

RatingsDirect®

Supplementary Analysis: Iceland (Republic of)

Primary Credit Analyst:

Eileen X Zhang, CFA, London (44) 20-7176-7105; eileen.zhang@standardandpoors.com

Secondary Contact:

Aarti Sakhuja, London (44) 20-7176-7111; aarti.sakhuja@standardandpoors.com

Table Of Contents

Rationale

Outlook

Institutional And Government Effectiveness: Election Promises Pose Fiscal Risk

Economic Analysis: A Fragile Recovery

External Analysis: Iceland Shelters Under Capital Controls

Fiscal Analysis: Household Debt Forgiveness Could Be Costly

Monetary Policy Analysis: Exploring The Options

Related Criteria And Research

Supplementary Analysis:

Iceland (Republic of)

This report supplements our research update "Republic Of Iceland Outlook Revised To Negative On Fiscal Risk; 'BBB-/A-3' Ratings Affirmed," published on July 26, 2013. To provide the most current information, we may cite more recent data than that stated in the previous publication. These differences have been determined not to be sufficiently significant to affect the rating and our main conclusions.

Rationale

The ratings on Iceland are supported by our opinion of its prosperous and flexible economy, and its institutional capacity to address financial sector problems and build an environment more conducive to job creation and sustainable economic growth. The rapid post-crisis adjustment, on both the fiscal and external accounts, has allowed Iceland to complete its IMF program and regain market access, with its foreign currency debt maturity extended up to 10 years.

Sovereign Credit Rating

BBB-/Negative/A-3

The ratings are constrained by high external and public-sector debt. We believe debt could have been higher still if capital controls were not present to limit residents' rights to invest overseas and nonresidents' ability to exchange krona holdings for foreign currencies. The banking sector has undergone significant restructuring, but private sector nonperforming loans (NPLs) remain high. As published in the central bank's Financial Stability Report, for the three largest commercial banks, 6% of their total loans (book value) were in default over 90 days at end-2012, down from 12% a year before.

Since the onset of the 2008 financial and economic crisis, the Icelandic economy has shown resilience by reining in its fiscal and external deficits. After contracting by more than 10% during 2009-2010, Iceland's GDP began to recover. The 36% depreciation in its real effective exchange rate since mid-2007 has helped its economic rebalancing, but has also resulted in high inflation due to pass-through (that is, the effect of exchange rate changes on domestic inflation).

We expect the Icelandic economy to continue growing on average by nearly 2% annually in 2013-2016. The export sector is growing due to strong tourism and an increased fishing quota after years of conservation. This offsets subdued investment, which remains well below pre-crisis levels. We expect the current account, adjusted to remove the accrued interest of the defaulted Icelandic banks (the old banks), will remain in surplus from 2012 to 2016. Medium-to-long-term growth will depend largely on business investment, which is facing several uncertainties related to fishery fees; the price of energy; financing conditions; and the lifting of capital controls.

In our view, while exceptionally lax financial sector oversight contributed to the boom-bust cycle in Iceland, other established economic policies have served it 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 also expect that efforts to attract net FDI (which totaled 5.3% of GDP in 2012) will bear fruit, enhancing already-high capital intensity and productivity levels in the small and increasingly open economy.

The recovery of domestic demand since 2011 has improved tax collections. This has narrowed the general government headline deficit to 3.4% of GDP in 2012, from around 10% in 2009 and 2010. In May 2012, the Icelandic government successfully issued a 10-year bond amounting to 7% of GDP and used the receipts to prepay some official borrowing from the IMF and Nordic countries; this transaction has lengthened the maturity of the government's external liabilities.

High public sector and external debt burdens, however, remain key ratings constraints. Foreign exchange controls, implemented in 2008 to limit capital flight and stabilize the exchange rate, remain in place. Government plans to lift the controls have been hampered by significant risks associated with potential capital flight. Iceland's relatively shallow domestic capital markets also continue to be a ratings weakness.

The financial sector has been significantly restructured since the bank defaults of 2008. New commercial banks have made notable progress in restructuring their balance sheets. Loan-loss provisions have declined steadily and we expect restructuring will continue in 2013. However, NPLs remain significant; concentration risk--given the economy's dependence on the fisheries and aluminum sectors--is still high; and further meaningful losses cannot be ruled out, especially if the banking sector has to participate in a partial write-off of household debt.

