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Research Update:

Republic of Iceland Ratings Affirmed At 'A/A-1'; Outlook Stable

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Overview

- We project Iceland will continue to display strong growth dynamics, but we see risks of the domestic economy overheating, as suggested by the magnitude of recent wage hikes and house price growth.
- We are affirming our 'A/A-1' ratings on Iceland.
- The stable outlook balances the potential for improvements in Iceland's fiscal position against the risks of the economy overheating during the next two years.

Rating Action

On June 30, 2017, S&P Global Ratings affirmed its 'A/A-1' long- and short-term foreign and local currency sovereign credit ratings on the Republic of Iceland. The outlook is stable.

Rationale

The affirmation reflects our view that the ratings on Iceland will continue to be supported by the country's high per capita income levels, favorable growth prospects, and strong institutional arrangements, characterized by the government's commitment to sustainable public finances and an effective system of checks and balances between government bodies. The ratings are primarily constrained by the limited flexibility of Iceland's monetary policy, the risks stemming from overheating of the domestic economy, and the economy's inherent volatility and susceptibility to external shocks, which could negatively impact the country's balance of payments and banking system, in our view.

Over the past several years, Iceland has posted strong growth performance, largely owing to the rapid expansion of the tourism sector. This trend has continued into 2017 with tourist arrivals increasing by an estimated 50% in year-on-year terms over the first four months of 2017.

Tourism has underpinned Iceland's strong balance of payments performance. Last year's current account surplus amounted to 8% of GDP, one of the highest on record over the past 20 years. Large service sector inflows have allowed the Central Bank of Iceland (CBI) to accumulate significant reserves totaling $7.2 billion (36% of GDP) at end-2016.

The rapid expansion of reserves has been instrumental in allowing the CBI to successfully complete the lifting of capital controls on domestic residents in

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March 2017, and to release a large portion of the trapped offshore Icelandic krona overhang (which originated principally from bonds denominated in krona issued by nonresident entities before 2008, which are known as glacier bonds, and from nonresident holdings of bonds of the government-owned mortgage lender, Housing Financing Fund). Although close to $1.7 billion of foreign exchange reserves were deployed in 2017 to release the mentioned overhang and undertake a buy-back of a U.S. dollar-denominated bond in April, we anticipate the level of reserves will remain broadly flat in year-on-year terms in 2017, owing to our forecast of a strong current account surplus.

We currently don't project a further increase in foreign exchange reserves beyond 2017. This is because we anticipate the sizable Icelandic pension funds to gradually step up their foreign investment, following years of capital controls and taking advantage of a stronger krona. As a result, we expect that the government will allocate future current account surpluses to meet these outflows, which will still lead to an improvement in Iceland's net international investment position (IIP). We forecast Iceland will end 2017 in a positive net IIP position of 6% of GDP.

Rapid economic growth has also led to a consistent improvement in the sovereign's fiscal performance. The general government deficit reduced to 0.8% in 2015 from almost 10% of GDP in 2009. In 2016, the Treasury received one-off revenues related to the settlement of the old defaulted banks, mostly in nonliquid form (equity stakes in commercial banks). Unlike the authorities or the International Monetary Fund, we have excluded this one-time windfall from our fiscal calculations. Even so, the government still posted a general budgetary surplus of 1.3% of GDP last year.

We currently anticipate a 1.5% of GDP surplus in 2017 owing to strong economic performance, supported by the rapidly expanding tourism sector. We project deficits will kick in from 2018 as growth moderates while expenditures rise--particularly in the social sphere and infrastructure. Under this baseline scenario, Iceland's net general government debt will reduce to just over 30% of GDP in 2020 from 42% of GDP at end-2016.

We believe, however, that the pace of debt reduction could be faster than we presently anticipate. This could happen, for example, if the authorities proceed with the sale of commercial banks and use the proceeds to pay down debt (which we have not factored in our base-case scenario). It could also happen if the fiscal policy is tightened in an attempt to cool off the economic boom. Although Iceland's fiscal performance has been strong in recent years, we believe a substantial part of the improvement is cyclical in nature and could partially reverse if growth slows down sharply. We still see some risks from contingent fiscal liabilities--particularly from the high stock of government guarantees to public-sector entities, such as the Housing Financing Fund or energy company Landsvirkjun--which we currently assess as moderate.

