S&P Global
Ratings

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Research Update:

Iceland 'A/A-1' Ratings Affirmed; Outlook Stable

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Overview

- In recent years, Iceland has strengthened its fiscal and external balance sheets.
- Even so, the small, relatively concentrated economy remains vulnerable to external developments and the risk of re-emergence of domestic overheating.
- We project growth rates will slow over the coming years, as tourism inflows decelerate.
- We are affirming our 'A/A-1' ratings on Iceland.
- The outlook is stable.

Rating Action

On Dec. 7, 2018, S&P Global Ratings affirmed its 'A/A-1' long- and short-term foreign and local currency sovereign credit ratings on Iceland. The outlook is stable.

Outlook

The stable outlook balances the potential for Iceland's stronger-than-anticipated fiscal and balance of payments performance against the risks posed by the economy's dependence on foreign trade developments and potential re-emergence of overheating stemming from the upcoming wage negotiations in 2019.

We could raise the ratings on Iceland if the country's fiscal and external balance sheets strengthened by more than we presently anticipate over the next two years.

We could lower the ratings on Iceland if financial stability risks or balance of payments pressures emerged over the next two years. These could, for instance, result if the domestic economy overheated, posing risks for Iceland's competitiveness and adversely affecting long-term growth prospects. It could also be the case if tourism flows slowed sharply, which could negatively affect Iceland's balance of payments performance and the banking system. The latter could manifest itself through an impact on the housing market, given the rapid pace of tourism-related construction projects in recent years.

Rationale

The ratings on Iceland primarily reflect the country's high levels of prosperity and its highly educated workforce, as well as effective policymaking and stable institutions. The prudent fiscal policy has led to a steady decline in the net government debt burden, both in absolute terms and as a percentage of GDP over the last several years. At the same time, the ratings remain constrained by the inherent volatility and susceptibility to external shocks of Iceland's small economy. The ratings also take into account Iceland's moderate external indebtedness and the structurally constrained flexibility of monetary policy.

Institutional and Economic Profile: Growth is slowing down, with rougher waters potentially ahead

- We project real GDP growth will moderate to 2.3% on average in 2019-2021.
- While a growth slowdown would alleviate recent overheating concerns, it could pose risks if the adjustment is sharp.
- In our view, upcoming wage negotiations could rekindle concerns over the competitiveness of the domestic economy in the event of substantial pay hikes.

Iceland's economy remains small in absolute terms (GDP of US$24 billion in 2018 and a population of about 350,000) and structurally volatile. It is ultimately dependent on the economic performance of its main trading partners and developments in terms of trade. It is primarily concentrated in the tourism, marine, and metals sectors. Positively, we believe Iceland benefits from high levels of education, favorable demographics, and the presence of natural resources, such as very competitive hydro and thermal energy production. These factors partially mitigate the negative impact from the aforementioned inherent volatility.

We forecast Iceland's economic growth will slow to a still strong 3.6% in 2018 following 4% in 2017. This trend reflects a deceleration in private consumption, which makes up the lion's share of the Icelandic economy. Strong investment growth continued throughout the first half of 2018 with gross fixed capital formation expanding by almost 8% in real terms as compared with the first half of 2017. Nevertheless, we understand that this dynamic has been supported through frontloading some investment projects, including in the airline and energy industries. As these effects taper off, investment growth will moderate in the remainder of the year, also contributing to moderating headline growth rates.

Later on, we expect growth will gradually slow further to 2% by end-2021. In our view, this will be underpinned by several factors:

- Private consumption should further moderate following two years of rapid expansion, averaging 7.5% in real terms annually;
- Investment growth will slow as some large-scale investment projects are

completed while also reflecting a base effect from previous years' high investments;

- We believe it is unlikely that the export growth rates exhibited in recent years in the country's tourism sector would be sustained over our four-year forecast horizon. This owes partially to emerging capacity constraints, including in air travel and infrastructure, as well as to some tourists likely being priced out. The 12% appreciation of sterling versus the Icelandic krona (ISK) since August may somewhat support a resurgence of fishing and tourism exports to Iceland's second-largest trading partner, the U.K., which has underperformed other export markets over the last year. Nevertheless, Brexit is likely to weigh on U.K. growth.

