Iceland

Full Rating Report

Ratings

Foreign Currency

Long-Term IDR	BBB
Short-Term IDR	F3

Local Currency

Long-Term IDR	BBB+
Country Ceiling	BBB

Outlooks

Foreign-Currency Long-Term IDR	Stable
Local-Currency Long-Term IDR	Stable

Financial Data

Iceland

(USDbn)	**2012**
GDP	13.8
GDP per head (USD000)	42.2
Population (m)	0.3
International reserves	8.7
Net external debt (% GDP)	619.5
Central government total debt (% GDP)	86.4
CG foreign-currency debt	3.4
CG domestically issued debt (ISKbn)	1,065.7

Related Research

Global Economic Outlook (December 2012)

2013 Outlook: Global Sovereign Review (December 2012)

Sovereign Data Comparator (December 2012)

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Key Rating Drivers

Upgrade to 'BBB': The upgrade on 19 February 2013 reflects Iceland's impressive progress in its recovery from the financial crisis of 2008-2009. The economy is growing, notwithstanding developments in the eurozone; fiscal consolidation remains on track and public debt/GDP is falling; financial sector restructuring and deleveraging are well-advanced; and the resolution of Icesave in January has removed a material contingent liability for public finances and brought normalisation with external creditors a step closer.

Economic Resilience: The Icelandic economy displayed the ability to adjust and recover at a time when many countries with close links to Europe stumbled in the face of adverse developments in the eurozone. The economy grew by a little over 2% in 2012, notwithstanding continued progress with deleveraging across the whole economy.

Fiscal Consolidation on Track: Iceland has made progress with fiscal consolidation following its successful completion of a three-year IMF-supported rescue programme in August 2011. Fitch Ratings estimates that the general government realised a primary surplus of 2.8% of GDP in 2012, its first since 2007, and a headline deficit of 2.6% of GDP. Our forecasts suggest that with primary surpluses set to rise to 4.5% of GDP by 2015, general government balance should be in sight by 2016.

Public Debt Has Peaked: In contrast to near rating peers Ireland (BBB+) and Spain (BBB), Iceland's general government debt/GDP peaked at 101% of GDP in 2011 and now appears to be declining steadily, falling to an estimated 96% of GDP in 2012. Fitch's base case sees debt/GDP falling to 69% by 2021. Renewed access to international capital markets has allowed Iceland to repay early 55% of its liabilities to the IMF and the Nordic countries.

Legacy Issues Remain: Little progress has been made with lifting capital controls and EUR2.3bn of non-resident Icelandic krona holdings remain locked in. Fitch estimates that the legal framework for lifting capital controls will be extended beyond the previously envisaged expiry at end-2013, thereby reducing the risk of a disorderly unwinding of the controls.

Banking Sector Vulnerabilities Persist: Progress in domestic debt restructuring is reflected in a fall in commercial banks' non-performing loans from a peak of 18% in 2010 to 9% by end-2012. Nonetheless, banks remain vulnerable to the lifting of capital controls, while the financial position of the sovereign-owned Housing Finance Fund (HFF) is steadily deteriorating and will need to be addressed over the medium term.

Rating Sensitivities

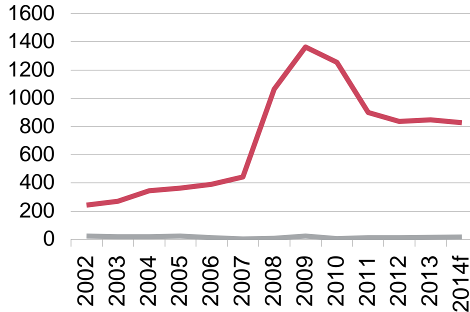
Fiscal Loosening: Significant fiscal easing that resulted in government debt resuming an upward trend, or adverse shocks that implied higher government borrowing and debt than projected would be rating negative.

Capital Controls: A disorderly unwinding of capital controls leading to significant capital outflows and a sharp depreciation of the Icelandic krona would lead to negative rating action.

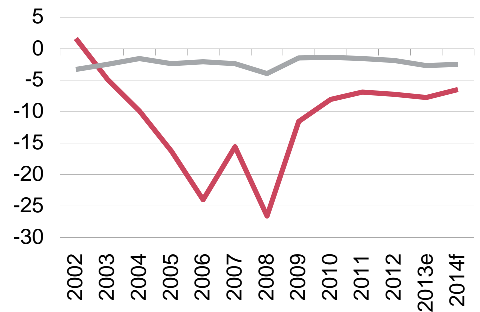
Positive: Greater clarity about the mechanism for releasing offshore krona coupled with sustained economic recovery and continued reduction in public and external debt ratios would be rating positive.

Peer Comparison

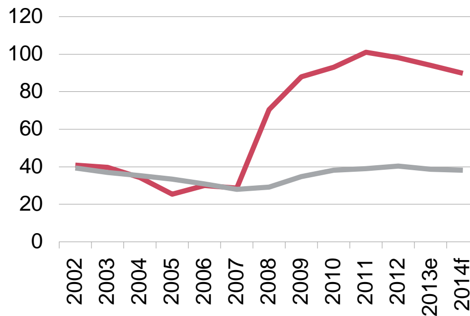
Net External Debt
% of CXR



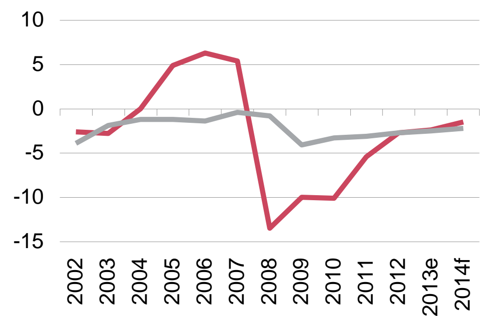
Current Account Balance
% of GDP



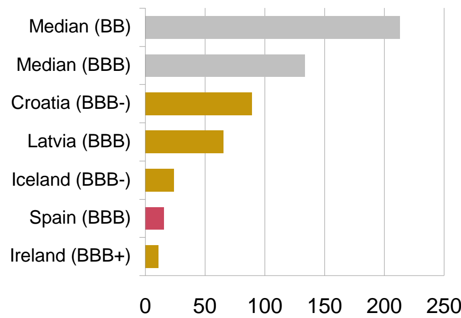
General Government Debt
% of GDP



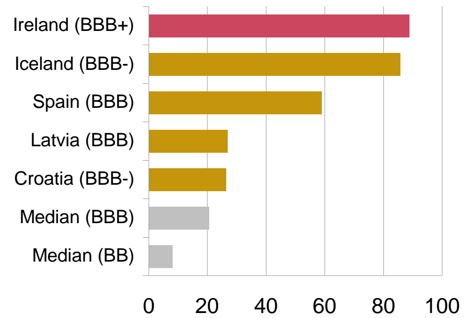
General Government Balance
% of GDP



International Liquidity Ratio, 2012
%



GDP per capita Income, 2012e
At market exchange rates, USA=100



Iceland Medians

Related Criteria

Sovereign Rating Methodology (August 2012)

