FitchRatings

FITCH UPGRADES ICELAND TO 'BBB+'; OUTLOOK STABLE

Fitch Ratings-London-24 July 2015: Fitch Ratings has upgraded Iceland's Long-term foreign currency Issuer Default Rating (IDR) to 'BBB+' from 'BBB'. The Long-term local currency IDR has been upgraded to 'A-' from 'BBB+'. The Outlooks are Stable. The issue ratings on Iceland's senior unsecured foreign and local currency bonds have also been upgraded to 'BBB+' and 'A-', respectively. The Country Ceiling has been revised to 'BBB+' from 'BBB' and the Short-Term Foreign-Currency IDR upgraded to 'F2' from 'F3'.

KEY RATING DRIVERS

The upgrade of Iceland's IDRs reflects the following key rating drivers and their relative weights:

HIGH

In early June the Ministry of Finance presented a detailed strategy for the liberalisation of capital controls. This will address the sources of potential balance of payments pressures, which in the Icelandic authorities' view have made capital controls necessary since the financial crisis of 2008/2009. The first is the mismatch between domestic claims and assets of the banks which collapsed in 2008 (Glitnir, Kaupthing and Landsbanki). The second is the 'locked in' assets in Icelandic kronur owned by non-residents. Fitch believes that the plan is credible and will allow for the lifting of capital controls without generating undue balance of payments pressures.

The removal of capital controls should improve the business environment. Moreover, the implementation of the strategy and the related completion of composition agreements with the old bank estates will bring substantial fiscal windfalls and a dramatic improvement in the country's external metrics, as (according to central bank estimates) three-quarters of all external liabilities will drop out of estimates of the net international investment position.

Almost all of the claims on the failed banks are foreign, while around 40% of the assets are domestic. The 'overhang' of domestic assets, which would be transferred to creditors in the absence of controls, is estimated to be around ISK900bn (around 42% of GDP).

The Icelandic authorities have presented two possibilities for the failed bank estates for obtaining the authorisation to transfer assets to creditors. The first is to fulfil conditions in composition agreements ('stability conditions') designed to neutralise the adverse balance-of-payments effects of creditor payments. The second possibility - if composition agreements are not complete by year-end - is the payment of a one-off 'stability tax' amounting to 32%-39% of total assets. All three estates have produced proposals in the last few weeks outlining plans for addressing the stability conditions. These plans involve the transfer of domestic assets to the Treasury, the transformation of domestic short-term FX assets into long-term financing and refinancing of government FX funding offered at the time of the financial crisis.

Later this year the authorities will provide details of currency auctions designed to unwind the 'locked-in' non-resident ISK assets (around ISK290bn, or 15% of GDP). The Ministry of Finance has indicated that non-resident ISK owners will have to choose among taking part in currency auctions (at a discounted exchange rate), investing in long-term Treasury bonds, or locking assets in non-interesting-bearing accounts.

The liberalisation strategy, even if well thought out, inevitably carries some execution risks. One is that the old bank estates will not be able to complete the composition agreements with the authorities by the year-end deadline. This would trigger the imposition of the stability tax, which would likely

be challenged legally by the estates. However, the fact that the bank estates have proposed plans for addressing the stability conditions mitigates this risk.

Another key uncertainty is the extent to which Iceland's balance of payments will be affected by strong capital flows in a post-capital controls environment, as in the years leading to the financial crisis. The authorities have indicated that 'speed-limits' on the extent to which Icelandic residents can invest abroad will be in place. Ten days ago the central bank stated that pension funds would initially only be authorised to invest ISK10bn abroad this year.

MEDIUM

Since our last review, Iceland's public debt dynamics have improved. The general government debt to GDP ratio fell to 81.2% in 2014 from its peak of 96.5% in 2011. Iceland has been running primary surpluses since 2012. This year, we expect stock-flow adjustments to push down the debt ratio by around 2 percentage points (the Treasury has paid down the outstanding balance on some foreign debts, thanks to its strong FX reserve position - USD4.5bn in June). We forecast that the debt ratio will fall to 74.6% this year and decline to 63.3% by 2017.

