FitchRatings

RATING ACTION COMMENTARY

Fitch Revises Iceland's Outlook to Stable; Affirms at 'A'

Fri 18 Mar, 2022 - 5:06 PM ET

Related Fitch Ratings Content:
Iceland - Rating Action Report

Fitch Ratings - London - 18 Mar 2022: Fitch Ratings has revised the Outlook on Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Stable from Negative and affirmed the IDR at 'A'.

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

KEY RATING DRIVERS

The revision of the Outlook reflects the following key rating drivers and their relative weights:

High

Macroeconomic Resilience: The revision of the Outlook to Stable reflects the resilience shown by the Icelandic economy to the pandemic shock and our expectation of a sustained growth recovery, which should facilitate fiscal deficit and debt reduction over time.

The Icelandic economy has proved more resilient to the pandemic shock relative to our initial expectations. Following a contraction of 7.1% in 2020, real GDP grew by 4.3% in 2021 and we expect growth at a similar pace in 2022. This was slightly better than our forecast at the previous review (4%) but weaker than the current 'A' peer median. The recovery is underpinned by a rebound in tourism flows, solid performance of the aluminium sector supported by high aluminium prices, improvement of the labour market and sizeable fiscal policy support. Private consumption and investment have been the main growth drivers. Net trade detracted from growth as imports grew at a faster pace than exports particularly in 4Q21 due to strong domestic demand.

Recovery to Continue: We expect real GDP to grow by 4.5% in 2022 and 3% in 2023 (vs current 'A' peer medians of 4.3% and 3.5%). High aluminium prices will improve Iceland's terms of trade and the lifting of all border containment measures in February should support the recovery in the tourism sector. Private consumption and investment will remain the main growth drivers, supported by further declines in unemployment and the government's "Investment and Construction" initiative.

Higher fuel and food prices represent a shock, but household purchasing power and industry profit margins are likely to be less affected by higher energy costs than the rest of Europe. The share of renewables in the energy mix, at above 80%, is the highest in Europe, and Iceland does not rely on natural gas.

Medium

Gradual Deficit Reduction Ahead: The general government deficit widened to 8.9% of GDP in 2021 from 8.7% in 2020, a better outturn relative to our expectation at the previous review (10% of GDP) but worse than the current 'A' median (7% of GDP). We expect the deficit to decline to 6.5% of GDP as the recovery in revenue growth strengthens and the majority of pandemic-related fiscal support unwinds. For 2023 we expect a deficit of 4.8% of GDP, above the projected 'A' median (3.3% of GDP) and the Western European median (2.1% of GDP). The government does not intend to reinstate its own fiscal rules before 2026. In our view, this suggests that fiscal consolidation will be gradual and that the government will likely extend further fiscal support to the economy should the recovery be weaker than expected. This poses risks to the fiscal adjustment.

High Financing Flexibility: We expect general government debt to remain broadly stable at around 75% of GDP in 2022-23 and to decline slowly thereafter. The sovereign has high financing flexibility due to the extremely large pool of private pension funds' assets (194% of GDP), 65% of which was invested domestically at end-2020. The government also has strong access to the international bond market, a large cash deposit buffer and is supported by robust liquidity in the banking system. Moreover, government assets are large at 84% of GDP. In June 2021, the Treasury sold 35% of its stake in Islandsbanki, raising ISK55 billion (1.7% of 2021 projected GDP), which was earmarked for public debt reduction. Further sales of government equity stakes could accelerate debt reduction over the coming years.

Iceland's 'A' rating also reflects the following key rating drivers:

Tourism Rebound to Strengthen: Foreign tourist arrivals swiftly recovered in 2021but have room to recover further in 2022. Between August and November 2021, foreign tourist arrivals were above 60% of 2019 levels and tourism receipts peaked at above 80% of 2019 levels. The positive trend was interrupted by the emergence of the Omicron variant. For 2021 as a whole, foreign arrivals were 35% of the 2019 level, up from 24% in 2020. With Covid-19 containment measures and travel restrictions lifted in February 2022, we expect the recovery in foreign tourist flows to continue. This will underpin services exports and private consumption growth.