Peer Group

Rating	Country
BBB	**Iceland**
	Aruba
	Bahrain
	Brazil
	Latvia
	Lithuania
	Mexico
	Panama
	Peru
	Russia
	South Africa
	Spain
	Thailand
BBB−	Azerbaijan
	Bulgaria
	Colombia
	Croatia
	India
	Indonesia
	Morocco
	Namibia
	Romania
	Turkey
BB+	Costa Rica
	Guatemala
	Hungary
	Macedonia
	Philippines
	Portugal
	Tunisia
	Uruguay

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
14 Feb 13	BBB	BBB+
17 Feb 12	BBB-	BBB+
05 Jan 10	BB+	BBB+
08 Oct 08	BBB-	A-
30 Sep 08	A-	AA
15 Mar 07	A+	AA+
03 Feb 00	AA-	AAA

Rating Factors

Summary: Strengths and Weaknesses

Rating factor	Macroeconomic	Public finances	External finances	Structural issues
Status	Neutral	Weakness	Weakness	Strength
Trend	Stable	Positive	Stable	Stable

Note: Relative to ‘BBB’ category/sovereigns rated ‘BBB+’, ‘BBB’ and ‘BBB−’.
Source: Fitch

Strengths

- In qualitative terms – measures of governance, Human Development, and Ease of Doing Business – Iceland is more akin to an ‘AAA’ than a ‘BBB’ rated sovereign.
- Iceland’s superior income per head is indicative of a greater level of debt tolerance than poorer rating peers which, together with its robust tax base and well-endowed pension funds, supports sovereign creditworthiness.
- A track record of public debt reduction prior to the financial crisis has reasserted itself: a medium-term fiscal consolidation programme aims to reduce the debt/GDP from a peak of 101% in 2011 to 60% by 2020.
- Flexible labour and product markets, coupled with a floating exchange rate and a penchant for national unity in the face of adversity helped Iceland to graduate from its IMF programme and post growth of over 2% in 2011-12, following a deep recession in 2009-10.
- Fitch views Iceland as less at risk of slipping back into recession than some troubled eurozone countries, given the depth of its financial sector reforms, the robustness of its fiscal austerity programme and the elimination of serious macroeconomic imbalances.
- Iceland maintained sovereign debt service in the face of unprecedented financial sector distress, albeit with capital controls, and regained market access in mid-2011.

Weaknesses

- Extensive capital controls are still in place, blocking non-resident repatriation of a captive USD3bn-USD4bn of Icelandic krona-denominated assets.
- Monetary and exchange rate policy are in an unstable equilibrium, pending the dismantling of exchange controls. The challenge for the authorities is to dismantle these in a sufficiently timely manner that avoids damaging the outlook for investment and growth, yet is not so hasty as to trigger renewed funding strains and macro-economic instability.
- Gross/net general government debt is markedly higher than peer group medians, driven upwards by the direct and indirect costs of the financial sector crisis in 2008-2009. Public external debt has also risen sharply, but net sovereign external debt is relatively low, reflecting levels of international reserves (USD4.3bn at end-2012).
- High levels of private debt/GDP, much of it foreign exchange or inflation indexed, pose a risk to financial stability and economic recovery. Externally, Iceland is a stand-out on measures of gross and external debt, pending resolution of failed banks’ external assets and liabilities.

Local Currency Rating

The one-notch differential between the Long-Term Foreign (BBB) and Local-Currency IDRs (BBB+) reflects the comparative sophistication and depth of the domestic krona market.

Country Ceiling

The Country Ceiling is aligned with the sovereign’s Long-Term Foreign Currency IDR, reflecting the imposition of capital controls since 2008, which ring-fenced sovereign debt service but trapped USD3bn-USD4bn of non-resident investment in local-currency debt instruments.

Outlook and Key Issues

Iceland was the first developed economy to be downgraded in the global financial crisis, a process that began in February 2006, culminating in a sub-investment grade rating of 'BB+'/Negative in January 2010. Rating rehabilitation began in May 2011 when the Outlook was revised from Negative to Stable, followed by a straight upgrade to 'BBB−'/Stable in February 2012.

The uplift to investment grade in February 2012 reflected the progress in restoring macroeconomic stability, restructuring the financial sector and rebuilding sovereign creditworthiness since the banking and currency crisis that befell Iceland in late 2008.

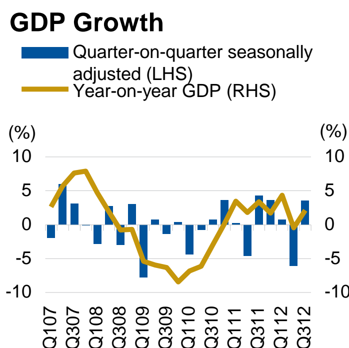
The upgrade to 'BBB' in February 2013 reflects the impressive progress Iceland is making in recovering from the financial crisis of 2008-2009. The economy is growing, notwithstanding developments in the eurozone; fiscal consolidation is on track and public debt/GDP is falling; financial sector restructuring and deleveraging are well-advanced; and the resolution of Icesave in January has removed a material contingent liability for public finances and brought normalisation with external creditors a step closer.

Macroeconomic Developments

Real GDP grew by 2.2% year-on-year in 2012, in line with Fitch's estimate of 2.3%. Given its close trading ties with Europe – over 80% of exports go to the European Economic Area – this was a respectable outcome. Inflation averaged 5.2% in 2012 (up from 4% in 2011) on the back of a weaker Icelandic krona (ISK) since August 2012. Unemployment fell to 5.8%, down from 7.4% in 2011.

Figure 1

GDP Growth



Source: Datastream

In the first nine months of 2012, real GDP grew by 2% yoy. Gross fixed investment, which rose by 15.8%, was the main driver of growth. Nevertheless, investment contracted markedly in Q3-Q4 2012 and Fitch projects growth of about 5% for the year as a whole. Exports of goods and services grew by 3.3%, down from 4.5% a year earlier. Private consumption grew by 3.2%, underpinned by continuing household debt restructuring, extension of third-pillar pension payouts and generous real wage increases. Nominal wages increased by 8% in 2012 whilst inflation rose by 5.2% over the same period.

The impact of the eurozone crisis was felt largely through a deterioration in the terms of trade and limited access to external refinancing for corporates. Iceland's export sector is working close to capacity, but the hoped-for Baltic-style bounce in investment has not materialised for the most part. However, tourism is buoyant with the number of visitors to Iceland reaching a record high in 2012.

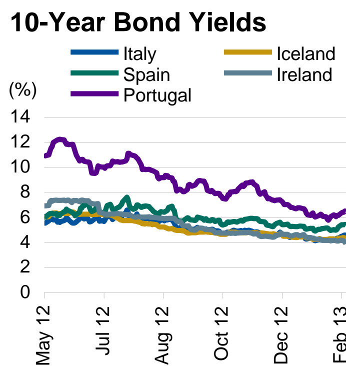
Growth Will Slow in 2013

The outlook is dominated by the global economy. Given its close links to Europe, Iceland is vulnerable to an escalation in the eurozone banking and sovereign debt crisis. With 60% of Icelandic exports destined for the eurozone, contagion is expected to come mainly through trade channels. In the short-term, capital controls act as an effective buffer against financial contagion; in the long-term, further delays in their relaxation would act as a drag on a recovery.

