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Research Update:

Iceland Ratings Raised To 'BBB+' On Further Progress Toward Capital Account Liberalization And Declining Debt Levels

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Overview

- Since our last publication in July 2015, Iceland has made further progress toward resolving the issues preventing the lifting of capital controls.
- We also expect general government indebtedness to decline and interest expenditures to reduce over the next four years.
- We are therefore raising our long-term ratings on Iceland by one notch, to 'BBB+'.
- The stable outlook balances the upside potential stemming from materially faster-than-anticipated reduction in public debt levels against downside risks, primarily stemming from our expectation of sizable wage hikes.

Rating Action

On Jan. 15, 2016, Standard & Poor's Ratings Services raised its long-term sovereign credit ratings on Iceland to 'BBB+' from 'BBB'. At the same time, we affirmed the short-term ratings at 'A-2'. We have also raised the Transfer & Convertibility Assessment to 'BBB+' from 'BBB'. The outlook on the long-term ratings is stable.

Rationale

The upgrade primarily reflects the further progress Iceland has achieved in resolving the issues standing in the way of capital account liberalization since June 2015. In particular, the comprehensive proposals unveiled in mid-2015 have received support from the creditors of the three banks that defaulted in the 2008 crisis (the old bank estates), thereby reducing the uncertainties surrounding the capital account liberalization plan. It also reflects our expectation that general government debt will continue to decline over the next four years, lowering government expenditure on interest payments.

Since our last publication in July 2015, the creditors of the old bank estates have agreed to support the government's capital account liberalization plan by paying the government stability contributions (see "Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable," published on July 17, 2015). These have remained largely unchanged compared with the June 2015 proposals. The chief exception is that the estate of Glitnir has handed over its holding of Islandsbanki to the government. The stability contributions comprise a set of measures, akin to a tax, tailored to each estate, broadly aimed at staunching any related balance-of-payment outflows. In particular, they prevent any assets denominated in Icelandic krona (ISK) originating from the sizable claims the estates hold against Icelandic residents from being sold and converted into foreign currency--thus destabilizing the Icelandic krona--over the next several years.

Consequently, the composition proposals that allow for distribution of the assets to creditors without bankruptcy for all three estates were approved by the District Court of Reykjavik in December 2015 and the appeal period has expired without any appeals being filed, making the proposals binding under Icelandic law. Subsequently, the Central Bank of Iceland (CBI) granted an exemption from the capital controls to the three estates, allowing them to start distributing the assets to the creditors. This effectively finalizes the resolution of the largest problem standing in the way of the capital account liberalization in Iceland.

As a result of the settlement of the old bank estates, sizable stability contributions (potentially worth over 20% of GDP) will accrue to the Icelandic Treasury. At present, we do not include these in our net general government debt calculations because the majority of the contributions (especially the government’s claims on commercial banks) are not liquid. Although the government intends to use the eventual proceeds to reduce public debt level, the pace at which these assets can be converted into cash and the amounts that will be realized remain uncertain. Moreover, we believe there could still be pressure to spend these fiscal windfalls in a procyclical manner, especially in light of general elections approaching in 2017. That said, we understand the authorities have put in place provisions making the use of stability contributions subject to the opinion of the CBI, adding credibility to the government's stated intentions.

Even excluding the stability contributions, we expect Iceland’s fiscal standing to improve over the four-year forecast horizon. Gross general government debt has declined by an estimated 15% of GDP in 2015 as the sizable accumulation of nonborrowed CBI reserves has allowed the government to draw on its foreign exchange deposits at the central bank and prepay some of its obligations. For example, it has prepaid the bilateral loan from Poland, the Avens Bond (held by domestic pension funds stemming from an earlier settlement with the European Central Bank), and part of a 2016 Eurobond (through a US$500 million debt buyback).

However, 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 the potential for larger-than-expected contributions to the government-owned mortgage lender Housing Financing Fund (see "Ratings On Iceland's Housing Financing Fund Affirmed At 'BB-/B'; Outlook Stable," published on July 22, 2015). In our view, this poses a material contingent liability to the government. Fiscal pressures could also intensify ahead of the general elections in 2017. In fact, the budget for 2016 already represents a loosening of fiscal policy--import duties on certain items have been revoked, income taxes reduced, and certain social expenditures increased.

Nevertheless, our baseline forecast assumes that Iceland's underlying fiscal performance will remain strong and that deficits will average a modest 0.9% of GDP through 2019. As a result, we expect net general government debt to decline to below 45% of GDP by 2019 and interest expenditures to average less than 9% of government revenues in 2016-2019, down from nearly 11% of revenues over the preceding four years.

