Iceland

Key Rating Drivers

Outlook Revision: The revision of the Outlook to Stable reflects the resilience shown by the Icelandic economy to the Covid-19 pandemic shock and Fitch Ratings' expectation of a sustained growth recovery, which should facilitate a reduction in the fiscal deficit and debt over time.

Recovery Ahead: We expect real GDP to grow by 4.5% in 2022 and 3% in 2023 (vs. current 'A' peer medians of 4.3% and 3.5%). High aluminium prices will improve Iceland's terms of trade and the lifting of all border-containment measures in February should support the recovery in the tourism sector. Private consumption and investment will remain the main growth drivers.

Less Impact from Energy Costs: Higher fuel and food prices represent a shock, but household purchasing power and industry profit margins are likely to be less affected by higher energy costs than the rest of Europe. The share of renewables in the energy mix, at above 80%, is the highest in Europe, and Iceland does not rely on natural gas.

Gradual Deficit Reduction Ahead: We expect the deficit to narrow to 6.5% of GDP in 2022 from 8.9% in 2021 as the recovery in revenue growth strengthens and the majority of pandemic-related fiscal support unwinds. For 2023 we expect a deficit of 4.8% of GDP, above the projected 'A' median (3.3% of GDP) and the western European median (2.1% of GDP). We expect general government debt to remain at around 75% of GDP in 2022-2023 and to decline slowly thereafter.

The government does not intend to reinstate its own fiscal rules before 2026. In our view, this suggests that fiscal consolidation will be gradual and that the government will likely extend further fiscal support to the economy should the recovery be weaker than expected. This poses risks to the fiscal adjustment.

High Financing Flexibility: The sovereign has high financing flexibility due to the extremely large pool of private pension funds' assets (208% of GDP), 64% of which was invested domestically at end-2021. The government also has strong access to the international bond market, a large cash deposit buffer and is supported by robust liquidity in the banking system. Moreover, government assets are large at 84% of GDP. Sales of government equity stakes could accelerate debt reduction over the coming years.

Higher Inflation for Longer: The rate of headline consumer price inflation rose by 6.7% in March, its highest level in nearly a decade. Inflation is being driven by domestic factors, such as rising housing costs (which are accounted for directly in the national measure of inflation), a more rapid rebound in economic activity, and wage growth. Increasing global commodity prices are also contributing, but are not the main driver, due to the predominance of renewables in the country's energy mix.

In our view, the combination of higher interest rates, macro-prudential measures and gradual withdrawal of fiscal support should mitigate house price pressures. Moreover, from 2023 oil and commodity prices should also start to decline. We therefore expect inflation to average 5.3% in 2022 and decline to 3.5% in 2023.

This report does not constitute a new rating action for this issuer. It provides more detailed credit analysis than the previously published Rating Action Commentary, which can be found on www.fitchratings.com.

Ratings

Foreign Currency	
Long-Term IDR	A
Short-Term IDR	F1+
Local Currency	
Long-Term IDR	A
Short-Term IDR	F1+
Country Ceiling	A+
Outlooks	
Long-Term Foreign-Currency IDR	Stable
Long-Term Local-Currency IDR	Stable

Rating Derivation

Component	
Sovereign Rating Model (SRM)	A
Qualitative Overlay (QO)	0
Structural features	0
Macroeconomic	0
Public finances	0
External finances	0
Long-Term Foreign-Currency IDR	A
Source: Fitch Ratings	

Data

	2021E
GDP (USDbn)	25
Population (m)	0.4
Source: Fitch Ratings	

Applicable Criteria

Sovereign Rating Criteria (April 2021)

Country Ceilings Criteria (July 2020)

Related Research

Fitch Revises Iceland's Outlook to Stable; Affirms at 'A' (March 2022)

Global Economic Outlook (March 2022)

