FitchRatings

Tagging Info

Fitch Affirms Iceland at 'BBB'; Outlook Stable

Ratings Endorsement Policy

11 Oct 2013 12:34 PM (EDT)

Fitch Ratings-London/Hong Kong-11 October 2013: Fitch Ratings has affirmed Iceland's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BBB' and at 'BBB+' respectively. The agency has also affirmed the Short-term foreign currency IDR at 'F3' and the Country Ceiling at 'BBB'. The Outlooks on the Long-term IDRs are Stable.

KEY RATING DRIVERS

Iceland's ratings are underpinned by high income per capita levels and by measures of governance, human development, and ease of doing business which are more akin to 'AAA'-rated countries. Furthermore, Iceland's relative standing according to these indicators has not been affected by the global financial crisis.

Economic growth has remained steady in the first half of the year amid a process of debt restructuring in both the household and corporate sectors. Real GDP growth prospects for this year are markedly more positive in comparison with rated peers such as Ireland and Spain. Fitch expects GDP growth to be 1.9% this year before accelerating to an average 2.5% over the next two years.

A new government took office in May following parliamentary elections. The new government has signalled its intention to introduce further household debt relief measures. At the same time, the new government has signalled a continuation in the commitment to public debt consolidation.

Public finances remain a credit weakness. There has been fiscal slippage in 2013. The general government deficit reached 1.3% of GDP in Q2. Fitch estimates that the deficit for the full year will be 3% of GDP. Gross government debt was 99.5% of GDP in 2012, against a 'BBB' median of 39.3%. At the same time, due to large government deposits of liquid assets, net public debt is much lower than gross debt, at around 70% of GDP.

However, the new government has taken steps to address this slippage through a package of spending and revenue measures worth around ISK30bn (around 1.5% of GDP) for 2014. This reinforces Fitch's view that a strong cross-party consensus exists in Iceland on the need for fiscal consolidation, a factor reflected in the agency's projections. Fitch projects on the basis of the recent budget proposal that the deficit will narrow substantially in 2014, to 0.4% of GDP. The agency expects a surplus of 1.3% in 2015. Iceland had already achieved a primary balance in 2012, and large primary surpluses are expected in 2014 and 2015. These surpluses would drive the government debt to GDP ratio below 90% of GDP by 2015.

The country's external finances are a credit weakness. The legacy of the financial crisis in 2008/2009 and the winding up proceedings of the old banks weigh on the country's external position and the balance of payments in the near future. In 2012, the country's net external debt (including the estates of the old banks) was more than five times the size of the economy - peer comparison countries such as Ireland and Spain are both below 100% of GDP. At the same time, the public sector's scheduled foreign loan repayments are small against the stock of foreign exchange reserves. The current account is expected to strengthen over the forecast horizon, but a deficit of around 2% of GDP is still expected in 2015.

The presence of capital controls implies that a substantial amount of non-residents claims - estimated to be around ISK341bn (EUR2bn, around 20% of GDP) - are currently 'locked in' krona assets.

The Icelandic authorities are not committed to a precise date for the removal of capital controls, and appear committed to avoid a disorderly unwinding. Overall, Fitch expects this factor will continue to weigh on Iceland's fundamental economic and financial stability at least out to 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 downgrade of the ratings include:

-A weakening commitment to fiscal consolidation - for example, if election promises on the implementation of further household debt relief affect the sovereign balance sheet - resulting in a slower pace of reduction in the government debt to GDP ratio relative to Fitch's current projections
-A substantially weaker-than-expected economic performance, resulting in trend growth over the projection horizon falling significantly below Fitch's assumptions, which would in turn weaken public debt dynamics
-A crystallisation of contingent liabilities from the banking sector, and especially the Housing Finance Fund (HFF), over and above the amounts already assumed in Fitch's debt sensitivity analysis

The main factors that could, individually or collectively, lead to a positive rating action are:

-Continued reductions in external and public debt ratios
-Enduring monetary and exchange rate stability in the context of continued steady economic growth
-Evidence of continued and successful debt restructuring in the private sector
-Greater clarity about the evolution of the process for lifting capital controls.

KEY ASSUMPTIONS

The rating 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.

For its debt sensitivity analysis, Fitch assumes a trend real GDP growth rate of 2.5%, GDP deflator growth of 3%, an average primary balance of 3.5% of GDP, a nominal effective interest rate of 5.7% and an annual depreciation of 2% in the nominal exchange rate over 2015-2022. A recapitalisation of HFF equivalent to 0.7% of GDP is assumed in 2013, and of 0.2% of GDP in each of the following five years. Under these assumptions, gross government debt as a share of GDP would decline to around 73% by 2022.

Under a growth stress scenario (where trend growth is assumed to be 0.2% per annum), the debt ratio would still fall back over the next five years, but would then edge back up to just under 97%. In a scenario with no further fiscal consolidation (and a primary balance of 1.5% of GDP in the medium term), the debt ratio would still fall back, but only to just under 94% of GDP.

The agency assumes that contingent liabilities from HFF or other financial institutions will be limited. Under a scenario where contingent liabilities associated with HFF are triggered via substantial recapitalisations, assumed to be 4% of GDP between 2014 and 2016, then the debt ratio would only edge down to just 97.5% in 2016, before falling back to 85% of GDP by 2022.

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
Andrew Colquhoun
Senior Director
+852 2263 9938

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

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.

Applicable Criteria and Related Research:
Sovereign Rating Criteria
Country Ceilings

Additional Disclosure
Solicitation Status