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Supplementary Analysis:

Iceland (Republic of)

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Supplementary Analysis:

Iceland (Republic of)

This report supplements our research update "Iceland Outlook Revised To Positive On Strong Growth And Improving Public Finances; 'BBB-/A-3' Ratings Affirmed," published on July 18, 2014. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

Sovereign Credit Rating
BBB-/Positive/A-3

The ratings are supported by high productivity and income levels and positive long-term growth prospects, as well as Iceland's generally strong institutional and governance 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 2013 GDP at $15 billion) is characterized by high income levels, with GDP per capita exceeding $45,000 in 2013. 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 cheap hydro and geothermal energy widely available on the island. The economy expanded by 3.3% in 2013 and we expect continued strong growth averaging 3% over 2014-2017, supported by strong domestic demand against a background of rising wages, falling unemployment, and household debt relief.

In our view, Iceland's long-term prospects are positive. We expect investment levels will pick up in 2014-2016 as the fishing fleet is modernized and capacity in the tourism sector expands. Several projects in metals and energy will also support hitherto depressed investment levels--currently below 14% of GDP compared to 24% on average over 1998-2008. The Icelandic economy also benefits from a well-educated workforce, very high labor force participation rates, and favorable demographics.

The ratings are also supported by 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.

Iceland's external vulnerabilities continue to constrain the ratings. When we analyze Iceland's balance of payments and the international investment position, we exclude the positions of banks in winding-up proceedings (the banks that collapsed in the financial crisis) from our calculations. Instead, we consider the underlying external position assuming that the liabilities of the failed banks will not be repaid in full. In our baseline projections we expect narrow net external debt to reduce to 56% of current account receipts (CARs) in 2015 before stabilizing and then edging slightly upward. Even though commercial banks (as well as the government) have borrowed abroad over the last year, access to external financing for other Icelandic entities remains limited partly due to still-fragile confidence against a background of capital controls.

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

Pent-up capital outflows come from a number of sources. The Central Bank of Iceland (CBI) estimates that short-term krona assets held by nonresidents are worth approximately 17% of GDP, even though this is markedly less than 35% at the beginning of 2009. This is largely due to CBI currency auctions, which have allowed the least patient foreign creditors to exit, albeit at a less attractive exchange rate. This combines with estimated net settlements of the claims of foreign creditors on the collapsed Icelandic banks (43% of GDP). We also believe that domestic residents--and specifically Iceland's sizable pension funds (with assets close to 140% of GDP)--would opt to diversify their asset holdings by investing abroad once the controls are lifted. Recent IMF estimates suggest that these rebalancing preferences could result in a balance of payments outflow of 20%-45% of GDP. Combined, the aforementioned settlements amount to at least 80% of GDP, well in excess of the CBI's reserves of about 26% of GDP as of June 2014. Accordingly, while we believe that capital controls will be eased gradually--with some steps potentially taken in the near future--full capital account liberalization seems remote.

The underlying current account surplus--corrected for accrued domestic and foreign interest payments and receipts of the old banks--improved markedly rising from 0.6% of GDP in 2012 to over 6% in 2013. That said, the development largely reflects a considerable improvement in the income deficit, which has been partly due to weaker returns on direct investment in Iceland as well as low interest rates. We currently expect these temporary effects to disappear as profitability strengthens and foreign interest rates gradually rise. Given high projected investment growth and strong domestic demand, we expect that the current account surplus will 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 material improvements in the services surplus, more than we currently expect. Tourism performance has been strong in recent years and this trend continues in 2014.

In our view, Iceland has improved its fiscal position considerably following the average general government deficits of 11% of GDP over 2008-2010. We estimate that the deficit measured 2.1% of GDP last year and expect it to move close to balance in the forecast period. This year's fiscal performance is supported by some expenditure restraint as well as one-off sizable dividends from the majority government-owned Landsbankinn. We also think that the organic budget law--currently being considered in parliament--has the potential to improve the fiscal framework and could contribute to less pro-cyclical budgetary policies in the future.

At the same time, there are a number of downside risks. These stem primarily from the proposed household debt relief plan, which provides for an Icelandic krona (ISK) 160 billion (approximately 8.5% of GDP) debt reduction. The plan comprises a direct write-off of ISK80 billion for households with index-linked mortgages and ISK80 billion from redirecting private pension contributions (through tax incentives) to loan repayment. We understand that the design of the scheme is fiscally neutral, with the lion's share of financing to come from the bank levy expanded to cover the old failed Icelandic banks. The creditors of these defaulted Icelandic banks could mount a legal challenge to these measures, leading to some of the expenditures crystallizing on the government's balance sheet. Debt relief could also increase prepayments and therefore reinvestment risk for the government-owned Housing Financing Fund (HFF), leading to further recapitalization needs from the government. HFF's government-guaranteed debt accounts for a sizable portion of the sovereign's moderate contingent liabilities.