Higher Inflation for Longer: Headline consumer price inflation rose by 6.2% in February, its highest level in nearly a decade. Inflation is being driven by domestic factors, such as rising housing costs (which are accounted for directly in the national measure of inflation) a more rapid rebound in economic activity and wage growth. Increasing global commodity prices are also contributing, but are not the main driver, due to the predominance of renewables in the country's energy mix. The Central Bank of Iceland (CBI) has withdrawn its pandemic-related accommodative policies and since May 2021 has raised the key policy rate to 2.75% from 0.75%. In addition, it has also adopted a raft of macro-prudential measures to cool the property market.

In our view, the combination of higher interest rates, macro-prudential measures and gradual withdrawal of fiscal support should mitigate house price pressures. Moreover, from 2023 oil and commodity prices should also start to decline. We therefore expect inflation to average 5.3% in 2022 and decline more markedly to 3.5% in 2023.

Strong Governance and Demographics: Iceland's 'A' rating is driven by its very high income per capita and very strong governance and human development indicators that are more consistent with those of 'AAA' and 'AA' rated countries. A favourable demographic composition (the share of people of working age was 65% in 2020) supports growth potential. The rating is constrained by the small size of the economy and limited export diversification that result in vulnerability to external shocks and capital account risks.

ESG - Governance: Iceland has an ESG Relevance Score (RS) of '5[+]' for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model. Iceland has a high WBGI ranking at the 94th percentile, reflecting its long track record of stable and peaceful political transitions, well established rights for participation in the political process, strong institutional capacity, effective rule of law and a low level of corruption.

RATING SENSITIVITIES

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Factors that could, individually or collectively, lead to negative rating action/downgrade:

-Public Finances: Evidence that the government's economic and fiscal strategy will lead to a resumption of an upward trajectory of the government debt/GDP ratio over time.

-Macro: Renewed economic weakness or an adverse shock, for example due to a slower-than-expected recovery in tourism, a sustained correction in the real estate market and material negative impact on the banking sector.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Public Finances: Greater confidence that the government debt to GDP ratio will be placed on a firm downward path, for example through implementation of a fiscal consolidation strategy or sustained GDP growth over time.

-Macro: Sustained economic recovery beyond 2022, for example supported by a diversification of the export base and without generating macroeconomic imbalances.

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.

In accordance with its rating criteria, Fitch's sovereign rating committee decided not to adopt the score indicated by the SRM as the starting point for its analysis because the SRM output is close to the threshold between 'A-' and 'A', and on the basis of our forecasts we expect it to improve to 'A'.
Assuming an SRM output of 'A', in accordance with its rating criteria, Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the LTFC IDR.

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 LTFC 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.

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BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Iceland has an ESG Relevance Score of '5[+]' for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and a key rating driver with a high weight. As Iceland has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Iceland has an ESG Relevance Score of '5[+]' for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight. As Iceland has a percentile rank above 50 for the respective Governance Indicators, this has a positive impact on the credit profile.

Iceland has an ESG Relevance Score of '4[+]'for Human Rights and Political Freedoms as the Voice and Accountability pillar of the World Bank Governance Indicators is relevant to the rating and a rating driver. As Iceland has a percentile rank above 50 for the respective Governance Indicator, this has a positive impact on the credit profile.

Iceland has an ESG Relevance Score of '4[+]' for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Iceland, as for all sovereigns.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING	PRIOR

Iceland	LT IDR A Rating Outlook Stable Affirmed	A Rating Outlook Negative
	ST IDR F1+ Affirmed	F1+
	LC LT IDR A Rating Outlook Stable Affirmed	A Rating Outlook Negative
	LC ST IDR F1+ Affirmed	F1+
	Country Ceiling A+ Affirmed	A+
senior unsecured	LT A Affirmed	A

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Apr 2021) (including rating assumption sensitivity)

Supranationals Rating Criteria (pub. 20 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	UK Issued, EU Endorsed

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