Despite the strong growth, alongside positive fiscal and balance of payments' performance, we continue to see several risks for Iceland, specifically:

- There are multiple signs of overheating in the domestic economy. The CBI estimates a positive output gap with unemployment being below the natural rate. Over the past three years, nominal wages have expanded in double digits on an annual basis. Combined with contained domestic inflation, a much stronger krona, and potentially procyclical fiscal policy, this poses considerable risks to the competitiveness of the domestic economy, particularly in the non-tourism-related sectors.

- There could be risks if the tourism inflows stopped suddenly. Under such a scenario, the banks' and households' balance sheets could be adversely affected if house prices were to adjust in response. The latter have grown substantially over the past two years. Positively, were such a scenario to materialize, we believe the prompt adjustment of the exchange rate should help release any external pressures and at least partly contribute to the economy cooling down. We also note that in recent years domestic credit has grown slower than nominal GDP, resulting in private-sector leverage declining as a share of the economy.
- More broadly, the Icelandic economy remains small, vulnerable to shocks, and volatile, as demonstrated by the large boom-bust cycles in the past. It is significantly dependent on the economic fortunes of its key trading partners.
- In our view, the economy is also exposed to adverse changes in terms of trade given the export concentration in the tourism, fishing, and metal sectors. Terms of trade have been particularly favorable in recent years, which has contributed substantially to the positive dynamics of U.S. dollar-expressed GDP. We believe that a reversal in the terms of trade trend could contribute to the economy's weaker external performance.
- In our view, Iceland's monetary policy flexibility remains constrained and represents a ratings weakness. Domestic price developments remain significantly influenced by foreign prices and the value of the exchange rate, which we anticipate will still present challenges to CBI monetary policy over the medium to long term.

Our ratings on Iceland remain supported by the country's strong institutional arrangements, underlined by a policy track record that has contributed to the country emerging successfully from its deep economic, fiscal, and financial crisis. A narrow majority coalition government between the Independence Party, Bright Future, and the Reform Party was formed following lengthy talks after the early general elections in October 2016.

Outlook

The stable outlook balances the potential for improvements in Iceland's fiscal position against the risks of the economy overheating in the next two years.

We could raise the ratings if Iceland's fiscal performance materially exceeded our forecasts, while the risks posed by overheating gradually receded.

We could lower the ratings if we observed that the present economic overheating, potentially fanned by procyclical policy and rapid wage growth, put the country's long-term growth prospects, balance of payments performance, or financial stability at risk.

