S&P Global Ratings

RatingsDirect®

Research Update:

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

November 13, 2020

Overview

- Icelandic authorities have backloaded fiscal consolidation and introduced extraordinary fiscal measures of about 5% of GDP this year to support private companies and households affected by the global pandemic.
- Therefore, we project gross general government debt, having declined to about 30% of GDP last year from almost 80% in 2011, will rise to nearly 60% of GDP by 2023, also owing to the uncertain timing of economic recovery.
- However, we expect Iceland's other credit strengths--its strong external balance sheet, resilient institutions, and economic flexibility--to outlast the temporary, albeit considerable, fallout from the global health emergency.
- We are consequently affirming our 'A/A-1' ratings on Iceland and maintaining the stable outlook.

Rating Action

On Nov. 13, 2020, 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 reflects our expectation that Icelandic authorities will be able to gradually stabilize the damage done to public finances by the global pandemic through 2023. Moreover, despite the significant hit to the tourism sector, we also expect that Iceland will be able to maintain its current account balance in surplus over the next few years.

Downside scenario

We could lower the rating on Iceland if the pandemic causes more permanent damage to the productive capacity of Iceland's economy than we expect, while pushing net general government debt to GDP to levels materially beyond our expectations.

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Upside scenario

Although unlikely over the next two years, we could raise the rating if the economy's recovery from the pandemic exceeds our expectations, and leads to a diversification of the Icelandic economy and export categories, in the process reducing the volatility in Iceland's terms of trade. At the same time, such a scenario could enable quicker fiscal consolidation.

Rationale

We expect the pandemic to cause Iceland's economy to contract by 7.8% in 2020 before partially recovering by 4.0% in 2021. Since 2010, tourism has been a major impetus of growth across the economy, accounting for more than 10% of gross value added, and almost 50% of total services exports in 2019. Its role in creating employment and investment, including in the construction sector, will likely diminish.

In response to the global health emergency, authorities have mobilized significant fiscal resources to absorb some of the economic shock and aid recovery. We expect this will cause a sharp increase in general government debt from the currently low levels. That said, we believe the authorities will be able to consolidate public balances after 2021. We note Iceland's successful record of fiscal deleveraging over the past decade. Resilient external balances and low net external leverage provide further economic buffers and represent a significant difference compared with the financial crisis of 2008-2009. Iceland's stable institutional framework and effective policymaking continue to support the rating. The rating is constrained by the volatile nature of Iceland's small and open economy and limited effectiveness of monetary policy, given the strong influence of external developments on domestic inflation trends.

Institutional and economic profile: Iceland's economy and its tourism sector will take a severe hit in 2020, but effective policy measures have supported domestic demand

- Iceland's economy will contract by almost 8% this year, before starting a long recovery process in 2021, although we don't believe the 2019 GDP level will be reached before 2023.
- The pandemic is severely affecting the tourism industry (above 10% of GDP in 2019), but domestic demand has recovered quickly over the third quarter.
- Extensive testing and several economic support measures to combat the effects of the pandemic have been effective.

Icelandic authorities were quick in their policy response to contain the pandemic and curtail its economic effects. The measures included one of the most comprehensive testing regimes globally. This effectively helped limit the first outbreak of the pandemic in the second quarter and has helped curb the rise of infections after a second outbreak started in mid-September. In parallel, the authorities have rolled out comprehensive fiscal and monetary measures to support the economy.

Iceland will endure significant GDP contraction in 2020, but government policy support has contributed to relatively resilient domestic demand. We assume a contraction of 7.8% of real GDP, with a subsequent recovery of 4.0% in 2021. In our view, the economy will achieve its pre-pandemic real GDP levels only in 2023. We believe there is a high degree of uncertainty regarding the economy's health over the next several years. Iceland's small and open economy, with a population of about 360,000 and GDP of $24 billion at year-end 2019, is generally very susceptible to external developments and shifts in terms of trade. The country's export base is very concentrated. The main exports pertain to the tourism, marine, and metals (aluminum) sectors. COVID-19 has hit tourism hard this year, with foreign arrivals down by about 90% since mid-March compared with 2019 and tourism employment commensurately falling by over a third. This represents the major cause for the overall rise in unemployment, which we expect to be above 7% this year, despite generous labor-market support schemes. The disproportionately high shock to the tourism industry follows a decade of rapid growth, with the number of visitors to Iceland increasing about fivefold since 2010. We believe tourism inflows could experience a longer-lasting and uncertain setback if travelers shift their preferences after the pandemic abates. This is somewhat offset by robust exports in other sectors, such as marine product exports, as well as resilient domestic demand.

