



Fitch Affirms Iceland at 'BBB+'; Outlook Stable

Fitch Ratings-London-15 July 2016: Fitch Ratings has affirmed Iceland's Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) at 'BBB+' and 'A-', respectively with Stable Outlooks. The issue ratings on Iceland's senior unsecured foreign and local currency bonds have also been affirmed at 'BBB+' and 'A-'. The Country Ceiling has been affirmed at 'BBB+' and the Short-term foreign currency IDR and commercial paper at 'F2'.

KEY RATING DRIVERS

Iceland's ratings are underpinned by a very high level of income per capita (USD50,500 compared with the 'BBB' median of USD9,400). Its governance indicators and human development indicators are more akin to the highest-rated sovereigns.

Public debt sustainability has improved substantially over the past year. The general government debt to GDP ratio declined to 66.2% in 2015 from 82% in 2014, thanks to favourable debt dynamics and to down payments on a number of outstanding debts. Since peaking in 2011 following the financial crisis of 2008/2009, the debt ratio has declined by almost 30pp. Fitch expects the government debt ratio to fall further, mainly thanks to a combination of favourable debt dynamics and further debt down-payments, to 48% of GDP by 2018. Despite the sharp improvement in debt dynamics, public sector indebtedness remains higher than both the 'A' and the 'BBB' medians (43.9% and 40.6%, respectively).

Iceland remains relatively highly indebted to foreign creditors with a gross external debt stock at over 300% of CXR, but its external finances continue to improve reflecting consistent current account surpluses. The current account surplus widened to 4.2% of GDP, from 3.7% in 2014. We expect the current account to remain in surplus over the next three years, albeit at a lower level. The Icelandic krona has appreciated by 4.7% against the USD and 4% against the EUR since our last review. The Icelandic central bank has offset in part the upward pressure on the exchange rate by accumulating foreign exchange reserves. At end-May, FX reserves were ISK739bn (around 31% of GDP). This buffer gives the authorities a greater degree of confidence to proceed with the removal of capital controls on Icelandic households and firms.

Paving the way for this, the Icelandic authorities have recently taken measures to reduce the overhang of ISK claims by non-residents. In June, the central bank held a voluntary currency auction designed to encourage non-resident holders of ISK assets 'locked-in' due to capital controls to unwind their positions by exchanging ISK assets for foreign currency at a discount to the onshore exchange rate. Overall, ISK83bn were exchanged in the auction. This implies that around ISK237bn (around 10% of GDP) remain subject to capital controls. Owners of these assets can still exchange their holdings until November 1 at the exchange rate of EUR/ISK220 (the average rate resulting from the 21 foreign exchange auctions which took place between 2011 and 2015).

However, the authorities will seek to control capital inflows. In conjunction with the currency auction, the Icelandic authorities have introduced a special reserve requirement to avoid excessive capital inflows related to the carry trade, given the interest rate differential between Iceland and other developed market economies. Initially, non-resident investors will have to deposit 40% of the invested amount in a special reserve at the central bank for 12 months.

The Icelandic economy expanded by 4% in 2015, with domestic demand (+6.3%) and tourism the main drivers of GDP growth - services exports were up by 13.7% on 2014. Strong domestic investment and consumption drove up imports, so that overall there was a negative net trade contribution (with net

services partly offsetting net goods). Data for 1Q16 shows this pattern of growth continuing, with real GDP up by 4.2% on 1Q15, and domestic demand 8.5% higher. We expect this pattern of growth to continue, with GDP rising by 4% this year, before slowing down to 3% by 2018.

Domestic cost pressures resulting from above-trend growth and high wage settlements have not yet translated into high inflation, but coupled with the appreciating real exchange rate, this represents a potential risk to macroeconomic stability. Consumer price inflation has averaged 1.8% this year - 0.8% on the harmonised HICP measure - below the official target of 2.5%. Import prices are pushing down on inflation and at the same time, positive terms of trade developments may be encouraging firms to absorb rising labour costs within profit margins rather than raise prices. We expect inflation to pick up from the second half of this year, and average 3% in 2017-2018.