Key Statistics

Table 1

Republic of Iceland Selected Indicators										
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. ISK)	1,702	1,778	1,891	2,006	2,214	2,422	2,607	2,760	2,914	3,077
Nominal GDP (bil. $)	15	14	15	17	17	20	24	26	26	27
GDP per capita (000s $)	46.1	44.5	48.1	52.7	51.0	60.3	70.7	75.0	75.1	75.1
Real GDP growth	2.0	1.2	4.4	1.9	4.1	7.2	4.5	2.8	2.5	2.5
Real GDP per capita growth	1.7	0.9	3.7	0.7	3.0	6.1	2.7	1.3	1.0	1.0
Real investment growth	11.6	5.3	2.2	16.0	17.8	22.7	6.0	3.0	2.2	2.0
Investment/GDP	15.6	16.1	15.4	17.3	19.1	21.3	21.6	22.0	22.4	22.7
Savings/GDP	16.3	17.8	23.6	23.2	25.3	29.3	28.2	26.5	26.1	25.5
Exports/GDP	56.6	57.0	55.4	53.3	53.7	49.1	45.9	47.2	48.5	50.0
Real exports growth	3.4	3.6	6.7	3.2	9.2	11.1	6.0	4.0	4.0	4.0
Unemployment rate	7.1	6.0	5.4	5.0	4.0	3.0	2.8	2.8	3.0	3.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.7	1.7	8.2	5.8	6.3	7.9	6.6	4.5	3.8	2.9
Current account balance/CARs	1.2	2.6	13.3	10.0	10.7	14.5	13.1	9.0	7.3	5.3
CARs/GDP	61.6	63.3	61.7	58.3	58.4	54.7	50.1	50.7	52.2	53.7
Trade balance/GDP	2.1	0.7	0.4	(0.5)	(1.6)	(4.2)	(3.6)	(4.3)	(5.0)	(5.6)
Net FDI/GDP	7.4	29.8	(0.3)	4.3	4.2	3.6	2.0	2.0	0.0	0.0
Net portfolio equity inflow/GDP	0.6	0.6	(0.0)	(0.0)	(2.4)	(5.4)	(5)	(5.0)	(3)	(3.0)
Gross external financing needs/CARs plus usable reserves	112.0	95.5	96.5	99.9	93.3	90.0	80.4	85.0	86.5	88.9
Narrow net external debt/CARs	96.5	88.5	71.0	58.2	143.3	55.9	45.6	41.9	42.5	42.5
Net external liabilities/CARs	110.9	44.4	19.2	9.9	10.3	(3.5)	(13.4)	(20.2)	(26.0)	(30.5)
Short-term external debt by remaining maturity/CARs	65.0	61.6	50.3	49.9	41.9	44.7	41.9	39.7	38.3	38.0
Usable reserves/CAPs (months)	5.6	8.2	5.8	5.3	5.5	6.3	8.3	7.1	6.6	6.2
Usable reserves (mil. $)	5,984	4,008	4,017	3,988	4,895	7,231	7,015	7,015	7,015	7,015
FISCAL INDICATORS (%, General government)										
Balance/GDP	(5.6)	(3.7)	(1.8)	(0.1)	(0.8)	1.3	1.5	(0.5)	(0.5)	(0.5)
Change in debt/GDP	19.8	(9.9)	(3.0)	(1.4)	(8.5)	(8.2)	(7.8)	0.5	0.5	0.5
Primary balance/GDP	(1.4)	1.0	2.7	4.6	3.8	5.5	4.7	2.2	2.1	1.9
Revenue/GDP	40.1	41.7	42.1	45.2	42.0	42.6	41.8	41.5	41.5	41.5

Table 1

Republic of Iceland Selected Indicators (cont.)										
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Expenditures/GDP	45.7	45.4	43.9	45.3	42.9	41.2	40.3	42.0	42.0	42.0
Interest /revenues	10.3	11.4	10.9	10.4	11.0	9.8	7.7	6.6	6.2	5.8
Debt/GDP	115.1	100.2	91.2	84.6	68.1	54.0	42.4	40.6	38.9	37.4
Debt/Revenue	286.9	240.5	216.8	187.1	162.0	127.0	101.6	97.8	93.8	90.1
Net debt/GDP	81.5	70.5	67.7	57.3	48.7	41.5	34.5	33.1	31.8	30.6
Liquid assets/GDP	33.6	29.6	23.5	27.3	19.4	12.5	8.0	7.5	7.1	6.7
MONETARY INDICATORS (%)										
CPI growth	4.0	5.2	3.9	2.0	1.6	1.7	2.0	3.0	3.0	3.0
GDP deflator growth	3.0	3.3	1.8	4.1	6.0	2.0	3.0	3.0	3.0	3.0
Exchange rate, year-end (LC/$)	122.71	128.99	115.55	126.90	129.59	112.82	105.00	109.20	113.57	118.11
Banks' claims on resident non-gov't sector growth	(8.5)	(5.8)	(2.6)	(2.7)	0.8	1.6	5.0	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	206.3	185.9	170.2	156.1	142.5	132.4	129.2	128.1	127.4	126.7
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	11.0	10.5	10.1	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	8.6	N/A	N/A	N/A	N/A
Real effective exchange rate growth	1.4	(0.3)	4.6	6.6	2.2	11.9	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. ISK--Icelandic krona. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. 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

Table 2

Republic of Iceland Ratings Score Snapshot (cont.)
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

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 23, 2014
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings History, June 7, 2017
- Sovereign Risk Indicators, April 10, 2017. An interactive version is available at http://www.spratings.com/sri.
- Global Sovereign Rating Trends: First-Quarter 2017, April 10, 2017
- 2016 Annual Sovereign Default Study And Rating Transitions, April 3, 2017

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 deteriorated. 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	
Foreign and Local Currency	A/Stable/A-1
Transfer & Convertibility Assessment	A
Iceland (Republic of)	
Senior Unsecured	
Foreign and Local Currency	A
Short-Term Debt	
Local Currency	A-1
Commercial Paper	
Foreign Currency	A-1

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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 the S&P Global Ratings' public website 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.