Even though it remains substantial, we expect public-sector debt to steadily decline over the 2014-2017 forecast horizon. We forecast net general government debt to decline to 60% of GDP in 2017, from 71% in 2014. This compares with a high of 88% in 2011. We include the CBI's debt to the IMF (7% of GDP at end-2013) in our general government debt calculations and expect it will be replaced by market borrowing. Iceland's regained international capital market access should contribute to maturities lengthening as well as more-favorable interest expenditures, which we expect to average 10% of general government revenues over 2014-2017, lower than the 13% of 2009-2013.

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. 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 bank defaults of 2008. New commercial banks have made notable progress in restructuring their balance sheets. Loan-loss provisions have declined steadily and we expect restructuring will continue in 2014. However, nonperforming loans remain significant; concentration risk--given the economy's dependence on the marine products sector--is still high; and further meaningful losses cannot be ruled out.

Outlook

The positive outlook reflects our view that there is a more than one-in-three likelihood that we could raise the ratings within the next 24 months.

Specifically, we could raise the ratings on Iceland if sustainable growth, significant fiscal improvements, and external balance sheet repairs continue while international capital market access gradually improves for Icelandic entities and financial stability remains secure.

We could revise the outlook back to stable if we observed sustained fiscal slippage, resulting, for instance, from unfinanced expenditures related to the household debt relief plan. We could also revise the outlook or lower the ratings if the lifting of the capital controls resulted in a significant decline in reserves or renewed pressure on the Icelandic financial system.

Summary Statistics:

Table 1

Republic of Iceland - Selected Indicators											
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Nominal GDP (US$ bil)	20	17	12	13	14	14	15	16	16	17	18

Table 1

Republic of Iceland - Selected Indicators (cont.)											
GDP per capita (US$)	66,396	53,357	37,936	39,558	44,097	42,513	45,424	48,892	50,196	52,933	55,820
Real GDP growth (%)	6.0	1.2	(6.6)	(4.1)	2.7	1.5	3.3	3.0	3.3	2.8	2.8
Real GDP per capita growth (%)	3.3	(1.3)	(7.7)	(3.6)	2.4	1.1	2.5	2.3	2.6	2.1	2.1
Change in general government debt/GDP (%)	1.7	52.2	21.1	10.4	20.7	(10.4)	(3.0)	0.3	0.8	0.4	0.4
General government balance/GDP (%)	5.4	(13.5)	(9.9)	(10.1)	(5.6)	(3.8)	(2.1)	0.0	(0.5)	(0.2)	(0.2)
General government debt/GDP (%)	28.5	77.4	97.6	105.5	120.2	104.8	96.7	92.1	87.4	82.8	78.4
Net general government debt/GDP (%)	12.4	50.2	67.8	77.9	87.8	76.1	74.1	70.6	67.2	63.7	60.4
General government interest expenditure/revenues (%)	5.4	7.6	16.1	13.3	12.4	12.9	12.0	11.1	10.7	10.2	9.7
Oth dc claims on resident non-govt. sector/GDP (%)	311.2	208.1	153.7	147.1	146.4	138.8	133.3	129.0	125.2	121.4	118.3
CPI growth (%)	5.0	12.4	12.0	5.4	4.0	5.2	3.9	2.6	3.1	3.3	3.4
Gross external financing needs/CARs +use. res (%)	317.7	653.9	157.6	139.5	113.1	90.9	96.3	95.8	93.8	94.2	96.5
Current account balance/GDP (%)	(15.7)	(18.0)	(0.2)	(2.1)	(0.5)	0.6	6.2	1.8	0.5	(0.0)	(0.3)
Current account balance/CARs (%)	(28.0)	(35.1)	(0.4)	(3.7)	(0.8)	0.9	10.1	3.0	0.7	(0.1)	(0.5)
Narrow net external debt/CARs (%)	433.4	158.1	175.4	145.8	92.5	84.3	69.2	59.8	56.2	56.5	56.7
Net external liabilities/CARs (%)	205.6	111.9	145.9	153.3	113.3	45.2	22.3	19.6	21.6	27.0	34.1

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 S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Institutional and Governance Effectiveness: The Lifting Of Capital Controls Is Under Discussion

- Iceland is characterized by generally strong institutions and governance standards.
- Lifting capital controls as well as promoting large-scale industrial investments remain government priorities.
- Iceland is unlikely to join the European Union (EU) in the medium term.
- Some pressure points remain in Iceland's international relations.

We consider institutional and governance effectiveness to be a credit strength for Iceland. Iceland is a parliamentary republic with a unicameral Althingi (parliament). The country has deep democratic roots, robust political institutions, and high social and educational standards. Even though lax oversight contributed to the collapse of the financial system in 2008--leading to the introduction of the still-present capital controls--the regulatory environment has since improved, in our view. The current government, comprising a majority coalition between the centre-right Independence Party (IP) and the centrist Progressive Party (PP), came to power in May 2013. There are no scheduled parliamentary elections before April 2017.

