Fitch Upgrades Iceland to 'BBB'; Outlook Stable

Fitch Ratings, London, 14 February 2013: Fitch Ratings has upgraded Iceland's Long-term foreign currency Issuer Default Rating (IDR) to 'BBB' from 'BBB-' and affirmed its Long-term local currency IDR at 'BBB+'. The agency has affirmed the Short-term foreign currency IDR at 'F3' and upgraded the Country Ceiling to 'BBB' from 'BBB-'. The Outlooks on the Long-term IDRs are Stable.

KEY RATING DRIVERS

The upgrade reflects the impressive progress Iceland continues to make in recovering from the financial crisis of 2008-09. The economy has continued to grow, notwithstanding developments in the eurozone; fiscal consolidation has remained on track and public debt/GDP has started to fall; financial sector restructuring and deleveraging are well-advanced; and the resolution of Icesave in January has removed a material contingent liability for public finances and brought normalisation with external creditors a step closer.

The Icelandic economy has displayed the ability to adjust and recover at a time when many countries with close links to Europe have stumbled in the face of adverse developments in the eurozone. The economy grew by a little over 2% in 2012, notwithstanding continued progress with deleveraging economy-wide. Macroeconomic imbalances have corrected and inflation and unemployment have continued to fall.

Iceland has continued to make progress with fiscal consolidation following its successful completion of a three-year IMF-supported rescue programme in August 2011. Fitch estimates that the general government realised a primary surplus of 2.8% of GDP in 2012, its first since 2007, and a headline deficit of 2.6% of GDP. Our forecasts suggest that with primary surpluses set to rise to 4.5% of GDP by 2015, general government balance should be in sight by 2016.

In contrast to near rating peers Ireland ('BBB+') and Spain ('BBB'), Iceland's general government debt/GDP peaked at 101% of GDP in 2011 and now appears to be set on a downward trajectory, falling to an estimated 96% of GDP in 2012. Fitch's base case sees debt/GDP falling to 69% by 2021. Net public debt at 65% of GDP in 2012 is markedly lower than gross debt due to large government deposits. This also contrasts with Ireland (109% of GDP) and Spain (81% of GDP). Renewed access to international capital markets has allowed Iceland to prepay 55% of its liabilities to the IMF and the Nordic countries.

Risks of contingent liabilities migrating from the banking sector to the sovereign's balance sheet have receded significantly following the favourable legal judgement on Icesave in January 2013 that could have added up to 19% of GDP to public debt in a worst case scenario. Meanwhile, progress in domestic debt restructuring has been reflected by continued falls in commercial banks' non-performing loans from a peak of 18% in 2010 to 9% by end-2012. Nonetheless, banks remain vulnerable to the lifting of capital controls, while the financial position of the sovereign-owned Housing Finance Fund (HFF) is steadily deteriorating and will need to be addressed over the medium term.

Little progress has been made with lifting capital controls and EUR2.3bn of non-resident ISK holdings remain 'locked in'. However, Fitch estimates that the legal framework for lifting capital controls will be extended beyond the previously envisaged expiry at end-2013, thereby reducing the risk of a disorderly unwinding of the controls. Fitch acknowledges that Iceland's exit from capital controls will be a lengthy process, given the underlying risks to macroeconomic stability, fiscal financing and the newly restructured commercial banks' deposit base. However, the longer capital controls remain in place, the greater the risk that they will slow recovery and potentially lead to asset price bubbles in other areas of the economy.

Iceland's rating is underpinned by high income per capita levels and by measures of governance, human development and ease of doing business which are more akin to 'AAA'-rated countries. Rich natural resources, a young population and robust pension assets further support the rating.

RATING SENSITIVITIES
The main factors that could lead to a negative rating action are:
- Significant fiscal easing that resulted in government debt resuming an upward trend, or adverse shocks that implied higher government borrowing and debt than projected
- Crystallization of sizeable contingent liabilities arising from the banking sector. In this regard, the HFF represents the main source of risk.
- A disorderly unwinding of capital controls leading to significant capital outflows a sharp depreciation of the ISK and a resurgence of inflation.

The main factors that could lead to a positive rating action:
- Greater clarity about the evolution capital controls and, in particular the mechanism for releasing offshore krona.
- Enduring monetary and exchange rate stability.
- Further signs of banking sector stabilisation accompanied by continued progress of private sector domestic debt restructuring.
- Continued reduction in public and external debt ratios.

KEY ASSUMPTIONS
In its debt sensitivity analysis, Fitch assumes a trend real GDP growth rate of 2.5%, GDP deflator of 3.5%, an average primary budget surplus of 3.2% of GDP, nominal effective interest rate of 6% and an annual depreciation of 2% (to capture potential exchange rate pressures resulting from the lifting of capital controls) over 2012-21. Moreover a recapitalization of HFF equivalent to 0.7% of GDP is assumed in 2013. Under these assumptions, public debt/GDP declines from its current level to 69% of GDP in 2021.

The debt path is sensitive to growth shocks. Under a growth stress scenario (0.2% potential growth), public debt would remain on a downward trajectory but it would stabilise at a markedly higher level (90% of GDP) by 2019. While Iceland's debt dynamics appears to be resistant to an interest-rate stress scenario, a sharp deterioration in the exchange rate (possibly associated with a disorderly unwinding of capital controls) would have a more adverse effect.

Similarly, a scenario with no fiscal consolidation (primary deficit of 0.3% of GDP in the medium-term) would reverse the debt downward path: debt would reach 100% of GDP in 2015 and would remain above that level for 2015-21.

Fitch assumes that contingent liabilities arising from the banking sector (mainly through HFF) will be limited. Under a scenario where contingent liabilities arise due to the recapitalisation of HFF and they account for 4% of GDP each year from 2014 to 2016, public debt would still remain on a downward trajectory. However, it would reach 81% of GDP by 2021 (versus 69% under the baseline).

Fitch assumes that capital controls will ultimately be unwound in an orderly manner.

Fitch assumes that the eurozone remains intact and that there is no materialisation of severe tail risks to global financial stability.

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Additional information is available on www.fitchratings.com

Applicable criteria, ‘Sovereign Rating Methodology’, dated August 2012, are available at www.fitchratings.com.