FitchRatings

RATING ACTION COMMENTARY

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

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Iceland - Rating Action Report

Fitch Ratings - London - 22 May 2020: Fitch Ratings has revised the Outlook on Iceland's Long-Term Foreign-Currency Issuer Default Rating (IDR) to Negative from Stable and affirmed the IDR at 'A'.

KEY RATING DRIVERS

The revision of the Outlook on Iceland's IDRs reflects the following key rating drivers and their relative weights:

Medium

The revision of the Outlook to Negative reflects the deterioration in Iceland's near-term growth and public finance outlook caused by the coronavirus pandemic and risk of further adverse impact on the economy. As a small and highly open economy with a sizeable concentration in tourism and commodity exports, Iceland is exposed to the economic shock with a severe recession, widening budget deficits and significant rise in government debt. Iceland entered the COVID-19 crisis in a relatively strong starting position with a small average general government fiscal balance in 2017-2019, low net government debt, strong household balance sheet and large external reserves.

Fitch forecasts real GDP growth contracts by 8.5% in 2020, a substantial deterioration from 1.9% growth in 2019. Although our baseline scenario assumes the economy recovers in 2021, uncertainty regarding the scope and length of the pandemic creates significant downside risks.

The coronavirus pandemic will severely affect Iceland's tourism industry, which accounts for around 9% of the economy's GDP (excluding indirect effects) and 35% of total exports. Passenger traffic had been in decline already in the first quarter of the year (-25% yoy), driven by a reduction in airline seat capacity following the bankruptcy of the budget airline Wow Air in 2019, and the grounding of Icelandair's Boeing Max jets. As a result, we forecast foreign tourist arrivals to decline by 80% this year. While we expect a recovery in 2021, we forecast arrivals to remain 40% below their 2019 levels.

Having grown fivefold in less than a decade, the tourism industry has been one of the key drivers of Iceland's economic growth, wage increase, influx of foreign labour, and rising real estate prices. We expect Iceland's tourism sector to be particularly vulnerable to the ongoing shock, owing to an oversupply of tourism infrastructure, for example, the hotel capacity in the capital area is expected to increase by around 25% over the next three years.

We see risks that a prolonged contraction in the sector could spill over to other sectors of the economy, such as the real estate and banks. The commercial banks' loan book exposure to construction, real estate, and retail stood at 25% as of end-2019, with the tourism sector estimated at 9% of the total loan book. A sharp contraction in real estate prices could further weigh on growth through the wealth effect and depressed bank lending.

At the same time, the coronavirus pandemic poses challenges to Iceland's two other major export industries, the aluminium and fishing sectors, which account for 35% of total exports. A sharp contraction in global economic activity resulted in a steep decline in aluminium prices and weighs on the demand for aluminium products. The fishing industry is also vulnerable to the ongoing health crisis curbing demand for fresh fish from restaurants (30% of Iceland's marine exports), despite some diversification into frozen products.

Fitch forecasts the current account balance turns into a deficit of 2.3% of GDP in 2020 from a 5.8% surplus a year before. Capital account flows have so far been resilient, supporting FX reserves, which we expect to remain robust at above seven months of imports. The capital account will be supported by the pension funds (167% of GDP in total assets), which agreed with the Central Bank of Iceland to temporarily stop increasing investments abroad. However, this does not eliminate the risk of strong capital outflows from the funds, especially with the differential with international interest rates narrowing.

Fitch projects a sharp widening of the fiscal deficit to 9.0% of GDP in 2020 from a deficit of 1.0% in 2019, reflecting a rise in expenditure from automatic stabilisers and the government´s support measures. In Fitch's view, there is a risk that the medium-term fiscal stimulus will increase beyond our current forecasts. The government announced stimulus measures amounting to ISK129.4 billion (4.8% of GDP). To date, the government has introduced three support packages mostly focused on wage subsidies for part-time workers (recently extended until end-August, equal to 1.3% of GDP), subsidies of salaries during the notice period (0.7% of GDP) and acceleration of investment in 2020 (0.6% of GDP). At the same time, Fitch expects that weaker economic activity and higher unemployment will weigh on revenues. Tax deferrals, estimated at ISK100 billion (3.7% of GDP) have also been announced to support the economy in 2020.

The increase in the deficit, effects of krona depreciation, and likely crystallisation of some of the contingent liabilities should push general government debt to 53.3% of GDP at end-2020. This compares with 37.1% of GDP in 2019 and the all-time high of 92.0%. Fitch assumes around 20% of the total amount earmarked as guarantees for bridge and support loans (ISK 19.6 billion, or around 0.7% of GDP) will crystalise onto the government balance sheet.

Under our baseline scenario, Fitch expects a narrowing of the fiscal deficit in 2021 to 4.5% of GDP, as expenditure pressures fall and revenue growth recovers in line with the stabilisation of employment. This should help bring public debt/GDP down, to a forecast 51.9% in 2021. Iceland's track record of prudent fiscal policies and steady debt reduction in 2012-2019 support our view that fiscal consolidation and debt reduction is likely over the medium term. Under our baseline public debt dynamics, we forecast debt/GDP to decline slightly to 50.4% by 2024 although downside risks remain present.

