S&P Global
Ratings

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Summary:
Iceland

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Summary:
Iceland

Issuer Credit Rating	A/Stable/A-1

Key Rating Factors

Institutional and economic profile	Flexibility and performance profile
A recession is likely in 2019 due to declining tourist arrivals. • Iceland's second-largest airline WOW Air's bankruptcy caused a supply shock to tourism, the country's largest export. • We project real GDP will decline by 1.5% in 2019, but return to growth thereafter. • We believe the recently concluded wage negotiations, which agreed a modest wage increase for a large share of private sector employees, should foster stability.	The current account is turning to deficit, but fiscal and external buffers remain. • Iceland's net general government debt is now below 30% of GDP, reflecting significant debt reduction in recent years. • Iceland's current account balance will swing to deficit this year, but the country remains a net external creditor. • We continue to view monetary policy as constrained by the small Icelandic economy's susceptibility to external developments.

Outlook

The stable outlook reflects our view of Iceland's existing strong fiscal and external buffers, mitigated by risks stemming from the inherent volatility of Iceland's small open economy and a potentially abrupt slowdown in tourism.

We could raise the ratings on Iceland if its fiscal performance and external position significantly strengthen beyond our current projections over the next two years.

We could lower the ratings on Iceland if we observed signs of increasing balance of payments pressures or risks to the stability of the financial sector over the next two years. These could emerge if the current reduction in tourism flows was sharper than expected, putting pressure on the balance of payments and the financial system, including the lending activities of pension funds via an impact on the housing market.

Rationale

The ratings on Iceland reflect our view of Iceland's high GDP per capita and the country's institutional stability, as well as a track record of effective policymaking. Our ratings also reflect our opinion of the Icelandic government's steady debt reduction in recent years and its larger fiscal buffers, offset by structurally constrained monetary policy flexibility. The vulnerability to external developments and the inherent volatility of Iceland's small economy constrain the ratings.

Institutional and economic profile: After a recession in 2019, growth is set to resume, albeit at lower rates than in recent years

We forecast Iceland's economy will contract by 1.5% in real terms in 2019, but anticipate growth of about 2% annually over 2020-2022. This is, however, well below the average of over 5% recorded in the past four years.

After a decade of rapid growth, with visitor numbers increasing fivefold since 2010, the tourism sector directly accounts for about 9% of Iceland's GDP. Hence, the supply shock caused by WOW Air's bankruptcy will significantly affect the Icelandic economy. The airline accounted for 23% of tourist arrivals to Iceland in 2018, but we expect tourist arrivals will decrease by less. The total effect will depend on by how much other airlines increase supply and if there is a lower share of transit passengers relative to travelers to Iceland on their planes. However, even without the effects from WOW Air's bankruptcy, the tourism sector's brisk growth has ended. Despite tourist arrivals being roughly back to 2017 figures, we do not expect a continuous and protracted reversal of tourism flows. Therefore, we think that this year's shock could result in consolidation of the sector and ultimately lead to more sustainable growth. That said, a more severe slowdown than we currently expect could also affect bank balance sheets, given their exposure to the housing market and real estate developments.

In addition, the failure of the capelin fishing season will likely weigh on exports. In the weaker economic environment, we also anticipate subdued private consumption growth compared with the high levels in recent years. Still, we forecast consumption will contribute positively to growth, thanks to likely robust public consumption. Similarly, we expect investment will increase slightly this year, despite increased uncertainty because of continued housing and public investment. We expect growth will resume from 2020 as investment and consumption recover, and export growth recommences.

The tourism sector's past rapid expansion has also strained Iceland's infrastructure and increased pressure in the housing market. Rising cost of housing, particularly for lower-income earners, also supported the confrontational rhetoric surrounding the most recent wage negotiations. In this environment, the government helped facilitate relatively moderate wage increases, with extra increases tied to economic growth, by stepping in with a package aimed at raising lower income earners' disposable incomes and measures directed at the housing market. These included, for example, strengthening social housing provision. The new wage agreements, covering almost the whole private labor market, alleviate concerns regarding a wage-inflation spiral or of overshooting the real effective exchange rate, which were results of prior examples of collective bargaining in Iceland. Furthermore, the wage agreements and accompanying government measures could reaffirm Iceland's tradition of ensuring a high degree of social equity.

