Fitch Ratings

Fitch Upgrades Iceland's ST Ratings to 'F1+'; Affirms LT Ratings at 'A'/Stable

Link to Fitch Ratings' Report(s):

Iceland - Rating Action Report

Fitch Ratings - London - 24 May 2019:

Fitch Ratings has upgraded Iceland's Short-Term (ST) Foreign- and Local-Currency Issuer Default Ratings (IDR) to 'F1+' from 'F1', and raised Iceland's Country Ceiling to 'A+' from 'A'. Fitch has also affirmed Iceland's Long-Term IDRs at 'A' with Stable Outlooks.

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

Key Rating Drivers

The upgrade of Iceland's ST IDRs reflects the following key rating driver and its relative weight:

High

Fitch has upgraded Iceland's ST ratings as a result of the application of its updated ST rating criteria. Iceland's affected ratings have been removed from Under Criteria Observation (UCO), where they were placed following the publication of the updated ST rating criteria on 02 May 2019. The details of the revision of the ST rating criteria as applied to sovereign issuers are laid out in our rating action commentary "Fitch Places Iceland's Short-Term Ratings Under Criteria Observation" dated 3 May 2019. More information on our new criteria approach is available at https://your.fitchratings.com/short-term-credit-2019.

The raising of Iceland's Country Ceiling reflects the following key driver:

Restrictions on the remainder of offshore krona assets held in restricted accounts (3.2% of GDP) were lifted in March 2019, allowing the assets to be converted into foreign currency assets at market rates. Capital controls that prevented large-scale capital outflows during the banking crisis have almost entirely been lifted.

Iceland's 'A' Long-Term IDRs reflect the following key rating drivers:

Iceland has a very high income per capita and outperforms the peer medians on governance, human development and doing business metrics. These strengths are set against the small size of its economy and limited export diversification, resulting in vulnerability to external shocks and macroeconomic and financial volatility.

Real GDP growth averaged 4.6% in 2017-2018, after a cyclical high of 6.6% in 2016 as the overheated tourism sector cools. We forecast real GDP growth to fall to 0.0% in 2019 (revised down from 3.0% growth at the time of our December 2018 review) as a result of short-term shocks in tourism and fisheries. Investments are expected to contract sharply as sentiment is weighed down by the shocks, while net exports should contract by a lesser extent. Private consumption should slow but continue to support growth. Fitch forecasts the economy to recover from the short-term shocks by 2H19, bouncing back to 2.5% growth in 2020 and to average around 2% in the medium term.

The troubled budget airline WowAir's collapse in March 2019 accelerated the slowdown in the tourism sector and has caused a contraction in tourism capacity in 1H19. This was compounded by the grounding of IcelandAir's Boeing 737 Max jets. Airport passenger arrivals fell by 11.7%yoy in April, and could fall further before partly recovering in summer 2019 when replacement aircraft and expansions by other airline operators are expected. Iceland's volatile pelagic fishing sector also suffered a shock from the absence of capelin in Iceland's waters this season. Capelin accounted for 0.5% of GDP in exports in 2018, but the loss should be partly offset by the growth in fish farming exports.

Labour market tensions have eased. WowAir's collapse precipitated the conclusion of a private sector wage agreement amounting to average salary increases of 3.6% per year for the next four years. This round of talks had been more acrimonious than previous rounds, with an increase in tourism and transport sector strikes. A feature to link wage increases in later years to GDP per capita could see faster wage growth, but prevents unit labour costs from outpacing productivity. Assuming moderate agreements in the ongoing public sector wage talks, national wage growth should be contained at 4.5%yoy in 2019 and 2020, limiting upward pressure on inflation and further loss of competitiveness. The unemployment rate continues to be near historical lows at 2.9% in March 2019, but we forecast a rise to an average of 3.5% by 2020 as labour-intensive tourism activity declines.

HICP inflation picked up to 3.2%yoy in April 2019, driven by the depreciation of the krona, higher energy prices and rising air travel fares. Fitch forecasts inflation to ease for the rest of the year averaging 1.5% for 2019 as energy inflation fades and as aggregate demand softens. With a softening inflation and growth outlook, Fitch expects the Central Bank of Iceland (CBI) to lower rates in 2019.

