Fitch Ratings

Fitch Affirms Iceland at 'A'; Outlook Stable

Fitch Ratings - London - 22 November 2019:

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

Key Rating Drivers

Iceland's 'A' rating is driven by the island economy's very high income per capita, solid performance on governance, human development and doing business metrics that are more in line with that of 'AAA' and 'AA' rated countries, and healthy public finances. Broad political consensus among political parties on macroeconomic and fiscal policy has underpinned the rebuilding of fiscal and external buffers. The rating is somewhat constrained by the small size of the economy and limited export diversification that result in vulnerability to external shocks and macroeconomic and financial volatility.

Iceland's near-term growth outlook has worsened since the closure of the budget airline WowAir and the grounding of IcelandAir's Boeing 737 Max jets affected the country's tourism and aviation sectors. We now forecast real GDP to contract 0.2% in 2019 (May 2019 review: 0%), bouncing back to just 1.6% in 2020 (Mary 2019 review: 2.5%), and 2.5% in 2021. The revision is mainly due to a sharper-than- expected slowdown in domestic demand, while external demand in 1H19 partially offset this as imports contracted faster than expected relative to exports. Domestic demand is affected by dampened economic sentiment, households increasing savings and by a cooling labour market. In the medium-term, Fitch forecasts real GDP growth to recover to a trend of 2%.

Tourism, the biggest driver of above-trend economic growth through 2018, faces more muted growth prospects. Tourism capacity has contracted since the WowAir and 737 Max jets shocks. Total passengers arriving at Keflavik airport in the year-to-October 2019 fell 11.5% yoy, with October 2019 recording the sharpest year-on-year fall in passenger arrivals of 17.2%. Airline operators have shifted capacity towards tourists visiting Iceland and away from transit passengers, which partially explains robust growth in tourist expenditure in 2Q19-3Q19. A changing composition of tourists away from budget and private accommodation towards hotel-stay tourists, as well as a weaker krona, have also supported tourist spending. Despite announcements of some new airline operators, there is significant uncertainty surrounding when air passenger capacity will recover.

The growth slowdown has affected labour market dynamics, with employment contracting 1%yoy in September 2019, and for five of the last seven months. Layoffs were concentrated in the transportation and tourism sectors. The unemployment rate also ticked up to 3.2% in September 2019, from 1.5% in the previous year. Wage growth slowed to 4.2% yoy in September 2019, and Fitch expects wage growth at about 4% in 2019-2020 as ongoing public sector wage negotiations are likely to adopt similar outcomes to the Spring private sector agreements.

HICP inflation subsided to 1.9% in October 2019, as petrol prices and airfares fell, and as pass-through from the krona depreciation in 2018 faded. Fitch forecasts inflation to be broadly stable, averaging 2% in 2020, before accelerating to 3%. Between May and November 2019, the Central Bank of Iceland has lowered its key policy rate five times, for a total of 1.5pp to a historical low of 3%, narrowing the interest rate differential with central banks of Iceland's key trading partners. Rate cuts have led to lower bank deposit and lending rates, but credit growth has slowed over the period.

Icelandic pension funds hold 164% of GDP in assets, with 28% of assets invested abroad (end-2018: 22%). The narrowing differential with international interest rates could accelerate pension funds' portfolio rebalancing to diversify assets overseas following years of capital controls, potentially leading to strong capital outflows. The sector is made up of 21 funds with considerable heterogeneity and a strong preference for krona assets to match krona-denominated liabilities.

Fitch forecasts the current account surplus to widen slightly to 3.3% of GDP in 2019 (2018: 2.9%) as imports have contracted much faster than exports, with imports of fuel and consumer durables and WowAir aircraft lease payments falling as the economy adjusts to the slowdown. Favourable marine product prices have also supported Iceland's terms-of-trade, limiting the impact of the slowdown on external finances. Fitch forecasts foreign exchange reserves to improve slightly to a robust 6.4 months of current external payments at end-2019. Notwithstanding six years of large current account surpluses averaging 4.8% of GDP, Iceland lacks diversification in its export base, which makes the economy vulnerable to terms-of-trade shocks and the krona sensitive to capital flows.