Even with wage changes taking into account a weaker macroeconomic environment, we expect the unemployment rate will increase to over 4% in 2019-2020 due to the effects of WOW AIR's bankruptcy and further job losses in the tourism sector.

This year's supply shock to the tourism industry underpins our view of the inherent volatility of the small Icelandic economy (with a population of about 360,000 and a GDP of $26 billion). Iceland is ultimately dependent on developments in terms of trade, with its economy concentrated in the tourism, marine, and metals sectors. We note

Iceland's favorable demographics, with the population increasing both organically (by 2.4% in 2018) and due to significant net immigration in recent years. Immigration reflected about 2% of the population in 2018, and reflects the rapid job creation in Iceland's tourism sector.

The Icelandic krona exchange rate has remained relatively stable in recent months, despite the weakening economic outlook. However, it depreciated by about 10% in the months after WOW Air's difficulties became public. Given the weaker outlook for exports, we forecast slight krona depreciation in 2019. This could help improve price competitiveness, which suffered in recent years when the krona appreciated significantly as the balance of payments strengthened.

We continue to view Iceland's institutional arrangements as a key rating strength. There are broadly functioning checks and balances between various state bodies and consensus on key issues, such as the need to maintain a comparatively prudent fiscal position. Iceland is in the process of setting up a sovereign wealth fund, with part of the future dividends generated by its government-owned power utility Landsvirkjun. Iceland's coalition government following the October 2017 snap elections comprises three parties spanning the left and right of the political spectrum. The challenge of navigating the economy through a generally weaker macroeconomic environment could highlight divergent policy priorities more prominently than in the first half of the government's term.

Flexibility and performance profile: Fiscal and external balance sheets have improved but more challenging times lie ahead

We project Iceland will post a roughly balanced budget in 2019, down from a surplus of 1.1% in 2018. Going forward, we project contained deficits of 1.5% on average in 2020-2022. This compares with the government's forecast of surpluses included in its fiscal policy documents. We think that the weaker growth outlook, rising unemployment, and fiscal measures agreed around the wage negotiations will increase fiscal pressures. At the same time, some loosening of tax policy and infrastructure investments will continue. We note however that Iceland's fiscal policy framework and fiscal rules curb the potential for significant fiscal slippage.

Iceland has reduced its government debt burden remarkably over the past few years, and net general government debt is now below 30% of GDP. We expect net government debt will be just below 30% of GDP in 2019-2022. This compares with net general government debt peaking at almost 80% of GDP in 2011, and underlines Iceland's rapid deleveraging after the 2008 financial crisis, restoring fiscal buffers. We currently do not factor any additional proceeds from the sale of commercial banks into our projections, but anticipate that government ownership in the sector could reduce over the coming years.

We still see some moderate risks from contingent fiscal liabilities, particularly from the decreasing, albeit still-high stock of government guarantees to public-sector entities, such as the Housing Financing Fund (HFF) or energy company Landsvirkjun. We expect HFF's liabilities will continue to reduce as its ceases new lending activities.

We expect Iceland's current account will swing to deficit in 2019 following years of high surpluses. This is primarily due to the tourism sector's contraction, but also thanks to lower marine products exports. The growth in tourism in recent years has enabled Iceland's external position to improve significantly, and the country is now in a net external creditor position. We think that the strengthened external position will allow Iceland to weather a contraction in exports in 2019 without a re-emergence of external financing pressure.