We see a risk that household debt forgiveness--as the new government promised in its coalition agreement--could substantially worsen Iceland's fiscal ratios or weaken our assessment of the effectiveness and predictability of policymaking. The contemplated debt write-offs, if funded through a haircut imposed on existing creditors to the old banks, could also damage foreign investors' confidence in Iceland and further delay the lifting of capital controls. The scope, overall cost, and financing of the write-down remain unclear, but we consider the risk of bringing additional debt from the private sector onto the public sector balance sheet to be significant. The parliament has agreed on a 10-point working plan to examine this particular issue and expects to announce a proposal in November 2013.

The new government, a majority coalition of the Progressive Party (PP) and the Independent Party (IP), was formed after the April 2013 election. Both parties had made strong election pledges to write-down household debt. In particular, the parties focused on the inflation-linked loans, the principal of which had increased by about 38% between 2007 and 2012. This increase was due to high inflation rates in Iceland caused by the krona depreciating.

In 2010, a round of household debt relief was implemented to write-down all private household mortgages with a loan-to-value ratio greater than 110%. Moreover, households with foreign-exchange-linked loans received significant debt relief due to court rulings. In contrast, there have been no additional debt relief measures that specifically address inflation-indexed household loans. Households with these loans are exerting strong pressure for a further write-down.

We estimate that the proposed write-down could exceed 10% of 2013 GDP, possibly much more. HFF, the state-owned housing financing fund, would likely bear a significant part of the cost related to debt forgiveness as all of its private mortgages are inflation-linked. HFF has not defaulted on its obligations and has already been running significant losses since 2008 due to asset quality problems, previous write-downs, and realized prepayment risk. Over the past three years, the government has injected Icelandic krona (ISK) 46 billion (3% of GDP) into HFF to boost its capital. In contrast, foreign-exchange-linked loans have been mostly on the new commercial banks' balance sheets, received at a deep discount after the old banks defaulted, and write-off costs were therefore borne by foreign creditors

to whom the banks had defaulted.

Outlook

The negative outlook reflects that we could lower the ratings over the next two years if household debt forgiveness substantially worsens Iceland's fiscal ratios or weakens our assessment of the effectiveness and predictability of policymaking. The contemplated debt forgiveness could be seen as a departure from government policy, which has so far focused on ring-fencing sovereign liabilities and limiting the cost of financial crisis to the government. We could consider lowering the rating if we reassess the strength of Iceland's policy environment and institutional framework as a result of this policy shift.

The ratings could stabilize at the current level if we see that the scope of debt relief is limited, the cost to the state is contained, and the mode of financing does not, in our view, deter investment into the Icelandic economy.

Table 1

Republic of Iceland Selected Indicators										
	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Nominal GDP (bil. U.S. \$)	20.4	16.8	12.1	12.6	14.1	13.7	13.6	14.0	14.4	14.9
GDP per capita (U.S. \$)	66,396	53,357	37,934	39,556	44,196	42,733	42,703	43,844	45,021	46,594
Real GDP (% change)	6.0	1.2	(6.6)	(4.1)	2.9	1.6	1.3	1.8	2.0	2.0
Real GDP per capita (% change)	3.3	(1.3)	(7.7)	(3.6)	2.6	1.3	1.3	1.8	2.0	2.0
Change in general government debt (% of GDP)	1.7	52.2	22.6	8.7	21.8	(8.7)	2.2	1.8	(2.4)	(3.3)
General government balance (% of GDP)	5.4	(13.5)	(9.9)	(10.1)	(5.6)	(3.4)	(2.0)	(1.5)	(0.5)	0.5
General government debt/GDP (%)	28.5	77.4	99.1	105.4	121.0	106.9	104.3	101.1	93.6	85.5
Net general government debt/GDP (%)	12.4	50.2	58.1	65.3	68.3	70.3	69.4	67.9	65.4	62.1
General government interest expenditure/revenues (%)	5.4	7.6	16.1	13.3	12.4	12.4	11.6	11.0	10.6	9.8
Other dc claims on resident non-government sector/GDP (%)	311.2	208.1	153.7	147.1	146.1	137.8	133.6	131.0	128.1	125.2
CPI growth (%)	5.0	12.4	12.0	5.4	4.0	5.2	4.0	3.9	4.0	4.0
Gross external financing needs/CAR + usable reserves (%)	317.7	653.9	157.7	139.5	112.9	90.9	96.0	91.3	87.6	86.6
Current account balance/GDP (%)	(15.7)	(18.0)	(0.2)	(2.1)	(0.3)	0.8	1.2	1.5	1.1	0.4
Current account balance/CARs (%)	(28.0)	(35.1)	(0.4)	(3.7)	(0.5)	1.3	1.9	2.3	1.8	0.6
Narrow net external debt/CARs (%)	433.4	158.1	175.5	145.9	92.6	93.0	90.4	82.0	79.6	77.5
Net external liabilities/CARs (%)	205.6	69.6	54.5	74.3	47.9	5.8	9.6	13.9	19.4	26.1