In March 2019, the CBI further liberalised capital controls, removing restrictions on the remaining offshore krona assets from being converted to foreign-currency assets at market rates. Despite the further lifting of controls and the WowAir shock, the krona was relatively stable, falling by just 1.8% against the US dollar in March and April 2019. This was partly due to the CBI intervening in the FX market and lowering the special reserve requirement ratio to 0% (from 20%), shoring up investor appetite for krona assets.

The current account surplus is forecast to narrow to 2.5% of GDP in 2019 (2018: 2.9%) as tourism service and fish exports fall (historical 'A' median: 1.1%). FX reserves have stayed at a robust 6.1 months of current external payments at end-2018. Six years of large current account surpluses have rapidly reduced net external debt to 24% of GDP in 2018 (2015: 40%), but net external debt remains above the current 'A' median of 16%. Notwithstanding the improvement in the external balance sheet in recent years, Iceland has a high dependence on commodity exports (38% 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 Icelandic pension funds sector's expected portfolio rebalancing to diversify assets overseas (approximately 26% of assets are invested abroad at end-2018) following years of capital controls could result in strong capital outflows as the interest rate differential between domestic and global assets narrows. In 2018, pension funds made investments in foreign-currency assets amounting to 3.9% of GDP. The sector is made up of 21 funds (assets worth 1.5x GDP in 2018) with considerable heterogeneity and a strong preference for krona assets to match krona-denominated liabilities.

Fitch forecasts the general government surplus to narrow to 0.6% of GDP in 2019 from 1.1% in 2018, before improving slightly to 0.8% in 2020, compared with a budget deficit of 1.4% of GDP for the current 'A' median. This includes our expectation that automatic stabilisers would be allowed to respond to the short-term economic shock from the collapse of WowAir and the failure of the capelin fishing catch in 1Q19. This differs from the government's current fiscal plan targeting a general government surplus of at least 1.2% of GDP in 2019 and to average 1.0% in 2020-24. Gross general government debt is marginally lower than the 'A' and 'AA' medians, and under Fitch's forecasts will fall to 36% of GDP in 2019 (2018: 38%) and stabilise at 30% from 2021.

The direct impact of WowAir's collapse on Icelandic banks is expected to be insignificant, with an estimated ISK1.2 billion in write-offs accounting for just 0.03% of 2018 banking system assets. Banks are highly capitalised (combined capital adequacy ratio of 23% at end-2018) with low non-performing loan ratios (2.2% at end-2018) and should be resilient to a decline in the tourism sector (9% of banks' loan portfolio), although a downturn in the housing sector, which has been supported by demand for tourist accommodation could pose more significant challenges. House price growth slowed from the peak of 24.2%yoy in July 2017 to 4.6%yoy in April 2019. The impact on the banking sector could be exacerbated by a rise in supply as many hotels and homes are completed in the coming years.

Iceland has very high income per capita, estimated at USD73,949 in 2018, making it more aligned with the 'AAA' median of USD60,953. Its 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. Broad political consensus among political parties on macroeconomic and fiscal policy has underpinned the rebuilding of fiscal and external buffers.

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 longer-term debt projections, Fitch assumes nominal GDP growth of 4.5% per year, government primary balance of 2.0% of GDP, and a nominal effective interest rate of 7.5% by 2028. 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 and stabilise at around 30.0% by 2021.

RATING SENSITIVITIES

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

- A sustained fall in the public debt ratio, supported by prudent fiscal policy.

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

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

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

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

Liquidity and Debt Structure

Summary of Financial Adjustments

Sources of Information

RATING ACTIONS

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

senior unsecured	ST F1+ Upgrade		F1

Additional information is available on www.fitchratings.com

Applicable Criteria

Sovereign Rating Criteria (pub. 19 Jul 2018)
Country Ceilings Criteria (pub. 19 Jul 2018)
Short-Term Ratings Criteria (pub. 02 May 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

DISCLAIMER

COPYRIGHT

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.

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 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.

Fitch Updates Terms of Use & Privacy Policy