FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Stable

Fri 01 Mar, 2024 - 5:01 PM ET

Fitch Ratings - Frankfurt am Main - 01 Mar 2024: 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 very high income per capita and governance indicators more consistent with 'AAA' and 'AA' category sovereigns. Sizeable buffers mitigate the country's vulnerability to external shocks, including ample foreign reserves, and a fiscal cash buffer, which has been reduced in recent years. Strong fundamentals include sizeable pension fund assets, a sound banking sector, and strong private sector balance sheets. However, the rating remains constrained by Iceland's small size economy with limited export diversification and high public debt.

Economic Resilience: GDP growth is set to moderate in 2024 (to 1.9% vs 4.1% in 2023), but continue to outperform most European peers (Fitch's latest eurozone growth forecast is 0.7%). Tighter monetary policy has led to a more pronounced slowdown in domestic demand than previously anticipated. Despite strong labour market activity and positive real wage growth, private consumption slowed markedly in 2H23. Business sentiment also remains tepid, with imports of investment goods having contracted in 2H23.

Eventual easing of monetary policy and an improved external trade environment should boost growth in 2H24. A potential risk to our GDP forecast is the ongoing seismic unrest in the Reykjanes peninsula. Indicators for tourism have shown some recent weakness in demand, although we expect the outlook for the sector to remain positive. A stronger recovery in external trade and pick up in private sector investment will support real GDP growth of 2.7% in 2025.

Inflation Risks: The Central Bank of Iceland (CBI) has kept its key policy rate on hold at 9.25% since August 2023. The recent slowdown in domestic activity suggests the CBI's policy rate has likely peaked. However, we do not expect the CBI to begin monetary easing until late 2Q24. Headline inflation (6.6% in February 2024) has eased steady from its peak of 10.2% in February 2023, but it remains well above the inflation target of 2.5%. Elevated short and long-term inflation expectations also pose an inflationary risk to the current wage negotiations. In its latest forecast, the CBI does not expect inflation to align with its target until 2H26.

Declining Debt Ratio: Iceland's general government debt ratio has decreased significantly since peaking at 77.5% of GDP in 2020, driven by robust nominal GDP growth and use of accumulated cash deposits to paydown upcoming maturities. We forecast debt to have reached 61.6% of GDP in 2023, still well above the current median debt ratio of 'A' peers at 52.0% of GDP. For 2024-2027, a more moderate pace of debt decline is projected.

With the slower pace of GDP growth, debt reduction will be underpinned by a return to modest primary fiscal surpluses. We forecast debt this year to reach 58.1% of GDP, moderating to 55.9% by 2027. General government cash deposits as of end 2023 were 8.9% of GDP (Fitch estimates), down from peak of 16.7% of GDP in 2020.

Fiscal Risks Balanced: Risks to our baseline for Iceland's public finances remain fairly balanced. In our projections, we have not accounted for proceeds that could materalise from the government's planned privatisation of Íslandsbanki. It is also uncertain what financing the State Treasury will provide for the SPV set up to manage the home purchase programme for affected residents of Grindavík, either through possible on-lending or capital equity.

Low Fiscal Deficits: Authorities remain committed to prioritising fiscal consolidation. The 2024 Budget sets out various expenditure-saving and revenue-raising measures. There is overall restraint in investment spending, with ISK4.9 billion (0.1% of GDP) of previously planned infrastructure projects being postponed, although key investment priorities (such as in healthcare and social housing) have increased. Authorities also aim to streamline ministerial operations. Revenue-raising measures include an increase in fuel and alcohol excise duties, implementation of a new motoring tax scheme (Phase 1), and an increase and broadening of the hotel accommodation tax.

The budget targets a central government fiscal deficit of 1.0% of GDP in 2024, compared with Fitch's projected deficit of 1.5%. Our forecast assumes lower real GDP growth (1.9% vs Budget forecast of 2.1%). We have also assumed increased expenses related to the uncertain seismic activity in the Reykjanes peninsula.

Strong External Finances: Iceland has a positive net international investment position (29.7% of GDP in 3Q23), partly a reflection of its significant pension fund sector (assets 180% of GDP, end 2023). International reserves amounting to 18.3% of GDP (end 2023) provide a significant buffer against FX volatility risks.

The weaker external environment has weighed on current account developments, and we expect modest deficits in 2024-2025 averaging 0.2% of GDP. This compares with an average five-year surplus of 5.7% of GDP between 2015-2019. Expanding the capacity of Iceland's limited export industries (tourism, aluminum and fisheries) and diversification of domestic sectors will help reduce the country's vulnerabilities to external shocks. There are already early signs of investment into higher productivity and less cyclically sensitive sectors, such as biotechnology and ICT. Iceland is also well positioned to increase its global competitive advantage in fish farming.

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 93.2nd 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:** A marked deterioration in the debt/GDP ratio, for example, from a sustained period of fiscal loosening.

-Macro: A severe 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: Increased confidence in a sharp and sustained decline in the government debt/GDP ratio.

-Macro: Higher trend growth and/or 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.

COUNTRY CEILING

The Country Ceiling for Iceland is 'A+', 1 notch above the LT FC IDR. This reflects moderate constraints and incentives, relative to the IDR, against capital or exchange controls being imposed that would prevent or significantly impede the private sector from converting local currency into foreign currency and transferring the proceeds to non-resident creditors to service debt payments.

Fitch's Country Ceiling Model produced a starting point uplift of +2 notches above the IDR. Fitch's rating committee applied an offsetting -1 notch qualitative adjustment to this, under the Balance of Payments Restriction pillar reflecting Iceland's short track record of full liberalisation from capital controls that were previously in place during the extended period of 2008-2019.

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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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

FITCH RATINGS ANALYSTS

Kit Yeung
Director
Primary Rating Analyst
+49 69 768076 129
kit.yeung@fitchratings.com
Fitch Ratings – a branch of Fitch Ratings Ireland Limited
Neue Mainzer Strasse 46 - 50 Frankfurt am Main D-60311

Federico Barriga Salazar
Senior Director
Secondary Rating Analyst
+49 69 768076 145
federico.barrigasalazar@fitchratings.com

Thomas Rookmaaker
Senior Director
Committee Chairperson
+852 2263 9891
thomas.rookmaaker@fitchratings.com

MEDIA CONTACTS

Peter Fitzpatrick
London
+44 20 3530 1103
peter.fitzpatrick@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

Sovereign Rating Criteria (pub. 06 Apr 2023) (including rating assumption sensitivity)

Country Ceiling Criteria (pub. 24 Jul 2023)

APPLICABLE MODELS

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

Country Ceiling Model, v2.0.1 (1)

Debt Dynamics Model, v1.3.2 (1)

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

Sovereign Rating Model, v3.14.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	EU Issued, UK Endorsed

DISCLAIMER & DISCLOSURES

not listed on Form NRSRO (the “non-NRSROs”) and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

dv01, a Fitch Solutions company, and an affiliate of Fitch Ratings, may from time to time serve as loan data agent on certain structured finance transactions rated by Fitch Ratings.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch’s international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch’s approach to endorsement in the EU and the UK can be found on Fitch’s Regulatory Affairs page on Fitch’s website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.