There is broad political consensus on key issues within the government. Both parties oppose EU membership. The government is currently considering a formal withdrawal of Iceland's application after accession negotiations were suspended in June 2013. We believe the European debt crisis as well as the necessity to adhere to the EU's common fisheries policy played important roles in reversing Iceland's accession aspirations, which were only initiated after the banking and economic crisis had hit the country. Accordingly, we do not expect the country to join the EU over the forecast horizon. Iceland will, however, remain a member of the European Economic Area (EEA), which entails participation in the EU's internal market. With the EEA absorbing four-fifths of Iceland's goods exports, this favorable relationship remains critically important.

The government remains supportive of industrial investments in the aluminium and energy sectors, recognizing Iceland's significant untapped potential benefitting from unique geothermal and hydro energy sources. Lifting Iceland's capital controls is also a government priority.

Work is underway on a new plan to address some of the crisis legacies, such as further reducing the liquid Icelandic krona overhang (nonresidents' krona-denominated investments remain trapped in the small Icelandic capital market following the imposition of capital controls in 2008) as well as handling the defaulted banks' domestic assets. In our opinion, these factors stand in the way of an instant and complete removal of capital controls. Full capital account liberalization seems a distant goal and would, in our view, require a more-resilient banking system and further strengthening of Iceland's external liquidity position. The amount of trapped assets held by nonresidents is close to 60% of 2014 GDP, of which over half is short-term (see External Analysis). Outflows of such magnitude would put considerable pressure on the krona and full capital market liberalization is unlikely until this overhang is materially reduced.

In our view, the government also appears committed to a sustained reduction in public debt levels. These jumped significantly following the 2008 collapse. The adopted 2014 budget aims for a small surplus for the first time since 2007. The authorities are also working on strengthening the fiscal framework and parliament is currently considering the Organic Budget Law, a set of fiscal rules.

Various pressure points remain in Iceland's international relations. The U.K. and Dutch authorities have filed a lawsuit against the Icelandic Deposit Insurance Fund, demanding an estimated ISK1,000 billion (53% of 2014 GDP) in compensation, including interest and costs. The lawsuit is related to the collapse of Icesave, an online bank active outside Iceland. Iceland also disagrees with the EU on fishing policy, and with the U.S. on Iceland's resumed commercial whaling, potentially leading to economic sanctions. However, we do not see the mentioned risks as material over the medium term and do not include them in our forecasts.

Economic Analysis: High Income Levels and Favorable Long-Term Prospects

- A small economy concentrated on fisheries and aluminium and, more recently, tourism.
- We expect growth to average 3% over 2014-2017, supported by strong domestic demand.
- The economy is operating at close to full capacity and there are risks of overheating.
- Upcoming investments in the metals, energy, and tourism industries support favorable long-term growth prospects.

Iceland's economy is small: with a population of 320,000, the country's 2013 GDP amounted to $15 billion. Goods and services exports correspond to about 60% of GDP and have traditionally been dominated by marine products, but also aluminium and tourism more recently. Following the collapse of the three major Icelandic banks in late 2008, the financial services as well as construction sectors have downsized significantly. The financial services sector's contribution to GDP reduced to 6% in 2009-2013 from an average of about 9% over 2004-2008; the construction industry reduced to under 5% from more than 10%.

The default of virtually the entire banking system set off a two-year-long recession and led to a sharp depreciation of the krona with per capita income levels declining to under $38,000 in 2009 from a peak of more than $66,000 in 2007. At the same time, with GDP per capita estimated at $49,000 in 2014, Iceland's population remains far more prosperous than that of most other 'BBB' rated sovereigns, whose median GDP per capita is about $12,000. We believe, however, that the capital controls may lead to an overestimation of GDP per capita (in U.S. dollar terms) as it is calculated at a nonmarket clearing exchange rate.