We continue to anticipate a pick-up in investment abroad by the Icelandic pension funds because they are diversifying their investments after capital controls were lifted in early 2017. The special reserve requirement on inflows of foreign currency was lowered to 0% from 20% in March 2019, and we expect rising inflows into Iceland's domestic bond market. We forecast our preferred measure of net external indebtedness relative to current account receipts will rise to about 60% by 2022 from 41% in 2018.

Iceland's monetary policy effectiveness remains limited by the structural features of the Icelandic economy, including its small size and the inflation level's pronounced dependence on the value of the exchange rate and foreign prices. That said, Iceland's monetary flexibility has improved following the March 2017 lifting of capital controls and given the adherence to a broadly flexible exchange rate arrangement since then. We also believe that the accumulation of substantial extra net foreign exchange reserves has underpinned the Central Bank of Iceland's (the central bank) improved ability to act as a lender of last resort for the domestic banking system both in foreign and local currencies.

We also note that Iceland's real effective exchange rate tends to be particularly volatile over the economic cycle, and subject to large valuation swings that have historically exacerbated the cyclicality already inherent in Iceland's economy. In April 2019, inflation of 3.3% was broadly in line with the central bank's 2.5% target. However, we expect inflation will only slightly accelerate to 3.4% on average in 2019-2022, taking into account the projected currency depreciation, wage changes, and the dampened economic outlook. Economic agents in Iceland expect a potential reduction of interest rates by the central bank, as demonstrated by references made in the wage negotiations. The wage agreements contain an exit clause if rates are not lowered. This could indirectly affect the perceived flexibility of monetary policy, but we understand that the clause would not be triggered automatically. Furthermore, the central bank continues to reiterate that it bases its monetary policy decisions solely on the available data and the country's economic outlook. We therefore note that the central bank is independent in its monetary policy decisions.

Icelandic banks remain well capitalized and liquid. Domestic credit has picked up recently following negative credit growth until late 2015, and we expect it will increase roughly in line with nominal GDP over the next three years. Iceland saw substantial house price hikes, particularly in the Reykjavik area, but they appear to have peaked in 2017. Since then, price growth in the housing market has cooled, in line with the slowdown in tourism and an increasing housing supply. Private sector leverage has been on a steady declining trend as a percentage of GDP since 2008, but has recently shown signs of picking up.

In our view, there are risks stemming from the increasing role pension funds are playing in providing domestic credit. Over the last few years, they have been significantly increasing their share of the market. The market share in total lending to households has risen to 20%, from 13%, over the last two years. We see risks for the banks stemming from this development as the pension funds' distort competition by operating on an uneven playing field. Iceland is currently preparing to merge the central bank and the Financial Supervisory Authority with the aim of integrating all financial supervision functions at the central bank. Changes should take effect in 2020.