Other depository corporations (dc) are financial 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 non-residents minus official reserves minus public-sector liquid assets held by non-residents minus financial sector loans to, deposits with, or investments in non resident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Institutional And Government Effectiveness: Election Promises Pose Fiscal Risk

- A strong political institution has helped Iceland to recover from severe financial crisis.
- A new PP/IP coalition, formed after the April 2013 parliamentary election, is committed to change a number of policies.
- The key election promise of further household debt forgiveness could increase the general government debt burden.

Iceland has deep democratic roots, robust political institutions, and high social and educational standards

Internal and external security risks are negligible, in our view. There is strong political consensus on key macroeconomic and fiscal policies across the parties. For instance, there is a broad consensus among political parties that capital controls--which were imposed to allow the Icelandic economy to deal with the financial crisis--must be lifted gradually in a phased manner, despite differences among the political parties on the exact timeframe. That said, Iceland's political climate, as in some peer countries, has in our view become more confrontational and less cohesive since the financial crisis. As the economy recovers, we expect the government's willingness to keep wages low or embark on further spending cuts to diminish. The asymmetry of household debt write-down due to court decisions on foreign-exchange-linked loans could result in private debt being brought onto the government balance sheet.

The parliamentary election in April brought in a PP/IP coalition government

The parliamentary election on April 27, 2013, saw a massive surge in the popularity of the PP, which won 19 seats, more than double the number of seats in the last election. Together with the IP, which also obtained 19 seats, a majority coalition was formed with 38 out of the 63 seats in the parliament.

The surge in popularity of PP followed the dismissal of a case brought by the European Free Trade Association Surveillance Authority (ESA), which found Iceland to be in breach of the Deposit Guarantee Directive in January 2013. The dismissal means the Icelandic state is no longer liable to meet obligations related to the deposit guarantees of foreign customers of Icesave, a branch of the defaulted Landsbanki, a privately owned Icelandic bank. The bankruptcy of Landsbanki in October 2008 resulted in a diplomatic dispute between Iceland, the U.K., and The Netherlands over the Icelandic state's liability for deposit guarantee payments. The U.K. and the Dutch government brought the case to the ESA. Voters considered the leader of PP, Sigmundur Gunnlaugsson, who is now Iceland's prime minister, to be one of the politicians who foresaw this outcome and refused to negotiate with the U.K. and Dutch authorities.

We believe that key election promises to provide further household debt forgiveness could pose fiscal risks in the near term. Both IP and PP made an election pledge to write down household debt. In particular, the parties focused on inflation-linked loans, the principal of which increased by about 38% between 2007 and 2012. This increase was due to high inflation rates in Iceland caused by the Icelandic krona depreciating.

In 2010, a round of household debt relief was implemented to write-down all private household mortgages with a loan-to-value ratio greater than 110%. Moreover, households with foreign-exchange-linked loans received significant debt relief due to court rulings. In contrast, there have been no additional debt relief measures that specifically address inflation-indexed household loans. Households with these loans are exerting strong pressure for a further write-down.

The new coalition government has pledged to follow a different economic policy

The coalition has stated that negotiations over the accession of Iceland to the EU have been put on hold and will only restart after a referendum. Recent polls suggest there is strong demand for a referendum to be held in the next 12 months. The government also plans to make changes to the constitution, focusing on the national ownership of resources and on referenda on parliamentary legislations on the initiative of a substantial share of voters.