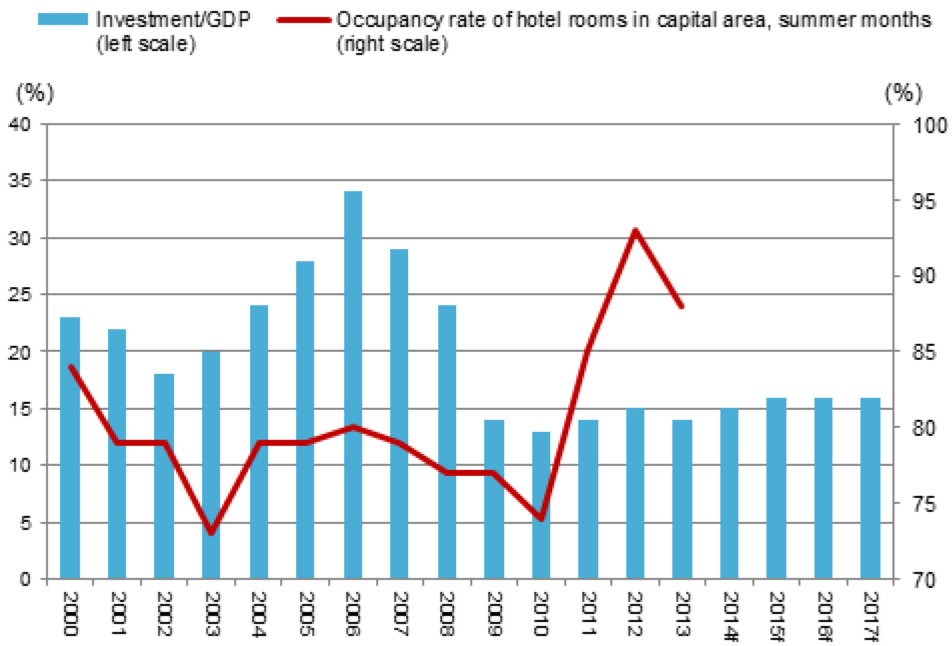
Following 2% growth on average in 2011-2012, the economy expanded by a robust 3.3% in 2013, helped by strong export performance, primarily reflecting continued expansion of tourism. We project growth to remain solid at close to 3% over 2014-2017, although the composition is likely to shift toward domestic demand. In our view, consumption growth will be supported by increasing incomes, a continued reduction in unemployment, and household debt relief (currently being implemented).

There is some risk of the domestic economy overheating. According to central bank estimates, the economy is operating at close to full capacity and a positive output gap may emerge as early as this year. The labor market continues to tighten and we believe that recently negotiated pay rises for teachers of close to 30% over a three-year period could put upward pressure on wages for other groups during the next round of negotiations. This, in turn, may contribute to accelerating inflation as well as competitiveness risks.

In our view, Iceland's long-term prospects are positive. We expect investment levels will pick up in 2014-2016 as the fishing fleet is modernized and capacity in the tourism sector expands. Several projects in metals and energy will also support hitherto depressed investment levels--currently below 14% of GDP compared to 24% on average over 1998-2008 (see chart 1). The Icelandic economy also benefits from a well-educated workforce, very high labor force participation rates, favorable demographics, and a strong pension system.

Chart 1

Investment Levels Are Low In A Historical Context While Spare Capacity In The Tourism Sector Is Disappearing



Source: Statistics Iceland, Standard & Poor's. f--Forecast.

External Analysis: There Are Key Uncertainties Around The Removal Of Capital Controls

- Capital controls continue to shelter Iceland from sizable external pressures.
- The pace and consequences of their removal remain a key uncertainty.
- We expect current account to gradually return to deficit as strong domestic demand and rising investments lead to an increase in imports.

After the collapse of the banking system, the central bank introduced capital controls in November 2008 to shelter the domestic economy from considerable external pressures and further depreciation of the krona. Nevertheless, even excluding defaulted debt, gross external debt was close to a sizable 92% of GDP as of end-2013. This largely reflects significant external borrowing by the public sector as well as nonbank private-sector liabilities, whereas borrowing by the banking system has remained quite muted.

When we analyze Iceland's balance of payments and the international investment position, we exclude the positions of banks in winding-up proceedings (the banks that defaulted in 2008) from our calculations. Instead, we consider the underlying external position--assuming the liabilities of the failed banks will not be repaid in full. Our base case is for narrow net external debt to reduce to 56% of CARs in 2015 before stabilizing and then edging slightly upward. Even though commercial banks (as well as the government) have borrowed abroad over the last year, access to external financing for other Icelandic entities remains limited partly due to still-fragile confidence.

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

Pent-up capital outflows come from a number of sources. The central bank estimates that short-term krona-denominated assets held by nonresidents are worth approximately 17% of GDP, albeit this is markedly less than the 35% at the beginning of 2009. This is largely due to CBI currency auctions, which have allowed the least-patient foreign creditors to exit, albeit at a less attractive exchange rate. This combines with estimated net settlements of the claims of foreign creditors on the collapsed Icelandic banks (43% of GDP). We also believe that domestic residents--and specifically Iceland's sizable pension funds (with assets close to 140% of GDP)--would opt to diversify their asset holdings by investing abroad once the controls are lifted. Recent IMF estimates suggest that these rebalancing preferences could result in a balance of payments outflow of 20%-45% of GDP. Combined, the aforementioned settlements amount to at least 80% of GDP, well in excess of the CBI's reserves of about 26% of GDP as of June 2014. Accordingly, while we believe that capital controls will be eased gradually--with some steps potentially taken in the near future--full capital account liberalization seems remote.

The underlying current account surplus--corrected for accrued domestic and foreign interest payments and receipts of the old banks--has improved markedly. It rose to more than 6% of GDP in 2013 from 0.6% in 2012. That said, this largely reflects a considerable improvement in the income deficit, reflecting positive net factor income from the pharmaceuticals companies for the first time since 2008; lower profitability in the aluminium industry due to price declines; as well as low interest rates. We currently expect these temporary effects to disappear as profitability strengthens and foreign interest rates gradually rise. Given high projected investment growth and strong domestic demand, we expect that the current account surplus will turn into a deficit by 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 material improvements in the services surplus, more than we currently expect. Tourism performance has been strong in recent years and this trend continues in 2014.