Fitch expects growth to slow to 2.1% in 2013 before rebounding to 2.9% in 2014, accompanied by further falls in inflation and unemployment. Private consumption growth will be sustained by the extension of third-pillar pension payouts and declining unemployment. However, employment growth has slowed in H212 and consumer confidence has weakened; these trends coupled with a more subdued economic outlook are likely to constrain consumption growth in 2013.

Investment will decline markedly in 2013 due to delays in energy-related investments. Exports are also likely to fall as a result of weak external demand. The projected rebound in 2014

Figure 2



Source: Datastream

assumes some energy investments will start in 2014 and that the eurozone will grow by 1.2% in 2014.

Public Finances

Despite minor slippage ahead of elections in May 2013, medium-term fiscal consolidation is on track; central government attained a primary surplus of 2.7% of GDP in 2012 and a headline deficit of 1.7% of GDP. The government's latest medium-term fiscal projections envisage the primary surplus rising to over 5% of GDP by 2014, sufficient to deliver a headline surplus of 0.9%[1].

On a general government basis, Fitch estimates that the government realised a primary surplus of 2.8% of GDP in 2012, its first since 2007, and a headline deficit of 2.6% of GDP. Our forecasts suggest that with general government turning in primary surpluses of close to 4.5% of GDP by 2015, general government balance should be in sight by 2016.

Fiscal consolidation (measured from peak primary deficit to estimated 2012 outturns) has outpaced all other advanced economies touching 13% of GDP, compared to 10.8% in the case of Greece, the next highest. In contrast to Greece, the composition of these measures has been well-balanced between revenue and expenditure, with few temporary and one-off measures (although the 2013 budget detracts a little from this). Structural reforms to Iceland's fiscal framework are well advanced, underlining its superior measures of governance relative to 'BBB' medians.

Fiscal Financing

The sovereign is highly liquid. The central government holds deposits at the Central Bank of Iceland (CBI) equivalent to more than 30% of GDP, mostly the krona counterpart of external borrowing from official and private creditors. These deposits are more than sufficient to cover annual debt service and reduce net public debt to around 65% of GDP, compared to 82% for Spain and 108% for Ireland.

Figure 3

Public Finances: Sources and Uses (% GDP)

	2011	2012	2013e	2014f
Uses	**16.3**	**7.5**	**8.1**	**13.9**
Budget balance	5.4	2.7	2.4	1.6
Amortisation (by place of issue)	10.8	4.8	5.7	12.3
Domestic	5.5	3.1	5.3	10.5
Foreign	5.4	1.7	0.3	1.7
Sources	**16.3**	**7.5**	**8.1**	**13.9**
Gross borrowing (by place of issue)	17.0	13.1	10.8	9.8
Domestic	9.2	5.3	4.9	4.9
Foreign	7.8	7.8	6.0	4.9
Privatisation	0.0	0.0	0.0	0.0
Other	-0.7	4.4	-0.3	4.1

Source: Fitch Ratings

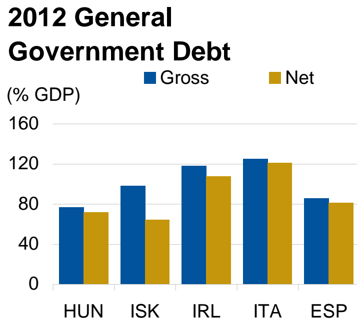
Iceland regained external market access in June 2011, raising USD1bn over five years; a 10-year USD1bn bond was issued in May 2012. Part of the proceeds from these bond issues was used to repay early 55% of the emergency loans extended to Iceland by the IMF and the Nordic countries.

The combination of fiscal consolidation and a favourable maturity structure was reflected in more modest gross fiscal financing (GFFN) needs of around 10% of GDP, down from over 20% in 2008-2010. GFFNs will fall further to around 5% of GDP in 2014.

[1] Fitch numbers for central and general government primary balances differ from the Icelandic authorities because of the manner in which Fitch treats interest revenues and payments. Fitch nets off only gross interest payments, whereas the authorities (and the IMF) net off both receipts and payments. The difference is significant in the case of Iceland because of the size of the government's deposits (over 30% of GDP) at the central bank.

Figure 4

2012 General Government Debt



Source: Fitch

Iceland has a well-functioning domestic debt market (reflected in a one-notch uplift of the Local-Currency IDR over the FC IDR), while capital controls have delivered the sovereign a captive non-resident financing pool of USD3bn-USD4bn at low interest rates, which has been favourable for public debt dynamics.

Favourable Public Debt Dynamics

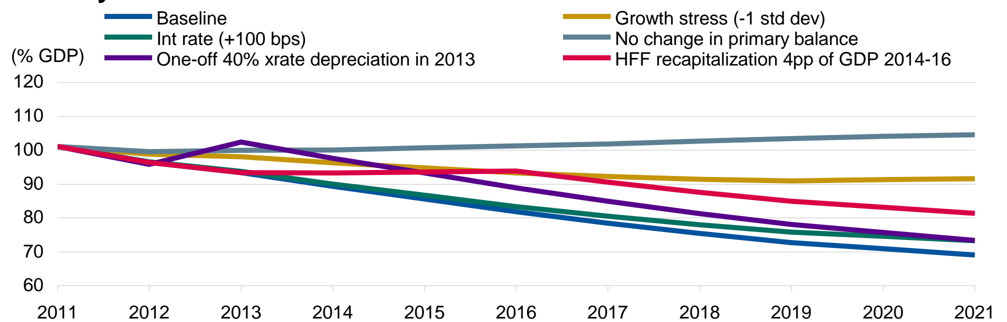
In contrast to near rating peers Ireland ('BBB+') and Spain ('BBB'), Iceland's general government debt/GDP peaked at 101% of GDP in 2011 and now appears to be steadily declining, falling to an estimated 98% of GDP in 2012. Fitch's base case sees debt/GDP falling to 66% by 2021 (ie, close to Maastricht levels).

In its debt sensitivity analysis, Fitch assumes a trend real GDP growth rate of 2.5%, GDP deflator of 3.5%, an average primary budget surplus of 3.2% of GDP, nominal effective interest rate of 6% and an annual depreciation of 2% to capture potential exchange pressures resulting from the lifting of capital controls over 2012-2021.

A recapitalisation of the Housing Finance Fund (HFF) equivalent to 0.7% of GDP is assumed in 2013. Fitch is not factoring in additional materialisations of contingent liabilities from 2014. Public debt peaked at 101% of GDP in 2011 and, under these assumptions, declines from its current level to 69% of GDP in 2021.

