9	47.6	47.1
Net external liabilities/CARs	110.9	44.4	19.2	9.9	9.6	(4.8)	(9.7)	(12.0)	(14.6)	(17.3)
Short-term external debt by remaining maturity/CARs	65.0	61.6	50.3	49.9	42.0	46.5	40.6	42.2	43.5	43.0
Reserves/CAPs (months)	5.6	8.2	5.8	5.3	5.4	6.2	7.7	7.1	6.7	6.3
Reserves (mil. $)	5,984	4,008	4,017	3,988	4,895	7,063	7,063	7,063	7,063	7,063
FISCAL INDICATORS (%, General government)										
Balance/GDP	(5.6)	(3.7)	(1.8)	(0.1)	(0.8)	0.0	(0.5)	(0.5)	0.0	0.0
Change in debt/GDP	19.8	(9.9)	(3.0)	(1.4)	(8.6)	(6.0)	0.5	0.5	0.0	0.0
Primary balance/GDP	(1.4)	1.0	2.7	4.6	3.8	4.1	3.0	2.8	3.1	2.9
Revenue/GDP	40.1	41.7	42.1	45.2	42.1	42.0	41.8	41.5	41.5	41.5
Expenditures/GDP	45.7	45.4	43.9	45.3	42.9	42.0	42.3	42.0	41.5	41.5
Interest /revenues	10.3	11.4	10.9	10.4	11.0	9.8	8.4	7.9	7.4	7.1
Debt/GDP	115.1	100.2	91.2	84.6	68.1	57.2	54.3	51.8	49.0	46.5
Debt/Revenue	286.9	240.5	216.8	187.1	161.8	136.1	129.9	124.8	118.2	111.9
Net debt/GDP	81.5	70.5	67.7	57.2	48.7	41.8	39.8	38.1	36.1	34.2
Liquid assets/GDP	33.6	29.6	23.5	27.3	19.4	15.4	14.5	13.7	13.0	12.3
MONETARY INDICATORS (%)										
CPI growth	4.0	5.2	3.9	2.0	1.6	1.6	3.0	3.0	3.0	3.0
GDP deflator growth	3.0	3.3	1.8	4.1	6.0	2.6	3.2	3.0	3.0	3.0
Exchange rate, year-end (LC/$)	122.71	128.99	115.55	126.90	129.59	113.00	117.52	122.22	127.11	132.19
Banks' claims on resident non-gov't sector growth	1.0	0.2	(0.4)	1.2	0.4	1.7	2.5	3.0	3.0	3.0
Banks' claims on resident non-gov't sector/GDP	160.1	153.5	143.9	137.2	124.8	117.8	113.6	110.5	107.8	105.2
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	12.4	11.9	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	14.0	14.1	18.5	18.0	16.5	N/A	N/A	N/A	N/A	N/A

Table 1

Republic of Iceland Selected Indicators (cont.)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Real effective exchange rate growth	1.4	(0.3)	4.6	6.6	2.2	N/A	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. LC--Local currency. 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

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Related Research

- 2015 Annual Sovereign Default Study And Rating Transitions, May 24, 2016
- Sovereign Risk Indicators - December 14, 2016. For an interactive version, go to www.spratings.com/sri

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 the 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

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

Ratings List Continued...

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.

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