

ISSUER COMMENT

3 April 2019


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Government of Iceland

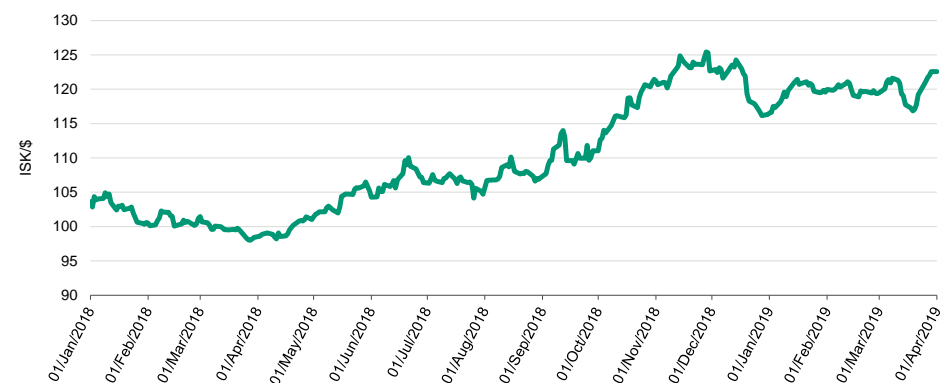
Wow Air's collapse poses downside risks for Iceland's 2019 economic growth, a credit negative

On 28 March, Icelandic low-cost airline Wow Air announced that it had ceased trading and canceled all its flights. The airline's collapse is credit negative for the [Government of Iceland \(A3 positive\)](#) because it poses a material short-term risk to the tourism sector, a key growth driver in recent years, and the potential for an increase in unemployment. The airline's collapse poses a significant downside risk to our 2019 growth estimate, but over the medium to long term we expect that the other 27 airlines that fly to Iceland will eventually take up the slack created by Wow Air's failure.

Increased competition, a rise in jet fuel prices and slowing tourism to Iceland began exerting liquidity pressure on Wow Air last year. After a number of rescue attempts failed, including a merger with Icelandair, the company was forced to ask bondholders to convert debt into shares earlier in March. However, the airline failed to secure further investment, forcing it to declare bankruptcy and cease operations, stranding an estimated 10,000 passengers.

In the worst case, the disruption caused by Wow Air's collapse could lead to a significant decline in exports as a result of lower tourism receipts, while a notable increase in unemployment risks weighing on private consumption. Furthermore, a sharp depreciation in the Icelandic krona threatens to drive up inflation, further weighing on demand and investment. The currency has depreciated by around 12% relative to the US dollar since September 2018, after the news about Wow Air's financial difficulties emerged, and we expect it to remain under pressure on the back of shrinking tourist arrivals (see Exhibit 1).

Exhibit 1

Uncertainty over Wow Air contributed to the Icelandic krona's depreciation
 Exchange rate of the krona to the US dollar


Sources: Central Bank of Iceland and Moody's Investors Service

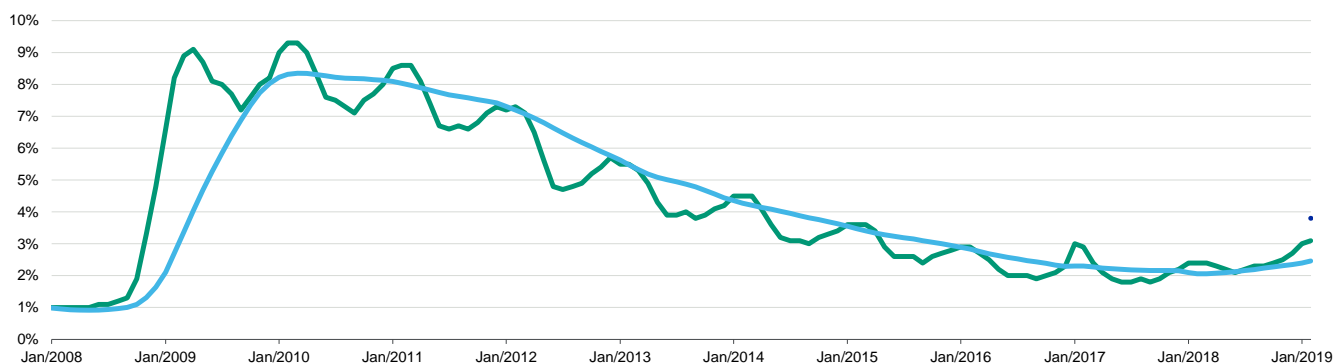
The most notable short-term effect could come from substantially lower tourist arrivals in the coming months, potentially hurting the crucial summer season. Wow Air transported around one-quarter of total tourists to Iceland last year. However, the airline's importance to the country's tourism sector had already declined since the airline's financial troubles became public late last year as the airline's restructuring reduced the size of its fleet and it materially shrank its operations.