In addition, the government will review the Master Plan for the protection and utilization of energy resources, which governs future energy-intensive projects. The government encourages the exploitation of potential oil and gas resources, and has granted two licenses for the exploration and production of hydrocarbons in the Dreki area in the northeast of Iceland. The new PP-IP coalition has promised a review of the controversial fishery fees that the previous left-wing government introduced and has already passed a law to stop the implementation of fee collection. The new government is also planning to review the plan to lift capital controls. In March 2013, the previous government scrapped the 2013 deadline for the removal of capital controls.

Economic Analysis: A Fragile Recovery

- A small economy concentrated on fishery and aluminum sectors.
- The Icelandic economy has recovered from the severe recession in 2009/2010, but deleveraging continues.
- Exports are constrained by supply factors and could only expand significantly with further investment.
- The investment outlook remains uncertain, despite an active government policy.

Iceland's economy is small, open, and flexible

In 2012, Iceland's GDP was \$13.6 billion and its population was 320,000. Exports amounted to near 60% of GDP in 2012 and are dominated by marine products and aluminum, which account for about 78% of all merchandise exports. The financial services sector has shrunk substantially after the collapse of three major Icelandic banks in late 2008, from 9% of the gross value added (GVA) to 6% of GVA in 2011. The resulting recession and depreciation of the krona caused per capita income to drop sharply to \$42,700 in 2012, from a peak of \$64,000 in 2007. However, Iceland's population remains far more prosperous than that of most other 'BBB' rated sovereigns, whose median GDP per capita is only about \$14,000.

Iceland's economic growth returns to positive for the first time since 2011

The rate of economic growth slowed somewhat in 2012 and 2013--decelerating to an average of 1.5% compared to 3% in 2011--but the recovery is broad. Exports have grown, thanks to the strong performance of the tourism sector and an increased quota for the fishery sector after years of conservation. Consumption is supported by improving labor market conditions and significant hikes in wages, although the temporary withdrawal of pension assets has been terminated and household credit conditions remain tight. Imports, particularly of durable goods, have recovered as a result, and the net contribution of trade only slightly boosted growth. We forecast economic growth of 2% on average from 2013-2016.

A large proportion of exports from Iceland remain under supply constraints

Fishery quotas are determined scientifically and constrain the volume of exports from the fishery sector. The most recent fishery quota is an increase in volume from previous years, which we believe will boost export growth. The

aluminum smelters are running at capacity and would need further large-scale investments to increase output. The tourism sector has grown rapidly in the past year, with overnight stays increasing by 15% in 2012 from 2011, and notable investments in accommodation and restaurants.

Investment prospects remain uncertain, despite a more investment-friendly policy

The growth in business investment mainly reflects that in the tourism sector. The number of hotel and restaurants is on the rise thanks to an increased number of overseas visitors. However, investment in two other key export sectors--fishery and energy-intensive projects--is hindered by near-term uncertainties. These uncertainties include:

- A review of the fishery catch fee.
- The feasibility of building an undersea power link to the European Grid.
- A review of the Master Plan for the protection and utilization of energy resources.
- The availability of external funding for investment under volatile external financial conditions.
- Risks related to capital controls.

Table 2

Republic of Iceland Economic Indicators										
	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Nominal GDP (bil. LC)	1,309	1,480	1,498	1,536	1,632	1,708	1,788	1,878	1,978	2,085
Nominal GDP (bil. U.S. \$)	20.4	16.8	12.1	12.6	14.1	13.7	13.6	14.0	14.4	14.9
GDP per capita (U.S. \$)	66,396	53,357	37,934	39,556	44,196	42,733	42,703	43,844	45,021	46,594
Real GDP (% change)	6.0	1.2	(6.6)	(4.1)	2.9	1.6	1.3	1.8	2.0	2.0
Real GDP per capita (% change)	3.3	(1.3)	(7.7)	(3.6)	2.6	1.3	1.3	1.8	2.0	2.0
Real investment (% change)	(12.2)	(20.4)	(51.4)	(9.4)	14.3	4.4	(8.5)	5.0	6.0	6.0
Gross domestic investment/GDP (%)	28.5	24.4	13.8	12.7	14.1	14.4	13.0	13.2	13.6	13.9
Gross domestic savings/GDP (%)	12.8	6.3	13.6	10.6	13.7	15.2	14.2	14.7	14.7	14.3
Real exports (% change)	17.7	7.0	7.0	0.6	4.1	3.9	2.7	2.4	2.6	2.7
Unemployment rate (average %)	2.3	3.0	7.2	7.6	7.1	6.0	5.0	4.6	4.5	4.5

Savings are 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. The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility and usability of available information.