We continue to see risks from the 2015 wage settlements. National wage hikes in the public and private sectors will likely exceed 20% over the next three years, which could cause the krona's real effective exchange rate to appreciate, diminishing Iceland's competitiveness. The wage settlements could also cause the underlying current account surpluses to decline faster than anticipated. We currently estimate the surplus at 5% of GDP in 2015--similar to 2014--and we expect it to decline gradually owing to strong growth in import volumes, widening income account deficit, and deteriorating terms of trade. The decline could be more pronounced in a downside scenario, leading to current account deficits. To confront this risk, the CBI has embarked on a cycle of tightening of monetary policy, in an attempt to contain the consequences of large wage hikes on the domestic economy.

The impact of these factors is reflected in our forecasts: growth peaked at 4.2% in 2015, but is projected to slow as the CBI tightens its monetary stance. Our base-case forecast, however, is that the wage hikes will not derail Iceland’s economic performance thanks to sizable investments in 2016-2017 in the tourism, metals, and fishing sectors.

Some uncertainties regarding the next steps in capital account liberalization still remain, although they have diminished considerably since July. Following the resolution of the old bank estates' overhang on the balance of payments, we expect the authorities will increasingly focus on addressing the liquid krona overhang (originating from the carry trade on the glacier bonds predating 2008). At present, the CBI estimates that this is about 14% of GDP. The government plans to offer nonresident creditors a choice of settlement: to invest in a long-term Treasury bond, to deposit funds in a blocked account, or to exit via a foreign exchange auction at an exchange rate weaker than the official rate. In our view, there are potential legal risks related to this proposal. There is also a possibility that too many krona holders could opt for the foreign exchange auction, putting pressure on the CBI reserves.

Overall, however, Iceland's external risks have declined over the past several months. We anticipate that as the restrictions on Iceland's capital account are gradually relaxed, nonsovereign Icelandic entities will be able to tap foreign credit markets more readily, thereby relieving potential future pressure from servicing the nonsovereign external debt. The relaxation of capital controls is also likely to result in a gradual reduction of the administrative burden imposed on Icelandic companies with foreign currency revenues, like those in the fishing sector, which are currently obliged to repatriate all their foreign currency earnings. We expect that foreign direct investors could also increase their investments, given the prospects for greater macroeconomic stability, although recent foreign direct investment has largely been exempted from the capital controls.

The ratings on Iceland continue to be supported by its 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 they agree on key issues. These include opposition to EU membership, promotion of large-scale investments, and the lifting of capital controls.

The ratings continue to be constrained by the limited flexibility of monetary policy. Iceland is the world's smallest economy with an independent monetary policy. In our assessment, Iceland's monetary policy has not historically been effective at keeping inflation near the central bank target. More recently, inflation has been somewhat contained, mostly reflecting imported deflation owing to lower foreign oil and commodity prices. That said, we expect it to rise due to the sizable wage hikes over the next three years.

The financial sector has been substantially rehabilitated since the 2008 bank defaults. 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 on Dec. 10, 2014, for more details on the Icelandic banking sector.) We also do not expect the government's approach toward gradually lifting the capital controls to put Iceland's financial stability at risk.

Outlook

The stable outlook indicates our view of balanced risks to the ratings on Iceland 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. The ratings could also be raised if the stability contributions are monetized faster than we presently anticipate and used to pay down government debt leading to a materially lower public debt-to-GDP ratio that we believe will be maintained.

We could lower the ratings if we perceived that the sizable wage hikes pose a material risk for the country’s monetary, fiscal, or external stability. We could also lower the ratings if progress on lifting capital controls is significantly delayed or if we observe a significant decline in net reserves, placing renewed pressure on the Icelandic krona exchange rate.

Key Statistics

Table 1

Republic of Iceland Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	1,618	1,701	1,775	1,879	1,989	2,183	2,331	2,476	2,614	2,754
Nominal GDP (bil. $)	13	15	14	15	17	17	18	18	18	18
GDP per capita (000s $)	41.7	46.1	44.4	47.8	52.3	51.9	53.4	53.9	54.2	54.9
Real GDP growth	(3.6)	2.0	1.2	3.9	1.8	4.2	3.0	2.7	2.5	2.5
Real GDP per capita growth	(3.1)	1.7	0.8	3.2	0.6	3.6	2.4	2.1	1.9	1.9
Real investment growth	(8.6)	11.6	5.3	(1.0)	15.4	16.2	10.0	3.5	3.2	3.0
Investment/GDP	13.9	15.6	16.1	15.0	16.8	18.3	19.6	19.9	20.2	20.5
Savings/GDP	14.2	16.3	17.5	22.9	21.9	23.5	24.1	22.7	22.0	21.1
Exports/GDP	53.7	56.6	57.0	55.7	53.6	54.3	55.3	56.9	58.9	61.2
Real exports growth	1.0	3.4	3.6	6.7	3.1	6.2	4.8	4.5	4.5	4.5

