Iceland

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The supply shock that hit the economy this year serves as a reminder of how volatile growth is in the small and trade dependent economy.

Country Risk Analysis

Summary

Economic growth has slowed significantly in 2019, mainly due to shocks to the tourism industry but also due to slowing fish exports. In addition, the global economic slowdown is weakening demand for Icelandic goods and services. Although the rise of the tourism industry to become the economy's main export has contributed to improving the resilience of the economy, the supply shock shows that there is still room for further export diversification.

The economic slowdown is leading to a narrowing of the current account surplus and is triggering an easing of fiscal and monetary policy. Following a long period of deleveraging, there is ample room for manoeuvre for the authorities. Government debt ratios have continued to decline and expectations are for a further near-term strengthening.

Looking at the broader range of country credit risk metrics, the economy's resilience has continued to improve over the past years. It has become more diverse, the banking sector's health and regulation has improved and its external position has improved as the country has shifted from a net debtor to net creditor.

Recent economic developments

Sharp short-term downturn. Following surprisingly strong growth of 4.8% in 2018, the economy is experiencing a sharp cyclical downturn. The March 2019 collapse of the budget airline WOW, which was the main carrier of tourists from outside Europe, accelerated an ongoing slowdown in the tourism industry. This was compounded by the grounding of Boeing 737 Max jets. Tourism is the country's most important export and it is estimated that it contributes to 30-40% of GDP. In the second quarter, tourist arrivals fell by nearly a fifth compared to the same period last year. Although other airlines have gradually been stepping in to cover the short-fall in transportation capacity, this shock to tourism is also expected to cause a sharp decline in investment. In addition, the absence of the fish capelin has further weakened the export momentum this year. These events are short-term shocks in their nature but official growth forecasts point to a contraction in real GDP in 2019. We are slightly more positive.

Inflation high but expected to decline. Despite cooling economic activity, inflation has risen in the past year. A depreciating currency and a cost push coming from wage increases have recently raised the inflation rate to 3%, significantly higher than EU average. Most indicators, however, point to a decline ahead. Meanwhile, the tight labour market has begun to cool, mainly due to the loss of jobs in connection with the shutting down of WOW's activities.

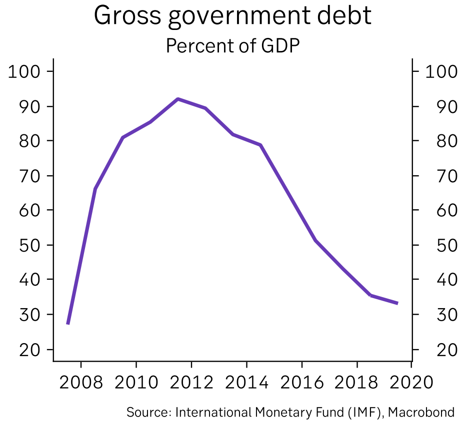
Current account surplus is decreasing on tourism slump. The trade and current account balances have been in surplus since the aftermath of the financial crisis, much helped by an expanding tourism industry. The sector has overtaken marine products to become the country's main export product, and it now accounts for about 40% of export income. Consequently, the sharp contraction in tourism exports so far in 2019 together with lower exports in the fishing industry is expected to produce lower surpluses. The losses on the export side may partly be offset by some decline in imports (lower investments and lower import needs in the domestic export industry). Expectations are for a current account surplus in the range of 0-1% of GDP which compares to 2.9% of GDP seen in 2018. On the financing side, foreign direct investment (FDI) remains low, partly due to the regulatory environment. OECD staff notes that restrictions on FDI are among the highest of the OECD members.

External debt edging down further. External debt continued on a downward trend in 2018. Less foreign borrowing by the public sector brought it down to about 77% of GDP. The ratio is expected to decline further in 2019. Iceland's net external creditor position also grew last year, adding to the resilience of the economy. Furthermore, the current account surplus has helped generate a rise in foreign exchange reserves over the past year. At more than USD 6.5 bn in September they cover about 10 months of imports or more than four times outstanding short term external debt.