External Analysis: Iceland Shelters Under Capital Controls

- Capital controls shelter Iceland temporarily from severe external pressure.
- The underlying current account has moved to close to balance, but remains far from sufficient to bridge the external gap.
- Changes in the ownership of Icelandic pharmaceutical company Actavis and the composition of Iceland's defaulted banks could affect external statistics.

Iceland remains under severe external pressure, even though the default of its three largest banks in 2009 wiped out a large part of its external debt

Excluding defaulted debt, gross external debt fell from 5x GDP in 2007 to 2x GDP in 2011. However, gross debt is still among the highest of the sovereigns we rate. Moreover, nearly all of private sector external debt is short term, which poses very high external liquidity needs and acute downward pressure on the krona. These pressures are kept under the lid of exchange control arrangements that restrict the movement of capital outside Iceland, supporting the relatively stable exchange rate and sheltering the domestic economy.

Iceland's current account--excluding income payments and receipts related to the old banks--has been in a near-balance position since 2010, and reached a surplus in 2012

Due to Iceland's supply constraints and small amount of pricing power over its key goods exports due to their commodity-like nature, Iceland has improved its current account position largely by shrinking its imports. As the economy recovers, we expect the current account to provide a limited net inflow of foreign currencies that would reduce external debt materially. The unencumbered foreign reserve (gross reserve minus the foreign-currency deposits from the old banks' resolution committee) amounts to \$4 billion, or 26% of GDP at year-end 2012. These deposits are held at the Central Bank of Iceland and are either borrowed directly from the IMF and Norway, or are foreign currency deposits from the government, raised in the market or from other Nordic countries.

We expect the exchange control to remain in place for an extended period

The central bank estimates that about ISK400 billion (22% of GDP) of nonresident holdings of assets denominated in krona remains trapped in the local market. These are almost all short-term assets that would exit as soon as the control is lifted. The central bank's two-phase plan to lift the exchange control aims to deal with this external pressure by gradually reducing the krona overhang and by converting the short-term ISK assets into longer-term investments. The Central Bank has carried out a number of foreign currency/ISK auctions, but progress has been relatively slow. The current focus is on attracting funds through foreign investment. The subdued demand for ISK during central bank auctions highlights to us that Icelandic pension funds are also reluctant to take on more ISK exposure given their mandate to diversify investment. The pent-up demand for foreign-currency assets from Icelandic residents is another source of external liquidity risk, but we expect the second phase of the plan to lift the exchange control to be managed with restrictive measures.

Both the balance of payments and the international investment position that is published by the Central Bank still include the defaulted banks in the nonbank private sector accounts. We therefore make analytical adjustments based on information provided by the Central Bank to exclude the old banks' assets and liabilities, as well as the associated accrued interest in the balance of payment account. As a result, we estimate external liabilities at 360% of GDP, less than the Central Bank's headline figures.

This approach, however, underestimates Iceland's overall external liabilities, as it does not include the expected equity holdings of new banks by the old banks' creditors. It also understates Iceland's external liabilities, as Landsbanki's contingent bond of ISK300 billion (17% of GDP) is not included in the external data either. This is because LBI hf--the old defaulted Landsbanki that is being wound up--is considered an Icelandic resident. Our data therefore underestimate the income deficit because expected dividend payments are not accounted for. Iceland's external data could also be restated if the pharmaceutical company Actavis comes under foreign ownership. Depending on the

accounting method adopted, external debt could be reduced because Actavis' net external liabilities account for some 40% of GDP.