In our view, Iceland's institutional arrangements remain a key rating strength, with functioning checks and balances between various state bodies. The swift and effective policy responses to the pandemic from several Icelandic institutions underpin our view of generally effective and stable policymaking. Since the October 2017 snap elections, Iceland's coalition government comprises three parties that span the political spectrum. We note the government's broadly consensus-oriented approach to roll out its policy response to the pandemic and increased political cohesion within the coalition during the pandemic.

Flexibility and performance profile: Continuous fiscal policy support will widen deficits over the near term, but subsequent consolidation will restore fiscal flexibility

- The government's policy response to the economic contraction will result in substantial fiscal deficits in 2020 and 2021.
- General government debt will rise significantly over the next few years, but we do not foresee any financing constraints for the government domestically and abroad.
- Monetary policy support has been effective, and the central bank's ample reserves enable it to reduce exchange rate volatility.

The expected fiscal deficits in 2020 and 2021 are sizable, estimated at about 11% and 9% of GDP, but we anticipate a subsequent narrowing thereafter. Much of this fiscal deterioration represents the effects of automatic stabilizers kicking in to provide economy relief, as the tax burden decreases and social transfers increase. Authorities have further reduced tax payments for the heavily affected sectors, such as construction and tourism. Social spending has increased, for example in the form of additional unemployment benefits, wage compensation, and other social transfers. Furthermore, the authorities are increasing their investment envelope, and foregoing a significant share of dividend payments, for example from the state energy company. We estimate that about 50% of the deficits in 2020 and 2021 will stem specifically from the government's support measures to counter the COVID-19 health crises.

The government is suspending its own fiscal rules until at least 2023, because the fiscal consolidation path following 2021 will be gradual. That said, we expect the government will start converging toward its previous, prudent fiscal stance from 2022. We note Iceland's past track record in reducing net general government debt, to 34% of GDP in 2019 from a peak of close to 80% of GDP in 2011. Consequently, we think Iceland entered this contraction with ample fiscal flexibility to support the economy. Despite the high deficits in 2020 and 2021, we do not expect that net general government debt will increase beyond 60% of GDP over the next few years. Although nominal debt levels will increase significantly, we consider debt management will benefit from pronounced improvements in the debt profile achieved since 2011. For example, more than 75% is held domestically and only about 22% of gross government debt is denominated in foreign currency.

With the exception of an international bond issuance earlier this year, which has bolstered foreign exchange reserves, we believe the government will be able to cover all funding needs on the domestic market in 2020. In addition, the government could draw upon the liquid assets of the Icelandic Housing Financing Fund (HFF), which have been partially consolidated under the treasury's liquidity management. The Central Bank of Iceland (CBI) announced a purchasing program for treasury bonds in the secondary market of up to Icelandic krona (ISK) 150 billion (about US$1.09 billion). At the end of October, such purchases amounted to less than ISK1.0 billion. We think this program could support the government's very low financing costs and keep interest spending well below 10% of fiscal revenue in the next few years.

Although decreasing, the total stock of government guarantees currently amounts to approximately one-third of GDP and covers a broad spectrum of public-sector entities, such as the energy company Landsvirkjun or the student loan fund. However, more than 80% of guarantees are to HFF. In line with the government's own debt reporting, we now include a portion of HFF's debt (equivalent to 5%-6% of GDP) in general government debt. This portion equals HFF's estimated capital shortfall. However, HFF's liabilities will continue to reduce because it has ceased new lending activities.

The CBI mobilized swift and significant monetary policy support. The immediate measures included:

- A significant cut of the policy rate;
- An adjustment of several macroprudential measures concerning bank regulation; and
- An open market purchasing program for the treasury's bonds on the secondary market, which started at the beginning of May and has barely been used until now.

The previous accumulation of substantial net foreign currency reserves has created additional policy flexibility for the CBI. Reserves amounted to over 30% of GDP and have been further bolstered by the government passing on the proceeds of a foreign currency bond issuance in May. The CBI's foreign exchange interventions have reduced exchange rate volatility this year. We do not believe these interventions will meaningfully erode the overall reserves in the next months. The reserves also underpin the CBI's improved ability to act as a lender of last resort for the domestic banking system in foreign and local currencies. That said, we continue to view Iceland's monetary policy effectiveness as generally constrained. The underlying economy represents one of the smallest currency areas globally, and Iceland's real effective exchange rate tends to fluctuate over the economic cycle and is subject to large valuation swings that have historically exacerbated the cyclicality already inherent in Iceland's economy.

External balances have remained resilient this year, despite the dearth of tourist arrivals for 2020. This decline has been largely compensated by import demand and depressed energy prices, which have kept the current account in surplus. Iceland's net international investment position has improved substantially over the past three years. Following significant external deleveraging in the years after the financial crisis, we estimate external debt will exceed liquid external assets by 64% of current account receipts in 2020.

Despite notable currency depreciation this year, inflation should remain close to the CBI's target rate of 2.5% over the next 12-18 months. Deflationary pressures due to the contraction in domestic demand, as well as the lower energy price, partially outweigh the pass-through effects from higher import prices.