The tourism sector has been a key driver of Iceland's recovery after the financial crisis, as foreign visitors increased fivefold since 2010. Several indicators suggest that the sector continues to grow, albeit at much lower rates than in the past. Foreign tourist numbers were up by 5.8% through November, but we expect growth to level off. While the reduced growth in tourism will alleviate strains on Iceland's infrastructure, we note that an abrupt decrease of tourism inflows could have adverse consequences for Iceland's economy, with negative effects on banks' and households' balance sheets. To this end, the uncertainties surrounding the future of WOW Air--Iceland's second-largest airline--pose some risks, in our view.

Concerns about the financial standing of WOW Air emerged in mid-2018 and subsequently it was announced that the airline would be acquired by the Icelandair group. However, at the end of November, the acquisition was cancelled and it remains unclear whether WOW Air will be able to continue as a going concern. While we see risks for the tourism sector from this development, there are several mitigating factors. First, we understand that a large proportion of the airline's customers transit through Iceland--mostly en route to the U.S.--implying a smaller potential impact on arrival numbers than suggested by the headline number of passengers transported by the airline. We understand that there is also substantial intersection between Icelandair and WOW Air in terms of destinations, meaning the former could at least partially fill any potential gaps. Lastly, we note that Iceland's tourism arrivals display a pronounced seasonal pattern, peaking in the summer, which provides some time to fix any potential capacity constraints.

In addition to the aforementioned tourism sector uncertainties, we continue to see risks to the price competitiveness of Iceland's economy. Iceland's stronger balance of payments performance in recent years has translated into a notable appreciation of the ISK, making export products more expensive. In our view, this in itself has been one of the factors contributing to the slowdown in tourism expansion this year. More importantly, however, the strengthening trend in the exchange rate has impacted other sectors with predominantly krona-denominated costs, such as IT, which could have negative consequences for Iceland's diversification prospects in the longer term.

We note that in recent months the krona has depreciated, losing about 10% since August 2018. Nevertheless, this partial recovery of competitiveness on the back of the currency's recent weakening could be lost via overgenerous wage settlements as a consequence of upcoming wage negotiations. To the degree that corporate earnings have historically been shared with labor via wage hikes, rather than retained as earnings, collective bargaining has not only benefited perceptions of social equity in Iceland, but has also sustained growth. On the other hand, large blanket wage hikes across all sectors in excess of productivity performance have in the past frequently exacerbated the overshooting of Iceland's real effective exchange rate in relation to key trade partners.

In our view, the frequent past wage hikes exceeding growth in productivity are at least partially a result of the structure of the Icelandic labor market. Various labor market groups negotiate at different times, with some negotiations typically taking place every year. In the past, it often took one labor market group to secure better terms for other wage contracts to be reopened as those employees demanded matching pay rises. We understand that the government has considered reforming the existing system and potentially moving to a Nordic type labor market model with a more clearly defined negotiation process, although progress along this line has not yet been achieved. We do not expect material changes to the existing arrangements over our forecast period through 2021.

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 upcoming wage negotiations and a generally weaker growth environment could especially expose divergent policies.

Flexibility and Performance Profile: General government debt continues to reduce but balance of payments performance is weakening

- Iceland's net general government debt burden will fall to below 30% of GDP by end-2018.
- Iceland is in a net external creditor position versus the rest of the world, but we project the current account to swing into deficit by 2020.
- Monetary policy flexibility remains structurally constrained by the economy's small size and significant dependence on external developments.

We project Iceland's fiscal performance will remain strong in 2018-2019. Specifically, we expect Iceland's general government will operate a surplus of 1.2% of GDP this year with the stock of gross general government debt reducing not only as a percent of GDP but also in absolute terms for the seventh

consecutive year.

For 2019, we expect the general government account to remain in surplus, despite spending increases in health care, social security, and housing. We also expect infrastructure spending to increase and some loosening of tax policy. As we believe further spending pressures could arise and given the moderating growth rates, we expect fiscal deficits to emerge from 2020. This contrasts with the authorities' projections for the general government sector to post recurrent surpluses in the medium term, as outlined in the most recent fiscal strategy.

Nevertheless, we project any deficits to be contained and for the fiscal performance to remain strong. As a result, net general government debt will stabilize at below 30% of GDP over the medium term. This compares with net general government debt of almost 80% of GDP in 2011 and underlines how quickly Iceland has deleveraged in the aftermath of the 2008 financial crisis. 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 risks from contingent fiscal liabilities--particularly from the high stock of government guarantees to public-sector entities, such as the Housing Financing Fund or energy company Landsvirkjun--which we currently assess as moderate.