Table 3

Republic of Iceland External Indicators										
	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Narrow net external debt/CARs (%)	433.4	158.1	175.5	145.9	92.6	93.0	90.4	82.0	79.6	77.5
Gross external financing needs/CAR + usable reserves (%)	317.7	653.9	157.7	139.5	112.9	90.9	96.0	91.3	87.6	86.6
Net external liabilities/CARs (%)	205.6	69.6	54.5	74.3	47.9	5.8	9.6	13.9	19.4	26.1
Current account balance/GDP (%)	(15.7)	(18.0)	(0.2)	(2.1)	(0.3)	0.8	1.2	1.5	1.1	0.4
Current account balance/CARs (%)	(28.0)	(35.1)	(0.4)	(3.7)	(0.5)	1.3	1.9	2.3	1.8	0.6
Trade balance/GDP (%)	(6.7)	(0.5)	6.0	7.8	6.0	4.4	4.6	4.0	3.5	2.9
Net FDI/GDP (%)	(16.5)	30.5	(18.2)	20.7	7.7	28.7	4.0	5.0	5.0	5.0
Net portfolio equity inflow / GDP (%)	(21.2)	0.4	1.5	8.1	0.6	0.6	1.0	1.0	1.0	1.0
Reserves/CAPs (months)	1.9	2.7	6.3	4.3	5.7	8.3	5.7	6.0	6.4	6.7

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 non-residents minus official reserves minus public-sector liquid assets held by non-residents minus financial sector loans to, deposits with, or investments in non resident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Fiscal Analysis: Household Debt Forgiveness Could Be Costly

- The pace of fiscal consolidation has slowed.
- The backlog in public investment and strong upward wage pressure challenges further fiscal consolidation.
- There are high contingent liabilities from HFF and the banking sector.
- The proposed household debt forgiveness could add to public sector debt.

Iceland has achieved significant fiscal consolidation, both in terms of expenditures and revenues, since the onset of the financial crisis

The cost of saving the economy from a potentially more dramatic plunge during the financial crisis has severely compromised Iceland's fiscal flexibility. The general government balance moved from a surplus of 6.3% of GDP in 2006 to a deficit of 8.6% of GDP in 2009. Despite the deep recession, under the IMF program, the government has managed to reduce the deficit to 3.4% of GDP in 2012, through both expenditure cuts and tax increases. However, the momentum has slowed, partly due to the parliamentary elections, and partly because the government has already taken more straightforward measures in the past few years. We calculate that the government will run a deficit of about 2% of GDP in 2013, on the back of continued spending controls, and we forecast that the general government will have a small surplus by 2016, excluding any costs related to household debt forgiveness or additional support to HFF.

We expect the improvement in the general government account to be gradual, due to the backlog in public investment and strong upward wage pressure

Public investment has reduced to less than 2% of GDP in the past two years, from a historical average of about 4%,

and the pressure to resume a normal level of spending is substantial. Additionally, a large part of government expenditure relates to its wage bill, which is determined through centralized wage negotiations. Strong pressure to increase wages is likely to continue to weigh on government expenditure. In the 2013 budget, we understand that the treasury wage bill is likely to increase by 3.7%.

Government debt and interest burden are likely to stay high

The general government debt ratio more than quadrupled to 121% of GDP in 2011 from about 30% in 2006-2007 due to the financial crisis. This stemmed from large fiscal deficits, the cost of refinancing the banking system, and borrowing to prop up foreign exchange reserves. Loans from the IMF and Norway are on the Central Bank's balance sheet, but included in the general government debt in our analysis. The public debt ratio also increased because of the severe depreciation of the krona. The general government debt ratio started to decrease in 2012, mainly due to early repayment to IMF and Nordic lenders, but supported by significant budgetary belt-tightening and stronger nominal GDP growth.

We expect net general government debt to reach 69% of GDP in 2013, gradually reducing to 62% by the end of 2016 on the basis of our current assumptions on fiscal consolidation and debt repayment. However, our assumption of the country's debt trajectory does not consider any additional debt burden as a result of household debt write-offs. Nevertheless, unless any one-off fiscal windfalls from foreign creditors are used to pay off general government debt, rather than provide households with debt relief, we believe it could take two decades for the debt ratio to return to pre-financial crisis levels, even if the government was to run balanced budgets from 2014 onward and nominal GDP were to rise by 4%-5% per year.