Interactive Sovereign Rating Model

Fitch Fiscal Index - Analytical Tool

Click here for more Fitch Ratings content on Iceland

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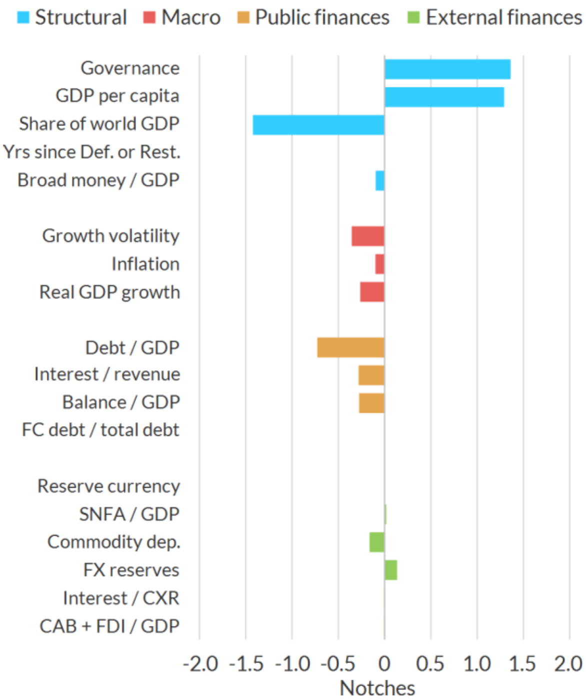
Rating Summary

Long-Term Foreign-Currency Issuer Default Rating: A

Sovereign Rating Model: A[a]

Contribution of variables, relative to A median



Qualitative Overlay: 0

Adjustments relative to SRM data and output

Structural features: No adjustment.

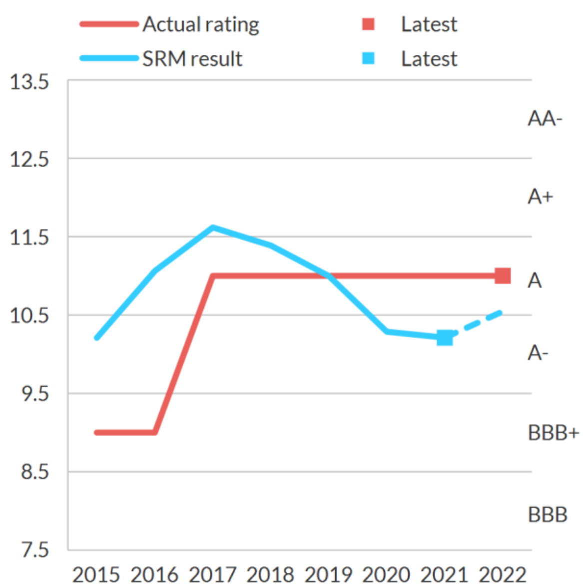
Macroeconomic outlook, policies and prospects: No adjustment.

Public finances: No adjustment.

External finances: No adjustment.

Note: See Peer Analysis table for summary data, including rating category medians; see the Full Rating Derivation table for detailed SRM data.
[a] Sovereign rating committee can override SRM Predicted Rating if a marginal change in the Model Result leads to a notch change which is judged to be temporary or caused by a re-estimation of the SRM, a process that Fitch undertakes on at least an annual basis. Please refer to the Rating Action Commentary for further information when the Applied Rating differs from the Predicted Rating.
Source: Fitch Ratings

Sovereign Rating Model Trend



Rating Derivation History (last 10 reviews)

Review Date	LT FC IDR	SRM Result[ab]	QO S	M	PF	EF
Latest	A	A	0	0	0	0
24 Sep 21	A	A	0	0	0	0
26 Mar 21	A	A	0	0	0	0
23 Oct 20	A	A	0	0	0	0
22 May 2020	A	A	0	0	0	0
22 Nov 19	A	A+	0	0	0	-1
24 May 2019	A	A+	0	0	0	-1
07 Dec 18	A	A+	0	0	0	-1
08 Jun 18	A	A+	0	0	0	-1
08 Dec 17	A	A+	0	0	0	-1

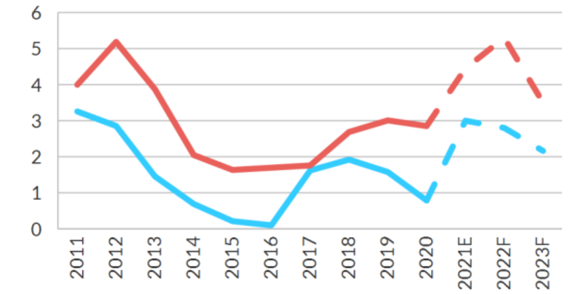
[a] The latest rating uses the SRM result for 2021 in the chart (this will roll forward to 2022 in July 2022).
[b] Historical SRM results in this table may differ from the chart, which is based on our latest data, due to data revisions.
Abbreviations: LT FC IDR = Long-Term Foreign-Currency Issuer Default Rating; SRM = Sovereign Rating Model; QO = Qualitative Overlay
Source: Fitch Ratings