Figure 5

Debt Dynamics

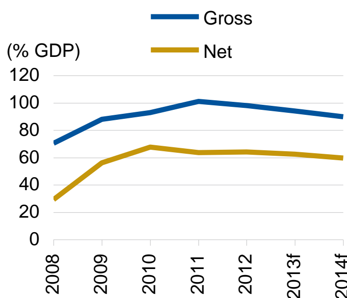


Source: Fitch

The debt path is sensitive to growth shocks. Under a growth stress scenario (0.2% potential growth), public debt would continue to fall but would stabilise at a markedly higher level (90% of GDP) by 2019. The debt path appears to be resistant to an interest-rate stress scenario; the debt/GDP ratio would decline to 73% of GDP by 2021 (4pp higher than the baseline).

Figure 6

General Government Debt



Source: Fitch

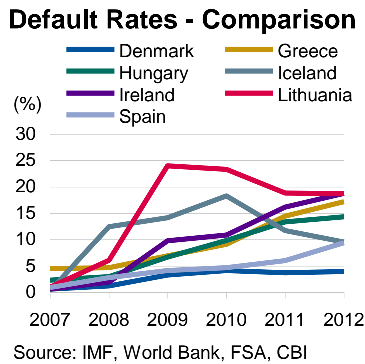
A one-off 40% depreciation of the exchange rate (a proxy for sharp exchange rate volatility in the event of lifting of capital controls) would increase the debt ratio to 102% of GDP in 2013 and leave debt at 73% of GDP in 2021. A scenario with no fiscal consolidation (a primary deficit of 0.3% of GDP in the medium term) would reverse the debt downward path; debt would reach 100% of GDP in 2015 and would remain above that level for 2015-2021.

Fitch assumes that contingent liabilities arising from the banking sector (mainly through HFF) will be limited. Under a scenario where contingent liabilities arise due to recapitalisation of HFF and they account for 4% of GDP each year from 2014 to 2016 (a stress scenario), public debt would still decline. However, it would reach 81% of GDP by 2021 (compared with 69% under the baseline).

Banking Sector

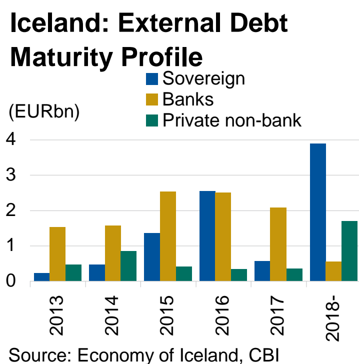
Risks of contingent liabilities migrating from the banking sector to the sovereign's balance sheet receded significantly following the favourable legal judgement on Icesave in January 2013 that could have added up to 19% of GDP to public debt in a worst-case scenario.

Figure 7



Source: IMF, World Bank, FSA, CBI

Figure 8



Source: Economy of Iceland, CBI

Nonetheless, banks remain vulnerable to the lifting of capital controls, while the financial position of the sovereign-owned HFF is steadily deteriorating and will need to be addressed over the medium term.

The HFF continues to record losses in its mortgage loan portfolio. Non-performing loans at HFF increased since the start of 2012 and reached 15% in June, in marked contrast with the rest of the banking sector. Its capital ratio dropped from a regulatory target of 5% to 1.4% at end-June 2012. The government has confirmed that it will provide HFF with additional equity over time. Moreover, bonds issued by HFF are government guaranteed. For the 2013 budget, HFF's guarantee capital was increased up to ISK13bn (0.8% of GDP).

In the rest of the financial sector, debt restructuring is well advanced. Progress is reflected in continued falls in commercial banks' non-performing loans from a peak of 18% in 2010 to 9% by end-2012. Completion of debt restructuring will mark an important step in the rehabilitation of the banking system. Financial sector risk has declined in tandem with the recovery of the economy; capital ratios for the big three are well above 20%, while their leverage ratio now averages around 5 compared to 30 pre-crisis.

However, there is little lending growth beyond the refinancing of home loans (which is undermining the financial standing of the sovereign-owned HFF) while, at some point, banks will have to confront the potential erosion of their deposit bases as capital controls are lifted.

Icesave and the Capital Controls Dilemma

The EFTA Court ruled in Iceland's favour on Icesave on 29 January 2013 effectively removing a significant potential contingent liability for the state – a highly adverse ruling could have added 19% of GDP to public debt – and marking a further step towards normalising relations with external creditors.

The lifting of capital controls is moving towards becoming conditions-driven as opposed to time bound. One of the conditions (of liberalisation) is that the government should have restored fiscal balance and public debt sustainability. In this sense, the Icesave ruling brings the liberalisation of capital controls a step closer, but there are a number of other obstacles that need to be addressed.

Little progress has been made with lifting capital controls and EUR2.3bn of non-resident Icelandic krona holdings remain locked in. Regular auctions to match willing foreign investors against impatient krona holders have made only modest inroads into the stockpile of offshore bonds since 2011. However, Fitch estimates that the legal framework for lifting capital controls will be extended beyond the previous one that was envisaged to expire at end-2013, thereby reducing the risk of a disorderly unwinding of the controls.

Fitch acknowledges that Iceland's exit from capital controls will be a lengthy process, given the underlying risks to macroeconomic stability, fiscal financing and the newly restructured commercial banks' deposit base. In the short-term, capital account liberalisation could undermine the krona, drive up inflation and weaken balance sheets; in the longer term, however, it should play to improved business confidence and higher investment and growth. On balance, therefore, an orderly unwinding of capital controls should be viewed as rating positive for Iceland, but it is likely to remain a medium-term objective.

Fitch recognises that capital controls have cushioned Iceland from the eurozone crisis, while providing the sovereign with a captive funding pool at lower interest rates than it might otherwise had to pay. However, the longer capital controls remain in place, the greater the risk that they will begin to fuel asset price bubbles, as non-residents abandon government stock for other asset classes.

External Finances

Following the collapse of the banks in 2008 and depreciation of the krona, Iceland's net international investment position turned highly negative, rising to 568% of GDP by end-2011. However, this position is highly distorted by the impact of old banks in wind-up proceedings that are recorded in Iceland's external debt data pending resolution. Iceland's failed banks account for 74% of total external debt (625% of GDP), with banks in wind-up proceedings accounting for virtually all of this. Assets equivalent to about 40% of GDP offset this liability.

When Iceland split its major financial institutions into old and new banks in 2008, the new Landsbanki issued bonds to the old banks in lieu of assets taken on to their balance sheets from the old banks. Repayments on these bonds will ramp up significantly in 2015 and remain high until 2017 (see Figure 8). Failing renewed access to international capital markets for Icelandic financial institutions, these liabilities could require rescheduling and could have a bearing on the lifting of capital controls. Landsbanki has already taken steps to repay early some instalments falling due in 2014-2015 (see *Comparative Analysis: External Finances*).

