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Research Update:

Republic of Iceland 'A/A-1' Ratings Affirmed; Outlook Stable

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Table Of Contents

Research Update:

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Overview

- We expect the currently overheated Icelandic economy to gradually cool down over the next few years. The current account balance will weaken as tourism sector growth moderates amid the Icelandic krona's rapid appreciation.
- At the same time, we forecast continued strong fiscal performance with net general government debt stabilizing at 30% of GDP over the next four years.
- We are affirming our 'A/A-1' ratings on Iceland.
- The outlook is stable.

Rating Action

On June 8, 2018, S&P Global Ratings affirmed its long- and short-term foreign and local currency sovereign credit ratings on the Republic of Iceland at 'A/A-1'. The outlook is stable.

Outlook

The stable outlook balances the risks stemming from the domestic economy overheating against the potential for more rapid improvements in the government and external balance sheets over the next few years.

We could raise the ratings on Iceland if its external and fiscal performance were to significantly exceed our current expectations, improving its public and external balance sheet well beyond what we currently anticipate.

We could lower the ratings on Iceland if economic overheating were place at risk its long-term growth prospects, balance of payments performance, or financial stability.

Rationale

The ratings on Iceland reflect the country's strong institutional framework and general policymaking effectiveness, comparatively low net general government debt at 30% of GDP, and high per capita income levels. The ratings are constrained by Iceland's vulnerability to external developments as well as typically high volatility throughout the economic cycle. The ratings are also constrained by risks stemming from the domestic economy overheating.

Institutional and Economic Profile: The overheating of the domestic economy poses risks, but so far we project a soft landing

- GDP growth will moderate to 2%-3% in 2018-2021, cooling off from a brisk expansion.
- Signs of overheating are showing in the domestic economy and could pose risks.
- Still, with GDP per capita of over US$70,000, Iceland's income levels are among the highest globally, while the economy also benefits from high education standards and favorable demographics.

The economy of Iceland expanded by 3.6% in real terms in 2017, which is a notable slowdown compared to 7.5% real GDP growth in 2016. We project growth will further moderate to 2.8% in 2018. This will be partly driven by a slowdown in the pace of tourism sector expansion but also by the completion of some investment projects, for instance in the metals sector. This should help cool the recent economic overheating, which has been particularly evident in recent exchange rate, labor, and housing market trends.

That said, we continue to see multiple risks.

Several rounds of wage negotiations are coming up in 2018 and early 2019. Iceland has a history of wage increases notably exceeding productivity growth and inflation. Given the recent strong economic performance, we believe certain labor market groups could demand substantial wage hikes, which may have country-wide implications if other groups follow on. In our view, this poses risks to the competitiveness of the domestic economy.

Competitiveness risks are also stemming from the strengthening of the Icelandic krona exchange rate, which has appreciated by over 20% in real effective terms (CPI-based) over the last three years. The tourism sector underpinned much of Iceland's recent economic expansion, posting double-digit growth rates in 2012-2016. It has also contributed significantly to the strengthening of Iceland's balance of payments position, ultimately facilitating the resolution of the old overhang and the removal of capital controls in March 2017. However, the rapid expansion has also been a key factor behind the aforementioned strengthening of the exchange rate. Together with wage hikes, this presents competitiveness challenges for the domestic economy. This is particularly the case for sectors with predominantly krona-denominated costs, such as IT, and in the long-run could undermine Iceland's diversification prospects. Positively, these risks are somewhat mitigated by the country's flexible labor markets: labor importation has picked up substantially in recent years, which at least partially alleviates the impact of rising domestic costs.

During the first few months of 2018, there have been signs of tourist inflows moderating. This likely stems from Iceland becoming an increasingly expensive destination as well as indicating capacity constraints. In our view, the moderation of inflows could actually prove positive for the broader economy as it reduces the overheating risks. We assume that tourist inflows will demonstrate a flat dynamic or only a slow growth over the next three years. As a result, we expect the exchange rate to weaken by 13% through 2021.

However, if tourism inflows were to abruptly decrease rather than flatten out, this could expose multiple vulnerabilities. Specifically, we believe that the housing market could weaken with knock-on effects on household and banks' balance sheets.