In April 2020, we revised down our Banking Industry Country Risk Assessment for Iceland's banking sector to '5' from '4' owing to our changed view on the sector's economic and industry risk. We expect the forecast sharp reduction in economic activity in 2020 will exacerbate the structural weaknesses of the domestic banking industry, such as generally low profitability. The business environment is fiercely competitive and further distorted by the role of pension funds in lending. Declining interest rates and increasing provisions mean Icelandic banks' business prospects and earnings in the coming six to 18 months are more fragile than peers'. Although their asset quality metrics will deteriorate in the coming quarters, mainly due to tourism exposures, we expect the banks to be more resilient to the economic headwinds than during the 2008-2009 financial crisis, thanks to their much higher capitalization. This is why we believe the financial sector poses a limited contingent liability for the government.

Key Statistics

Table 1

Iceland Selected Indicators

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. ISK)	2,074	2,294	2,491	2,616	2,788	2,970	2,799	2,989	3,159	3,327
Nominal GDP (bil. $)	18	17	21	24	26	24	21	21	23	25
GDP per capita (000s $)	54.5	52.8	62.0	72.4	73.9	67.9	58.5	57.9	62.7	66.5
Real GDP growth	2.1	4.7	6.6	4.5	3.9	1.9	(7.8)	4.0	3.1	2.7
Real GDP per capita growth	0.9	3.7	5.5	2.7	0.8	(0.5)	(8.7)	2.0	1.6	1.2
Real investment growth	15.9	21.3	17.8	10.7	(1.0)	(6.6)	(8)	5.0	2.5	2.3
Investment/GDP	17.3	19.6	21.2	22.0	22.0	20.0	20.2	20.6	20.5	20.4
Savings/GDP	23.0	25.5	28.8	25.8	25.1	26.2	21.7	21.8	22.1	22.1
Exports/GDP	51.5	51.8	47.6	46.1	47.5	45.3	34.3	38.6	40.2	41.1
Real exports growth	3.2	9.1	10.9	5.4	1.7	(4.9)	(27.5)	16.0	6.5	5.0
Unemployment rate	4.9	4.0	3.0	2.8	2.7	3.5	7.6	7.0	6.5	6.0
External indicators (%)										
Current account balance/GDP	5.7	6.0	7.6	3.8	3.2	6.2	1.4	1.2	1.5	1.7
Current account balance/CARs	10.1	10.6	14.1	7.5	6.2	12.5	3.8	2.7	3.4	3.6
CARs/GDP	56.4	56.4	53.6	50.2	51.2	49.5	38.1	43.4	44.8	45.6
Trade balance/GDP	(0.5)	(1.5)	(4.1)	(6.3)	(5.8)	(3.4)	(4.1)	(4.9)	(5.0)	(5.1)
Net FDI/GDP	4.1	4.0	3.5	0.7	(1.8)	(3.2)	(1.5)	(1.5)	(2)	(2)
Net portfolio equity inflow/GDP	(0.2)	(2.2)	(5.9)	(1.6)	(1.4)	(1.0)	(0.5)	(0.5)	(1)	(1)

