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Research Update:

Republic of Iceland Ratings Raised To 'A/A-1' On Lifting Of Capital Controls; Outlook Stable

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Overview

- We believe that the recent lifting of most of the remaining capital controls and the conclusion of an agreement with the owners of offshore krona assets strengthen Iceland's external profile.
- We are therefore raising our long- and short-term ratings on Iceland to 'A/A-1' from 'A-/A-2'.
- The stable outlook reflects our view that the potential for improvements in Iceland's public finances is balanced by the risk of the domestic economy overheating over the next two years.

Rating Action

On March 17, 2017, S&P Global Ratings raised its long- and short-term foreign and local currency sovereign credit ratings on Iceland to 'A/A-1' from 'A-/A-2'. The outlook is stable.

As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 ("EU CRA Regulation")), the ratings on Iceland are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2017 EMEA Sovereign, Regional, And Local Government Rating Publication Dates," published Dec. 16, 2016). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation.

In this case, the reason for the deviation is that, in our view, Iceland's move to lift the capital account restrictions and the conclusion of agreement with the owners of the liquid krona overhang reduce balance of payments risks for the Icelandic economy, with an immediate positive effect on the sovereign's creditworthiness. The next rating publication on Iceland is scheduled for June 30, 2017, according to our calendar.

Rationale

The upgrade follows Iceland's lifting of most of its remaining capital controls on domestic residents that had been in place since the 2008 financial crisis, and an agreement being reached with a substantial share of offshore Icelandic krona (ISK) holders. Specifically, the upgrade reflects our view that:

- The likelihood of our previous downside scenario of potential balance of payments stress upon the liberalization of the exchange restrictions has reduced;
- The removal of controls on residents should help further strengthen domestic parties' access to foreign capital markets as well as attract more foreign

investment into the country;

- The undertaken measures also provide the Central Bank of Iceland (CBI) further policy flexibility; and
- While we expect Iceland's pension funds to increasingly diversify their portfolios toward foreign assets, associated exchange rate risks are likely to remain contained; we consider that the Central Bank of Iceland has the necessary tools to monitor and regulate the pace of these potentially material outflows.

On March 12, 2017, the CBI published new rules on foreign exchange, effective from March 14, 2017. Under the rules, most of the capital controls on domestic residents, including Iceland's pension funds, have been lifted. In addition, the CBI announced that an agreement had been reached with the holders of a substantial portion of the so-called liquid krona overhang under which at least one-half of the overall overhang (which totaled 8% of GDP as of end-February 2017) will exit at a better exchange rate than offered at the auction in mid-2016. This overhang originated principally from bonds denominated in ISK issued by nonresident entities before 2008 (known as glacier bonds) and from nonresident holdings of bonds of the government-owned mortgage lender, Housing Financing Fund.

Importantly, although the release of part of the overhang leads to an immediate decline in foreign currency reserves, we believe an orderly resolution reduces the potential for stress on Iceland's external finances in the future. Iceland has benefitted from large tourism inflows over the past two years, which has allowed the CBI to accumulate substantial amounts of additional foreign currency reserves (reserves totaled \$7.3 billion as of February 2017, or 36% of GDP). This accumulation of reserves has been instrumental in allowing the CBI to undertake the measures described above to lift exchange restrictions and conclude an agreement with offshore ISK holders.

We anticipate that even taking into account the release of the offshore krona overhang and the potential outflows from the domestic residents following years of controls, foreign currency reserves will remain broadly stable in 2017 and beyond--a result of forecast current account surpluses. In our view, should the outflows become too large, the CBI could dampen their pace via regulation applied to the pension funds. We also think that the elimination of the exchange restrictions should further strengthen domestic parties' access to foreign capital markets.

Although the removal of capital controls on residents awards the CBI some additional policy room, we believe Iceland's monetary flexibility remains constrained and represents a ratings weakness. The Icelandic economy remains relatively small and particularly volatile, as shown by the large boom-bust cycles in the past. Domestic price developments remain largely influenced by foreign prices and the value of the exchange rate, which we anticipate will still present challenges to CBI monetary policy over the medium to long term.

Finally, we have also revised upward our growth forecast to 3.5% in 2017 from 3.0% previously. We believe that similar to 2016, growth will remain supported by the expansion of the tourism sector and robust domestic consumption. Real GDP expanded by 7.2% last year, exceeding our previous forecast. That said, we continue to see

risks of overheating, and some of the improvements in the domestic economy may prove cyclical over the medium term.

Outlook

The stable outlook reflects our view that the potential for improvements in Iceland's public finances is balanced by the risk of the domestic economy overheating over the next two years.

We could raise the ratings if net general government debt to GDP declines materially faster than we presently anticipate, or if the flexibility and effectiveness of Iceland's monetary policy improves.

We could lower the ratings if we observe that the sizable wage hikes have led to a significant overheating of the domestic economy, with heightened risks for the country's monetary, fiscal, or external stability.