Economic policies

Fiscal policy adjusts to milden downturn. The authorities are adhering to its public finance law adopted in 2016, including its numerical targets for government budget balances and net debt. Budget surpluses have been recorded in the past few years and reached 1.1% of GDP in 2018. The government now appears willing to let automatic fiscal stabilisers work and have recently relaxed its previous target for 2019 of a 1% of GDP surplus. Even a small deficit for the year, which we expect, should reasonably be of limited concern given the overall healthy fiscal situation and the stringent fiscal rules.

Government debt continues to fall. Large primary budget surpluses have contributed to a continued decline in the government debt to just above 35% of GDP in 2018. The share of foreign currency denominated debt declined further to about 12%. This compares to more than 40% in 2011. Contingent liabilities stemming from government guarantees for the national power

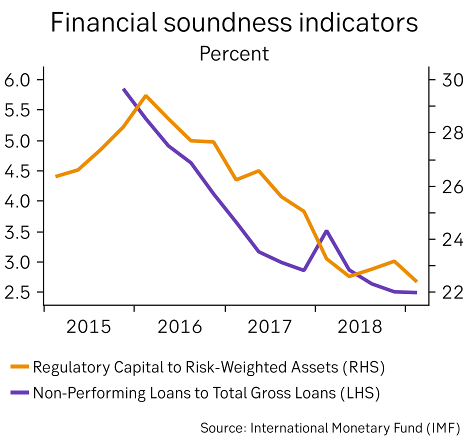


company and for the Housing Fund are sizeable but the overall health of these institutions is considered strong.

Looser monetary policy. With the economy growing below potential and inflation expected to decline towards the central bank's 2.5% target, the bank started a sequence of interest rate cuts in May 2019. The 7 day term deposit rate was recently taken to 3.25%. Markets expect some further easing. Some of the sovereign credit rating agencies have argued that the bank's flexibility has improved since the removal of capital controls in 2017 (as we understand it, following further liberalisation during 2019, only some regulation related to derivatives trading remains), and following the recovery in foreign reserves. We would agree, in particular on the latter point as it improves the bank's lender of last resort function.

Plans for a stabilisation fund. The government recently submitted a bill to parliament regarding establishing a sovereign wealth fund. Its primary role would be to mitigate adverse effects from natural disasters or economic shocks. The fund will be built primarily by dividends from the national power company, Landsvirkjun. It has been noted that Iceland's economy differs substantially from most other economies which have set up such funds. Normally, they are, like Norway, exporters of natural resources wishing to have a safeguard against price fluctuations.

Banking sector largely sound. The banking sector which went through a complete overhaul in the aftermath of the crisis is now considered largely sound. Banks are well capitalised and liquid. Non-performing loans are on a downward trend. Despite continued disinvestments, the government still owns two of the three main banks. The fact that three main banks completely dominate the market implies concentration risks. Credit growth is strong but appears to be easing following a steady pick-up in the past few years. The shock to the tourism industry has also weighed on the housing market. Price rises have moderated considerably since peaking in mid-2017. At about 3% yoy house prices are increasing half as quickly as nominal GDP. This should reduce the risk of overheating and the risks to financial stability.



Political

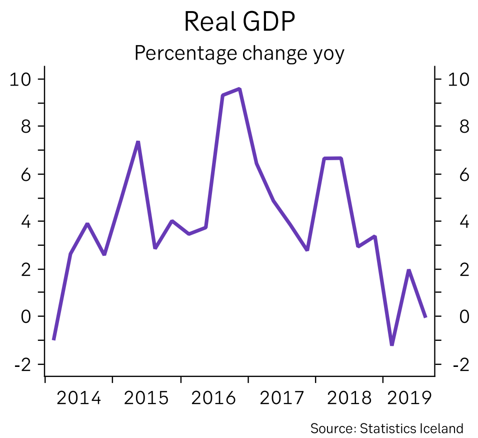
Following the 2017 elections, Prime Minister Jakobsdottir of the Left Greens is heading a coalition with the Independence party (the largest party with 16 of 63 seats) and the Progressives. Together the coalition holds 35 seats. Parliamentary elections are scheduled for 2021.

