

Research Update:

Outlook On Iceland Revised To Stable From Negative On Return To Growth; 'BBB-/A-3' Ratings Affirmed

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Overview

- The Republic of Iceland's economy is recovering from the systemic failure of its three largest banks, and has returned to positive economic growth after two years of severe contraction.
- In our view, significant headway has been made in restructuring the private-sector balance sheet and we expect the process to be mostly completed by mid-2012.
- We are therefore revising the outlook on the ratings on Iceland to stable from negative, which balances our view of Iceland's improved economic fundamentals with downside risks associated with capital controls being lifted in the next few years.
- We are also affirming the 'BBB-/A-3' sovereign ratings on Iceland.

Rating Action

On Nov. 23, 2011, Standard & Poor's Ratings Services revised to stable from negative its outlook on the Republic of Iceland. At the same time, we affirmed our long- and short-term sovereign credit ratings at 'BBB-/A-3'. The transfer and convertibility assessment is 'BBB-'.

Rationale

The ratings on Iceland are constrained by high external and public-sector debt that we believe could become heavier still, if not for capital controls limiting residents' ability to invest overseas and nonresidents' ability to exchange krona holdings for foreign currencies.

The ratings are supported by what we view as Iceland's relatively prosperous and flexible economy, and its institutional capacity to address its financial sector problems and build an environment more conducive to sustainable economic growth.

Both the merchandise trade and the cash current accounts are operating surpluses, supported by 20% year-on-year nominal export growth (including manufacturing exports). Within the context of controls on capital convertibility, these surpluses and recent external borrowings have enabled the central bank to accumulate gross foreign-exchange reserves amounting to an estimated 50% of GDP, and usable foreign-exchange reserves of just under 30% of GDP. While Iceland's unemployment is up sharply compared with pre-crisis levels, at 6.6% it is still below that of most other advanced economies.

In our view, exceptionally lax financial sector oversight contributed to the boom-bust cycle in Iceland. That said, other long-standing economic policies have served the economy well. These include measures to ensure high labor-market participation; at 85%, Iceland's is the highest in Europe and one of the highest in the world.

We project Iceland's GDP will expand during 2011, after contracting by more than 10% between 2009 and 2010. Over the medium term, planned energy-intensive investment projects and related exports will likely contribute to further GDP growth, in our view. With this expected growth and continued fiscal consolidation, we estimate that the government will reach a primary surplus in 2011. This will likely result in the net general government debt burden trending downward from 2012. Including IMF loans and Norwegian lending to the central bank, and assumed drawdown of all remaining available bilateral financing by the end of 2011, we forecast gross general government debt to peak at 130% of GDP, and net debt to peak at about 76%, in 2011, when assets in the form of foreign-exchange reserves are netted out. Our forecast includes a central government additional capital injection into Ibudalanasjodur (Housing Financing Fund) (HFF; BB/Negative/B) and local government support of Reykjavik Energy (not rated).

Iceland continues to follow its adjustment program after successfully returning to international capital markets in June 2011. We expect Iceland will draw on its remaining bilateral funding from the Nordic countries and Poland to boost its foreign exchange reserves in anticipation of its gross reserves declining as pay-outs associated with bankrupted banks commence in 2012. A Supreme Court decision in November 2011 to uphold depositors' priority claims on old banks' assets will also reduce the potential liabilities to the government related to Icesave. We expect assets from the former Landsbanki to cover almost all of the claims the U.K. and the Netherlands have in relation to Icesave deposit guarantees, and we expect payments will start in 2012.

In 2011, the three largest domestic banks and HFF have made significant progress in restructuring their household and corporate loans. We expect nearly all loans will be restructured by mid-2012. We anticipate nonperforming loans would remain high, however, until the Icelandic economy returns to sustained growth. In our view, business investment will likely pick up, from a very low base, when banks return to normal lending operations.

If global demand were to weaken in 2012, we would expect the Icelandic economy to remain relatively resilient as its export volume is capped by capacity constraints. This means it is less subject to any volume contraction as a consequence of weakening external demand. Nevertheless, a deterioration in Iceland's terms of trade could depress wages in the export sector and thus weaken overall domestic demand.

Outlook

The stable outlook balances our view of Iceland's improved economic fundamentals with downside risks associated with capital controls being lifted in the next few years.

We could consider raising the ratings on Iceland if, in attracting further foreign investment, its economic growth potential is boosted and external vulnerabilities are reduced. In this scenario, we would anticipate public and external debt declining more rapidly than we currently assume, thereby helping to create favorable conditions for a smooth lifting of Iceland's capital controls. This would likely strengthen Iceland's credit standing.

We could consider lowering our ratings on Iceland if net government debt levels increase significantly on further fiscal slippage resulting from political tensions, higher-than-expected support of the banking sector, or substantial currency depreciation as capital controls are lifted.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Iceland (Republic of)		
Sovereign Credit Rating	BBB-/Stable/A-3	BBB-/Negative/A-3

Ratings Affirmed

Iceland (Republic of)	
Transfer & Convertibility Assessment	BBB-
Senior Unsecured	BBB-
Senior Unsecured	BBB-
Short-Term Debt	A-3
Commercial Paper	A-3

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