Proposed household debt forgiveness could pose significant fiscal risk

As we discuss above, the proposed household debt forgiveness could increase fiscal risks substantially in the near term. Given the relatively tight deadline to fulfill the promise before the municipality election due in 2014, we see it as unlikely that any external financing could be secured, and so the most likely financing source would be public debt. As the scope of the forgiveness is not yet defined, we cannot quantify the total cost at this stage.

We estimate that the proposed write-down could exceed 10% of 2013 GDP, possibly much more. HFF, the state-owned housing financing fund, would likely bear a significant part of the cost related to debt forgiveness as all of its private mortgages are inflation-linked. HFF has not defaulted on its obligations and has already been running significant losses since 2008 due to asset quality problems, previous write-downs, and realized prepayment risk. Over the past three years, the government has injected ISK46 billion (3% of GDP) into HFF to boost its capital. In contrast, foreign-exchange-linked loans have been mostly on the new commercial banks' balance sheets, received at a deep discount after the old banks defaulted, and write-off costs were therefore borne by foreign creditors to whom the banks had defaulted.

The bulk of the contingent liabilities from the banking sector are now on the state's books

Most of the sizable contingent liabilities from the commercial financial sector are now on the government's balance sheet. Nevertheless, we still believe the gross problematic assets of the reestablished Icelandic banks are substantial and could total up to 50% of system loans if the country were to fall back into a deep recession. Considering the very high level of intermediation, the contingent liabilities from the financial sector remain a credit weakness, although less

so than before the collapse of the old banks. At ISK184 billion, or 13% of GDP, the cost of recapitalizing the failed banks was much lower than we initially expected. The restructuring of Landsbanki, formerly Iceland's largest financial institution, consumed about two-thirds of the cost. Landsbanki is now the only commercial bank majority-owned (98%) by the state.

Government-guaranteed debt is high, at almost 83% of GDP in 2012

More than four-fifths of these government guarantees are on debt issued by HFF. Additionally, the government's liability is subject to the development of house prices in Iceland and the credit risk of Icelandic households. Most of the remaining guarantees are on the debt of state-owned power company Landsvirkjun, which we consider to have a very weak stand-alone credit profile of 'b+'.

Table 4

Republic of Iceland Fiscal Indicators										
	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Change in general government debt (% of GDP)	1.7	52.2	22.6	8.7	21.8	(8.7)	2.2	1.8	(2.4)	(3.3)
General government balance (% of GDP)	5.4	(13.5)	(9.9)	(10.1)	(5.6)	(3.4)	(2.0)	(1.5)	(0.5)	0.5
General government primary balance/GDP (%)	8.0	(10.2)	(3.4)	(4.5)	(0.4)	1.9	3.1	3.5	4.3	4.9
General government revenue/GDP (%)	47.7	44.2	41.0	41.5	41.7	43.1	44.0	45.2	45.3	45.3
General government expenditures/GDP (%)	42.3	57.7	51.0	51.6	47.3	46.5	46.0	46.7	45.8	44.8
General government interest expenditure/revenues (%)	5.4	7.6	16.1	13.3	12.4	12.4	11.6	11.0	10.6	9.8
General government debt/GDP (%)	28.5	77.4	99.1	105.4	121.0	106.9	104.3	101.1	93.6	85.5
Net general government debt/ GDP (%)	12.4	50.2	58.1	65.3	68.3	70.3	69.4	67.9	65.4	62.1
General government liquid assets/GDP (%)	16.1	27.2	41.0	40.0	52.7	36.6	34.9	33.3	28.2	23.5

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Monetary Policy Analysis: Exploring The Options

- Strong pass-through effects undermine monetary policy creditability.
- The exchange rate is relatively stable thanks to capital controls in place.
- The banking system does not yet operate under a sustainable business model.

Iceland is one of world's smallest economies, with an independent monetary policy based on a flexible exchange-rate regime

Iceland's monetary policy has been ineffective in managing inflation in the past ten years, demonstrated by much higher inflation compared with its target. This is due to both external reasons, such as conditions in the global financial market conditions, as well as Iceland's domestic structural issues. In particular, there is a strong pass-through effect when the ISK depreciates. This is not only due to the large import content of the consumer basket, but also to strong domestic wage pressure, when wages in the export sector rise due to the weaker ISK. The lack of domestic substitution to imported goods--due to the small and relatively concentrated economy--also augments the effect of the exchange rate on domestic prices.