We project Iceland's current account balance will weaken to a slight deficit of -0.7% by 2021, from a surplus of 1.6% in 2018, chiefly driven by a slowdown in tourism receipts. Strong growth in the tourism sector has facilitated a substantial improvement in Iceland's external position in recent years. We estimate that the economy is currently in a small net external asset position. While external buffers are currently sound, a sudden stop of tourism revenues could trigger a re-emergence of external financing pressures. We anticipate a pick-up in investment abroad by the Icelandic pension funds because they are diversifying their investments after the capital controls were lifted in early 2017. The central bank did not intervene until September 2018, when the krona depreciated sharply, driven by news on financing pressures faced by WOW Air. The special reserve requirement on inflows of foreign currency was lowered to 20% from 40% in November because of narrowing interest rate differentials with major central banks and krona depreciation. We forecast our preferred measure of net external indebtedness relative to current account receipts rising to around 61% by 2021 from 51% 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's 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 (REER) 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. According to central bank data, the consumer price index-based REER has appreciated by about 20% (as of October 2018) since end-2014. In October 2018, inflation surpassed the central bank's 2.5% target, after undershooting the target consistently in 2014-2017. We expect inflation to slightly accelerate to 3.4% in 2019 before moderating again to 2.5%.

Icelandic banks remain well capitalized and liquid. Domestic credit has picked up recently, following negative credit growth until late 2015, and we expect it to grow 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 increasing their share of the market at the expense of commercial banks. The market share in total lending to households has risen to 18%, from 10%, over the last two years. We see risks stemming from this development as the pension funds' supervision and their capacity to monitor credit risks is untested. We understand that there is a built-in adjustment mechanism in that the poor performance of a pension fund could ultimately lead to a lower pension payout. However, this could then affect the financial position of households and may also have fiscal implications.

For more information on the banking system, see "Banking Industry Country Risk Assessment: Iceland," published Feb. 21, 2018.

Key Statistics

Table 1

Iceland Selected Indicators

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. ISK)	1,842	1,959	2,074	2,288	2,503	2,615	2,788	2,946	3,086	3,230
Nominal GDP (bil. $)	15	16	18	17	21	24	24	23	24	24
GDP per capita ($000s)	46.1	49.8	54.5	52.7	62.3	72.3	70.1	65.5	65.7	65.7
Real GDP growth	1.3	4.1	2.1	4.5	7.4	4.0	3.6	2.7	2.3	2.0
Real GDP per capita growth	0.9	3.4	0.9	3.4	6.2	2.2	0.6	0.2	0.8	0.5
Real investment growth	5.2	2.2	15.9	19.7	21.7	9.5	4.5	3.0	3.0	3.0

