Iceland (/gws/en/esp/issr/80442256)

FitchRatings

Fitch Affirms Iceland at 'A'; Outlook Stable

Fitch Ratings-London-08 June 2018: Fitch Ratings has affirmed Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'A' with a Stable Outlook.

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

KEY RATING DRIVERS
Iceland's 'A' IDRs balance very high income per capita, strong performance on governance, human development and doing business indicators against high commodity export dependence, vulnerability to external shocks and experience of macroeconomic and financial volatility.

Net external debt has fallen sharply to 30% of GDP at end-2017, from a peak of 751% at end-2009 as external liabilities of the old banks were reduced. Notwithstanding this and the resilience of the krona to the lifting of virtually all capital controls in March 2017, a high 35% commodity exports share of current account receipts, and lack of diversification in the export base make the economy vulnerable to terms of trade shocks and the krona sensitive to large capital outflows. A healthy 6.9 months of imports in foreign exchange reserves at end-2017 partly mitigate these external finance risks.

Iceland has recorded strong current account surpluses (five-year average of 5.3% of GDP against the 'A' median of 2.0%), driven by favourable terms of trade and robust growth in tourism activity, which have led to a strong appreciation of the krona (19% against the US dollar between 2015 and 2017). A slowdown in tourism growth narrowed the current account surplus to 3.7% of GDP (2016: 7.7%), which Fitch forecasts to fall further to 2.2% and 1.1% of GDP in 2018-2019, additionally dampened by a widening trade deficit due to robust domestic demand and rising oil prices.

The Icelandic pension funds sector's expected portfolio rebalancing to diversify asset holdings internationally (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 finances are slightly stronger than the 'A' and 'AA' medians, with the general government balance in surplus at 1.5% of GDP and forecast to remain at an average of 1.2% of GDP in 2018-2019. The new coalition government that was formed in November 2017, the third in 18 months, spans both ends of the political spectrum but was able to reach an agreement on fiscal policy that targets lower surpluses relative to the previous government's plans. The plan continues the pro-cyclicality of fiscal policy in recent years, which represents a deterioration in the structural balance of 4pp of GDP over 2015-2018 according to the Central Bank of Iceland, but adheres to the fiscal rules enshrined in the organic budget law. There are also political pressures for increasing expenditure in the lead up to tripartite wage negotiations at end-2018.

Gross general government debt-to-GDP fell slightly below the 'A' median of 47.4% in 2017 to 42.4%, under half of its 2011 peak. Debt reduction has primarily been financed by financial stability contributions from the old banks' estates, and was further accelerated by strong nominal GDP growth with a five-year average of 7.4% in 2017 and the strong krona appreciation. Fitch forecasts gross government debt-to-GDP to continue falling to 38.8% in 2018, and 35.2% in 2019, helped by the sale of the 13% public stake (0.9% of GDP) in Arion Bank in February 2018, and to stabilise around 30% by 2025 as the government accumulates assets and maintains an annual debt issuance target. Debt maturities and interest payments as a share of GDP are expected to remain significantly higher than the 'A' median. Roughly 3% of GDP in offshore krona government bonds are still restricted from being converted to non-krona assets at the market rate.

Real GDP growth in Iceland has been significantly stronger than the rating peer medians, with the five-year average growth of 4.4% (A median: 3.0%; AA median: 2.3%). Growth peaked in 2016 at 7.5% before slowing to 3.6% in 2017 as the positive output gap narrowed and the strong krona slows tourism growth. Fitch forecasts growth to slow further to 3.3% in 2018 and 2.9% in 2019.

National CPI inflation (Iceland's main inflation measure for monetary policy) has been relatively stable since 2014 and measured 2.0%yoy in May 2018. HICP in contrast measured -0.7%yoy in April, reflecting the exclusion of housing costs. The stability in CPI inflation masks strong inflationary pressure from housing costs, which offsets underlying disinflation in the economy from the pass-through of the krona appreciation in recent years. As tourism growth slows, these two effects are likely to offset each other. However, rising global oil prices is likely to support inflation while there is upside risk to higher wages due to increasingly vociferous demands from trade union leaders and a heightened sense of inequality amidst rising housing costs and rising costs for low wage earners, leading up to the end-2018 wage negotiations.

Iceland has a very high income per capita, estimated at USD70,795 in 2017, making it more aligned with the 'AAA' median of USD55,241. The small island economy's performance on the measures of governance, human development and ease of doing business are also consistent with that of 'AAA' and 'AA' rated countries.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
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.

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

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 6.7% by 2027. Fitch has not included any proceeds from further sale 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 29.1% by 2027.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR affirmed at 'A'; Outlook Stable
Long-Term Local-Currency IDR affirmed at 'A'; Outlook Stable
Short-Term Foreign-Currency IDR affirmed at 'F1'
Short-Term Local-Currency IDR affirmed at 'F1'
Country Ceiling affirmed at 'A'
Issue ratings on long-term senior unsecured foreign-currency bonds affirmed at 'A'
Issue ratings on long-term senior unsecured local-currency bonds affirmed at 'A'
Issue ratings on short-term senior unsecured foreign-currency commercial paper affirmed at 'F1'
Issue ratings on short-term senior unsecured local-currency bond/note affirmed at 'F1'

Contact:
Primary Analyst
Eugene Chiam
Director
+44 20 3530 1512
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Secondary Analyst
Ed Parker
Managing Director
+44 20 35301176

Committee Chairperson
Charles Seville
Senior Director
+1 212 908 0277

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com

Additional information is available on www.fitchratings.com

Applicable Criteria

Country Ceilings Criteria (pub. 21 Jul 2017)
(https://www.fitchratings.com/site/re/901393)
Sovereign Rating Criteria (pub. 23 Mar 2018)
(https://www.fitchratings.com/site/re/10024428)

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