Peer Analysis

—— Iceland —— A Median

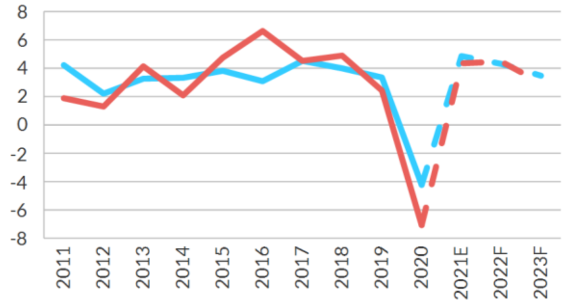
Consumer Price Inflation

(annual avg, %)



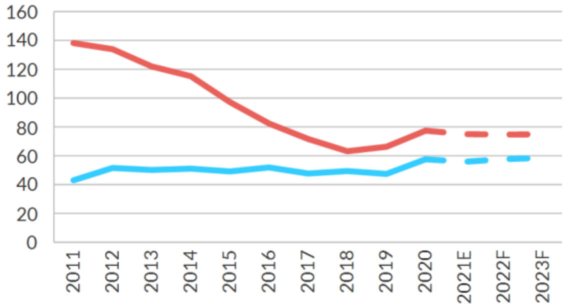
Real GDP Growth

(%)



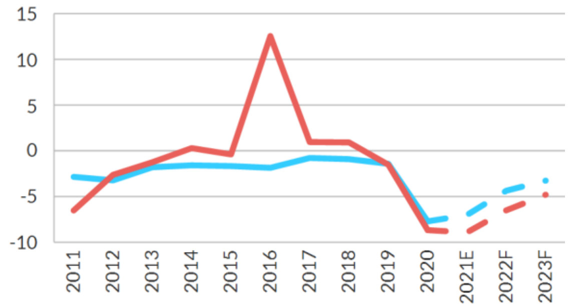
Gross General Government Debt

(% GDP)



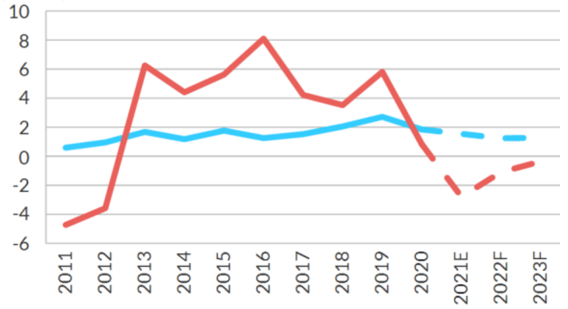
General Government Balance

(% GDP)



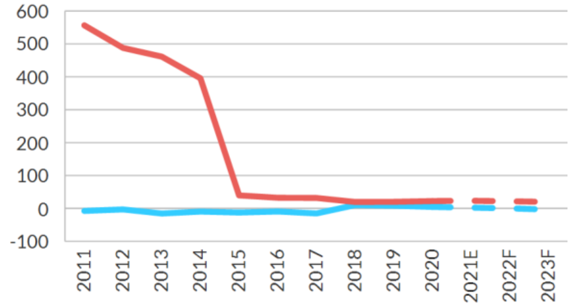
Current Account Balance

(% GDP)



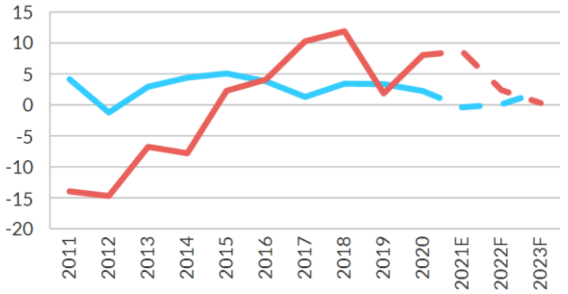
Net External Debt

(% GDP)



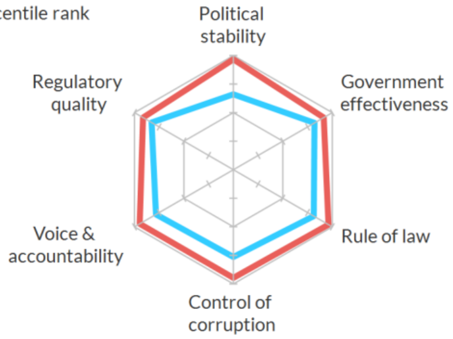
Real Private-Sector Credit Growth

(%)