As a very small, open economy, Iceland is more susceptible to growth and inflation volatility than larger developed countries. Rising labour costs support the real exchange rate; strong domestic demand and falling unemployment point to risks of overheating in the domestic economy. Monetary policy may be tightened further while tax cuts are implemented. The continued expansion of the tourist sector relative to other sectors may entrench current low productivity growth.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Iceland a score equivalent to a rating of 'A+' on the Long-Term FC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:

- Public finances: -1 notch, to reflect the fact that the estimate for the general government balance this year will be boosted (by around 16% of GDP) by the stability contributions of the old banks' estates, and therefore would not reflect underlying trends in public finances.
- External finances: -1 notch, to reflect the fact that the small size of the economy makes it vulnerable to external shocks and balance of payments risks.
- Structural: -1 notch, to reflect the fact that capital controls on residents have been in place since 2008, adversely affecting the business environment.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES

The main factors that, individually or collectively, could trigger positive rating action are:

- A track record of continued economic growth without excessive macroeconomic imbalances.
- Continued improvements in debt dynamics, supported by prudent fiscal policy.
- Continued reductions in external vulnerability.

Future developments that could, individually or collectively, could trigger negative rating action are:

- Evidence of overheating in the domestic economy, for example through wage-price spirals, inflation overshooting, and adverse effects on household and corporate balance sheets.
- Excessive capital outflows after the lifting of capital controls, leading to external imbalances and pressures on the exchange rate.
- A weakened commitment to fiscal consolidation, for example through continued pro-cyclical fiscal policy

that would reverse or stall the decline in the public debt ratio.

KEY ASSUMPTIONS

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

Fitch assumes that the government's implementation strategy for capital controls liberalisation on domestic households and firms continues as planned.

In its debt sensitivity scenario, Fitch projects that government debt as a share of GDP will decline to 32.7% by 2025. In a negative scenario with low growth, a substantial one-off depreciation, and higher interest rates and inflation, the debt ratio would be broadly unchanged by 2025.

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Applicable Criteria

Country Ceilings (pub. 20 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame?rpt_id=869287&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOiJlE0Njg2NTA5NjAsInNlc3Npb25LZXkiOiJHS0FXUjIjMIRHNk0yRINJOUhWUkw3Q1kyWjBBNTVaWEhMRjdVVFBSIn0.bZWlp3yl5iURaa6rdcZsvnPgwTgTeyb1rNkb3scHRkY)

Distressed Debt Exchange (pub. 08 Jun 2016)

(https://www.fitchratings.com/creditdesk/reports/report_frame?rpt_id=882737&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOiJlE0Njg2NTA5NjAsInNlc3Npb25LZXkiOiJHS0FXUjIjMIRHNk0yRINJOUhWUkw3Q1kyWjBBNTVaWEhMRjdVVFBSIn0.bZWlp3yl5iURaa6rdcZsvnPgwTgTeyb1rNkb3scHRkY)

Sovereign Rating Criteria (pub. 26 May 2016)

(https://www.fitchratings.com/creditdesk/reports/report_frame?rpt_id=881782&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOiJlE0Njg2NTA5NjAsInNlc3Npb25LZXkiOiJHS0FXUjIjMIRHNk0yRINJOUhWUkw3Q1kyWjBBNTVaWEhMRjdVVFBSIn0.bZWlp3yl5iURaa6rdcZsvnPgwTgTeyb1rNkb3scHRkY)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1009025&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOiJlE0Njg2NTA5NjAsInNlc3Npb25LZXkiOiJHS0FXUjI0MIRHNk0yRINJOUhWUkw3Q1kyWjBBNTVaWEhMRjdVVFBSIn0.bZWlp3yl5iURaa6r dcZsvnPgwTgTeyb1rNkb3scHRkY)

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