FitchRatings

Fitch Affirms Iceland at 'A'; Outlook Stable

Fitch Ratings - London - 07 December 2018: Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'A' with a Stable Outlook.

RATING ACTIONS

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

KEY RATING DRIVERS

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

Trend real GDP growth in Iceland is stronger than the 'A' and 'AA' medians with five-year average growth of 4.5%. Fitch has revised up its growth forecast for 2018 to 4.5% due to upward revisions of 2017 growth (4.0%) and stronger growth performance in 1H18. Growth is driven by robust private consumption and investments, as well as strong tourism activity, but is expected to slow to 3.0% in 2019 and 2.6% in 2020 as the overheated tourism sector normalises.

Labour market dynamics are robust, with strong employment growth of 4.1%yoy in 3Q18 and the unemployment rate falling to 2.2% of labour force in 3Q18. Wages grew at a robust 6.2% yoy in October 2018, with some risk of excessive growth in 2019, depending on the outcome of wage negotiations by end-2018. Vociferous demands by labour union leaders and discontent at perceived growing income inequality could lead to a return of strong wage increases that saw wage growth average 11.4% in 2016. Without offsetting forces, excessive wage growth could hurt Iceland's competitiveness and raise inflation resulting in pressures for faster tightening of monetary conditions.

Inflationary pressures picked up in 2018 with harmonised inflation (HICP) rising by 0.9% yoy in October 2018, and converging on national CPI inflation (2.8% yoy), which includes housing costs. Inflation is driven by above trend growth and demand in the economy, but has also been impacted by pass-through of the weakening krona in 2H18. Rising inflation led to the Central bank of Iceland (CBI) raising its key policy rate by 25bp to 4.5% on 7 November 2018.

The krona depreciated by 13% against the US dollar and 10% against the euro from September to November 2018, likely driven by a worsening outlook for wage-driven inflation, perceived risks from a key airline operating tourist routes to Iceland going into financial distress, and to a lesser extent, a narrowing of the current account surplus in the forecast period. The terms of trade is forecast by the CBI to fall by 1.9% in 2018 having improved by 15% cumulatively in 2013-2017, driven by higher oil and other import prices. However, a sharp fall in oil prices since October 2018 has not led to krona weakness abating.

Net external debt has fallen rapidly to 22.7% of GDP in 2018 from a peak of 751% at end-2009, but remains above the historical 'A' median of -8.0%. Notwithstanding the improvement in the external balance sheet in recent years, Iceland has a high dependence on commodity exports (37% of current account receipts) and lacks diversification in its export base, which makes the economy vulnerable to terms of trade shocks and the krona sensitive to capital flows.

The current account deficit is forecast to narrow to 2.9% of GDP in 2018 (2017: 3.3%), and further to 1.9% by 2020 as tourism activity slows (historical 'A' median: 1.1%). Despite the depreciating krona, FX reserves have been maintained at a robust 6.7 months of 2018 current external payments in October 2018. On 2 November 2018, the CBI lowered the special reserve requirement ratio to 20% (from 40%), shoring up investor appetite for krona assets.

The Icelandic pension funds sector's expected portfolio rebalancing to diversify assets overseas (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 finance metrics are consistent with 'A' rated peers, with the general government budget surplus averaging 1.2% of GDP in 2018-2020, compared with a budget deficit averaging 0.9% of GDP for the current 'A' median. The 2019 budget envisages a slight increase in expenditure in transport infrastructure and healthcare, while higher child benefits, reduced levies on incomes and housing support should lend some support to lower income earners and facilitate labour wage negotiations.

Gross general government debt at 36.7% of GDP has fallen rapidly from a peak of 92.0% in 2011 and is now slightly lower than the 'A' median (40.9% of GDP). However, compared with the medians, Iceland's debt has a high 20% of foreign currency debt, higher debt interest costs (7.3% of revenues) and a higher share coming due in a year at 7.3% of GDP.

Average yields for Icelandic government bonds have been rising since end-July 2018, partly reflecting waning investor confidence due to risks of a faster slowdown in Iceland's tourism sector from news of the airline facing financial distress. Risks from higher inflation, stronger than expected wage growth in the upcoming negotiations and a sharp weakening of the krona are also likely to be driving up the government's bond yields. Yields for the bond maturing in December 2025 peaked at 6.2% at end-October, but have since moderated slightly to 5.8% at end-November. While near-term risks are driven by bond yields, Fitch expects government interest costs to be manageable and continue falling due to overall debt reduction.

Iceland has a very high income per capita, estimated at USD77,040 in 2018, making it more aligned with the 'AAA' median of USD59,780. The small island economy's performance on the measures of governance, human development and ease of doing business are also more in line with that of 'AAA' and 'AA' rated countries.

DERIVATION SUMMARY

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.

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 8.4% by 2028. Fitch has not included any proceeds from further sales 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 30.0% by 2020 and remain relatively constant.

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:
- 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 negative rating action are:
- Evidence of overheating in the domestic economy, for example through wage-price spirals, inflation overshoots, and adverse effects on fiscal, household and corporate balance sheets.
- Excessive capital outflows leading to external imbalances and pressures on the exchange rate.

SUMMARY OF FINANCIAL ADJUSTMENTS

Iceland's General Government Balance as reported by Eurostat and the National Statistical Agency was revised down to 0.0% of GDP from 1.5% (actual data) at the time of our previous review, due to a revision of accounting treatment for a capital transfer to the public pension fund. Fitch understands that this is likely to be reversed, but has yet to be reflected by the statistical agency and Eurostat.

Additional information is available on www.fitchratings.com

Applicable Criteria

Sovereign Rating Criteria (pub. 19 Jul 2018) (/site/re/10037181)
Country Ceilings Criteria (pub. 19 Jul 2018) (/site/re/10037793)

Additional Disclosures

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