Forecast Summary

	2008	2009	2010	2011	2012	2013e	2014f
Macroeconomic indicators and policy							
Real GDP growth (%)	1.2	-6.6	-4.0	2.6	2.2	2.1	2.9
Unemployment (%)	3.0	7.3	8.1	7.4	6.0	5.6	5.3
Consumer prices (annual average % change)	12.7	12.0	5.4	4.0	5.2	4.0	4.0
Short-term interest rate (%)[a]	22.0	14.6	5.5	5.8	7.0	7.0	7.0
General government balance (% GDP)	-13.5	-10.0	-10.1	-5.4	-2.7	-2.4	-1.5
General government debt (% GDP)	70.4	87.9	93.0	101.0	98.0	94.0	89.7
ISK per USD (annual average)	87.9	123.6	122.2	116.0	124.6	127.2	129.0
Real effective exchange rate (2000=100)	88.3	71.4	75.0	76.0	74.7	76.1	78.1
External finance							
Current account balance (USDbn)	-4.5	-1.4	-1.0	-1.0	-1.0	-1.1	-1.0
Current account balance (% GDP)	-26.6	-11.6	-8.1	-6.9	-7.3	-7.8	-6.5
Current account balance plus net FDI (% GDP)	3.1	-29.9	13.7	1.5	0.4	-0.4	0.6
Net external debt (USDbn)	98.3	97.5	95.1	84.8	87.0	91.6	95.9
Net external debt (% GDP)	584.1	805.0	756.9	604.3	628.2	631.7	629.1
Net external debt (% CXR)	1062.7	1361.4	1254.2	897.7	847.8	857.4	836.4
Official international reserves including gold (USDbn)	3.6	3.9	5.8	8.6	4.3	4.5	5.0
Official international reserves (months of CXP cover)	3.1	5.4	8.1	9.9	4.6	4.6	4.8
External interest service (% CXR)	63.8	34.0	23.7	8.5	11.7	12.2	11.3
Gross external financing requirement (% int. reserves)	412.2	114.7	105.9	108.4	65.6	61.1	54.9
Memo: Global forecast summary							
Real GDP growth (%)							
US	-0.3	-3.5	3.0	1.7	2.2	2.3	2.8
Japan	-1.0	-5.5	4.5	-0.7	1.6	1.5	1.3
Euro area	0.3	-4.2	1.8	1.5	-0.4	0.9	1.5
World	1.5	-2.3	4.0	2.7	2.1	2.6	3.0
Commodities							
Oil (USD/barrel)	97.7	61.9	79.6	111.0	110.0	100.0	100.0

[a] Discount Rate
Source: Fitch

Comparative Analysis: Macroeconomic Performance and Policies

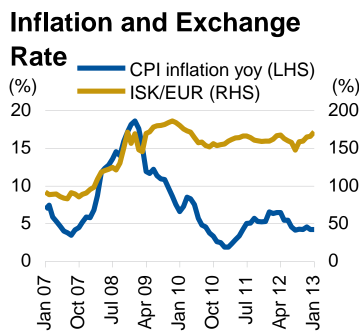
Iceland

	Latvia BBB	Ireland BBB+	Spain BBB	Croatia BBB-	Iceland BBB	BBB median	BB median
	2012						
Real GDP (5yr average % change)	-2.2	-1.7	-0.8	-1.6	-0.9	2.5	3.8
Volatility of GDP (10yr rolling SD)	8.8	4.1	2.6	4.0	4.6	3.4	2.3
Consumer prices (5yr average)	4.8	0.5	2.3	3.0	7.9	4.7	6.0
Volatility of CPI (10yr rolling SD)	4.6	1.9	1.2	1.2	3.6	2.5	2.9
Years since double-digit inflation	4.0	29.0	28.0	14.0	3.0	n.a.	n.a.
Unemployment rate	16.5	14.8	25.0	14.0	6.0	7.5	10.8
Type of exchange rate regime	Euro peg	Euro	Euro	Soft Peg	Floating	n.a.	n.a.
Dollarisation ratio	83.0	-	-	79.2	-	20.6	49.3
REER volatility (10yr rolling SD)	11.2	6.8	4.1	2.1	11.1	5.8	5.9

Source: Fitch

Figure 9

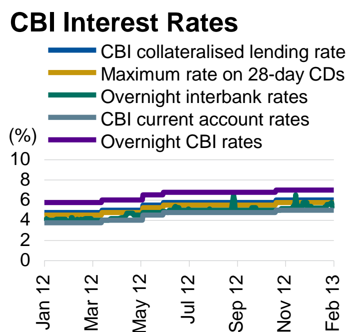
Inflation and Exchange Rate



Source: Datastream

Figure 10

CBI Interest Rates



Source: CBI

Strengths

- Despite the policy failures leading up to the financial crisis, policy-making institutions remain intact and the authorities are committed to honouring their sovereign obligations and restoring confidence in their solvency
- As the first country to suffer the full force of the global financial crisis, Iceland successfully completed a three-year IMF-supported rescue programme in August 2011. The programme has delivered renewed access to international capital markets, while fiscal consolidation has outpaced all other advanced economies touching 13.8% of GDP.
- In the past, the economy displayed an impressive track record of adjusting to external shocks, reflecting flexible labour and product markets and a penchant for national unity in the face of adversity. Despite the depth of the recession, unemployment is below the 'BBB' median, while there have been few signs of overt social unrest.

Weaknesses

- Iceland is a stand-out on measures of GDP/CPI/REER volatility. Rising inflation expectations and the protracted timetable for the removal of capital controls underline the challenge the authorities face in restoring domestic price and exchange-rate stability.
- Severe macroeconomic imbalances built up in 2004-2007 – mounting corporate and household debt, soaring private consumption, rising real estate prices, over-extended bank balance sheets and an unsustainable current account deficit – have taken time to unwind, constraining economic recovery from financial sector meltdown.
- As a small, open economy, weakened by the collapse of its financial system and the rise in public debt, Iceland remains vulnerable to external shocks.

Commentary

There was significant pressure on the Icelandic krona since the second half of 2012. On the one hand, the slowdown in the eurozone's economy caused a decline in Icelandic exports, weakening the trade surplus. On the other hand, the corporate sector sought foreign currency for repayments of foreign loans coming due. As a result, the krona depreciated and inflation rose.

Consumer price inflation averaged 4.2% yoy in January 2013, well above the CBI target of 2.5%. Higher inflation was due to a weaker krona combined with entrenched inflationary expectations. As a result, the CBI raised interest rates four times in 2012. The collateralised lending rate stood at 6% at end-2012, up from 4.75% in January 2012. This aggressive monetary policy stance was motivated by inflation expectations being constantly above the CBI's target. On 6 February 2013, the CBI kept interest rates unchanged and announced its intention to suspend its programme of regular foreign-currency purchases and support the krona through foreign-currency intervention.