Table 1

Iceland Selected Indicators (cont.)										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Investment/GDP	16.1	15.4	17.3	19.3	21.6	22.3	22.8	23.4	24.1	24.9
Savings/GDP	17.7	23.2	23.0	25.4	29.1	25.6	24.4	24.0	24.0	24.2
Exports/GDP	55.0	53.5	51.5	51.9	47.4	46.1	45.4	45.5	45.8	46.2
Real exports growth	3.6	6.7	3.2	9.1	10.9	5.5	3.3	3.0	2.5	2.5
Unemployment rate	6.0	5.4	5.0	4.0	3.0	2.8	2.8	3.0	3.5	3.5
EXTERNAL INDICATORS (%)										
Current account balance/GDP	1.6	7.8	5.7	6.0	7.5	3.3	1.6	0.6	(0.1)	(0.7)
Current account balance/CARs	2.6	13.2	10.1	10.6	14.1	6.6	3.2	1.3	(0.3)	(1.4)
CARs/GDP	61.2	59.5	56.4	56.6	53.4	50.3	48.8	49.2	49.7	50.1
Trade balance/GDP	0.7	0.4	(0.5)	(1.6)	(4.1)	(6.3)	(7.1)	(7.7)	(8.2)	(8.7)
Net FDI/GDP	28.7	(0.3)	4.1	4.0	3.5	0.4	2.0	2.0	2.0	2.0
Net portfolio equity inflow/GDP	0.6	(0.0)	(0.2)	(2.3)	(5.6)	(2.3)	(3.8)	(3.8)	(2.5)	(2)
Gross external financing needs/CARs plus usable reserves	95.5	96.6	99.8	93.3	90.3	80.6	85.5	90.3	94.4	96.1
Narrow net external debt/CARs	88.5	71.1	58.3	143.2	53.4	46.9	50.9	59.3	60.2	61.3
Narrow net external debt/CAPs	90.9	81.8	64.8	160.2	62.1	50.2	52.6	60.1	60.1	60.5
Net external liabilities/CARs	44.4	19.3	8.9	9.8	(7.9)	(13.8)	(17.3)	(18.9)	(18.0)	(16.0)
Net external liabilities/CAPs	45.6	22.2	9.9	10.9	(9.2)	(14.8)	(17.9)	(19.2)	(18.0)	(15.8)
Short-term external debt by remaining maturity/CARs	61.6	50.3	50.0	41.9	44.3	34.6	35.9	40.6	40.7	40.6
Usable reserves/CAPs (months)	8.2	5.8	5.4	5.5	6.2	7.5	6.9	6.6	5.9	5.7
Usable reserves (mil. $)	4,008	4,017	3,988	4,895	7,231	6,575	6,258	5,837	5,789	5,716
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.6)	(1.8)	(0.1)	(0.8)	(3.0)	0.0	1.2	0.4	(1.5)	(2.3)
Change in net debt/GDP	(7.2)	1.3	(6.3)	(3.0)	(3.6)	(4.3)	(3.6)	(0.1)	1.8	2.6
Primary balance/GDP	1.0	2.6	4.5	3.6	0.9	3.8	4.1	2.8	0.8	0.1
Revenue/GDP	40.2	40.6	43.7	40.7	41.3	42.5	43.5	43.0	43.0	43.0
Expenditures/GDP	43.8	42.4	43.8	41.5	44.3	42.5	42.3	42.6	44.5	45.3
Interest /revenues	11.4	10.9	10.4	10.9	9.5	8.9	6.7	5.7	5.4	5.5
Debt/GDP	96.7	88.0	81.8	66.0	51.7	41.4	34.5	32.6	32.9	34.0
Debt/Revenue	240.5	216.8	187.1	162.2	125.1	97.3	79.3	75.7	76.5	79.1
Net debt/GDP	68.1	65.3	55.4	47.2	39.6	33.6	27.9	26.3	26.9	28.3
Liquid assets/GDP	28.6	22.7	26.5	18.8	12.1	7.8	6.6	6.2	6.0	5.7
MONETARY INDICATORS (%)										
CPI growth	5.2	3.9	2.0	1.6	1.7	1.8	3.0	3.4	2.5	2.5
GDP deflator growth	3.4	2.1	3.7	5.6	1.9	0.5	2.9	2.9	2.4	2.6

Table 1

Iceland Selected Indicators (cont.)	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Exchange rate, year-end (ISK/$)	128.99	115.55	126.90	129.59	112.82	104.42	124.00	127.70	131.60	135.50
Banks' claims on resident non-gov't sector growth	(5.2)	(2.6)	(2.9)	(0.1)	1.6	6.7	7.0	6.0	5.0	5.0
Banks' claims on resident non-gov't sector/GDP	181.4	166.1	152.4	137.9	128.1	130.9	131.4	131.8	132.1	132.5
Foreign currency share of claims by banks on residents	N/A	N/A	9.8	9.4	8.9	9.7	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	14.1	18.5	18.0	16.5	8.6	9.7	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(0.3)	4.6	6.7	2.3	11.8	12.1	N/A	N/A	N/A	N/A

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. ISK--Islandic krona. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. 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	
Institutional assessment	2
Economic assessment	2
External assessment	4
Fiscal assessment: flexibility and performance	2
Fiscal assessment: debt burden	3
Monetary assessment	4

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

- Banking Industry Country Risk Assessment Update: November 2018, Nov. 23, 2018
- Sovereign Ratings History, Nov. 7, 2018
- Sovereign Ratings List, Nov. 7, 2018
- Sovereign Risk Indicators, Oct. 11, 2018. An interactive version is also available at http://www.spratings.com/sri
- Global Sovereign Rating Trends: Third-Quarter 2018, Oct. 3, 2018
- Default, Transition, and Recovery: 2017 Annual Sovereign Default Study And Rating Transitions, May 8, 2018
- Sovereign Debt 2018: Global Borrowing To Remain Steady At US$7.4 Trillion, Feb. 22, 2018
- Global Sovereign Rating Trends 2018, Jan. 10, 2018
- Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions, April 18, 2017

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the

rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

Ratings Affirmed

Iceland	
Sovereign Credit Rating	
Foreign and Local Currency	A/Stable/A-1
Transfer & Convertibility Assessment	A
Senior Unsecured	
Foreign and Local Currency	A
Foreign Currency	A-1
Short-Term Debt	
Local Currency	A-1

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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