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

FitchRatings

Fitch Affirms Iceland at 'A'; Outlook Stable

Fitch Ratings-London-08 June 2018: Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'A' with a Stable Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Iceland's 'A' IDRs balance very high income per capita, strong performance on governance, human development and doing business indicators against high commodity export dependence, vulnerability to external shocks and experience of macroeconomic and financial volatility.

Net external debt has fallen sharply to 30% of GDP at end-2017, from a peak of 751% at end-2009 as external liabilities of the old banks were reduced. Notwithstanding this and the resilience of the krona to the lifting of virtually all capital controls in March 2017, a high 35% commodity exports share of current account receipts, and lack of diversification in the export base make the economy vulnerable to terms of trade shocks and the krona sensitive to large capital outflows. A healthy 6.9 months of imports in foreign exchange reserves at end-2017 partly mitigate these external finance risks.

Iceland has recorded strong current account surpluses (five-year average of 5.3% of GDP against the 'A' median of 2.0%), driven by favourable terms of trade and robust growth in tourism activity, which have led to a strong appreciation of the krona (19% against the US dollar between 2015 and 2017). A slowdown in tourism growth narrowed the current account surplus to 3.7% of GDP (2016: 7.7%), which Fitch forecasts to fall further to 2.2% and 1.1% of GDP in 2018-2019, additionally dampened by a widening trade deficit due to robust domestic demand and rising oil prices.

The Icelandic pension funds sector's expected portfolio rebalancing to diversify asset holdings internationally (approximately 27% of assets are invested abroad currently) following years of capital controls could result in strong capital outflows as the interest rate differential between domestic and global assets narrows. The sector is made up of 21 funds (assets worth 140% of GDP in 2016) with

considerable heterogeneity and a strong preference for krona assets to match krona-denominated liabilities.

Public finances are slightly stronger than the 'A' and 'AA' medians, with the general government balance in surplus at 1.5% of GDP and forecast to remain at an average of 1.2% of GDP in 2018-2019. The new coalition government that was formed in November 2017, the third in 18 months, spans both ends of the political spectrum but was able to reach an agreement on fiscal policy that targets lower surpluses relative to the previous government's plans. The plan continues the procyclicality of fiscal policy in recent years, which represents a deterioration in the structural balance of 4pp of GDP over 2015-2018 according to the Central Bank of Iceland, but adheres to the fiscal rules enshrined in the organic budget law. There are also political pressures for increasing expenditure in the lead up to tripartite wage negotiations at end-2018.

Gross general government debt-to-GDP fell slightly below the 'A' median of 47.4% in 2017 to 42.4%, under half of its 2011 peak. Debt reduction has primarily been financed by financial stability contributions from the old banks' estates, and was further accelerated by strong nominal GDP growth with a five-year average of 7.4% in 2017 and the strong krona appreciation. Fitch forecasts gross government debt-to-GDP to continue falling to 38.8% in 2018, and 35.2% in 2019, helped by the sale of the 13% public stake (0.9% of GDP) in Arion Bank in February 2018, and to stabilise around 30% by 2025 as the government accumulates assets and maintains an annual debt issuance target. Debt maturities and interest payments as a share of GDP are expected to remain significantly higher than the 'A' median. Roughly 3% of GDP in offshore krona government bonds are still restricted from being converted to non-krona assets at the market rate.

Real GDP growth in Iceland has been significantly stronger than the rating peer medians, with the five-year average growth of 4.4% (A median: 3.0%; AA median: 2.3%). Growth peaked in 2016 at 7.5% before slowing to 3.6% in 2017 as the positive output gap narrowed and the strong krona slows tourism growth. Fitch forecasts growth to slow further to 3.3% in 2018 and 2.9% in 2019.

National CPI inflation (Iceland's main inflation measure for monetary policy) has been relatively stable since 2014 and measured 2.0%yoy in May 2018. HICP in contrast measured -0.7%yoy in April, reflecting the exclusion of housing costs. The stability in CPI inflation masks strong inflationary pressure from housing costs, which offsets underlying disinflation in the economy from the pass-through of the krona appreciation in recent years. As tourism growth slows, these two effects are likely to offset each other. However, rising global oil prices is likely to support inflation while there is upside risk to higher wages due to increasingly vociferous demands from trade union leaders and a heightened sense of inequality amidst

rising housing costs and rising costs for low wage earners, leading up to the end-2018 wage negotiations.

Iceland has a very high income per capita, estimated at USD70,795 in 2017, making it more aligned with the 'AAA' median of USD55,241. The small island economy's performance on the measures of governance, human development and ease of doing business are also consistent with that of 'AAA' and 'AA' rated countries.

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 Foreign-Currency (LT 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:

- External Finances: -1 notch, to reflect that a lack of diversification in the export base and potential for balance of payments volatility leaves the small economy vulnerable to external shocks, macroeconomic volatility and challenges to macroeconomic policy management.

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 Stable Outlook reflects Fitch's assessment that risks to the rating are currently balanced. However, the following factors could, individually or collectively lead to positive rating action:

- Continued falls in the public debt ratio, supported by prudent fiscal policy.
- Sustained improvement in the external balance sheet and resilience of the economy to external shocks.

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

- Evidence of overheating in the domestic economy, for example through wageprice 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.

KEY ASSUMPTIONS

In its debt sensitivity analysis, Fitch assumes medium-term nominal GDP growth will moderate to an annual average of 4.5%, government primary balance of 2.0% of GDP, and a nominal effective interest rate gradually rising to 6.7% by 2027. Fitch has not included any proceeds from further sale of the government's stakes in the banks in its debt dynamics, but that the gradual accumulation of government assets will act as a floor on gross general government debt/GDP in the projection horizon. Under these assumptions, Fitch projects that government debt/GDP will decline to 29.1% by 2027.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR affirmed at 'A'; Outlook Stable Long-Term Local-Currency IDR affirmed at 'A'; Outlook Stable Short-Term Foreign-Currency IDR affirmed at 'F1' Short-Term Local-Currency IDR affirmed at 'F1' Country Ceiling affirmed at 'A'

Issue ratings on long-term senior unsecured foreign-currency bonds affirmed at 'A' Issue ratings on long-term senior unsecured local-currency bonds affirmed at 'A' Issue ratings on short-term senior unsecured foreign-currency commercial paper affirmed at 'F1'

Issue ratings on short-term senior unsecured local-currency bond/note affirmed at 'F1'

Contact:

Primary Analyst
Eugene Chiam
Director
+44 20 3530 1512
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst Ed Parker Managing Director +44 20 35301176

Committee Chairperson Charles Seville Senior Director +1 212 908 0277 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

Country Ceilings Criteria (pub. 21 Jul 2017) (https://www.fitchratings.com/site/re/901393) Sovereign Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10024428)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/10033801) Solicitation Status (https://www.fitchratings.com/site/pr/10033801#solicitation) Endorsement Policy (https://www.fitchratings.com/regulatory)

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK:

HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT

HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2018 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch

believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreedupon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus

nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

Solicitation Status

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

Fitch Updates Terms of Use & Privacy Policy

We have updated our Terms of Use and Privacy Policies which cover all of Fitch Group's websites. Learn more (https://www.thefitchgroup.com/site/policies).

Endorsement Policy - Fitch's approach to ratings endorsement so that ratings produced outside the EU may be used by regulated entities within the EU for regulatory purposes, pursuant to the terms of the EU Regulation with respect to credit rating agencies, can be found on the EU Regulatory Disclosures

(https://www.fitchratings.com/regulatory) page. The endorsement status of all International ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for all structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.