Comparative Analysis: Structural Features

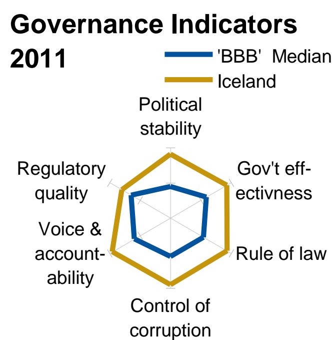
Iceland

	2012						
	Latvia BBB	Ireland BBB+	Spain BBB	Croatia BBB-	Iceland BBB	BBB median	BB median
GNI per capita PPP (USD, latest)	17,820	33,310	31,930	19,330	31,640	14,360	6,415
GDP per capita (USD, mkt exchange rates)	12,569	44,318	29,250	13,102	42,216	10,288	4,080
Human Development Index (percentile, latest)	76.8	96.7	88.1	75.8	93.0	64.5	46.5
Ease of Doing Business (percentile, latest)	87.0	92.4	76.7	54.9	93.0	70.7	47.3
Trade openness (CXR and CXP % GDP)	75.8	154.6	38.1	51.3	77.7	48.6	52.0
Gross domestic savings (% GDP)	24.7	35.6	21.4	20.6	22.7	23.1	15.6
Gross national savings (% GNP)	26.9	15.5	19.1	-	10.0	24.6	16.7
Gross domestic investment (% GDP)	29.6	9.7	20.0	20.4	15.8	23.2	21.4
Private credit (% GDP)	72.7	184.3	193.3	71.3	99.9	62.7	36.0
BSR Indicators	B1	B2	Bb2	Bb1	n.a.	n.a.	n.a.
Bank system CAR	17.7	10.1	12.6	19.9	24.0	15.9	16.8
Foreign bank ownership (% assets)	71.0	-	-	90.6	-	37.2	50.4
Public bank ownership (% assets)	17.5	7.0	25.0	4.5	66.0	18.0	29.5
Default record (year cured)[a]	-	-	-	1996	-	n.a.	n.a.

Source: Fitch and World Bank

Figure 11

Governance Indicators 2011



Source: World Bank

Strengths

- On measures of governance, Human Development and Ease of Doing Business, Iceland is far superior to 'BBB' medians and exactly aligned with 'AAA' medians.
- Iceland's income per capita is a clear stand-out in the 'BBB' range; whether measured at market prices or on a PPP basis, it is more akin to the 'AAA' median.
- Iceland's rich natural resource endowment – marine products and abundant renewable energy resources – coupled with a young population and robust pension assets support the rating.

Weaknesses

- The economy's weak supply side response to a much depreciated (and hence more competitive) real exchange rate has highlighted capacity constraints in some areas (marine products) and lack of investment in others (energy).
- High levels of private debt/GDP, much of it foreign exchange or inflation indexed, pose a risk to financial stability and economic recovery. Household and corporate debt restructuring has accelerated, but banks' capacity for new lending is likely to remain limited.

Commentary

A general election is due in April 2013. Coalition governments are the norm and while there may be some change in the current constituent members, major policy shifts are not expected. There is broad cross party agreement on Iceland's recovery strategy and the need to lift capital controls, but less agreement on EU membership and subsequent euro adoption (viewed by some as the most appropriate exit strategy for capital controls).

Structural factors offer considerable support to the sovereign rating. On measures of governance Iceland is exactly aligned to 'AAA' medians: these attributes have manifested themselves in the degree of ownership of the IMF programme; the sense of national unity that rallied behind austerity; and the readiness to undertake fundamental reforms of public finances (eg. Organic Budget law).

The economy needs to rebalance away from the financial sector, which generated severe macroeconomic imbalances in 2004-2008. While fishing, tourism and energy-related industries promise to be the mainstay of future prosperity, most sectors of the economy have emerged from the crisis with much higher debt. Extensive private sector restructuring has succeeded in bringing corporate and household debt down to 185% of GDP and 109% of GDP respectively by mid-2012 (down from 340% and 130% in 2008).

Comparative Analysis: External Finances

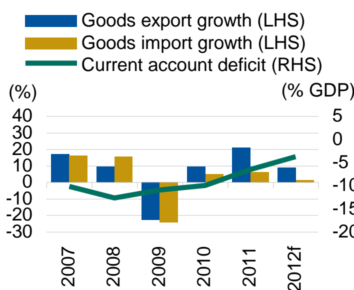
Iceland

	2012					Last 10 years	
	Latvia BBB	Ireland BBB+	Spain BBB	Croatia BBB-	Iceland BBB	BBB median	BB median
GXD (% CXR)	199.9	216.1	429.4	198.1	1008.7	103.0	102.3
GXD (% GDP)	148.6	336.7	160.6	100.0	747.4	48.1	40.7
NXD (% CXR)	70.2	56.0	232.5	120.2	847.8	12.2	5.5
NXD (% GDP)	52.2	87.2	87.0	60.7	628.2	4.6	2.3
GSXD (% GXD)	22.7	41.9	38.9	19.0	5.2	30.8	49.6
NSXD (% CXR)	14.3	82.1	135.9	-10.3	10.7	-10.3	2.8
NSXD (% GDP)	10.6	127.9	50.8	-5.2	7.9	-5.4	1.6
SNFA (USDbn)	-3.0	-258.8	-0.7	3.0	-1.1	4.8	-0.1
SNFA (% GDP)	-10.6	-125.4	-50.8	5.2	-7.7	6.4	-1.3
Ext. debt service ratio (% CXR)	29.6	26.9	64.8	43.3	56.5	15.0	13.1
Ext. interest service ratio (% CXR)	6.0	7.6	12.1	3.4	11.7	4.2	3.6
Liquidity ratio (latest)	65.6	11.3	15.9	89.2	22.0	138.5	172.2
Current account balance (% GDP)	-3.0	2.4	-1.3	-1.6	-7.3	-1.9	-2.3
CAB plus net FDI (% GDP)	1.7	-0.9	-0.6	1.0	0.4	0.5	1.3
Commodity dependence (% CXR, latest)	27.4	5.4	15.7	14.9	48.7	23.4	24.2
Sovereign net FX debt (% GDP)	33.7	-0.8	-3.2	11.7	-3.7	-6.0	-0.2

Source: Fitch

Figure 12

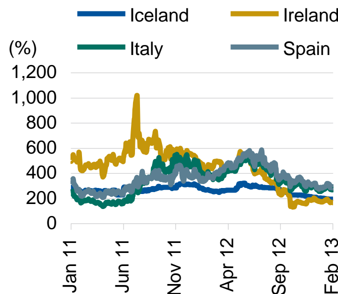
Current Account Adjustment



Source: IFS

Figure 13

10yr CDS Spreads



Source: Datastream

Strengths

- The narrowing in Iceland's current account balance from a record deficit of 26.5% of GDP in 2008 to an estimated 7% of GDP in 2012 has been remarkable.
- International reserves have been bolstered by IMF and associated bilateral funding and renewed access to international capital markets. However, reserves declined to USD4.2bn or 4.6 months of current external payments at end-2012 as Iceland prepaid loans to the IMF and the Nordic countries.

Weaknesses

- Iceland is a clear stand-out on (unadjusted for failed banks) measures of gross and net external debt that far exceed 'BBB' medians and distort its external debt service and international liquidity ratios.
- Commodity dependence is much higher than the 'BBB' median reflecting Iceland's narrow export base; three aluminium smelters and the marine products sector together account for over 80% of merchandise exports.

Commentary

The current account deficit has fallen to low single digits. The underlying balance (ie, excluding old banks imputed debt service payments, which are not being paid) is in surplus at about 2%-3% of GDP. However, external debt repayments weigh heavily on the capital account, the exchange rate and international reserves.