Table 1

Iceland Selected Indicators (cont.)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Gross external financing needs/CARs plus usable reserves	99.8	93.4	90.4	80.5	85.3	81.1	79.4	82.4	84.8	85.6
Narrow net external debt/CARs	58.3	143.4	57.2	53.3	42.8	39.6	64.3	59.9	56.4	55.1
Narrow net external debt/CAPs	64.8	160.4	66.5	57.7	45.6	45.2	66.9	61.6	58.4	57.2
Net external liabilities/CARs	8.9	9.8	(4.2)	(4.1)	(18.0)	(45.6)	(69.0)	(61.2)	(57.0)	(55.0)
Net external liabilities/CAPs	9.9	10.9	(4.8)	(4.4)	(19.2)	(52.1)	(71.7)	(62.9)	(59.0)	(57.0)
Short-term external debt by remaining maturity/CARs	50.0	41.9	44.6	35.5	34.0	36.5	50.3	43.8	40.6	36.9
Usable reserves/CAPs (months)	5.4	5.5	6.2	7.6	6.4	7.2	10.5	8.8	7.7	6.9
Usable reserves (mil. $)	3,988	4,895	7,231	6,575	6,328	6,787	6,576	6,470	6,393	6,330
Fiscal indicators (general government; %)										
Balance/GDP	(0.1)	(0.8)	(3.0)	0.6	0.8	(1.5)	(10.1)	(9.0)	(6.2)	(4.3)
Change in net debt/GDP	(7.3)	(2.9)	(3.6)	(1.8)	(4.6)	7.5	11.7	8.7	6.0	4.1
Primary balance/GDP	4.5	3.6	1.0	4.5	3.7	1.1	(7.6)	(6.3)	(3.3)	(1.4)
Revenue/GDP	43.7	40.6	41.5	43.5	43.1	40.8	40.2	38.7	40.5	41.0
Expenditures/GDP	43.8	41.4	44.5	42.9	42.3	42.3	50.3	47.7	46.8	45.3
Interest/revenues	10.4	10.9	9.5	8.9	6.6	6.3	6.2	7.1	7.2	7.0
Debt/GDP	80.9	65.0	51.2	43.2	37.4	43.9	59.1	63.0	64.9	65.7
Debt/revenues	184.9	160.2	123.4	99.4	86.8	107.6	147.0	163.0	160.2	160.3
Net debt/GDP	54.4	46.3	39.1	35.5	28.7	34.4	48.2	53.8	56.9	58.2
Liquid assets/GDP	26.5	18.7	12.2	7.8	8.7	9.4	10.9	9.2	7.9	7.5
Monetary indicators (%)										
CPI growth	2.0	1.6	1.7	1.8	2.7	3.0	2.7	3.0	2.5	2.5
GDP deflator growth	3.7	5.6	1.8	0.5	2.6	4.5	2.2	2.7	2.5	2.5
Exchange rate, year-end (ISK/$)	126.90	129.59	112.82	104.42	116.33	121.10	144.30	136.67	133.33	130.83
Banks' claims on resident non-gov't sector growth	(3.3)	(0.3)	1.7	6.8	9.0	4.1	3.0	3.0	4.0	4.0
Banks' claims on resident non-gov't sector/GDP	152.6	137.6	128.8	130.9	134.0	130.9	143.1	138.0	135.8	134.1
Foreign currency share of claims by banks on residents	9.8	9.4	8.9	9.7	10.4	12.8	N/A	N/A	N/A	N/A

Table 1

Iceland Selected Indicators (cont.)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Foreign currency share of residents' bank deposits	18.0	16.5	8.6	9.7	12.2	12.3	N/A	N/A	N/A	N/A
Real effective exchange rate growth	6.9	2.5	12.5	12.0	(2.6)	(6.7)	0	0	0	0

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, IMF (Monetary Indicators).
Adjustments: Government debt adjusted by including loans from Norges bank and IMF.
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 claims on nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. ISK--Icelandic krona. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. 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	Score	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, aluminum, and tourism. The metals and fishing sectors together account for over 20% of GDP and are subject to volatility due to changing aluminum prices and varying fishing catch levels. The tourism industry also accounts for well over 20% of GDP, including direct and indirect effects.
External assessment	3	Based on narrow net external debt and gross external financing needs as per Selected Indicators in Table 1.
		Iceland's net international investment position is more favorable than the narrow net external debt position by over 100% of CARs, 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 changes in metal prices.
Fiscal assessment: flexibility and performance	4	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1.
Fiscal assessment: debt burden	4	Based on net general government debt (% of GDP) and general government interest expenditure (% of general government revenue) as per Selected Indicators in Table 1.
		Contingent liabilities are moderate. We assess the amount of guarantees provided by Iceland (implicitly and explicitly) to various non-deposit-taking institutions at over 30% of GDP. We believe there is a significant likelihood of extraordinary government support.

Table 2

Iceland Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
Monetary assessment	4	The krona is largely floating following the removal of capital controls, albeit with a shorter track record. The central bank has broad operational independence and uses market-based monetary instruments. Given the removal of capital controls and accumulation of extra net foreign exchange reserves, the central bank can act as lender of last resort for the financial system. However, Iceland exhibits a very volatile real effective exchange rate over the economic cycle.
Indicative rating	a+	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	-1	Iceland's economy and its currency area are narrower than rating peers', which makes the country inherently more susceptible to external shocks. This is not fully captured in the indicative rating.
Sovereign credit 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings List, Nov. 9, 2020
- Sovereign Ratings History, Nov. 9, 2020
- Sovereign Ratings Score Snapshot, Nov. 2, 2020
- Iceland's Removal From FATF's Gray List Underlines Its Fast Anti-Money Laundering Response, Oct. 27, 2020
- European Economic Snapshots: A Second COVID-19 Wave Is Dampening The Recovery, Oct. 14, 2020
- Sovereign Risk Indicators, Oct. 12, 2020; a free interactive version is available at http://www.spratings.com/sri

- Economic Research: Keynes And Schumpeter Are What The European Economy Needs Right Now, Oct. 12, 2020
- Banking Industry Country Risk Assessment: Iceland, Sept. 17, 2019
- Default, Transition, and Recovery: 2019 Annual Sovereign Default And Rating Transition Study, May 18, 2020

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	A/Stable/A-1
Transfer & Convertibility Assessment	A
Senior Unsecured	A
Short-Term Debt	A-1