Governance Indicators

Percentile rank



Source: Fitch Ratings, Statistical Office, Ministry of Finance, IMF, World Bank

Peer Analysis

2021E[a]	Iceland	A median	AA median	BBB median
Structural features				
GDP per capita (USD) [SRM]	69,033	27,440	46,550	11,354
Share in world GDP (%) [SRM]	0.0	0.0	0.0	0.0
Composite governance indicator (percentile, latest) [SRM][b]	94.2	75.6	84.6	58.0
Human development index (percentile, latest)	97.8	81.9	88.7	68.0
Broad money (% GDP) [SRM]	51.5	89.4	98.3	59.7
Private credit (% GDP, 3-year average)	100.7	73.8	101.8	56.4
Dollarisation ratio (% bank deposits, latest)	11.2	10.2	12.2	17.1
Bank system capital ratio (% assets, latest)	24.9	15.6	15.9	15.3
Macroeconomic performance and policies				
Real GDP growth (%, 3-year average) [SRM]	0.6	3.7	2.3	3.4
Real GDP growth volatility (complex standard deviation) [SRM]	4.3	2.9	2.2	3.4
Consumer price inflation (%, 3-year average) [SRM]	4.2	2.3	2.2	3.3
Unemployment rate (%)	5.9	6.4	5.0	7.6
Public finances (general government)[c]				
Balance (% GDP, 3-year average) [SRM]	-8.0	-2.2	-0.4	-2.3
Primary balance (% GDP, 3-year average)	-4.0	-0.4	1.1	-0.3
Interest payments (% revenue, 3-year average) [SRM]	9.9	4.6	3.8	6.9
Gross debt (% revenue, 3-year average)	185.2	137.9	134.8	140.2
Gross debt (% GDP, 3-year average) [SRM]	75.7	42.2	39.7	36.1
Net debt (% GDP, 3-year average)	60.8	37.9	29.2	30.1
FC debt (% gross debt, 3-year average) [SRM]	13.9	11.0	0.8	35.2
External finances[c]				
Current account balance (% GDP, 3-year average)	-1.0	0.9	1.6	-1.8
Current account balance + net FDI (% GDP, 3-year avg.) [SRM]	-1.9	2.4	0.9	0.6
Commodity dependence (% CXR) [SRM]	51.4	11.5	16.0	20.1
Gross external debt (% GDP, 3-year average)	83.0	64.4	114.3	51.2
Net external debt (% GDP, 3-year average)	22.6	-8.1	-9.4	9.0
Gross sovereign external debt (% GXD, 3-year average)	15.6	17.5	16.2	28.9
Sovereign net foreign assets (% GDP, 3-year average) [SRM]	13.5	12.0	4.9	2.7
External interest service (% CXR, 3-year average) [SRM]	3.6	2.4	5.0	4.2
Foreign-exchange reserves (months of CXP) [SRM]	7.6	4.4	2.9	5.0
Liquidity ratio	227.3	102.6	59.9	138.7

[a] 3-year averages are centred on this year. Fitch does not forecast indicators labelled 'latest', meaning data may be lagging.
[b] Composite of all six World Bank Worldwide Governance Indicators (see chart on the previous page).
[c] See Appendix 2: Data Notes and Conventions for details of data treatment for public finances and external finances.
Source: Fitch Ratings, Statistical Office, Ministry of Finance, IMF, World Bank, United Nations

Supplementary Information

BSI / MPI = n.a. / 1. About the BSI and MPI: Fitch's bank systemic indicator (BSI) equates to a weighted average Viability Rating. The macro-prudential risk indicator (MPI) focuses on one potential source of financial stress, ranging from '3' – high potential vulnerability to financial stress over the medium term based on trends in credit expansion, equity and property prices and real exchange rates – to '1' – low likelihood. For more information, refer to Fitch Ratings' most recent Macro-Prudential Risk Monitor report.

Year cured from the most recent default or restructuring event, since 1980 = No event.

The de facto exchange rate regime, based on the latest IMF Annual Report on Exchange Arrangements and Exchange Restrictions report, is 'Floating'.

Rating Factors

Strengths

- Iceland ranks much higher on the World Bank Worldwide Governance Indicators and Human Development Index Indicators relative to the medians.
- GDP and income per capita are significantly higher than the 'A' and 'AA' medians.
- Pension funds' assets accounted for 208% of GDP at end-2021, providing support to the sovereign's fiscal financing flexibility.
- A favourable demographic composition (the share of people of working age was 65% in 2020) supports growth potential.
- Foreign-exchange reserves were 7.6 months of current external payments in 2021, well above the 'A' peer current median (of four months).