Landsbanki, the Icesave obligor, has made significant progress in recovering assets which are currently estimated at ISK1517bn: these should be more than sufficient to cover priority claims (deposits). Landsbanki has already paid out over 50% of priority claims and expects to pay out all Icesave claims, regardless of the recent EFTA Court ruling. The authorities estimate that resolution of old banks assets and liabilities should leave Iceland with a net IIP of around 90% of GDP. This ratio would be in line with Ireland (negative 91%) and Spain (negative 89%).

Renewed access to international capital markets in mid-2011 and 2012 was an important milestone in rebuilding sovereign creditworthiness. The perception that Iceland would sustain insurmountable reputational damage by failing to support its beleaguered financial sector has proved unfounded for the most part. However, given the scale of the imbalances this strategy has not been without drawbacks: capital controls remain and old banks have some way to go in unwinding their pre-crisis assets and liabilities.

Comparative Analysis: Public Finances

Iceland

	2012					Last 10 years	
	Latvia BBB	Ireland BBB+	Spain BBB	Croatia BBB-	Iceland BBB	BBB median	BB median
Budget balance (% GDP)	-1.9	-8.6	-7.0	-4.0	-2.7	-2.6	-2.1
Primary balance (% GDP)	-0.5	-4.4	-4.4	-1.5	2.8	-0.2	0.3
Revenues and grants (% GDP)	37.0	35.1	36.0	37.5	42.6	32.3	27.2
Volatility of revenues/GDP ratio	3.5	2.7	5.6	3.3	6.0	6.1	6.2
Interest payments (% revenue)	3.9	12.8	7.3	6.6	13.0	6.6	9.1
Debt (% revenue)	111.0	336.7	237.5	144.1	230.0	122.4	162.2
Debt (% GDP)	41.1	118.2	85.5	54.0	98.0	35.7	39.9
Net debt (% GDP)	36.5	107.9	81.2	45.9	69.7	30.4	33.4
FC debt (% total debt)	82.3	0.0	0.7	66.3	28.0	36.3	64.7
CG debt maturities (% GDP)	5.8	7.6	14.5	7.8	5.1	5.5	4.9
Average duration of CG debt (years)	-	-	-	-	-	5.4	3.7

Source: Fitch

Strengths

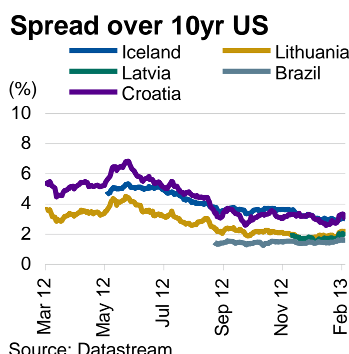
- Fiscal consolidation (measured from peak primary deficit to estimated 2012 outturns) has outpaced all other advanced economies touching 13% of GDP, compared to 10.8% in the case of Greece, the next highest.
- Revenue/GDP is markedly superior to 'BBB' medians, reflecting a wealthy economy with a broad and sophisticated tax base.
- Iceland has a well-developed government debt market relative to peers that benefits from regular auctions and a clear medium-term financing strategy.
- Iceland maintained sovereign debt service in the face of unprecedented financial sector distress, albeit with capital controls, and it regained market access in mid-2011.

Weaknesses

- Gross and net general government debt are markedly higher than peer group medians reflecting the direct and indirect costs of the financial sector crisis in 2008-2009, which materially damaged sovereign creditworthiness.
- Public debt service is high relative to peers and vulnerable to exchange rate fluctuations reflecting a high share of foreign-currency denominated debt.
- Capital controls have denied non-resident investors in krona-denominated government debt instruments unfettered access to their principal (but not interest) since 2008.

Figure 14

Spread over 10yr US



Source: Datastream

Commentary

A new organic budget law is set to pass through parliament in 2013. The aim of the law is to oblige future governments to adhere to a legally binding and independently monitored fiscal strategy. The purpose is to avoid pro-cyclical fiscal policies during periods of economic boom.

Despite Iceland's alternative approach to handling its failed banks, private-sector liabilities have migrated to the public sector's balance sheet and public debt has risen exponentially to 101% of GDP. However, the sovereign's past track record of fiscal consolidation has worked to its advantage, while a stronger economic recovery should set Iceland's public debt dynamics apart from its peers. Capital controls have played an important part by delivering the government a captive investor base. Any setbacks to fiscal consolidation would delay the unwinding of capital controls and undermine investor confidence in Iceland's recovery, as would the crystallisation of additional contingent liabilities.

Figure 15

Fiscal Accounts Summary

(% GDP)	2009	2010	2011	2012	2013e	2014f
General government						
Revenue	**41.0**	**41.5**	**41.9**	**42.6**	**42.6**	**42.0**
Expenditure	**51.0**	**51.5**	**47.3**	**45.3**	**45.0**	**43.5**
O/w interest payments	6.6	5.5	5.1	5.5	5.5	5.4
Primary balance	-3.4	-4.5	-0.3	2.8	3.1	3.9
Overall balance	**-10.0**	**-10.1**	**-5.4**	**-2.7**	**-2.4**	**-1.5**
General government debt	**87.9**	**93.0**	**101.0**	**98.0**	**94.0**	**89.7**
% of general government revenue	214.4	224.1	241.3	230.0	220.7	213.6
General government deposits	30.8	31.1	32.0	26.9	25.6	24.4
Net general government debt	56.2	67.7	63.5	69.7	67.8	64.6
Central government						
Revenue	**29.3**	**31.2**	**29.9**	**30.7**	**31.4**	-
O/w grants	0.1	0.1	0.1	0.1	0.1	-
Expenditure and net lending	**38.6**	**39.2**	**35.4**	**32.4**	**31.6**	-
O/w current expenditure and transfers	0.0	0.0	0.0	0.0	0.0	-
- Interest	5.6	4.4	4.0	4.4	4.6	-
O/w capital expenditure	0.0	0.0	0.0	0.0	0.0	-
Current balance	0.0	0.0	0.0	0.0	0.0	-
Primary balance	-3.7	-3.6	-1.5	2.8	4.4	-
Overall balance	**-9.3**	**-8.0**	**-5.5**	**-1.7**	**-0.2**	-
Central government debt	78.6	83.7	90.3	86.4	81.8	-
% of central government revenues	267.7	268.6	301.8	281.6	260.5	-
Central government debt (ISKbn)	**1176.4**	**1285.9**	**1468.3**	**1490.5**	**1509.1**	-
By residency of holder						
Domestic	905.9	1103.9	1288.3	1147.7	1162.0	-
Foreign	270.5	182.0	180.0	342.8	347.1	-
By place of issue						
Domestic	819.9	941.9	1020.1	1065.7	1088.3	-
Foreign	356.6	344.0	448.1	424.8	420.8	-
By currency denomination						
Local currency	819.9	941.9	1020.1	1065.7	1088.3	-
Foreign currency	356.6	344.0	448.1	424.8	420.8	-
in USD equivalent (eop exchange rate)	2.9	3.0	3.7	3.4	3.3	-
By maturity						
Less than 12 months (residual maturity)	178.7	211.3	192.9	88.5	112.5	244.1
Average maturity (years)	0.0	0.0	0.0	5.4	0.0	-
Average duration (years)	0.0	0.0	0.0	0.0	0.0	-
Memo						
Nominal GDP (ISKbn)	1,497.6	1,536.5	1,626.3	1,724.3	1,844.1	1,965.5