Key Statistics

Table 1

Iceland Selected Indicators

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Economic indicators (%)										
Nominal GDP (bil. LC)	1,959.0	2,073.6	2,293.9	2,490.9	2,616.8	2,803.0	2,839.7	2,963.1	3,102.4	3,248.4
Nominal GDP (bil. $)	16.0	17.8	17.4	20.6	24.5	25.9	23.4	23.1	23.5	24.2
GDP per capita (000s $)	49.8	54.5	52.8	62.0	72.4	74.3	65.7	63.9	63.9	64.9
Real GDP growth	4.1	2.1	4.7	6.6	4.6	4.6	(1.5)	1.8	2.0	2.1
Real GDP per capita growth	3.4	0.9	3.7	5.5	2.8	1.6	(3.9)	0.3	0.5	0.6
Real investment growth	2.2	15.9	21.3	17.8	11.6	2.1	0.9	2.5	2.7	2.7
Investment/GDP	15.4	17.3	19.6	21.2	22.1	22.6	23.6	24.4	25.1	25.8
Savings/GDP	23.2	23.0	25.5	28.7	25.8	25.5	23.2	23.2	23.4	23.9
Exports/GDP	53.5	51.5	51.8	47.6	46.1	47.2	45.0	45.5	46.1	46.9
Real exports growth	6.7	3.2	9.1	10.9	5.4	1.6	(6.1)	2.4	3.0	3.5
Unemployment rate	5.4	5.0	4.0	3.0	2.8	2.7	4.1	4.2	3.7	3.5
External indicators (%)										
Current account balance/GDP	7.8	5.7	5.9	7.5	3.6	2.9	(0.5)	(1.2)	(1.7)	(1.9)
Current account balance/CARs	13.2	10.1	10.5	14.0	7.3	5.7	(1.0)	(2.4)	(3.3)	(3.8)
CARs/GDP	59.5	56.4	56.4	53.6	50.1	50.6	48.6	49.3	49.9	50.7
Trade balance/GDP	0.4	(0.5)	(1.5)	(4.1)	(6.3)	(5.7)	(7.2)	(7.7)	(8.1)	(8.4)
Net FDI/GDP	(0.3)	4.1	4.0	3.5	0.7	(1.8)	1.8	2.1	2.5	2.5
Net portfolio equity inflow/GDP	(0.0)	(0.2)	(2.3)	(5.6)	(1.6)	(1.3)	(3.0)	(2.0)	(1.8)	(1.7)
Gross external financing needs/CARs plus usable reserves	96.6	99.8	93.4	90.5	80.6	85.1	88.8	95.7	97.9	99.5
Narrow net external debt/CARs	71.1	58.3	143.4	55.7	50.8	40.9	54.7	58.1	59.7	60.4
Narrow net external debt/CAPs	81.8	64.8	160.3	64.8	54.7	43.3	54.2	56.7	57.8	58.2
Net external liabilities/CARs	19.3	8.9	9.9	(5.7)	(7.2)	(18.1)	(19.6)	(16.9)	(12.9)	(8.2)
Net external liabilities/CAPs	22.2	9.9	11.0	(6.6)	(7.8)	(19.2)	(19.4)	(16.5)	(12.4)	(7.9)
Short-term external debt by remaining maturity/CARs	50.3	50.0	41.9	44.5	35.3	33.5	37.1	41.8	41.6	40.1
Usable reserves/CAPs (months)	5.8	5.4	5.5	6.2	7.6	6.4	6.6	5.9	5.6	5.2
Usable reserves (mil. $)	4,016.6	3,988.3	4,895.1	7,230.6	6,575.3	6,329.9	5,790.9	5,628.8	5,487.8	5,306.0
Fiscal indicators (general government; %)										
Balance/GDP	(1.8)	(0.1)	(0.8)	(3.0)	0.5	1.1	0.1	(1.5)	(1.5)	(1.5)
Change in net debt/GDP	1.3	(7.3)	(2.9)	(3.6)	(1.9)	(3.9)	0.2	1.7	1.6	1.5
Primary balance/GDP	2.6	4.5	3.6	1.0	4.4	4.2	2.9	1.2	1.2	1.3
Revenue/GDP	40.6	43.7	40.6	41.5	43.8	42.8	43.0	43.0	43.0	43.0
Expenditures/GDP	42.4	43.8	41.4	44.5	43.3	41.7	42.9	44.5	44.5	44.5
Interest/revenues	10.9	10.4	10.9	9.5	8.8	7.2	6.5	6.3	6.3	6.4
Debt/GDP	88.0	80.9	65.0	51.2	43.1	37.7	37.5	37.6	37.5	37.3