Structural issues

Iceland is generally regarded as having higher quality governance and higher level of human development than risk class peers. Per capita incomes are also higher than most other economies in similar country risk classes. Demographics are generally favourable, benefiting both from endogenous population growth and steady immigration. Economic growth has historically been broadly in line with average among risk class peers. However, the past year's economic shock is yet another reflection of the higher than average volatility of Iceland's real GDP growth. In the World Economic Forum's global competitiveness index, Iceland ranks 24th in 2019, leading economies such as Estonia and the Czech Republic, and narrowly lagging Ireland.

Outlook

Growth is likely to be below trend until 2021. Forecasts for near-term growth have generally been revised downward, mainly as a consequence of a slower than expected recovery in tourism. Most observers expect the economy to bounce back towards the end of the year but that the real GDP expansion should be limited to around 2% in 2020. This would be lower than the long-run potential of the economy of around 2.5%.



Risks mainly of external character. Domestically, risks of overheating have decreased as the economy has cooled and wages and house prices are likely to growth less rapidly in the next few years. It remains uncertain, however, how strong the recovery in the tourism sector will be. Some observers have also cautioned that the sector might have reached its maximum capacity. On the external side, the outcome of the Brexit negotiations is one of the key downside risks to our main scenario. Britain leaving the EU is initially likely to dampen export demand from one of Iceland's most important markets. It could also complicate future cooperation in the important fishing industry.

Other risks: Competitiveness may be threatened by wage-productivity differential. A recurring threat to price stability and to the competitiveness of the economy is the wage developments. The gains in competitiveness that followed the country's crisis, including the sharp krona devaluation and wage cuts, have largely been lost by now. Productivity gains have been held back, mainly by product market regulations and weak investments. During several years, wage increases have surpassed productivity gains. As a consequence, several indicators signal a decline in competitiveness. In this context, the private sector wage agreement of 2019 implying an average 3.6% yearly increase over the next four years should reasonably halt some of the deterioration in competitiveness.

Iceland: Key Economic Indicators

Macroeconomic	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
GDP (chg)	4.3%	7.5%	5.0%	4.6%	1.3%	1.8%	2.7%	2.4%
GDP (USD bn)	16.9	20.3	24.5	25.9	24.0	26.0	28.6	30.7
GDP/capita (USD)	51 307	60 994	73 192	76 838	70 797	76 299	83 362	88 788
Investments/GDP	17%	20%	21%	20%	19%	19%	19%	19%
Trade/GDP	99%	90%	88%	91%	95%	91%	87%	86%
Money & Prices								
CPI inflation (%)	1.6%	1.7%	1.8%	2.7%	3.3%	2.5%	2.5%	2.5%
Money (M2) growth (%)	27.2%	33.4%	27.6%	22.2%	17.2%	17.7%	15.6%	15.4%
Interest rates	5.0%	5.5%	4.5%	4.1%	4.8%	5.8%	6.5%	6.5%
Stock prices (avg)	2022	2250	1159	1147	1207	1260	1326	1393
Exchange rate (USD)	132	121	107	108	123	118	113	111
Government Finances								
Budget balance/GDP	-0.8%	12.6%	0.5%	1.1%	-0.7%	-0.4%	-0.4%	-0.4%
Govt debt/GDP*	68%	53%	43%	35%	33%	30%	28%	27%
Balance of Payments (USD bn)								
Current account	0.90	1.56	0.91	0.76	0.25	0.50	0.86	0.86
(% of GDP)	5.3%	7.7%	3.7%	2.9%	1.0%	1.9%	3.0%	2.8%
Export of goods	9.0	9.8	11.3	12.2	11.9	12.3	12.9	13.6
Imports of goods	7.8	8.5	10.3	11.4	11.0	11.4	12.0	12.7
FDI	0.7	0.7	0.2	-0.5	-0.5	-0.5	-0.5	-0.5
Loan repayments	-21.9	-0.4	-1.0	-2.1	-1.6	-1.7	-1.9	-2.0
Net other capital flows	21.1	0.9	2.1	3.0	1.1	1.5	1.4	1.3
Chg in intl reserves	0.7	2.8	2.2	1.2	-0.7	-0.2	-0.1	-0.3
External Debt & Liquidity (USD bn)								
Reserves	4.8	6.9	6.2	6.0	6.2	6.0	5.9	5.9
Gross external debt (% of GDP)	177%	126%	91%	77%	79%	71%	61%	54%
Gross external debt	30.0	25.6	22.2	19.9	18.9	18.4	17.5	16.7
o/w short term debt	9.7	1.6	1.6	1.4	1.3	1.3	1.2	1.2

