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

FitchRatings

Fitch Upgrades Iceland to 'A'; Outlook Stable

Link to Fitch Ratings' Report: Iceland - Rating Action Report (https://www.fitchratings.com/site/re/907605)

Fitch Ratings-London-08 December 2017: Fitch Ratings has upgraded Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'A' from 'A-'. The Outlook is Stable

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

KEY RATING DRIVERS
The upgrade of Iceland's IDRs reflects the following key rating drivers and their relative weights:

High
External vulnerability in Iceland has reduced considerably in recent years, and the economy has been resilient to the lifting of capital controls between October 2016 and March 2017 and repayment of external liabilities. International investor demand for Icelandic krona assets has resulted in capital inflows, which more than offset portfolio rebalancing capital outflows from Iceland. Consequently, the krona has appreciated strongly, by 8.1% yoy at end-November 2017 and 2.9% since end-February 2017. FX reserves have fallen from 9.3 months of current external payments at end-2016 but still represent a relatively strong 7.3 months.

Iceland has recorded strong current account surpluses (five-year average of 5.4% of GDP, higher than the 'A' median of 2.1% of GDP), driven by favourable terms of trade and robust growth in tourism activity. These surpluses, together with repayment of non-resident creditors of the failed banks' estates have supported external debt reduction and a significant improvement in the net international investment position (IIP) to 4.4% of GDP at end-3Q17 ('A' median: -23.5% of GDP at end-2016). Fitch forecasts the current account surplus to narrow to 2.1% of GDP by 2019 as private consumption and investment growth increases the import bill and as strong growth in tourism moderates.

Medium
The general government debt to GDP ratio remains on a downward trajectory, with Fitch forecasting a ratio of 45.0% of GDP by end-2017, below the 'A' median of 48.2%, faster than expected at the previous review and down from a peak of 94.7% in 2011. Sustainability in government debt is anchored by the debt reduction rule in the organic budget law. The sale of some of the government's stakes the banks may further contribute to debt reduction.

Iceland's 'A' IDRs also reflect the following key rating drivers:

Iceland has a very high income per capita, estimated at USD72,706 in 2017, making it more aligned with the 'AAA' median of USD53,582. The small island economy's performance on the measures of governance, human development and ease of doing business are also consistent with that of the 'AAA' and 'AA' rated countries.

Despite recent improvements to external buffers, the lack of diversification in Iceland's export base leaves the economy vulnerable to terms-of-trade shocks. The expected portfolio rebalancing of Icelandic pension funds to diversify asset holdings internationally following years of capital controls could also lead to capital outflows.

Icelandic real GDP growth has been very strong at an average 4.4% over 2013-2017 driven primarily by a robust tourism sector. Fitch has revised down its 2017 growth forecast to 4.0% (5.6% in our July 2017 review) due to slower net export growth. Tourism activity cooled slightly in the first two quarters as the appreciation of the krona slowed growth in tourist arrivals and receipts. A stronger than expected impact of the fishermen's strike in 1Q17 has also weighed on fish exports. Fitch forecasts growth to fall to 3.3% in 2018 and 2.9% in 2019 as the positive output gap closes. Growth is expected to be driven by private consumption, supported by rising real wage growth and strong terms of trade.

Inflation has been kept in check despite robust growth due to the strong krona. National CPI inflation has been relatively stable at slightly under the Central Bank of Iceland's 2.5% target, and measured 1.7% yoy in November 2017, supported by strong housing price developments. HICP inflation which excludes housing costs measured much lower at -1.2% yoy in October 2017 driven by strong pass-through of the appreciating krona. Fitch forecasts HICP inflation to rise to 1.0% in 2018 and 2.0% in 2019 due to higher nominal wage growth expected in 2018 wage talks, and as imported inflation fades.

Fitch expects broad policy continuity following snap elections held on 28 October 2017. The previous coalition government collapsed after just nine months due to the junior coalition partner withdrawing its support. Iceland's three biggest parties (the Independence, Left-Greens and Progress parties) recently formed a coalition government spanning different ends of the political spectrum with a narrow, three-seat majority in parliament and with the Left-Greens' leader, Katrin Jakobsdottir, holding the premiership.

The coalition agreement aims to reform the collective wage bargaining framework, increase infrastructure investments in the rural areas, reduce the lower tax rate and social security contributions, and gradually abolish indexation, among other issues. The new government will be required to present a new 2018 budget by end-December 2017. The new government will adhere to the debt reduction strategy in the organic budget law, but the treasury budget surplus is expected to be reduced compared with the draft 2018 budget presented in September 2017, primarily to increase welfare and health spending.

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 high degree of balance of payments volatility, which leaves the small economy vulnerable to external shocks.

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, put downward pressure on the ratings:
- Evidence of overheating in the domestic economy, for example through wage-price spirals, inflation overshoots, and adverse effects on household and corporate balance sheets.
- A weakened commitment to fiscal consolidation in the medium term.
- Excessive capital outflows leading to external imbalances and pressures on the exchange rate.

The main factors that could individually or collectively lead to a positive rating action are:
- Continued economic growth without excessive macroeconomic imbalances.
- Continued falls in the public debt ratio, supported by prudent fiscal policy.
- A build-up of a track record in resilience of the economy to external shocks, in the context of a more open capital account.

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 6.9% by 2026. Fitch has not included any proceeds from sale of the government's stakes in the banks in its debt dynamics. Under these assumptions, Fitch projects that government debt as a share of GDP will decline to 25.7% by 2026.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR upgraded to 'A' from 'A-'; Outlook Stable
Long-Term Local-Currency IDR upgraded to 'A' from 'A-'; Outlook Stable
Short-Term Foreign-Currency IDR upgraded to 'F1' from 'F2'
Short-Term Local-Currency IDR affirmed at 'F1'
Country Ceiling upgraded to 'A' from 'A-'
Issue ratings on long-term senior unsecured foreign-currency bonds upgraded to 'A' from 'A-'
Issue ratings on long-term senior unsecured local-currency bonds upgraded to 'A' from 'A-'
Issue ratings on short-term senior unsecured foreign-currency commercial paper upgraded to 'F1' from 'F2'

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Applicable Criteria
Country Ceilings Criteria (pub. 21 Jul 2017) (https://www.fitchratings.com/site/re/901393)
Sovereign Rating Criteria (pub. 21 Jul 2017) (https://www.fitchratings.com/site/re/901261)

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