Table 1

Iceland Selected Indicators (cont.)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Debt/revenues	216.8	184.9	160.2	123.4	98.3	88.2	87.1	87.4	87.2	86.8
Net debt/GDP	65.3	54.4	46.3	39.1	35.3	29.1	28.9	29.4	29.7	29.8
Liquid assets/GDP	22.7	26.5	18.7	12.2	7.8	8.7	8.5	8.2	7.8	7.5
Monetary indicators (%)										
CPI growth	3.9	2.0	1.6	1.7	1.8	2.7	3.2	3.5	3.5	3.5
GDP deflator growth	2.1	3.7	5.6	1.8	0.4	2.4	2.9	2.5	2.7	2.6
Exchange rate, year-end (LC/$)	115.6	126.9	129.6	112.8	104.4	116.3	126.0	130.0	134.0	134.0
Banks' claims on resident non-gov't sector growth	(4.3)	(3.3)	(0.3)	1.7	6.8	9.1	5.5	5.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	167.1	152.6	137.6	128.8	130.9	133.3	138.8	139.7	140.1	140.5
Foreign currency share of claims by banks on residents	N/A	9.8	9.4	8.9	9.7	12.3	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	18.5	18.0	16.5	8.6	9.7	12.2	N/A	N/A	N/A	N/A
Real effective exchange rate growth	4.6	6.7	2.3	11.8	12.1	(2.9)	N/A	N/A	N/A	N/A

Sources: Statistics Iceland (Economic Indicators), Central Bank of Iceland, The Government of Iceland External Indicators), Statistics Iceland, Central Bank of Iceland (Fiscal Indicators), and Central Bank of Iceland, International Monetary Fund (Monetary Indicators).
Adjustments: Government debt adjusted by including loans from Norges bank and International Monetary Fund.
Definitions: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. e--Estimate. f--Forecast. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Iceland Ratings Score Snapshot

Key rating factors	Scores	Explanation
Institutional assessment	2	Generally strong, but relatively shorter track record of policies that deliver sustainable public finances and consistently balanced economic growth over the long term. Generally effective checks and balances and free flow of information through society. Statistical information is generally timely and reliable.
Economic assessment	2	Based on GDP per capita ($) as per the Selected Indicators table above.
		The economy is concentrated in fishing, aluminium and tourism. The metals and fishing sectors together account for over 20% of GDP and are subject to volatility due to changing aluminium prices and varying catch levels. The tourism industry also accounts for well over 20% of GDP including direct and indirect effects.
External assessment	4	Based on narrow net external debt and gross external financing needs as per Selected Indicators in Table 1.
		The country is exposed to significant volatility in terms of trade, due to its dependence on tourism exports and change in metal prices.

Table 2

Iceland Ratings Score Snapshot (cont.)		
Key rating factors	**Scores**	**Explanation**
Fiscal assessment: flexibility and performance	2	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1
Fiscal assessment: debt burden	3	Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators in Table 1.
		Contingent liabilities are moderate, with a material size of non-deposit-taking institutions as guarantees provided by Iceland (implicitly and explicitly) to various entities amount to over 30% of GDP and there is a significant likelihood of extraordinary government support.
Monetary assessment	4	The krona is largely floating following the removal of the capital controls, albeit with a shorter track record. The central bank has broad operational independence and uses market-based monetary instruments and given the removal of capital controls and accumulation of extra net foreign exchange reserves the central bank has the ability to act as lender of last resort for the financial system. However, Iceland exhibits a very volatile REER over the economic cycle.
Indicative rating	a+	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	(1)	Some of the improvements over the past years have been cyclical improvements which will be reversed given the weaker economic outlook. The economy is particularly volatile and susceptible to external shocks as for example evidenced by the effects of the WOW Air bankruptcy on the tourism sector. This is not fully captured in the indicative rating.
Final rating		
Foreign currency	A	
Notches of uplift	0	Default risks do not apply differently to foreign- and local-currency debt
Local currency	A	

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Default, Transition, and Recovery: 2018 Annual Sovereign Default And Rating Transition Study, March 15, 2019
- Sovereign Ratings History, May 6, 2019
- Sovereign Ratings List, May 6, 2019
- Sovereign Debt 2019: Global Borrowing TO Increase By 3.2% To US$7.8 Trillion, Feb. 21, 2019
- Global Sovereign Rating Trends: First-Quarter 2019, April 04, 2019

- Banking Industry Country Risk Assessment Update: May 2019, May 10, 2019