FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Stable

Fri 10 Mar, 2023 - 5:01 PM ET

Fitch Ratings - Frankfurt am Main - 10 Mar 2023: 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

High Income, Strong Policy Buffers: Iceland's 'A' rating is underpinned by its very high income per capita and governance indicators that are more consistent with those of 'AAA' and 'AA' rated sovereigns. Despite its small sized economy, the country has built sizeable buffers, which help mitigate its vulnerability to external shocks and balance of payments' risks; including ample foreign reserves, and a comfortable fiscal cash buffer. Strong credit fundamentals also include the country's sizeable pension fund assets, sound banking sector, and strong private sector balance sheets.

The rating remains constrained by a high level of public debt and the small size of the economy with its limited export diversification.

Economic Slowdown: Iceland's post-pandemic recovery strengthened in 2022. The economy expanded by 6.4%, underpinned by robust domestic demand. Despite a strong rebound in tourism activity (with the number of foreign passengers through Keflavik airport in 2022 85% of the 2019 level), the contribution from net exports remained negative on account of significant import activity.

We forecast economic growth to slow to 2.1% in 2023. Tighter monetary policy and still elevated inflation, will mean a lower positive contribution from domestic demand. Although households' disposable income will benefit from the latest wage negotiations, higher inflation and interest rates have increased their debt-servicing burdens. Subdued investment growth is also forecast. Weaker global growth is expected to weigh on net exports.

Resilience to Energy Supply Shock: Iceland does not use natural gas in its energy mix, and therefore is not at direct exposure of any renewed volatility in the natural gas market of continental Europe. However, Iceland is exposed to volatility in global oil prices. While almost 90% of its energy consumption is domestically produced through renewable energy, the remaining share is imported, consisting entirely of petroleum products and consumed mostly by its transport and fishery sectors.

Elevated Inflation: Inflationary pressures have been much stronger than expected. February's inflation rate reached 10.2%, compared with 2.4% in February 2022. Fitch now forecasts annual inflation in 2023 of 7.5%, an upward revision of 3pp compared with six months ago, and only a modest slowdown from inflation of 8.3% in 2022.

The revision reflects risks associated with higher wage inflation, in addition to imported inflation which continues to trend upwards and affected partly by the weak króna. House prices have eased in recent months, but given the rise in the interest component of housing costs, we expect housing inflation to remain elevated for much of 2023.

CBI Policy Tightening: In its February monetary policy meeting, the Central Bank of Iceland (CBI) raised its key policy rate by 50bp to 6.50%. Since beginning its rate hiking cycle in May 2021, the CBI has increased its key rate by 575bp. In Fitch's opinion, monetary policy effectiveness in bringing down inflation may be hindered by larger than expected wage inflation for this year, following the latest wage negotiations (with still some negotiations outstanding, including the public sector). Both short- and long-term inflation expectations also remain well above the CBI's 2.5% inflation target.

We currently expect the CBI to undertake at least an additional rate hike in 1Q23. There is a risk that entrenched higher labour costs could translate to more persistent high inflation, as well as concerns for competitiveness.

Sound Banking Sector: The banking sector remains sound. Domestic systemically important banks hold significant capital (average 23%) and liquidity ratios (average 150%), with strong profitability (return on equity 10%, June 2022). Macroprudential oversight by the CBI remains vigilant against the backdrop of an overheated housing market, and high interest rate environment. In June 2022, the CBI tightened borrower debt service to income (DSTI) requirements and loan-to-value ratios (LTV) on mortgage loans, resulting in a slowdown in household credit demand.

Of the total household mortgages outstanding in the sector, 43% are inflation-indexed. Non-indexed mortgages (57% of total) are most vulnerable to interest rate increases. For now, we expect households to manage their increased debt service burdens, at the cost of temporarily lower consumption. An historically high savings ratio (10.8%, average 2015-2019) across the household sector will also help mitigate debt servicing risks.

Stable Public Debt Profile: Fitch estimates general government debt returned to its pre-pandemic ratio in 2022, declining to 66.5% of GDP, from 75.4% in 2021. Strong nominal GDP growth, proceeds from asset sales and the use of government deposits for fiscal financing supported the reduction in debt. We forecast debt to reach 64.5% of GDP by end 2023. Similar to 2022, the government plans to further divest its remaining stake in Íslandbanki, although Fitch has not included this in its debt assumptions.

Domestic fiscal rules remain suspended until 2026. Even so, Fitch expects general government debt to remain broadly stable over the medium term. The 2023 Budget outlines increased expenditure in areas of healthcare, R&D and domestic security. Inflation-linked social benefits and public sector wages will also increase this year. Total budgeted expenditures will increase compared with 2022, although this is expected to be offset by continued resilience in tax revenue growth.

Fiscal Financing Flexibility: For 2023 and 2024, debt maturities amount to 7.2% and 8.7% of GDP, respectively. The sovereign has a high degree of fiscal financing flexibility, underpinned by a large general government deposit buffer (Fitch estimates 11.5% of GDP end 2022) and robust liquidity in the banking system. Notably, around 65% of Iceland's significant pool of private pension fund assets (190% of GDP, end 2022) are invested domestically.

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

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

Public Finances: Looser fiscal policy that places the government debt/GDP ratio on an upward trajectory.

Macro: An adverse economic shock, for example due to a sharp correction in the real estate market.

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

Public Finances: A sharp and sustained decline in the government debt/GDP ratio.

Macro: Higher trend growth and evidence of economic diversification that reduces Iceland's vulnerability to external shocks.

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.

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.

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. As Iceland has a track record of 20+ years without a restructuring of public debt and captured in our SRM variable, this has a positive impact on the credit profile.

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 Stable
	ST IDR	F1+ Affirmed	F1+
	LC LT IDR	A Rating Outlook Stable Affirmed	A Rating Outlook Stable
	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. 11 Jul 2022) (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, v1.7.3 (1)

Debt Dynamics Model, v1.3.1 (1)

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

Sovereign Rating Model, v3.13.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	EU Issued, UK Endorsed

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