FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Iceland at 'A'; Outlook Stable

Fri 14 Feb, 2025 - 5:03 PM ET

Fitch Ratings - Frankfurt am Main - 14 Feb 2025: 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 akin to 'AAA' and 'AA' category sovereigns. Strong fundamentals include sizeable pension fund assets, a sound banking sector, and resilient private sector balance sheets. Ample foreign reserves help mitigate Iceland's external vulnerabilities. However, the rating remains constrained by Iceland's small economy with limited export diversification.

Cooling Economy: After a robust post-pandemic recovery, Iceland's economy cooled considerably in 2024. We estimate a mild contraction of 0.5%. Moderate growth in real incomes and high interest rates weighed on domestic demand. A larger-than-expected negative contribution from net exports also materialised, reflecting a slow 1H24 in tourism activity, lower marine production, but also a one-off surge in imports of investment goods. As inflation declines and monetary policy eases, we forecast real GDP growth to recover to 1.6% in 2025 and 2.8% in 2026.

Global Trade War: Increasing concerns about global trade protectionism are a key downside risk to our macroeconomic baseline. Although Iceland's direct trade with the US is relatively small (11.5% of Iceland's total goods exports), contagion risks through indirect channels remain significant. Iceland's import dependency is high, evidenced by its structural goods trade deficit (6.7% of GDP end-2023). The risk of higher imported inflation from an escalated global trade war could pose challenges for both fiscal and monetary policy. Across industry, Iceland's marine sector would be the most vulnerable to the risk of higher US tariffs, with the US accounting for 10-14% of Iceland's total marine exports.

CBI Policy Rate Cut: The Central Bank of Iceland (CBI) delivered its first policy rate cut since mid-2021 in October 2024, cutting its key rate of 9.25% by 25bp. Since then, it has delivered two additional 50bp cuts, bringing the policy rate down to 8.0% in this month's Monetary Policy Committee (5 February). With a cooling economy, lower imported inflation and limited wage drift after concluded collective agreements, we expect continued disinflation towards the upper bound of the CBI's inflation target (2.5% +/- 1.5pp) and scope for additional policy rate cuts this year. Our latest projection is for inflation to average 3.5% in 2025 and 2.9% in 2026, down from 5.8% in 2024.

Medium-Term Growth Prospects: Steady progress continues to be made in diversifying the economy into higher-value sectors, such as pharmaceuticals, information and communications technology and biotechnology. Iceland's abundant renewable energy sources, cool climate, and competitive energy prices has also attracted investments of energy-intensive data centres. These trends have increased Iceland's high value exports to 20% of total service exports (2023) from 14% in 2018.

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

Fiscal Consolidation Commitment: Iceland's 2025 Budget was passed under a caretaker government before snap elections in November 2024. Despite disagreements over issues of migration, energy and housing, a broad political consensus for medium-term fiscal sustainability remains. We expect Iceland's new governing coalition, led by Prime Minister Kristrún Frostadóttir from the Social Democratic Alliance, to present an updated plan this Spring, broadly in line with fiscal targets already outlined in the current Fiscal Plan (2025-2029), targeting a balanced budget at the general government level by 2029.

We forecast Iceland's general government deficit to reach 1.8% of GDP this year, after a temporary widening to 3.7% of GDP in 2024, from 2.0% in 2023. A lower fiscal deficit this year reflects the falling out of one-off costs related to the seismic activity on the Reykjanes peninsula (approximately ISK70 billion, 1.5% of GDP), as well as lower interest costs and indexed expenditures.

Declining Debt Ratio: At 61.8% of GDP (Fitch's estimate, end-2024), Iceland's general government debt ratio is above the current median debt ratio of 'A' category peers (57.4%) but projected by Fitch to remain on a gradual downward path. Our assumptions anticipate debt falling towards 55.8% of GDP by 2027. Debt reduction will be underpinned by a combination of modest primary fiscal surpluses and use of accumulated cash deposits (which stood at 7.4% of GDP at end-2024). The planned sale of the state's remaining stake (42.5%) of Íslandsbanki could also 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 (6.9% vs a historical median of 4.6% for 'A' rated sovereigns). A large pool of international FX reserves worth 19% of GDP (2024) and close to five months of imports coverage provide headroom against FX volatility risks. Iceland's positive net international investment position (40.2% of GDP in 3Q24) stands out against the 'A' category peer group (current median negative 0.8% 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 93.1 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 2008-2021.

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	Affirmed	A
	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	A	Affirmed	A
	LC ST IDR	F1+	Affirmed	F1+

	Country Ceiling	A+	Affirmed	A+
senior unsecured	LT	A	Affirmed	A

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VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

Country Ceiling Criteria (pub. 24 Jul 2023)

Sovereign Rating Criteria (pub. 24 Oct 2024) (including rating assumption sensitivity)

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, v3.14.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Iceland	EU Issued, UK Endorsed

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