The stability contributions should generate substantial windfalls to the Treasury, and the Ministry of Finance has indicated that these will be used to pay down debt rather than increase government expenditure. Given the uncertainty about the timing and amount of these windfalls, we have not included them in our baseline projections. In an illustrative scenario included in our debt sensitivity analysis, the debt ratio would fall by around 30% between 2015 and 2018.

Iceland's 'BBB+' IDRs also reflect the following key rating drivers:

The ratings are underpinned by a very high level of income per capita compared with 'BBB' range rating peers (USD48,000 compared with the peer median of USD10,200), and indicators of human development and governance more akin to the highest-rated sovereigns.

Public finances are now less of a risk than in previous reviews. Even without the windfalls discussed above, we forecast the debt ratio will decline to 63.3% by 2017. At the same time, the debt ratio is almost double that of the peer median. State guarantees are sizeable, amounting to 57% of GDP (three-quarters of which accounted for by the Housing Finance Fund).

Economic growth prospects for this year have improved. Real GDP growth in 1Q15 on an annual basis was 2.9%, and as in 2014, domestic demand was the driver of growth. Strong consumption and investment will push GDP growth this year up to 4.0%. Positive macroeconomic developments have translated into falling unemployment. The unemployment rate in May was 4.2%, down from 5.0% a year earlier.

However, there are clear downside risks to the macroeconomic outlook. Very generous wage settlements agreed over the past few months will put upward pressure on inflation over the years ahead. While inflation is still low, measures of inflation expectations have risen sharply. The Icelandic central bank has raised interest rates by 50bps, and has signalled further increases. The government has also planned fiscal loosening measures from next year that would strengthen the process of overheating in the economy.

If inflation expectations rise further, it will take an even stronger policy response in the form of higher interest rates, which will hinder growth. In addition, the gap between inflation and labour costs in Iceland and its main trading partners will push up the real exchange rate, adversely affecting external competitiveness.

Overall, we expect GDP growth to slow to 3.1% in 2016, and 2.7% in 2017. Inflation will remain low this year before rising to average around 4.9% in 2016-2017. Strong domestic demand and

deteriorating competitiveness will push down on the current account balance, forecast to average 3.4% over the next three years.

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.

The main factors that could, individually or collectively, result in positive rating action include:
-A track record of continued economic growth without excessive macroeconomic imbalances.
-Continued improvement in public debt dynamics, supported by prudent fiscal policy.
-Continued improvements in the external finances, such as further deleveraging of the balance sheet and sustained current account surpluses.

The main factors that could lead, individually or collectively, to negative rating action are:
-Evidence of excessive overheating in the domestic economy, for example through wage-price spirals, sharp interest rate rises, and adverse effects on household and corporate balance sheets.
-A weakened commitment to fiscal consolidation, for example through fiscal loosening via the windfalls from the old bank estates.
-Excessive capital flows in a post-capital controls world, leading to external imbalances and pressure on the exchange rate.

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

Fitch assumes that the government's strategy for capital controls liberalisation will be implemented broadly as planned.

In its debt sensitivity analysis, Fitch projects that government debt as a share of GDP will fall to 50% by 2024. In a positive scenario where fiscal windfalls from the old banks estates are assumed in 2016-2018, the debt ratio would fall to 33.5% by 2024. In a negative scenario with lower growth, a substantial one-off depreciation, and higher interest rates, the debt ratio would only decline to 60% by 2024.

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Additional information is available on www.fitchratings.com
Iceland - Rating Action Report
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869038

Applicable Criteria
Country Ceilings (pub. 28 Aug 2014)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=752194
Sovereign Rating Criteria (pub. 12 Aug 2014)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=754428

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