Source: Ministry of Finance and Fitch estimates and forecasts

Figure 16

External Debt and Assets

(USDbn)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Gross external debt	**16.2**	**26.9**	**46.2**	**72.3**	**119.9**	**122.4**	**121.4**	**120.5**	**110.8**	**103.5**
% of GDP	148.0	202.7	283.6	434.3	586.9	727.2	1002.5	958.7	789.9	747.4
% of CXR	391.1	537.3	698.7	909.5	1037.5	1322.9	1695.4	1588.6	1173.4	1008.7
By maturity										
Medium- and long-term	12.8	22.0	39.1	60.4	79.2	78.4	83.6	82.3	81.1	73.7
Short -term	3.5	4.9	7.1	11.9	40.7	44.0	37.9	38.2	29.7	29.8
% of total debt	21.4	18.1	15.3	16.4	34.0	36.0	31.2	31.7	26.8	28.8
By debtor										
Monetary authorities	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**2.5**	**1.6**	**2.4**	**3.2**	**0.2**
General government	**3.1**	**3.5**	**2.5**	**3.4**	**4.0**	**6.9**	**6.8**	**7.3**	**8.6**	**5.4**
O/w central government	2.5	2.9	1.8	3.1	3.6	2.0	2.2	1.6	1.5	2.7
Banks	**10.2**	**20.0**	**37.9**	**59.3**	**96.1**	**5.6**	**2.4**	**1.8**	**1.2**	**-2.8**
Other sectors	**2.9**	**3.4**	**5.9**	**9.5**	**19.8**	**109.9**	**112.2**	**111.4**	**100.9**	**100.9**
Gross external assets (non-equity)	**5.1**	**9.6**	**22.2**	**41.3**	**68.8**	**24.1**	**23.9**	**25.4**	**26.0**	**16.5**
International reserves, incl. gold	0.8	1.1	1.1	2.3	2.6	3.6	3.9	5.8	8.6	4.3
Other sovereign assets nes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit money banks' foreign assets	3.6	7.2	17.6	32.6	57.4	3.5	2.1	2.4	2.9	2.1
Other sector foreign assets	0.7	1.3	3.5	6.4	8.7	17.0	17.9	17.1	14.6	10.2
Net external debt	**11.2**	**17.2**	**24.0**	**31.0**	**51.1**	**98.3**	**97.5**	**95.1**	**84.8**	**87.0**
% of GDP	102.0	130.1	147.4	186.1	250.0	584.1	805.0	756.9	604.3	628.2
% of CXR	269.4	344.9	363.1	389.8	441.9	1062.7	1361.4	1254.2	897.7	847.8
Net sovereign external debt	2.3	2.4	1.4	1.1	1.3	3.3	2.9	1.5	0.1	1.1
% of GDP	20.9	18.2	8.6	6.6	6.5	19.7	23.9	12.2	0.7	7.9
Net bank external debt	6.6	12.7	20.2	26.8	38.7	2.1	0.3	-0.6	-1.7	-4.9
Net other external debt	2.3	2.1	2.4	3.1	11.1	92.9	94.3	94.2	86.3	90.8
Net international investment position	**-7.4**	**-10.3**	**-13.7**	**-16.8**	**-23.6**	**-84.8**	**-84.8**	**-85.3**	**-75.3**	**-67.1**
% of GDP	-67.6	-77.5	-84.3	-100.6	-115.5	-503.7	-700.4	-678.6	-537.2	-484.4
Sovereign net foreign assets	**-2.3**	**-2.4**	**-1.4**	**-1.1**	**-1.3**	**-3.3**	**-2.9**	**-1.5**	**-0.1**	**-1.1**
% of GDP	-20.8	-18.1	-8.5	-6.4	-6.3	-19.5	-23.7	-12.0	-0.5	-7.7
Debt service (principal & interest)	**2.0**	**2.3**	**4.6**	**5.8**	**14.4**	**12.3**	**5.1**	**4.9**	**6.1**	**5.8**
Debt service (% CXR)	47.9	45.9	69.6	72.6	124.3	132.7	71.5	64.6	64.6	56.5
Interest (% CXR)	9.2	10.1	14.7	29.9	38.0	63.8	34.0	23.7	8.5	11.7
Liquidity ratio (%)	22.9	40.6	39.9	71.3	77.7	145.8	7.0	8.6	12.2	22.0
Net sovereign FX debt (% GDP)	17.3	12.5	4.0	2.5	1.1	11.4	8.2	-0.7	-9.9	-3.7
Memo										
Nominal GDP	11.0	13.3	16.3	16.7	20.4	16.8	12.1	12.6	14.0	13.8
Gross sovereign external debt										
Inter-company loans	0.3	0.5	1.5	2.6	10.1	11.0	12.2	11.7	12.1	12.1

Sources: CBI, IMF, World Bank and Fitch estimates and forecasts

Figure 17
Balance of Payments

(USDbn)	2009	2010	2011	2012	2013e	2014f
Current account balance	**-1.4**	**-1.0**	**-1.0**	**-1.0**	**-1.1**	**-1.0**
% of GDP	-11.6	-8.1	-6.9	-7.3	-7.8	-6.5
% of CXR	-19.6	-13.3	-10.3	-9.9	-10.6	-8.6
Trade balance	**0.7**	**1.0**	**0.8**	**0.8**	**0.7**	**0.8**
Exports, fob	4.1	4.6	5.3	5.8	6.2	6.7
Imports, fob	3.3	3.6	4.5	5.0	5.5	5.9
Services, net	**0.3**	**0.3**	**0.4**	**0.3**	**0.2**	**0.3**
Services, credit	2.3	2.5	3.0	3.2	3.5	3.8
Services, debit	2.0	2.2	2.6	2.9	3.2	3.5
Income, net	**-2.4**	**-2.2**	**-2.1**	**-2.1**	**-2.0**	**-2.0**
Income, credit	0.8	0.5	1.1	1.2	1.0	1.0
Income, debit	3.1	2.7	3.2	3.3	3.0	3.0
O/w: interest payments	2.4	1.8	0.8	1.2	1.3	1.3
Current transfers, net	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Memo						
Non-debt-creating inflows (net)	-2.7	2.2	1.3	1.1	1.1	1.1
O/w equity FDI	-2.8	1.2	1.2	1.1	1.1	1.1
O/w portfolio equity	-2.8	1.2	1.2	1.1	1.1	1.1
O/w other	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (-=increase)	0.2	2.0	2.9	-4.3	0.2	0.5
Gross external financing requirement	4.1	4.1	6.3	5.6	2.6	2.5
Stock of international reserves, incl. gold	3.9	5.8	8.6	4.3	4.5	5.0

Sources: IMF and Fitch estimates and forecasts

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