Weaknesses

- Iceland is highly reliant on tourism. According to Statistics Iceland, the sector accounted for 8% of GDP and 13.9% of employment prior to the pandemic in 2019 (at end-2021 it accounted for 5% of GDP and 9.6% of employment).
- Volatility of real GDP growth and inflation are higher than the 'A' peer median.
- Gross general government debt stood at 75% of GDP at end-2021, well above the 'AA' current median.
- Iceland's public debt interest payments and the share of public debt maturing in a year are higher than the 'A' peer median.
- Gross and net external debt metrics are higher than the 'A' medians. But the net international investment position, which includes equity and investment fund shares, was 39% of GDP in 2021, well above the current 'A' median of 12%.

Rating	Sovereign
A+	China
	Israel
	Malta
A	**Iceland**
	Japan
	Lithuania
	Ras Al Khaimah
	Saudi Arabia
	Slovakia
	Slovenia
A-	Chile
	Latvia
	Poland
	Spain

Rating Sensitivities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Public Finances: Evidence that the government's economic and fiscal strategy will lead to a resumption of an upward trajectory of the government debt/GDP ratio over time.
- Macro: Renewed economic weakness or an adverse shock, for example due to a slower-than-expected recovery in tourism, a sustained correction in the real estate market and material negative impact on the banking sector.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- Public Finances: Greater confidence that the government debt-to-GDP ratio will be placed on a firm downward path, for example through implementation of a fiscal-consolidation strategy or sustained GDP growth over time.
- Macro: Sustained economic recovery beyond 2022, for example supported by a diversification of the export base and without generating macroeconomic imbalances.

Forecast Summary

	2018	2019	2020	2021E	2022F	2023F
Macroeconomic indicators and policy						
Real GDP growth (%)	4.9	2.4	-7.1	4.3	4.5	3.0
Unemployment (%)	3.1	3.9	6.4	5.9	5.5	5.0
Consumer price inflation (annual average % change)	2.7	3.0	2.9	4.5	5.3	3.5
Policy interest rate (annual average, %)	4.5	3.0	0.8	2.0	3.5	4.0
General government balance (% GDP)	0.9	-1.5	-8.7	-8.9	-6.5	-4.8
Gross general government debt (% GDP)	63.1	66.2	77.4	75.0	74.7	74.9
ISK per USD (annual average)	108.3	122.6	135.4	127.0	129.2	126.5
Real private credit growth (%)	11.9	1.9	8.1	8.7	2.4	0.3
External finance						
Merchandise trade balance (USDbn)	-1.5	-1.0	-0.7	-1.3	-1.5	-1.3
Current account balance (% GDP)	3.5	5.8	0.8	-2.8	-1.1	-0.4
Gross external debt (% GDP)	76.5	78.3	89.5	82.9	76.8	71.8
Net external debt (% GDP)	19.7	20.2	22.6	23.4	21.9	19.8
External debt service (principal + interest, USDbn)	2.6	2.1	1.7	1.2	2.2	1.3
Official international reserves including gold (USDbn)	6.3	6.8	6.4	7.1	6.7	6.9
Gross external financing requirement (% int. reserves)	18.2	3.5	16.5	25.2	28.8	14.9
Real GDP growth (%)						
US	2.9	2.3	-3.4	5.7	3.5	1.6
China	6.7	6.0	2.2	8.1	4.8	5.1
Eurozone	1.9	1.3	-6.4	5.3	3.0	2.3
World	3.2	2.6	-3.3	5.9	3.5	2.8
Oil (USD/barrel)	71.5	64.1	43.3	70.6	100.0	80.0

Source: Fitch Ratings

Sources and Uses

Public Finances

(General government)

(ISKbn)	**2021**	**2022**
Uses	**662.9**	**613.6**
Budget deficit	288.3	231.1
MLT amortisation	374.6	382.4
Domestic	291.5	297.4
External	83.1	85.0
Sources	**662.9**	**613.6**
Gross borrowing	533.0	613.6
Domestic	351.7	442.3
External	181.3	171.2
Privatisation	55.0	0.0
Other	61.9	-0.0
Change in deposits (- = increase)	12.9	-0.0