Key Statistics

Table 1

Republic of Iceland Selected Indicators										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. ISK)	1,702	1,778	1,891	2,006	2,214	2,422	2,582	2,734	2,886	3,047
Nominal GDP (bil. \$)	15	14	15	17	17	20	23	23	24	24
GDP per capita (000s \$)	46.1	44.5	48.1	52.7	51.0	60.3	67.0	68.1	68.9	69.7
Real GDP growth	2.0	1.2	4.4	1.9	4.1	7.2	3.5	2.8	2.5	2.5
Real GDP per capita growth	1.7	0.9	3.7	0.7	3.0	6.1	2.3	1.6	1.2	1.2
Real investment growth	11.6	5.3	2.2	16.0	17.8	22.7	4.0	3.0	2.4	2.4
Investment/GDP	15.6	16.1	15.4	17.3	19.1	21.3	21.4	21.7	22.0	22.2
Savings/GDP	16.3	17.8	23.6	23.2	25.4	29.3	27.2	25.4	24.9	24.8
Exports/GDP	56.6	57.0	55.4	53.3	53.7	49.1	50.1	51.4	53.0	54.8
Real exports growth	3.4	3.6	6.7	3.2	9.2	11.1	4.0	4.0	4.0	4.0
Unemployment rate	7.1	6.0	5.4	5.0	4.0	3.0	2.8	2.8	3.0	3.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.7	1.7	8.2	5.8	6.3	8.0	5.8	3.7	3.0	2.6
Current account balance/CARs	1.2	2.6	13.3	10.0	10.8	14.6	10.6	6.6	5.2	4.4
CARs/GDP	61.6	63.3	61.7	58.3	58.5	54.8	54.5	55.3	57.1	58.9
Trade balance/GDP	2.1	0.7	0.4	(0.5)	(1.6)	(4.2)	(4.8)	(5.6)	(6.2)	(6.5)
Net FDI/GDP	7.4	29.8	(0.3)	4.3	4.2	3.6	0.5	0.5	0.5	0.5
Net portfolio equity inflow/GDP	0.6	0.6	(0.0)	(0.0)	(2.3)	(5.5)	(3.5)	(3.0)	(3.0)	(3.0)
Gross external financing needs/CARs plus usable reserves	112.0	95.5	96.5	99.9	93.2	90.0	78.8	85.3	88.4	90.2

Table 1

Republic of Iceland Selected Indicators (cont.)										
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Narrow net external debt/CARs	96.5	88.5	71.0	58.2	143.1	50.2	39.6	37.9	37.9	37.5
Net external liabilities/CARs	110.9	44.4	19.2	9.9	10.4	0.3	(7.1)	(10.4)	(13.8)	(17.3)
Short-term external debt by remaining maturity/CARs	65.0	61.6	50.3	49.9	41.9	44.7	35.7	40.0	40.8	40.0
Reserves/CAPs (months)	5.6	8.2	5.8	5.3	5.5	6.3	7.9	7.2	6.7	6.3
Reserves (mil. \$)	5,984	4,008	4,017	3,988	4,895	7,227	7,227	7,227	7,227	7,227
FISCAL INDICATORS (% , General government)										
Balance/GDP	(5.6)	(3.7)	(1.8)	(0.1)	(0.8)	1.3	(0.5)	(0.5)	0.0	0.0
Change in debt/GDP	19.8	(9.9)	(3.0)	(1.4)	(8.5)	(8.2)	0.5	0.5	0.0	0.0
Primary balance/GDP	(1.4)	1.0	2.7	4.6	3.8	5.5	3.0	2.8	3.1	2.8
Revenue/GDP	40.1	41.7	42.1	45.2	42.0	42.6	41.8	41.5	41.5	41.5
Expenditures/GDP	45.7	45.4	43.9	45.3	42.9	41.2	42.3	42.0	41.5	41.5
Interest /revenues	10.3	11.4	10.9	10.4	11.0	9.8	8.5	7.9	7.5	6.9
Debt/GDP	115.1	100.2	91.2	84.6	68.1	54.0	51.2	48.8	46.3	43.8
Debt/Revenue	286.9	240.5	216.8	187.1	162.0	127.0	122.5	117.7	111.5	105.6
Net debt/GDP	81.5	70.5	67.7	57.3	48.7	41.6	39.5	37.8	35.8	33.9
Liquid assets/GDP	33.6	29.6	23.5	27.3	19.4	12.4	11.7	11.0	10.4	9.9
MONETARY INDICATORS (%)										
CPI growth	4.0	5.2	3.9	2.0	1.6	1.7	2.5	3.0	3.0	3.0
GDP deflator growth	3.0	3.3	1.8	4.1	6.0	2.0	3.0	3.0	3.0	3.0
Exchange rate, year-end (ISK/\$)	122.71	128.99	115.55	126.90	129.59	112.82	116.20	119.69	123.28	126.98
Banks' claims on resident non-gov't sector growth	1.0	0.2	(0.4)	1.2	0.4	1.7	2.5	3.0	3.0	3.0
Banks' claims on resident non-gov't sector/GDP	160.1	153.5	143.9	137.2	124.8	116.0	111.6	108.5	105.9	103.3
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	12.4	11.9	N/A	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	14.0	14.1	18.5	18.0	16.5	8.6	N/A	N/A	N/A	N/A
Real effective exchange rate growth	1.4	(0.3)	4.6	6.6	2.2	11.7	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. ISK--Icelandic krona. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not available. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Iceland Ratings Score Snapshot

Key rating factors	
Institutional assessment	Strength
Economic assessment	Strength
External assessment	Strength
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Neutral
Monetary assessment	Weakness

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Sovereign Risk Indicators - December 14, 2016. For an interactive version, go to www.spratings.com/sri
- 2015 Annual Sovereign Default Study And Rating Transitions, May 24, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the

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relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the external and monetary assessments had improved. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

	Rating	
	To	From
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	A/Stable/A-1	A-/Stable/A-2
Transfer & Convertibility Assessment	A	A-
Senior Unsecured		
Local Currency	A	A-
Foreign Currency	A	A-
Short-Term Debt		
Local Currency	A-1	A-2
Commercial Paper		
Foreign Currency	A-1	A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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