Fiscal Analysis: Continued Adjustment Not Without Risks

- Budgetary consolidation continues and debt levels have started to decline.
- The government has embarked on a reform of the fiscal framework and fiscal rules are to be introduced.
- Risks remain and reflect uncertainties surrounding financing of the household debt relief as well as the need for further capital injections for HFF.

Iceland has achieved significant fiscal tightening since the onset of the financial crisis in 2008. The general government budget deficit reduced to 2.1% last year after averaging a substantial 11% during 2008-2010. The adjustment took place through both tax increases and expenditure cuts. In our view, the government in office remains broadly committed to continued fiscal consolidation, although its pace could slow as budgets move closer to balance and pressure to increase public sector wages and investments intensifies.

We now expect the general government budget to be in balance this year for the first time since 2008 , supported by expenditure restraint, a broadening of the bank tax, and sizable one-off dividends from the majority government-owned Landsbankinn (one of the largest commercial banks in Iceland). We believe the deficit will remain close to balance over 2015-2017.

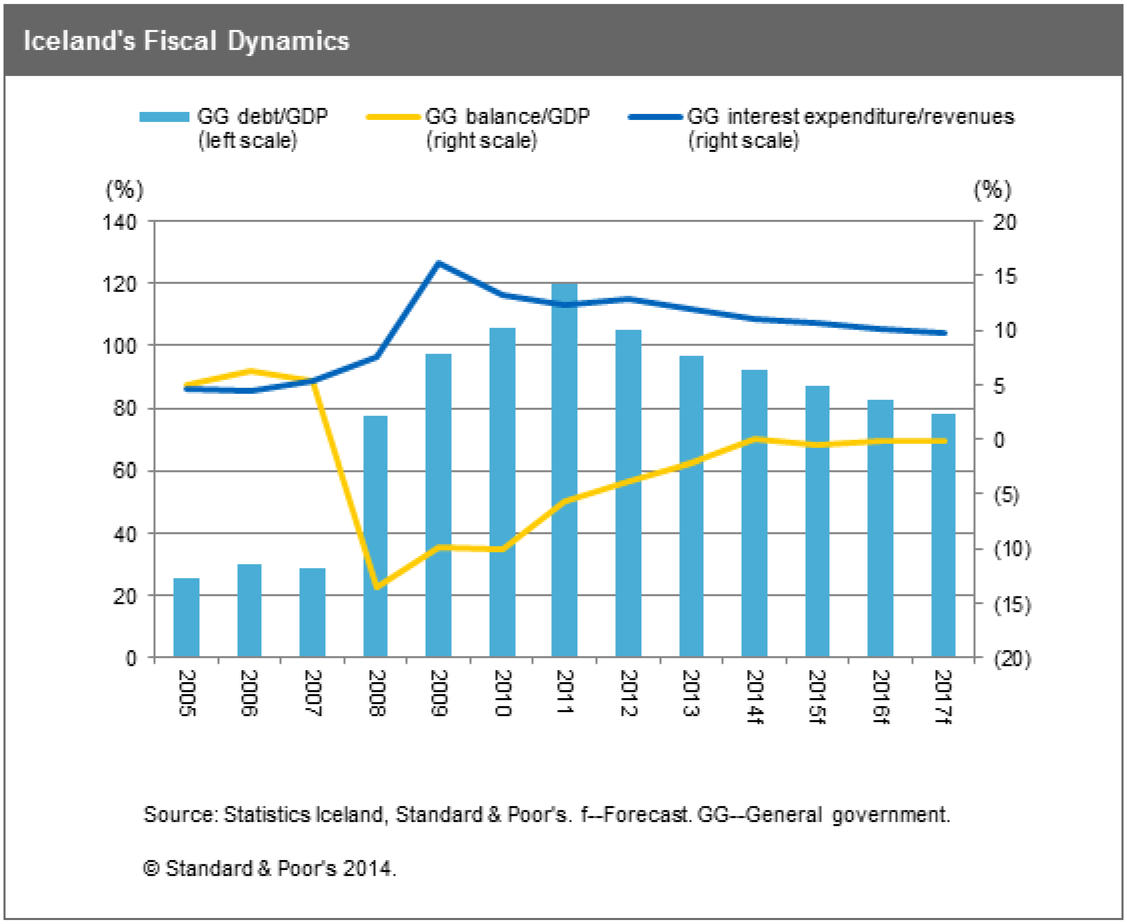
Work is underway to strengthen the fiscal policy framework. The proposals--which extend to the entire public sector--call for successive governments to establish a strategic fiscal path and increase clarity and transparency in budget preparation. They also introduce a set of numerical fiscal rules as well as a fiscal council to oversee their implementation. In addition, the government is considering revamping the VAT and income tax systems to ease administration and increase efficiency.