Source: Fitch Ratings

External Finances

(USDbn)	**2021**	**2022**
Uses	**1.6**	**2.0**
Current account deficit	0.7	0.3
MLT amortisation	0.9	1.7
Sovereign	0.0	0.6
Non-sovereign	0.9	1.1
Sources	**1.6**	**2.0**
Gross MLT borrowing	2.6	1.7
Sovereign	0.8	0.5
Non-sovereign	1.8	1.2
FDI	0.2	-0.1
Other	-0.9	-0.0
Change in FX reserves (- = increase)	-0.3	0.3

Source: Fitch Ratings

Credit Developments

Sustained Macro Recovery Ahead

The Icelandic economy has proved more resilient to the pandemic shock relative to our initial expectations. Real GDP grew by 4.3% in 2021, following a contraction of 7.1% in 2020. This was slightly better than our forecast at the previous review (4%) but weaker than the 'A' peer current median. The recovery is underpinned by a rebound in tourism flows facilitated by very high Covid-19 vaccination rates, solid performance of the aluminium sector supported by high aluminium prices, steady improvement of the labour market and sizeable fiscal policy support. Private consumption and investment have been the main growth drivers; net trade detracted from growth as imports grew at a faster pace than exports particularly in 4Q21 due to strong domestic demand.

We expect real GDP to grow by 4.5% in 2022 and 3% in 2023 (versus the 'A' peer current medians of 4.3% and 3.5%). High aluminium prices will continue to support Iceland's terms of trade and the re-opening of the border should support a strengthening in the recovery of the tourism sector. Private consumption and investment will remain the main growth drivers, supported by further declines in unemployment and the government's "Investment and Construction" initiative. We expect the level of real GDP to surpass pre-pandemic level in 3Q22.

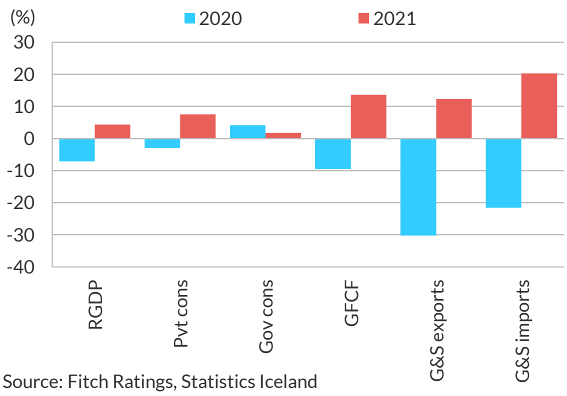
Foreign tourist arrivals swiftly recovered in 2021. Between August and November 2021 foreign tourist arrivals were above 60% of the 2019 level and tourism receipts peaked at above 80% of the 2019 level. The positive trend was interrupted by the emergence of the Omicron variant. For 2021 as a whole, foreign arrivals were 38% of the 2019 level up from 21% in 2020. Covid-19 containment measures and travel restrictions lifted in February 2022, so we expect the recovery in foreign tourist flows to continue and foreign arrivals to reach 50% of the 2019 level. This will underpin services' exports and private consumption growth. In January 2022, foreign arrivals in hotels were 48% of the January 2019 level, up from 1.6% in January 2021.

The other two key sectors of the economy, aluminium and fishing, have been resilient throughout the pandemic. Both sectors should continue to benefit from improving terms of trade. The prices of aluminium and some fish have risen strongly recently. In particular, the aluminium sector should fare well as the price in February reached its highest level since 2008. However, the high cost of energy can have a negative impact on the production capacity of the aluminium smelters. Marine products' export volumes are set to rise, mainly owing to the increase in the quota for capelin, which will be the largest since 2003. Iceland's aquaculture sector is small but expanding fast, with significant investment to increase output.

In our view, the Icelandic economy should be partly insulated from the impact of the Ukraine-Russia war. The share of renewables in the energy mix at above 80% is the highest in Europe, and gas is only a very small portion of it. As a result, household purchasing power and industry profit margins are likely to be less affected by higher energy costs than the rest of Europe. Moreover, direct trade and financial sector linkages with Russia, Ukraine and Belarus are very limited. Nevertheless, weaker GDP growth in the main trading partners could have a negative effect on Iceland's export performance.