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

Iceland's high level of wealth and relatively low indebtedness of the private sector are key rating strengths. At USD71,142 in 2019, Iceland's per capita income is above both medians for 'A' rated countries at USD23,184 and 'AAA' rated at USD60,236.

The increased share of foreign labour in the workforce has supported the flexibility of the labour market in recent years. The expected outflow of foreign labour could help to lower the unemployment rate through the crisis, but would have a further negative effect on private consumption. Despite the government's fiscal measures to support the economy, the lockdown has markedly affected labour market dynamics, with the registered unemployment rate increasing to 9.2% in March, up from a 3.6% average unemployment rate in 2019. At the same time, around 17% of the workforce has registered for the short-term work scheme.

Households' balance sheets are strong, with the assets at 256.5% of GDP by far exceeding the liabilities at 77.1% of GDP according to Eurostat data. The bulk of these assets is pension savings, which have served in the past as additional financial cushion in times of economic stress. Under the government stimulus package, individuals again have the flexibility to withdraw funds from their voluntary pension savings to a maximum of ISK800,000 (USD5,680) per month.

Deleveraging of the private sector and a build-up of buffers has been reflected in improvements to Iceland's external position. The net international investment position turned positive in 2018 and increased further to 22.5% of GDP as of end-2019. Net external debt also declined to 19.4% of GDP in 2019, in line with the 'A' rated median.

Large domestic assets under management of private pension funds, access to the international bond market, large cash deposit buffer (at around 9% of GDP), and robust liquidity in the banking system will help finance the deficits in 2020-2021.

Icelandic banks are highly capitalised, with combined capital adequacy ratio at 22.9% at 3Q19, broadly at the same level as in 2018 and comfortably above the regulatory threshold. Liquidity is ample, with the combined liquidity coverage ratio at 166% as of December 2019, also well above the regulatory minimum at 100%. Non-performing loans are low at 2.6% at end-2019 but slightly higher than 2.2% in 2018, driven by the shock to the tourism sector stemming from the collapse of troubled budget airline Wow Air in March last year.

Broad political consensus among political parties on macroeconomic and fiscal policy has underpinned the rebuilding of fiscal and external buffers over the last decade, providing Iceland with fiscal and monetary space to respond to the current shock. In Fitch's view, the government's swift response to the health crisis has contributed to a speedy decline in new infections, helping to avoid a strict lockdown of the economy.

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, as is the case for all sovereigns. Theses 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 93rd percentile that is more aligned with the 'AAA' median, reflecting its well established rights for participation in the political process, strong institutional capacity and effective rule of law.

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 did not adjust the output from the SRM to arrive at the final LT FC IDR.

The committee decided to remove the -1 notch on the external finances, which had reflected Iceland's vulnerability to external shocks, macroeconomic volatility and challenges to macroeconomic policy management on account of the lack of diversification in the export base and potential for balance-of-payments volatility. The current shock has exposed Iceland's vulnerability to external shocks and resulted in worse macroeconomic metrics and outlook, and deterioration in external finances, which have partly been reflected in the lower SRM score in this review.

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

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

- Severe and prolonged economic weakness, for example due to a larger than expected contraction in the export sectors or sustained correction in the real estate market and material adverse impact on bank asset quality.

- Failure to stabilise general government debt/GDP, for example due to lack of fiscal consolidation after the initial COVID-19 related support measures, weaker growth prospects or materialisation of contingent liabilities.

- Excessive capital outflows that precipitate macroeconomic instability or erosion of external buffers.

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

- Greater confidence that the economy will avoid a prolonged crisis, for example supported by diminishing downside risks in the export sectors.

- Greater confidence in general government debt/GDP stabilising in the medium term.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance 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.

KEY ASSUMPTIONS

We assume that the global economy develops in line with our Global Economic Outlook published on 22 April, with the global economy to go through a deep but short-lived recession in 2020 due to the pandemic. In particular, we forecast world GDP to decline by 3.9%, before recovering to 5.0% in 2021. Fitch notes that there is an unusually high level of uncertainty around these forecasts and that risks are firmly to the downside.

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 highly relevant to the rating and a key rating driver with a high weight.

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.

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 are relevant to the rating and a rating driver.

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 the 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(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Iceland	LT IDR	A	Affirmed

ENTITY/DEBT	RATING		
•	ST IDR	F1+	Affirmed
•	LC LT IDR	A	Affirmed
•	LC ST IDR	F1+	Affirmed
•	Country Ceiling	A+	Affirmed
• senior	LT	A	Affirmed

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 05 Jul 2019)

Sovereign Rating Criteria (pub. 27 Apr 2020) (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, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

Macro-Prudential Indicator Model, v1.4.0 (1)

Sovereign Rating Model, v3.12.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	EU Issued

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