More broadly, we note that Iceland's economy remains small in absolute terms with GDP of US$24 billion in 2017. It is structurally volatile and ultimately dependent on the economic performance of main trading partners and developments in terms of trade, which have been particularly favorable over the last few years. Even so, at US$71,000 in 2017, Iceland's GDP per capita is among the highest globally, which we view as a key strength. This is because high income levels indirectly indicate potentially higher resilience to withstand economic shocks, as well as a broader base that could theoretically be taxed.

We believe the country also benefits from high levels of education, favorable demographics, and the presence of natural resources, such as very competitive hydro and thermo energy production. These bode well for longer-term prospects.

Importantly, we view Iceland's institutional arrangements as another rating strength. There are broadly functioning checks and balances between various state bodies and consensus on key issues, such as the need to maintain a comparatively prudent fiscal position. Iceland's coalition government following the October 2017 snap elections comprises three parties spanning the left and right of the political spectrum. The coalition commands a narrow majority in parliament and, as such, we believe it could be more challenging to agree on some specific policy items. However, we do not expect a major shift in policy direction compared to recent years.

Flexibility and Performance Profile: Current account is set to weaken but fiscal and external buffers remain

- We forecast the current account to swing into deficit by 2020.
- Spending pressures remain but we project only modest fiscal deficits from 2019.
- Monetary policy flexibility has improved following the earlier lifting of capital controls but remains structurally constrained by the economy's size and significant dependence on foreign developments.

We project Iceland's current account balance to stand at 1.3% in 2018 and swing to a slight deficit by 2020. This is mainly driven by our projection of tourism receipts leveling off and strong consumption pulling in imports.

Strong growth in the tourism sector has underpinned a substantial improvement in Iceland's external position in recent years. We estimate that the economy is currently in a small net external asset position. While recent years' external performance has built up buffers against the reemergence of external financing pressures, a sudden stop of tourism revenues could pose a significant threat to Iceland's balance of payments. We expect the Central Bank of Iceland's (CBI) interventions and hence foreign exchange reserve growth to be rather limited, but we anticipate a pick-up in foreign investment by the Icelandic pension funds. They have had limited opportunities previously having spent years operating within the confines of capital controls. Overall, we forecast our preferred measure of net external indebtedness relative to current account receipts rising to around 53% by 2021.

On the back of the economic recovery, Iceland's fiscal performance has also improved, reaching a 1.5% general government surplus in 2017. We project modest deficits from 2019 onward. This is based on the government's fiscal agenda, which includes infrastructure and health care investments, increased spending on social services, and some loosening of tax policy with only limited revenue-raising measures. We believe further spending pressures could emerge, including for political reasons, given the only narrow majority commanded by the current administration. Combined with our more conservative growth projections, this underpins our fiscal deficit forecasts from 2019 while the government currently projects the general government sector to post recurrent surpluses in the medium term, as outlined in a recent fiscal policy statement. Given our deficit projections, we forecast net general government debt to stabilize at close to 30% of GDP.

There is potential, however, for the pace of debt reduction to be faster than we presently anticipate. This could happen, for example, if the authorities go ahead with the sale of commercial banks and use the proceeds to pay down debt (which we have not factored into our base-case scenario). It could also happen if the fiscal policy is tightened more in an attempt to cool off the economic boom, but that so far seems difficult given the composition of the governing coalition.

We still see some risks from contingent fiscal liabilities--particularly from the high stock of government guarantees to public-sector entities, such as the Housing Financing Fund or energy company Landsvirkjun--which we currently assess as moderate.

In our view, Iceland's monetary flexibility has improved following the March 2017 lifting of capital controls and given the adherence to a broadly flexible exchange rate arrangement since then. We also believe that the accumulation of substantial extra net foreign exchange reserves has underpinned the CBI's improved ability to act as a lender of last resort for the domestic banking system both in foreign and local currencies. Nevertheless, policy effectiveness remains limited by the structural features of the Icelandic economy, including its small size and the inflation level's pronounced dependence on the value of the exchange rate and foreign prices.