2021 Growth Recovery

Real GDP growth

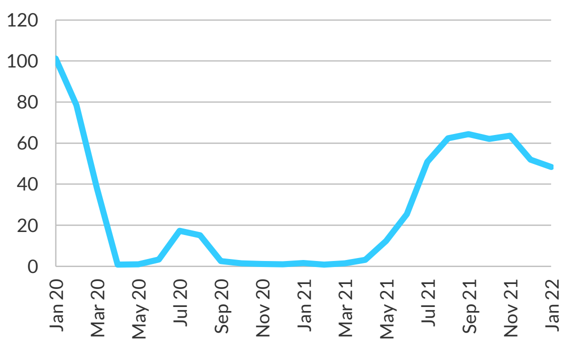


Source: Fitch Ratings, Statistics Iceland

Foreign Tourist Arrivals

Index 2019=100

Foreign tourist arrivals



Source: Fitch Ratings, Statistics Iceland

Gradual Deficit Reduction Ahead

The general government deficit widened to 8.9% of GDP in 2021 from 8.7% in 2020, although this was a better outturn relative to our previous review (10% of GDP) but worse than the 'A' peer current median (7% of GDP). We expect the deficit to decline to 6.5% of GDP as the recovery in revenue growth strengthens and the majority of pandemic-related support unwinds. For 2023, we expect a deficit of 4.8% of GDP, above the projected 'A' median (3.3% of GDP) and the western European median (2.1% of GDP). The government does not intend to reinstate its own fiscal rules before 2026. In our view, this suggests that it will withdraw fiscal support gradually and that it will likely extend further fiscal support to the economy should the recovery be weaker than expected.

We expect general government debt to remain around 75% of GDP in 2022-2023 and to decline slowly thereafter. The sovereign has high financing flexibility due to the extremely large pool of private pension funds' assets (208% of GDP at end-2021), 64% of which was invested domestically. The government also has strong access to the international bond market, a large cash deposit buffer and is supported by robust liquidity in the banking system. Moreover, government assets are large at 84% of GDP. On 23 March 2022, the Treasury sold 22.5% of its stake in Islandsbanki, raising ISK53 billion (1.5% of 2021 projected GDP), which is earmarked for public debt reduction[1]. This follows the sale of the first 35% stake in June 2021 (ISK55 billion, 1.7% of GDP) Further sales of government equity stakes could accelerate debt reduction in the coming years.

Iceland's debt structure has improved in recent years. Around 89% of central government debt is held by residents while only 11% is denominated in foreign currency. Since the start of the pandemic, the government has financed the budget deficit predominantly in the domestic market. It has also used the liquid assets of the Housing Finance Fund (HFF) – a 100% state-owned company. We estimate that around 21% of the 2021 financing requirement was financed by the use of HFF assets. Following a comprehensive revision of the public finance statistics in 2019, the HFF is within the general government scope. As the HFF assets wind down, general government debt should decline. As HFF assets become liquid either because mortgages are amortised or paid in advance, they will become a source of funding that will either lower the borrowing requirements or allow to retire other government debt.

Higher Inflation for Longer

Headline consumer price inflation rose by 6.7% in March, its highest level in nearly a decade. Inflation dynamics are different relative to the rest of western Europe. In Iceland they are mostly driven by domestic factors, such as a rapid rebound in economic activity, rising house prices and wage growth. The increasing global commodity prices also contribute, but are not the main driver due to the predominance of renewables in the country's energy mix.

The strong labour market performance and steady growth in nominal wages have contributed to higher inflation. The unemployment rate was 4.5% in February 2022, down from the April 2021 peak of 8.4%. We expect unemployment to fall further as the tourism recovery gathers pace. The swift recovery in the labour market has been accompanied by steady wage growth. Nominal wages rose by 7.3% in the 12 months to February 2022; however, real wage growth has declined sharply since June 2021 as consumer price inflation picked up. A large number of collective wage agreements in the private sector expire in November and the trade unions will likely push for pay settlements well above inflation. Our inflation forecasts assume that nominal wages will grow by 7%.

The Central Bank of Iceland (CBI) has withdrawn its pandemic-related accommodative policies and since April 2021 has raised the key policy rate to 2.75% from 0.75%. It has also adopted a raft of macro-prudential measures. These include the lowering of the maximum loan-to-value ratio (LTV) on new mortgages to 80% from 85%, an increase in the countercyclical capital buffer to 2% from 0% (effective from September 2022) and the introduction of a debt service-to-income (DSTI) limit of 35% on new mortgages.

The housing market has been buoyant since the start of the pandemic. Prices rose by nearly 16% in 2021 in nominal terms, and just above 10% in real terms. Despite rising interest rates and tighter macro-prudential measures, housing demand remains buoyant and nominal prices rose by 3% in January-February 2022. Fitch's Macro-Prudential Risk Monitor indicates that real house prices are above their long-term trend. Housing market turnover has eased in recent months as well as the number of purchase contracts made. According to the Housing and Construction Authority, a record 40% of flats in December 2021 were sold at above the asking price.