Nevertheless, fiscal risks remain. The coalition is implementing household debt relief worth ISK160 billion (8.5% of GDP) over the next few years. Of this, half is to be funded through the budget, and half from the tax-free diversion of households' 3rd pillar pension savings toward mortgage prepayments or house purchase. The scheme is designed to be fiscally neutral with the lion's share of financing for the first, budget-funded part to come from an extension of bank levies on old, defaulted Icelandic banks. Some of these institutions, however, have announced their intention to challenge these proposals in court, implying that there are risks of the costs ultimately landing on the government's balance sheet.

We also anticipate that debt relief could lead to further losses for the government-owned Housing Financing Fund (HFF) due to increased mortgage prepayments. HFF has been making losses since 2008 and it required over ISK50 billion (2.8% of 2013 GDP) in contributions from the government to keep it afloat in 2010-2014. Our forecasts factor in 0.3% of GDP in annual capital injections for HFF, but these costs could be higher (see "Long-Term Ratings On Iceland's Housing Financing Fund (HFF) Lowered To 'BB-' On Housing System Proposals; Outlook Stable," published on July 22, 2014).

Iceland's public debt is substantial: we estimate general government debt at 97% of GDP as of year-end 2013, including the CBI's loans from the IMF and Norway (see chart 2). That said, it has started to decline and we project it will reduce to below 80% of GDP by 2017. In our view, sizable contingent liabilities (classified as moderate under our criteria) could surpass 30% of GDP and weaken Iceland's fiscal position. These primarily include the guarantees provided on the debt of HFF (48% of 2014 GDP) as well as national power company Landsvirkjun (15% of 2014 GDP). Their stand-alone credit profiles, stripping out extraordinary government support, are low at 'b-' and 'b+', respectively.

Chart 2



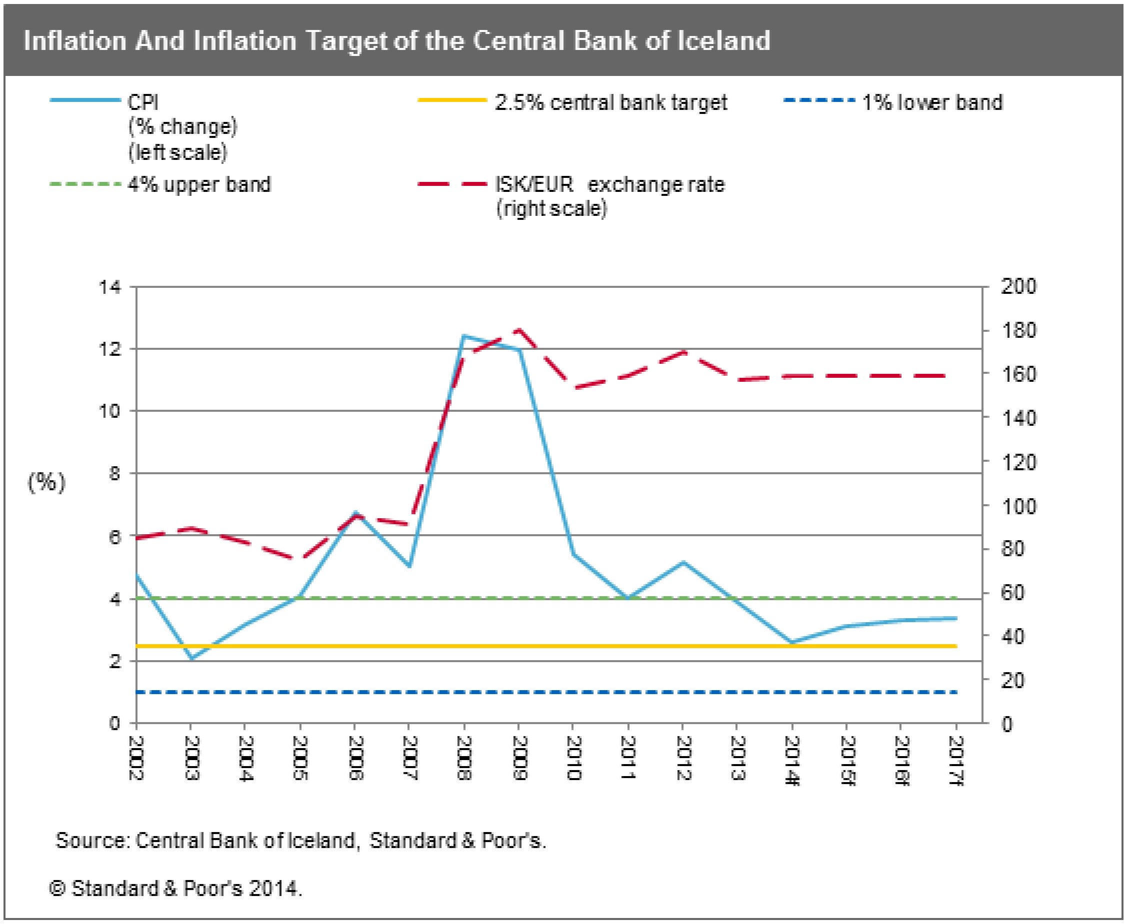
Iceland continues to benefit from access to capital markets on favorable terms. It issued a six-year €750 million bond in July, the first euro-denominated bond since 2006. In line with our expectations, most of the funds (€735 million) were used to prepay the official Nordic loans, which bore a higher interest rate. The latter had been complementing IMF funding after the financial and economic crisis struck Iceland.

