**Iceland (/gws/en/esp/issr/80442256)**

# Fitch Revises Outlook on Iceland to Positive; Affirms at 'BBB+'

**Link to Fitch Ratings' Report:** Iceland - Rating Action Report (https://www.fitchratings.com/site/re/893180)

Fitch Ratings-London-13 January 2017: Fitch Ratings has revised the Outlook on Iceland's Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) to Positive from Stable. The IDRs have been affirmed at 'BBB+'. The issue ratings on Iceland's senior unsecured foreign and local currency bonds have also been affirmed at 'BBB+'. The Country Ceiling has been affirmed at 'BBB+' and the Short-Term Foreign Currency and Local Currency IDRs and Commercial Paper at 'F2'.

KEY RATING DRIVERS
The revision of the Outlook of Iceland's IDRs reflects the following key rating drivers and their relative weights:

MEDIUM
External vulnerability is reduced. Current account surpluses and capital inflows have strengthened Iceland's external finances. Over 2016, the ISK appreciated by 13% against the USD, and 16% against the EUR. The Icelandic authorities have leaned against the upward pressure and built up FX reserves. At end-year, FX reserves had reached ISK815bn (around 34% of GDP). The strong FX position allowed the Icelandic authorities to pay down the residual USD503m of a USD bond at maturity, without need for refinancing.

Fitch estimates that the current account (CA) surplus was 4.5% of GDP in 2016, down from 5.1% in 2015. Tourism receipts are more than offsetting the trade deficit, and we expect this to continue, although we forecast the CA surplus to fall to 4.1% of GDP by 2018. Net external debt decreased further in 2016, to an estimated 24.7% of GDP (down from 41.4% at end-2015), although it remains higher than both the 'BBB' and 'A' medians. The net international investment position turned positive in 2016 for the first time on record.

Iceland's improved external resilience increases Fitch's confidence that capital controls liberalisation will not lead to excessive pressure on the exchange rate and the balance of payments. There are risks associated with the liberalisation of capital flows. Substantial outflows could put downward pressure on the exchange rate - historically, sharp falls in the exchange rate have pushed up prices and affected balance sheets. However, the build-up in FX reserves and current account surpluses provide significant buffers.

Public sector indebtedness has continued to decline, reducing risks associated with the public finances. We estimate that the government debt ratio declined from 66.0% of GDP at end-2015 to 58.7% of GDP at end-2016. The government debt ratio remains above both the 'BBB' and 'A' medians (40.6% and 52.1%, respectively). The 2017 budget is largely consistent with the five-year fiscal policy statement introduced to parliament last spring. We expect small surpluses of 0.2% of GDP in both 2017 and 2018, and forecast the government debt ratio will fall to 50.0% by 2018.

The Icelandic economy has continued to grow strongly, driven by domestic demand and tourism. We estimate that full-year GDP growth in 2016 was 5.4%, and we forecast GDP growth to slow to 4.2% this year and 3.0% in 2018. Investment will continue rising, but at much slower rates, and we expect higher inflation and lower wage growth compared to early 2016 to gradually constrain private consumption. Low import prices and an appreciating exchange rate kept consumer price rises subdued in 2016. Inflation (on the harmonised HICP) measure averaged 0.9% in the 11 months to November 2016. We expect inflationary pressures from above-trend growth and rising labour costs to lead HICP inflation to average 2.8% this year and 3% in 2018. However, domestic cost pressures resulting from above-trend growth, coupled with the appreciating real exchange rate, could lead to overheating and represent a potential risk to macroeconomic stability.

Iceland's IDRs also reflect the following key rating drivers:-

Iceland's ratings are underpinned by a very high level of income per capita. Governance and human development indicators are more akin to the highest-rated sovereigns. Policy continuity is likely following parliamentary elections held on 29 October. After lengthy negotiations, a government has been formed supported by a coalition of Independence, Revival (Vidreisn) and Bright Future (Bjort framtid) parties, which has 32 seats, a majority of one seat. Bjarni Benediktsson (Independence party), the finance minister in the previous government, has been named prime minister.

A recent reform will improve the sustainability of the public pension system, moving from a defined benefit to a defined contribution system, and harmonise pension eligibility across the economy. Shortfalls in the public pension schemes have been addressed by a one-off contribution of around ISK117bn (around 4.9% of GDP). This contribution has been financed by transfers of assets for ISK82.5bn (mainly loans to the student loan fund), liquid assets (pushing up on net debt), and ISK10bn

of new government bonds (which increase government debt).

The Icelandic authorities have taken significant steps over the past few months to substantially ease capital controls on Icelandic households and businesses. Since October last year, Icelandic residents have been able to invest in foreign-currency financial instruments, and purchase one piece of real estate per calendar year. The ceiling on investments in foreign-currency instruments has recently been raised to ISK100m (USD880,000).

Capital controls on non-resident investors remain. Following the currency auction in June, a substantial amount of assets owned by foreigners remain 'locked in' (ISK191bn in government bonds, around 8% of GDP), but the risk to the balance of payments from this overhang of ISK assets has declined substantially over the past few years.

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 for 2016 is boosted (by around 16% of GDP) by the stability contributions of the old banks' estates, and therefore do 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 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 could lead, individually or collectively, to an upgrade are:
-A track record of continued economic growth without excessive macroeconomic imbalances.
-Further reductions in external vulnerability, in the context of a more open capital account.
-Continued falls in the public debt ratio, supported by prudent fiscal policy.

The Outlook is Positive. Consequently, Fitch does not currently anticipate developments with a high likelihood of leading to a downgrade. However, future developments that may, individually or collectively, lead to negative rating action include:
-Evidence of overheating in the domestic economy, for example through wage-price spirals, inflation overshoots, and adverse effects on household and corporate balance sheets.
-Excessive capital outflows leading to external imbalances and pressures on the exchange rate
-A weakened commitment to fiscal consolidation in the medium term.

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

Fitch assumes that the government's implementation strategy for capital controls liberalisation continues as planned.

In its debt sensitivity analysis, Fitch projects that government debt as a share of GDP will decline to 30.0% by 2025.

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**Applicable Criteria**
Country Ceilings (pub. 16 Aug 2016) (https://www.fitchratings.com/site/re/885997)
Sovereign Rating Criteria (pub. 18 Jul 2016) (https://www.fitchratings.com/site/re/885219)

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