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FitchRatings

Fitch: Iceland Election Creates Near-Term Political Uncertainty

Fitch Ratings-London-03 November 2017: Iceland's general election on 28 October looks set to be followed by time-consuming coalition talks, increasing near-term policy uncertainty, Fitch Ratings says. Previous episodes of political uncertainty have not deflected Iceland's continuing recovery from the 2008 financial crisis, but policy choices by the next government could affect the pace of debt reduction.

A record eight parties are represented in the new parliament. The Independence Party, which led the previous coalition government, remains the largest party, but Iceland's president has given Katrin Jakobsdottir, leader of the Left-Green Movement, which came second, a mandate to explore forming a government. Jakobsdottir has said that she plans to work towards a four-way coalition of the Left-Greens, the Social Democratic Alliance, the Progressive Party and the Pirate Party. Together these parties would command a one-seat majority.

Jakobsdottir has said that she thinks coalition talks will be quicker than after last year's elections. Nevertheless, four-way talks will be complex and are not certain to succeed. Forming a government after last year's elections took more than two months, during which time the president's mandate was handed to three different parties. So the composition of the next government may take time to emerge, and a fragile coalition or a minority government is possible.

Icelandic politics has been fluid and unpredictable in recent years. Last Saturday's snap election was called after the Independence Party-led coalition collapsed in September. That government had taken office in January, after elections were brought forward following a political scandal relating to the Panama Papers. Popular trust in the integrity of Icelandic politics has waned, and new parties, such as the anti-establishment Pirate Party, and the Centre Party (which split from the Progressive Party to contest the most recent election), have emerged.

This has not stopped Iceland's sovereign creditworthiness improving since the 2008 financial crisis. Our upgrade of Iceland's sovereign rating to 'A-'/Positive in July reflected a continued reduction in external vulnerability, rapid debt reduction, and robust economic growth. The improvement has been supported by successive governments' consistent policy implementation in key areas, such as capital control liberalisation (which was largely completed this year) and dealing with the estates of Iceland's collapsed banks.

Nevertheless, whichever parties form the next government will face macroeconomic challenges and fiscal policy choices that will have a bearing on Iceland's sovereign credit metrics. There is broad consensus on the need for infrastructure investments, but disagreement over financing methods. Greater reliance on debt financing would slow the pace of debt reduction. Conversely, using excess capital in the state-owned banks to pay down debt could contribute to faster debt reduction than anticipated.

Our end-2017 debt/GDP forecast of 44% (which would be less than half the end-2012 peak) incorporates the planned sale of the government's 13% stake in Arion Bank. It could be weeks before greater clarity on the new government's policy stance emerges, although the organic budget law should provide an anchor for fiscal policy and continued debt reduction.

The Positive Outlook on Iceland's sovereign rating reflects the strong momentum that has sustained economic, fiscal and external improvements. We forecast real GDP growth to remain above the 'A' category median, at 5.6% this year and 4.2% next year, helping to support debt reduction, while tourism should continue to support a large current account surplus. However, any incoming government may be called on to manage the potential risk of an overheating tourism industry, which is driving economic growth but also fuelling rapid house price increases.

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