Public finances are a strength for Iceland's rating. Fitch forecasts the general government balance surplus to narrow to 0.2% of GDP in 2019 (current 'A' median: -1.2%), as automatic stabilisers work through the near-term slowdown. The government is bringing forward planned reductions in personal income taxes by a year to 2021 and increasing investments in transport and healthcare, marginally offset by higher carbon taxes. Fitch forecasts the general government balance to fall to -0.1% of GDP in 2020, before recovering to 0.3% in 2021. Gross general government debt at 35.3% of GDP, is lower than the 'A' (48%) and 'AA' (39%) medians and should fall further to 30% by 2023 according to our projections.

A possible correction in real estate prices presents downside risks to Fitch's growth projections. House price growth last peaked at 24.2% yoy in July 2017 but has since slowed to 4.2% yoy in October 2019. Dampened tourism sentiment, declining labour market metrics, and increasing supply of building completions could result in downward pressure on house prices. A sharp correction in commercial real estate prices also presents a risk as commercial and residential property had both benefitted greatly from the tourism boom in 2010-2018. A collapse in real estate prices could further weigh on private consumption and growth, but Icelandic banks and households should be fairly resilient. Banks are well-capitalised with a tier-1 capital adequacy ratio of 21% and a low level of non-performing loans (NPLs) at 2.5% of total loans in 2Q19.

Iceland was placed on the Financial Action Task Force's grey list of jurisdictions with strategic anti money-laundering and counter-financial terrorism deficiencies in October 2019. Fitch understands that remedial actions have been implemented and expect the status could be reversed by Spring 2020. Fitch expects this to have a muted impact on Icelandic banks' correspondent banking relationships.

Sovereign Rating Model (SRM) and Qualitative Overlay (QO)

Fitch's proprietary SRM assigns Iceland a score equivalent to a rating of 'A+' on the LTFC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LTFC 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 leave 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 LTFC 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 main factors that could individually or collectively lead to positive rating action are:

- Sustained improvement in the external balance sheet and increased resilience of the economy to external shocks.

- A marked improvement in the general government's balance sheet, supported by prudent fiscal policy.

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

- A sustained sharper-than-expected economic downturn impacting the banking sector (e.g. through the real estate market).

- Excessive capital outflows jeopardising financial stability and weakening external buffers.

Key Assumptions

In its longer-term debt projections, Fitch assumes nominal GDP growth of 4.2% per year, government primary balance of 2.2% of GDP, and a nominal effective interest rate of 5.4% by 2028. The gradual accumulation of government assets will act as a floor on gross general government debt/GDP over the projection horizon to 2028. Under these assumptions, Fitch projects that government debt/GDP will decline and stabilise at around 30% by 2023.

ESG Considerations

Iceland has an ESG Relevance Score of 5 for Political Stability and Rights as political stability, including divisions and vested interests as reflected in the World Bank Governance Indicators are highly relevant to the rating and a key rating driver with a high weight.

Iceland has an ESG Relevance Score of 5 for Rule of law, Institutional & Regulatory Quality, and Control of Corruption as these measures of institutional and quality of policymaking as reflected in the World Bank Governance Indicators are highly relevant to the rating and a key rating driver with a high weight.

Iceland has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as social stability, voice and accountability as reflected in the World Bank Governance Indicators are relevant to the rating and are rating drivers.

Iceland has an ESG Relevance Score of 4 for Creditors Rights as willingness to service and repay debt is relevant to the rating and a rating driver, as for all sovereigns.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
Iceland	LT IDR A Affirmed	A
	ST IDR F1+ Affirmed	F1+
	LC LT IDR A Affirmed	A
	LC ST IDR F1+ Affirmed	F1+
	Country Ceiling A+ Affirmed	A+
senior unsecured	LT A Affirmed	A
senior unsecured	ST F1+ Affirmed	F1+

Additional information is available on www.fitchratings.com

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Applicable Criteria

Sovereign Rating Criteria (pub. 26 May 2019)
Country Ceilings Criteria (pub. 05 Jul 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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