Fitch Affirms Iceland at 'BBB'; Outlook Stable

Fitch Ratings, London, 07 February 2014: Fitch Ratings has affirmed Iceland's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BBB' and 'BBB+', respectively, with Stable Outlooks. The issue ratings on Iceland's senior unsecured foreign and local currency bonds have also been affirmed at 'BBB' and 'BBB+', respectively. The Country Ceiling has been affirmed at 'BBB' and the Short-term foreign currency IDR at 'F3'.

KEY RATING DRIVERS

Iceland's ratings are supported by its high level of income per capita and indicators of governance and human development similar to the highest-rated sovereigns.

In Fitch's view, the Icelandic government's plan to finance the recently announced household debt relief programme through budget adjustments rather than increased borrowing is consistent with the authorities' commitment to fiscal consolidation. The debt relief programme envisages a write-down of inflation-linked mortgages, through direct relief from the government and tax incentives to use private pension savings to pay down the debt.

The authorities' commitment to fiscal consolidation is also underlined by the introduction of a proposed organic budget law, which should improve the fiscal policy framework.

At the same time, public finances remain a credit weakness. Fitch estimates that general government gross debt in 2013 was just over 96% of GDP, more than double the 'BBB' median of 40%. At the same time, Iceland has had a primary surplus for the past two years, and Fitch expects that primary surpluses over the next two years will push the debt to GDP ratio down to 87.6% by 2015. Fitch estimates that the overall government deficit was 2.8% in 2013, and forecasts an overall budget balance by 2015.

A substantial proportion of direct debt relief is financed by extending the bank tax to the estates of the failed banks. This may dent investor sentiment towards Iceland, making it more challenging to unwind capital controls.

Economic growth picked up in 3Q13 on an annual basis, from 3.8% to 4.9%. This was driven by both domestic demand and net exports. Fitch estimates that real GDP growth in 2013 was 2.1%, and expects that GDP growth will edge up further and average 2.6% over the next two years.

The country's external finances are a credit weakness, despite a sharp improvement in the current account over the first nine months of 2013. The legacy of the financial crisis in 2008/2009 and the winding up proceedings of the old banks, while unresolved, exacerbate the country's external position. Fitch estimates that in 2013 Iceland's net external debt was almost five times the size of the economy; in comparison, Ireland and Spain were between 80% and 85%, and the 'BBB' median is just 7.7%. The external liabilities are concentrated in the private sector – foreign reserve exchanges are large in comparison with public sector foreign repayment obligations. Fitch expects that the current account deficit will average 1.5% of GDP over the next two years.

The presence of capital controls implies that a substantial amount of non-resident claims (estimated to be around ISK327bn (EUR2bn, around 18% of GDP)) are currently 'locked in' krona assets.

The authorities are not committed to a precise date for the removal of capital controls, and appear committed to avoiding a disorderly unwinding. Overall, Fitch expects this factor will continue to weigh on Iceland's fundamental economic and financial stability at least until 2015, as well as on the credit profile.

RATING SENSITIVITIES
The Outlook is Stable. Consequently, Fitch's sensitivity analysis does not currently anticipate developments with a high likelihood of leading to a rating change. However, future developments that could, individually or collectively, result in a positive rating action include:

-Enduring monetary and exchange rate stability in the context of continued economic growth.
-Continued steady falls in external and public debt ratios.
-Greater clarity about the evolution of the process for lifting capital controls. The completion of this process will probably depend to some degree on the winding up of the estates of the old banks.

The main factors that could lead, individually or collectively, to a negative rating action are:
-A substantially weaker than expected economic performance, resulting in trend growth over the projection horizon falling substantially below Fitch's assumptions, which would in turn weaken public debt dynamics.
-A weakening commitment to fiscal consolidation.
-A large crystallisation of contingent liabilities from the financial system, especially the Housing Finance Fund (HFF), above the amounts already assumed in Fitch's debt sensitivity analysis. State guarantees are sizeable, totalling ISK1,275bn (around 73% of GDP) at end-November 2013. The HFF accounts for about three-quarters of these guarantees.

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

Fitch assumes that capital controls will ultimately be unwound in an orderly manner, beyond the end of the forecast horizon in 2015.

Fitch assumes that the household debt relief plan will be fully financed by the announced budget adjustments, implying that revenue-raising measures will not be subject to successful judicial challenges.

For its debt sensitivity analysis, Fitch assumes a trend real GDP growth rate of 2.5%, GDP deflator growth of 2.5%, an average primary balance of 3.5% of GDP, an average effective interest rate of 5.3% and an annual depreciation of 2% in the nominal exchange rate over 2016-2023. A recapitalisation of HFF equivalent to 0.2% of GDP is assumed over the debt over the next five years. Under these assumptions, gross government debt as a share of GDP would decline to 68.8% by 2023.

FitchRatings

Contact:
Primary Analyst
Alex Muscatelli
Director
+44 20 3530 1695
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Michele Napolitano
Director
+44 20 3530 1536

Committee Chairperson
Douglas Renwick
Senior Director
+44 20 3530 1045

Additional information is available on www.fitchratings.com

Applicable criteria, 'Sovereign Rating Criteria' dated 13 August 2012 and 'Country Ceilings' dated 09 August 2013, are available at www.fitchratings.com.