Monetary Policy Analysis: Limited Flexibility

- Iceland's monetary policy has historically been ineffective in managing inflation.
- Inflation has recently moderated to below target levels but we expect it will pick up again as the output gap closes, wage pressures rise, and import prices gradually recover.
- Private-sector debt remains high.
- The financial position of commercial banks is gradually improving and they are starting to regain foreign market access.

Iceland is one of the world's smallest economies, with an independent monetary policy based on a flexible exchange-rate regime. Iceland's monetary policy has historically been ineffective as demonstrated by significant deviations of inflation levels from the central bank's target (see chart 3). This is largely attributable to the small size of the Icelandic economy. Its consumer basket has a large imports component, and there is a lack of domestic substitutes for most imported goods. This has led to strong pass-through effects whenever the krona has depreciated. The krona can swing widely in real effective terms not only because of changes in terms of trade but also because of financial flows that can swamp commercial flows, as happened in 2008.

Chart 3



Inflation started to reduce at the start of the year and now stands close to the central bank's target of 2.5%. Stable import prices for consumer goods as well as disinflation in the domestic services sector have contributed to the decline. We believe, nevertheless, that inflation will gradually pick-up again to average just over 3% in 2015-2017 as the negative output gap narrows and potential wage pressures emerge. Longer-term inflation expectations--which remain above target according to the central bank--also point to a reversal in recent trends.

Despite declining significantly since 2008, private sector indebtedness remains high with corporate debt at 140% of GDP and household debt at close to 100%. The financial positions of both sectors appear to be stabilizing with the number of individuals on the default register falling and corporate bankruptcies declining. We nevertheless expect that deleveraging will take time and credit growth will remain somewhat muted over the forecast horizon, averaging 3% per year in 2014-2017 in nominal terms, much lower than during the boom years.

The banks' financial positions are generally stable, although key uncertainties remain related to the gradual lifting of capital controls and the settlement of claims of the old bank estates on the new banks. Liquidity levels appear adequate and capital ratios improved in 2013 from already high levels. Nonperforming loans, calculated using the cross-default method, have declined, although remain elevated at close to 12% of the total as of mid-2014. Unlike the pre-crisis years, banks are largely deposit-funded. They have also started to regain foreign market access amid gradually recovering confidence as reflected in recent external borrowings by key Icelandic banks. More information on the Icelandic banking system can be found in "Banking Industry Country Risk Assessment: Iceland," published Aug. 19, 2013, on RatingsDirect.

Table 2

Republic of Iceland - Selected Indicators

Economic Indicators	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (bil LC)	1,309	1,480	1,498	1,536	1,628	1,699	1,786	1,882	1,999	2,122	2,254
Nominal GDP (US$ bil)	20	17	12	13	14	14	15	16	16	17	18
GDP per capita (US$)	66,396	53,357	37,936	39,558	44,097	42,513	45,424	48,892	50,196	52,933	55,820
Real GDP growth (%)	6.0	1.2	(6.6)	(4.1)	2.7	1.5	3.3	3.0	3.3	2.8	2.8
Real GDP per capita growth (%)	3.3	(1.3)	(7.7)	(3.6)	2.4	1.1	2.5	2.3	2.6	2.1	2.1
Real investment growth (%)	(12.2)	(20.4)	(51.4)	(9.4)	14.1	5.5	(3.4)	12.0	10.0	6.7	5.2
Gross domestic investment/GDP (%)	28.5	24.4	13.8	12.7	14.1	14.6	13.6	14.8	15.7	16.1	16.2
Gross domestic savings/GDP (%)	12.8	6.3	13.6	10.6	13.6	15.2	19.8	16.6	16.1	16.0	16.0
Real exports growth (%)	17.7	7.0	7.0	0.5	3.8	3.8	5.3	3.0	4.0	4.1	4.1
Unemployment rate (average %)	2.3	3.0	7.2	7.6	7.1	6.0	5.4	4.8	4.4	4.1	3.9
External Indicators											
Narrow net external debt/CARs (%)	433.4	158.1	175.4	145.8	92.5	84.3	69.2	59.8	56.2	56.5	56.7
Gross external financing needs/CARs +use. res (%)	317.7	653.9	157.6	139.5	113.1	90.9	96.3	95.8	93.8	94.2	96.5
Net external liabilities/CARs (%)	205.6	111.9	145.9	153.3	113.3	45.2	22.3	19.6	21.6	27.0	34.1
Current account balance/GDP (%)	(15.7)	(18.0)	(0.2)	(2.1)	(0.5)	0.6	6.2	1.8	0.5	(0.0)	(0.3)
Current account balance/CARs (%)	(28.0)	(35.1)	(0.4)	(3.7)	(0.8)	0.9	10.1	3.0	0.7	(0.1)	(0.5)
Trade balance/GDP (%)	(6.7)	(0.5)	6.0	7.8	6.0	4.6	3.9	2.9	2.6	2.6	2.7
Net FDI/GDP (%)	(16.5)	30.5	(18.2)	20.7	7.7	31.1	(1.1)	2.0	2.0	2.5	2.5
Net portfolio eq inflow/GDP (%)	(21.2)	0.4	1.5	8.1	0.7	0.5	(0.3)	0.5	1.0	1.0	1.0
Short-term ext debt by remaining maturity/CARs (%)	254.5	717.6	140.1	88.1	66.2	54.3	49.3	38.0	32.5	30.8	31.6
Reserves/CAPs (months)	1.9	2.7	6.3	4.3	5.7	8.3	5.9	5.1	4.9	4.7	4.4
Fiscal Indicators											
Change in general government debt/GDP (%)	1.7	52.2	21.1	10.4	20.7	(10.4)	(3.0)	0.3	0.8	0.4	0.4