We also note that Iceland's real effective exchange rate (REER) tends to be particularly volatile over the economic cycle, and subject to large valuation swings that have historically exacerbated the cyclicality already inherent in Iceland's economy. According to CBI data, the consumer price index-based REER has appreciated steeply in recent years (by 30% since end-2014) and now hovers at the level of the pre-2008 peak. The REER calculated on the basis of unit labor cost has appreciated by an even larger 40% over the same period. Inflation has only recently, in first-quarter 2018, reached the central bank's 2.5% target after three years of hovering slightly below 2.0%. We expect inflation to slightly accelerate to 3.0% in 2018-2019 before moderating again to 2.5% thereafter.

The Icelandic banks remain well-capitalized and liquid. Domestic credit has picked up lately, and we expect it to grow roughly in line with nominal GDP over the next three years. This is a notable turnaround as domestic credit growth has been negative until 2015. Importantly, substantial house price hikes, particularly in the capital area, have therefore not been fueled by the financial system funding to the domestic economy. In fact, private sector leverage has been on a steady declining trend as a percentage of GDP since 2008 and has only recently shown signs of picking up.

In our view, there are risks stemming from the increasing role pension funds are playing in providing domestic credit. Over the last few years, they have been increasing their share of the market at the expense of commercial banks. The market share in total lending to households has risen to 18%, from 10%, over the last two years. We see risks stemming from this development as the pension funds' supervision and their capacity to monitor credit risks is untested. We understand that there is a built-in adjustment mechanism in that the poor performance of a pension fund could ultimately lead to a lower pension payout. However, this could then affect the financial position of households and may also have fiscal implications.

For more information on the banking system, see "Banking Industry Country Risk Assessment: Iceland," published Feb. 21, 2018.

Key Statistics

Table 1

Iceland Selected Indicators										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. ISK)	1,788	1,900	2,021	2,235	2,453	2,555	2,702	2,847	2,986	3,122
Nominal GDP (bil. $)	14	16	17	17	20	24	26	26	27	27
GDP per capita (000s $)	44.7	48.3	53.1	51.5	61.1	70.7	73.7	74.8	74.3	72.9
Real GDP growth	1.3	4.3	2.2	4.3	7.5	3.6	2.8	2.5	2.3	2.0
Real GDP per capita growth	1.0	3.6	1.0	3.2	6.4	1.9	(0.2)	1.0	0.8	0.5
Real investment growth	5.3	2.2	16.5	18.7	22.5	9.3	4.0	3.0	3.0	3.0