Sources: Oxford Economics, FitchRatings and SEB estimates

Rating history				
Fitch (eoy)	BBB+	BBB+	A	A
Moody's (eoy)	Baa3	A3	A3	A3
S&P (eoy)	BBB-	A3	A	A

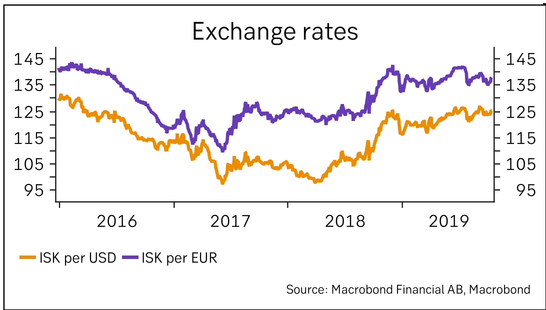
Type of government: Democratic

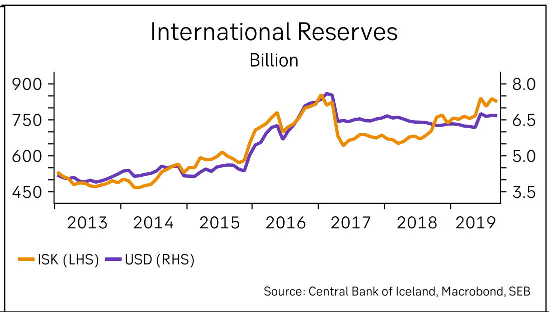
Next elections Parliamentary elections: 2021. Presidential elections: 2020

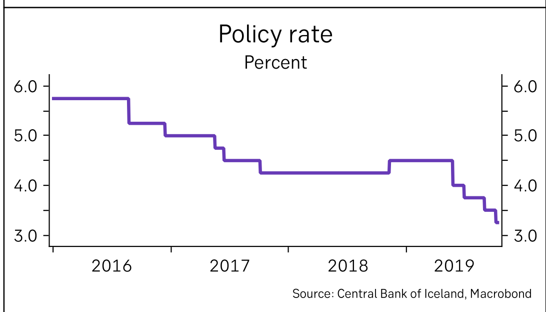
Other:

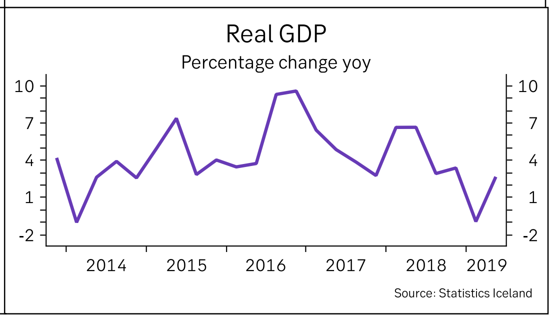
Latest PC deal None

Recent IMF programs 2008 Stand-By Arrangement (USD2.2 bn)









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