FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Stable

Fri 30 Aug, 2024 - 5:01 PM ET

Fitch Ratings - Frankfurt am Main - 30 Aug 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, including ample foreign reserves and a large fiscal cash buffer, help mitigate Iceland's external vulnerabilities. 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 economy with limited export diversification and high public debt.

Cooling Economy: Iceland recorded one of the strongest post-pandemic recoveries among OECD economies, with real GDP at end-2023 11% above its 2019 level. However, a tight monetary policy stance and a slowdown in net exports is cooling economic activity. We forecast a moderation in real GDP growth to 0.6% in 2024, from 4.1% in 2023. High inflation is weighing on domestic demand, and despite robust wage growth, real wage gains remain modest. Tourism activity is also moderating from a high base, and combined with lower production in the marine and aluminium sectors, will contribute to a negative impact from net trade on GDP this year.

Medium-Term Growth Prospects: Fitch forecasts real GDP growth to recover to 1.9% in 2025 and 2.4% in 2026. Aided by R&D tax incentives, steady progress has been made towards diversifying the economy into higher-value sectors, such as pharmaceuticals and biotechnology. Iceland is also well placed to increase its global competitive advantage in aquaculture. Strong inward migration is also supporting growth.

However, traditional sectors (processed aluminum, tourism and marine products) still represent the bulk of Iceland's total exports (on average 67%). This limited diversification leaves the country exposed to specific trade shocks. Headwinds from capacity constraints will also eventually lead to moderating population growth.

Inflation Risks: Inflation and inflation expectations remain above the upper bound of the Central Bank of Iceland's inflation target (2.5% +/- 1.5pp). We expect inflation to average 6.1% in 2024, declining to 4.1% in 2025. The risk of persistent inflation could result in higher policy rates for longer, although this is not our baseline and we see scope for a potential rate cut in late 4Q24. Inflationary pressures from collective wage agreements are expected to be limited. So far, agreements in the public sector have been in line with the private sector, which in March set out average wage growth of 4.0% annually effective for 2024-2028.

Fiscal Consolidation Commitment: We forecast Iceland's general government deficit at 2.0% of GDP in 2024, narrowing to 1.6% in 2025 and 1.7% of GDP in 2026. Our baseline assumes a degree of fiscal consolidation broadly in line with the Fiscal Plan (2025-2029), although our GDP forecasts are lower. Recent support measures responding to the March collective agreements will cost the government 0.3%-0.4% of GDP annually until 2027.

Apart from various expenditure reduction measures, the government is continuing to implement its progressive transport tax reform (a new comprehensive kilometre fee for all vehicles). The measure is already in effect on electric and hybrid cars and is expected to be introduced for all other vehicles in 2025 and 2026. If successful, the government estimates a permanent intake in transport-related taxes of 1.7% of GDP by 2029, which will help offset declining tax receipts from vehicles and fuel due to higher usage of fuel -efficient cars.

Declining Debt Ratio: At 64.8% of GDP (end 2023), Iceland's general government debt ratio is above the median debt ratio of 'A' category peers (50.3%), but projected by Fitch to remain on a gradual downward path. Our assumptions anticipate debt falling towards 59.2% by 2026. Debt reduction will be underpinned by a combination of modest primary fiscal surpluses and use of accumulated cash deposits (which stood at 9.4% of GDP in May 2024). The planned sale of the state's remaining stake (42.5%) of Íslandsbanki could result in a lower debt ratio than Fitch forecasts.

Strong External Buffers: Large net tourism flows and a high goods import dependency can impact exchange rate volatility. Compared with its peer group, Iceland's real effective exchange rate volatility is high (7.0% vs a historical median of 4.6% for 'A' rated sovereigns). A large pool of international FX reserves worth 19% of GDP (June 2024) and close to five months of imports coverage provide headroom against FX volatility risks. Iceland's positive net international investment position (41.5% of GDP in 1Q24) stands out against the 'A' category peer group (where the current median is negative 9% of GDP), a reflection of its significant pension fund sector (with assets of 171% of GDP as of end-2023).

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/External: 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 in place during 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

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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, v2.0.2 (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

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