Table 1

Iceland Selected Indicators (cont.)										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Investment/GDP	16.0	15.4	17.3	19.1	21.5	22.2	22.8	23.4	24.1	24.9
Savings/GDP	17.7	23.4	23.1	25.3	29.2	25.8	24.0	23.7	23.6	23.7
Exports/GDP	56.7	55.2	52.9	53.2	48.4	47.0	46.4	46.6	47.0	47.4
Real exports growth	3.6	6.7	3.2	9.2	10.9	4.8	3.0	3.0	2.5	2.5
Unemployment rate	6.0	5.4	5.0	4.0	3.0	2.8	2.8	3.0	3.5	3.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	1.7	8.1	5.9	6.1	7.7	3.7	1.3	0.3	(0.5)	(1.3)
Current account balance/CARs	2.6	13.2	10.1	10.6	14.1	7.1	2.6	0.6	(1.1)	(2.5)
CARs/GDP	63.0	61.4	57.8	57.9	54.4	51.4	49.7	50.0	50.5	51.1
Trade balance/GDP	0.7	0.4	(0.5)	(1.6)	(4.1)	(6.5)	(7.8)	(8.4)	(8.9)	(9.4)
Net FDI/GDP	29.6	(0.3)	4.2	4.1	3.5	0.3	2.0	2.0	2.0	2.0
Net portfolio equity inflow/GDP	0.6	(0.0)	(0.2)	(2.4)	(5.7)	(2.6)	(3.5)	(3.5)	-2	-2
Gross external financing needs/CARs plus usable reserves	95.5	96.6	99.8	93.4	90.2	80.3	86.4	90.0	93.2	95.4
Narrow net external debt/CARs	88.5	71.1	58.3	143.2	53.4	47.0	45.0	48.4	50.6	53.1
Narrow net external debt/CAPs	90.9	81.8	64.8	160.1	62.2	50.6	46.2	48.7	50.0	51.9
Net external liabilities/CARs	44.4	19.3	8.9	9.8	(7.9)	(14.8)	(19.3)	(20.6)	(18.3)	(16.2)
Net external liabilities/CAPs	45.6	22.2	9.9	11.0	(9.1)	(16.0)	(19.8)	(20.8)	(18.1)	(15.8)
Short-term external debt by remaining maturity/CARs	61.6	50.3	50.0	41.9	44.4	34.7	33.5	35.3	35.8	36.4
Usable reserves/CAPs (months)	8.2	5.8	5.4	5.5	6.2	7.6	6.3	6.0	5.6	5.3
Usable reserves (mil. $)	4,008	4,017	3,988	4,895	7,231	6,571	6,571	6,306	6,173	6,040
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.7)	(1.8)	(0.1)	(0.8)	(3.1)	1.5	0.5	(0.5)	(1.0)	(1.7)
Change in net debt/GDP	(7.4)	1.3	(6.5)	(3.0)	(3.7)	(4.4)	-2	0.7	1.3	2.0
Primary balance/GDP	1.0	2.7	4.6	3.7	0.9	5.5	3.5	2.2	1.6	0.9
Revenue/GDP	41.4	41.9	44.9	41.7	42.2	43.4	43.0	42.5	42.0	42.0
Expenditures/GDP	45.2	43.7	44.9	42.5	45.2	41.9	42.5	43.0	43.0	43.7
Interest /revenues	11.4	10.9	10.4	10.9	9.5	9.2	7.0	6.3	6.2	6.1
Debt/GDP	99.7	90.8	84.0	67.6	52.7	42.4	37.3	36.1	35.7	36.2
Debt/Revenue	240.5	216.8	187.1	162.2	125.1	97.6	86.8	85.0	85.1	86.2
Net debt/GDP	70.2	67.4	56.8	48.4	40.4	34.4	30.5	29.7	29.6	30.3
Liquid assets/GDP	29.5	23.4	27.1	19.2	12.3	8.0	6.8	6.5	6.2	5.9
MONETARY INDICATORS (%)										
CPI growth	5.2	3.9	2.0	1.6	1.7	1.8	3.0	3.0	2.5	2.5
GDP deflator growth	3.3	1.9	4.1	6.0	2.1	0.5	2.9	2.8	2.5	2.5

Table 1

Iceland Selected Indicators (cont.)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Exchange rate, year-end (LC/$)	128.99	115.55	126.90	129.59	112.82	104.42	106.00	109.18	114.64	120.37
Banks' claims on resident non-gov't sector growth	(5.2)	(2.6)	(2.9)	(0.1)	1.6	6.7	5.0	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	186.9	171.3	156.4	141.2	130.7	134.0	133.0	132.6	132.7	133.3
Foreign currency share of claims by banks on residents	N/A	N/A	9.8	9.4	8.9	9.7	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	14.1	18.5	18.0	16.5	8.6	9.7	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(0.3)	4.6	6.7	2.3	11.8	12.1	N/A	N/A	N/A	N/A

Savings is 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. Banks are other depository 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 nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key rating factors	
Institutional assessment	2
Economic assessment	2
External assessment	4
Fiscal assessment: flexibility and performance	2
Fiscal assessment: debt burden	4
Monetary assessment	4

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings

, April 7, 2017

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings History, June 5, 2018
- Sovereign Ratings List, June 5, 2018
- Global Sovereign Rating Trends: First-Quarter 2018, April 11, 2018
- Sovereign Risk Indicators, April 10, 2018. An interactive version is also available at http://www.spratings.com/sri
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 2018
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions, April 18, 2017
- Banking Industry Country Risk Assessment: Iceland, Feb. 21, 2018

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed

Iceland	
Sovereign Credit Rating	
Foreign and Local Currency	A/Stable/A-1
Transfer & Convertibility Assessment	A
Senior Unsecured	
Foreign and Local Currency	A
Foreign Currency	A-1
Short-Term Debt	
Local Currency	A-1

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.