In recent remarks, the governor of the Central Bank of Iceland noted that Wow Air's size and operations were roughly half of what they were in 2017. The magnitude of any short-term shock will depend on the speed by which other airlines are able to pick up the slack.

The airline's collapse may also affect the country's aggregate unemployment. Wow Air directly employed around 1,000 people, with a further approximately 400 employed through Airport Associates, the airline's service provider. Assuming none of these workers is able to find new jobs, the share of workers classed as unemployed could, all else equal, rise by about 0.7% (see Exhibit 2).

Exhibit 2

Job losses caused by Wow Air's bankruptcy may increase unemployment
Registered unemployment rate (NSA) and its trend, including forecast



Note: The dot is our projection for the unemployment rate in March 2019, all else being equal.

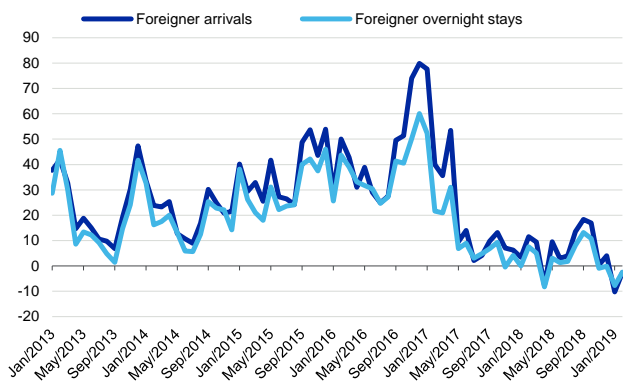
Sources: Iceland's Directorate of Labour and Moody's Investors Service

We already expect a sharp moderation in growth this year to 2%-3%, from real GDP growth in 2018 of 4.6%, reflecting the ongoing maturation of the tourism sector (see Exhibit 3). The World Travel and Tourism Council estimates that the total (including indirect) contribution from tourism to GDP is around 33%, more than doubling since 2009 (see Exhibit 4). Given the importance of tourism to the Icelandic economy, the potential for significant disruption to tourism inflows arising from the airline's collapse poses downside risks to this growth forecast. In addition, our growth forecast also faces risks from the ongoing wage dispute between trade unions and employers that has already led to strikes impacting the tourism sector.

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Exhibit 3

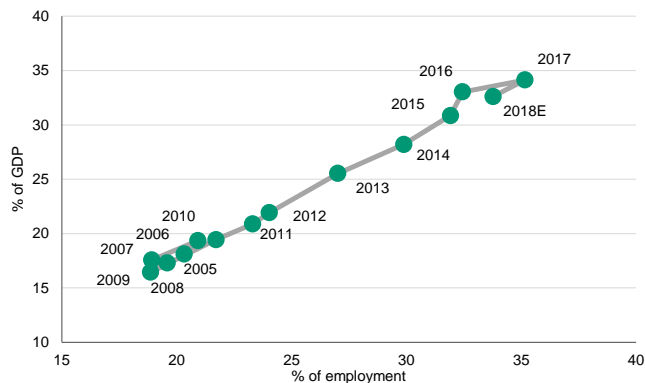
Tourist arrivals to Iceland have been decreasing recently...
Foreign arrivals and overnight stays, year-on-year change



Sources: Statistics Iceland and Moody's Investors Service

Exhibit 4

... although the economic importance of Iceland's tourism sector has increased materially over the past decade
Total (including indirect) share of tourism industry in employment and nominal GDP



Sources: World Travel and Tourism Council and Moody's Investors Service

We expect that the remaining 27 airlines that fly to Iceland will largely fill the gap created by Wow Air's failure, although its large share of tourist arrivals and its offering as a low-cost, long-haul airline with a strong focus on the US market, may be difficult to completely replicate. Additionally, Iceland's resilience to withstand shocks has materially improved since the global financial crisis, which would serve to limit any medium to long term effect.

Iceland's improving economic resilience is the result of a net external creditor position and its very high wealth levels, while its fiscal strength benefits from the precipitous decline in general government debt over recent years. An expected budget surplus in 2019 provides space to accommodate any indirect fiscal costs from lower growth such as reduced tax receipts or higher social security spending. Nevertheless, Iceland's vulnerability to shocks given the economy's small size and relatively limited diversification is one of the sovereign's main credit challenges.

Moody's related publications

- » **Issuer Comment:** [Government of Iceland: Stronger-than-expected growth will support decline in Iceland's debt/GDP ratio, a credit positive](#), 6 March 2018
- » **Credit Opinion:** [Government of Iceland - A3 positive: Regular update](#), 4 December 2018
- » **Issuer Comment:** [Government of Iceland: Central bank's reduced reserve requirements on capital inflows are credit positive](#), 7 November 2018
- » **Methodology:** [Sovereign Bond Ratings](#), 27 November 2018

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