Table 2

Republic of Iceland - Selected Indicators (cont.)											
General government balance/GDP (%)	5.4	(13.5)	(9.9)	(10.1)	(5.6)	(3.8)	(2.1)	0.0	(0.5)	(0.2)	(0.2)
General government primary balance/GDP (%)	8.0	(10.2)	(3.4)	(4.5)	(0.4)	1.8	3.2	4.9	4.2	4.2	4.0
General government revenue/GDP (%)	47.7	44.1	41.0	41.5	41.8	43.6	44.2	44.0	43.7	43.5	43.5
General government expenditures/GDP (%)	42.3	57.7	51.0	51.6	47.4	47.4	46.3	44.0	44.2	43.7	43.7
General government interest expenditure/revenues (%)	5.4	7.6	16.1	13.3	12.4	12.9	12.0	11.1	10.7	10.2	9.7
General government debt/GDP (%)	28.5	77.4	97.6	105.5	120.2	104.8	96.7	92.1	87.4	82.8	78.4
Net general government debt/GDP (%)	12.4	50.2	67.8	77.9	87.8	76.1	74.1	70.6	67.2	63.7	60.4
General government liquid assets/GDP (%)	16.1	27.2	29.8	27.6	32.5	28.8	22.7	21.5	20.2	19.1	18.0
Monetary Indicators											
CPI growth (%)	5.0	12.4	12.0	5.4	4.0	5.2	3.9	2.6	3.1	3.3	3.4
GDP deflator growth (%)	5.7	11.8	8.3	6.9	3.3	2.9	1.8	2.3	2.8	3.3	3.3
Oth dc claims on resident non-govt. sector growth (%)	35.9	(24.3)	(25.3)	(1.8)	5.5	(1.1)	0.9	2.0	3.0	3.0	3.5
Oth dc claims on resident non-govt. sector/GDP (%)	311.2	208.1	153.7	147.1	146.4	138.8	133.3	129.0	125.2	121.4	118.3

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. 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. CAPs--Current account payments. FI--Financial Institutions.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- 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
- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 2014
- Outlooks: The Sovereign Credit Weathervane, Year-End 2013 Update, Feb. 4, 2014

Ratings Detail (As Of August 19, 2014)		
Iceland (Republic of)		
Sovereign Credit Rating		BBB-/Positive/A-3
Transfer & Convertibility Assessment		BBB-
Commercial Paper		
Foreign Currency		A-3
Senior Unsecured		BB
Senior Unsecured		BBB-
Short-Term Debt		A-3
Short-Term Debt		B
Sovereign Credit Ratings History		
18-Jul-2014	*Foreign Currency*	BBB-/Positive/A-3
24-Jan-2014		BBB-/Stable/A-3
26-Jul-2013		BBB-/Negative/A-3
23-Nov-2011		BBB-/Stable/A-3
17-May-2011		BBB-/Negative/A-3
13-Apr-2011		BBB-/Watch Neg/A-3
30-Mar-2010		BBB-/Negative/A-3
05-Jan-2010		BBB-/Watch Neg/A-3
31-Dec-2009		BBB-/Stable/A-3
18-Jul-2014	*Local Currency*	BBB-/Positive/A-3
24-Jan-2014		BBB-/Stable/A-3
26-Jul-2013		BBB-/Negative/A-3
23-Nov-2011		BBB-/Stable/A-3
17-May-2011		BBB-/Negative/A-3
13-Apr-2011		BBB/Watch Neg/A-3
30-Mar-2010		BBB/Negative/A-3
05-Jan-2010		BBB+/Watch Neg/A-2
31-Dec-2009		BBB+/Stable/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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