Monetary policy is currently conducted under two exceptional conditions--exchange control and restructuring of the financial system

The ISK has been relatively stable in the past 12 months, and inflation rates have declined to about 4% in mid-2013. The Central Bank has not raised rates since November 2012, with a view to tightening monetary policy. However, the current inflation rates are modest in a historical context, because the existing exchange controls restrict financial outflows and keep the exchange rate relatively stable. A number of exchange-rate and monetary regime options after the lifting of capital control are currently under discussion, including Iceland joining the EU and EMU. However, this option is complicated by the government's recent decision to put Iceland's EU membership on hold and await the results of a referendum.

The transmission mechanism of Iceland's monetary policy is hindered by the continued restructuring of its banking sector

Domestic leverage--measured by the stock of outstanding credit to the private and nonbank sectors (excluding HFF mortgage loans)--rose to 311% of GDP by 2007. This follows a fall in the exchange rate, which inflated foreign-currency denominated loans. It has since declined to 138% in 2012. The nominal amount of outstanding credit is likely to continue shrinking as debts are restructured, written down, or defaulted on, but there are some signs that new credit is being extended to households and companies. Domestic credit contracted by 1.5% in 2012, but we expect it to return to minor growth in 2013. The legal cases regarding foreign-exchange-linked lending continue to slow down the restructuring process. More information on the Icelandic banking system can be found in our Banking Industry Country Risk Assessment on Iceland, published Aug. 19, 2013, on RatingsDirect.

Table 5

Republic of Iceland Monetary Indicators										
	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
CPI growth (%)	5.0	12.4	12.0	5.4	4.0	5.2	4.0	3.9	4.0	4.0
GDP deflator growth	5.7	11.8	8.3	6.9	3.3	3.0	3.3	3.2	3.3	3.3
Other dc claims on resident non-govt. sector growth (%)	35.9	(24.3)	(25.3)	(1.8)	5.5	(1.3)	1.5	3.0	3.0	3.0
Other dc claims on resident non-govt. sector / GDP (%)	311.2	208.1	153.7	147.1	146.1	137.8	133.6	131.0	128.1	125.2

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Related Criteria And Research

- Banking Industry Country Risk Assessment: Iceland, Aug. 19, 2013
- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Ratings Detail (As Of August 22, 2013)

Iceland (Republic of)

Sovereign Credit Rating	BBB-/Negative/A-3
Transfer & Convertibility Assessment	BBB-
Commercial Paper	
<i>Foreign Currency</i>	A-3
Senior Unsecured	BB
Senior Unsecured	BBB-
Short-Term Debt	A-3
Short-Term Debt	B

Sovereign Credit Ratings History

26-Jul-2013	<i>Foreign Currency</i>	BBB-/Negative/A-3
23-Nov-2011		BBB-/Stable/A-3
17-May-2011		BBB-/Negative/A-3
13-Apr-2011		BBB-/Watch Neg/A-3
30-Mar-2010		BBB-/Negative/A-3
05-Jan-2010		BBB-/Watch Neg/A-3
31-Dec-2009		BBB-/Stable/A-3
24-Nov-2008		BBB-/Negative/A-3
06-Oct-2008		BBB/Negative/A-3
29-Sep-2008		A-/Watch Neg/A-2
26-Jul-2013	<i>Local Currency</i>	BBB-/Negative/A-3
23-Nov-2011		BBB-/Stable/A-3
17-May-2011		BBB-/Negative/A-3
13-Apr-2011		BBB-/Watch Neg/A-3
30-Mar-2010		BBB/Negative/A-3
05-Jan-2010		BBB+/Watch Neg/A-2
31-Dec-2009		BBB+/Stable/A-2
06-Oct-2008		BBB+/Negative/A-2
29-Sep-2008		A+/Watch Neg/A-1

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

Additional Contact:

SovereignEurope; SovereignEurope@standardandpoors.com

Copyright © 2013 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

McGRAW-HILL