Table 1

Republic of Iceland Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Unemployment rate	7.6	7.1	6.0	5.4	5.0	4.4	4.0	3.8	3.6	3.6
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.4	0.7	1.4	7.9	5.2	5.2	4.5	2.8	1.9	0.7
Current account balance/CARs	0.7	1.2	2.2	12.8	8.8	8.8	7.5	4.6	2.9	1.0
Trade balance/GDP	3.9	2.1	0.7	0.4	(0.5)	0.2	(0.6)	(0.9)	(1.3)	(1.8)
Net FDI/GDP	19.7	7.4	29.8	(0.3)	4.1	2.5	2.5	1.0	1.0	1.0
Net portfolio equity inflow/GDP	7.6	0.6	0.5	0.1	0.0	(1.8)	(2.0)	(2.5)	(2.5)	(2.5)
Gross external financing needs/CARs plus usable reserves	136.5	112.1	94.8	95.5	99.8	94.4	91.5	94.6	96.7	99.3
Narrow net external debt/CARs*	148.1	96.3	88.9	71.3	58.6	67.2	66.4	65.9	68.0	66.8
Net external liabilities/CARs*	148.4	110.8	44.7	19.2	9.3	23.6	24.7	22.7	23.1	21.8
Short-term external debt by remaining maturity/CARs	86.8	65.3	60.5	48.6	49.2	40.8	41.2	38.5	38.6	38.8
Reserves/CAPs (months)	4.4	5.6	8.2	5.8	5.3	5.2	6.0	5.2	5.0	4.7
FISCAL INDICATORS (%, General government)										
Balance/GDP	(9.8)	(5.6)	(3.7)	(1.9)	(0.1)	(1.2)	(1.0)	(1.0)	(0.8)	(0.8)
Change in debt/GDP	9.8	19.8	(9.9)	(3.0)	(1.4)	(7.6)	1.0	1.0	0.8	0.8
Primary balance/GDP	(5.0)	(1.4)	1.1	2.8	4.7	3.1	2.7	2.7	2.8	2.7
Revenue/GDP	39.6	40.1	41.7	42.4	45.6	42.5	42.5	42.0	41.5	41.5
Expenditures/GDP	49.4	45.7	45.5	44.2	45.7	43.7	43.5	43.0	42.3	42.3
Interest /revenues	12.0	10.3	11.5	11.0	10.5	10.1	8.8	8.8	8.7	8.4
Debt/GDP	100.2	115.1	100.3	91.8	85.3	70.2	66.7	63.8	61.2	58.9
Net debt/GDP	73.9	84.0	72.8	70.3	58.2	52.3	49.9	48.0	46.3	44.7
Liquid assets/GDP	26.2	31.1	27.5	21.5	27.1	17.9	16.8	15.8	15.0	14.2
MONETARY INDICATORS (%)										
CPI growth	5.4	4.0	5.2	3.9	2.0	1.8	3.8	3.8	3.2	3.2
GDP deflator growth	5.6	3.0	3.2	1.8	4.0	5.3	3.7	3.4	3.0	2.8
Banks' claims on resident non-gov't sector growth	(10.7)	(15.9)	(5.3)	(1.9)	4.1	6.0	5.0	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	193.7	155.0	140.6	130.3	128.1	123.8	121.7	120.3	119.6	119.2
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	13.1	N/A	N/A	N/A	N/A	N/A

Table 1

Republic of Iceland Selected Indicators (cont.)										
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**

*From 2015 onward, we include the estimated impact of settlement of the old bank estates on Iceland's International Investment Position considering the impact of stability contributions. For years prior to 2015, we exclude the position of the old bank estates from the data. 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 Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's 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

Standard & Poor's 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 Standard & Poor's "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 Standard & Poor's 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: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Ratings On Iceland's Housing Financing Fund Affirmed At 'BB-/B'; Outlook Stable, July 22, 2015
- Iceland Ratings Raised To 'BBB/A-2' On Proposals Toward Lifting Capital Controls; Outlook Stable, July 17, 2015
- Banking Industry Country Risk Assessment: Iceland, Dec. 10, 2014
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015
- Sovereign Risk Indicators, Dec. 14, 2015. An interactive version is available at 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 Fiscal assessment: debt burden 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	BBB+/Stable/A-2	BBB/Stable/A-2
Transfer & Convertibility Assessment	BBB+	BBB
Senior Unsecured		
Foreign and Local Currency	BBB+	BBB

Ratings List Continued...

Short-Term Debt		
Local Currency	A-2	A-2
Commercial Paper		
Foreign Currency	A-2	A-2

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 Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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.