Housing supply lags significantly behind the level of demand, with very few flats currently listed for sale. By February 2022, the number of flats advertised for sale in the capital area had fallen by 69% since January 2020. The average time to sale has also fallen to an historical low. However, the construction sector appears to be picking up: the number of flats in the first stage of construction has increased from around 1,400 at the end of 2020 to 3,000 by the end of 2021, according to data from the Federation of Icelandic Industries (SI). This suggests that supply should rise in 2022.

In our view, the combination of higher interest rates, macro-prudential measures, some pick-up in housing supply and gradual withdrawal of fiscal support should mitigate housing price pressures. Moreover, from 2023, oil and commodity prices should also start to decline. We therefore expect the rate of inflation to average 5.3% in 2022 and decline more markedly to 3.5% in 2023, still above the CBI target.

[1] As the sale happened after the week of the rating committee, the privatisation revenues are not included in our fiscal projections and do not appear in the Sources & Uses table on page 6.

Stable External Finances

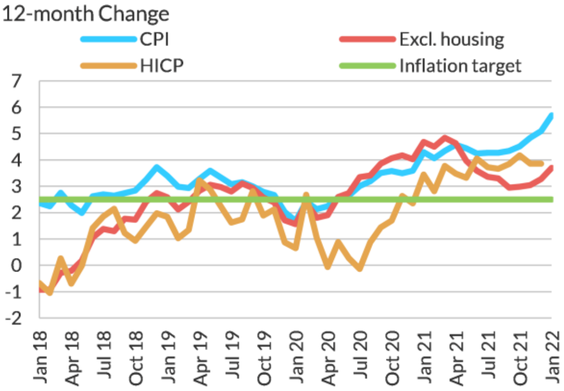
External finances have been broadly resilient throughout the pandemic despite the collapse in tourism receipts. Following a surplus in 2020, the current account swung into a deficit of 2.8% of GDP in 2021. This was due mainly to imports of goods growing at a much faster pace than exports. Investment grew strongly (by 13.6%) in 2021 and is import-intensive. Moreover, the primary income balance worsened markedly (to 0.4% from 2.4% of GDP in 2020.) The CBI said this is due to the improved performance of foreign-owned companies in Iceland. The services' balance recorded another surplus, supported by the exports of digital services, intellectual property rights and the partial recovery of tourism receipts. As the tourism sector recovery gathers pace, we expect the current account deficit to narrow to 0.4% of GDP by 2023.

The krona was broadly stable in 2021, depreciating only marginally against the US dollar (2.5%) and the euro (5.4%). The net international investment position improved despite the current account deficit and was at 39% of GDP at end-2021. Pension funds dominate in the domestic financial market and their activities have a strong impact on the NIIP and on the currency. In 2021, pension funds' net purchases of foreign assets totalled ISK53 billion (1.6 % of 2021 GDP), broadly unchanged from 2020.

Iceland has a 50% limit on the share of overseas foreign holdings in pension assets. The authorities are debating a potential lifting or removal of the limit. If the legislation were changed, we would not expect a significant change in funds' activity and do not think this would lead to excessive capital outflows. We would expect pension funds to continue diversifying their assets abroad given the reduced differential between international and domestic interest rates. However, we expect the process to remain orderly and gradual. The risk of sudden sharp capital outflows from pension funds remains low, as we believe it would not be in the funds' interest to destabilise excessively the krona. Among other things, a weaker currency would hurt their stock market value and inflate their own pension liabilities.

Various Inflation Measures

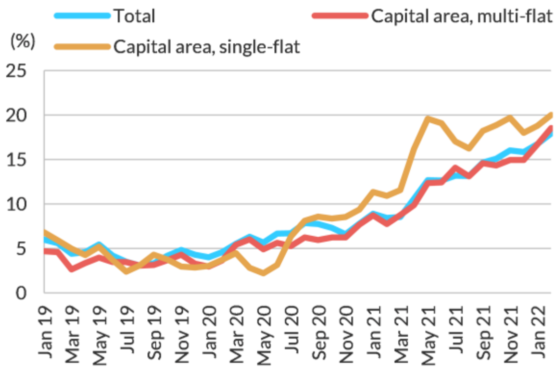
12-month Change



Source: Fitch Ratings, CBI

House Prices

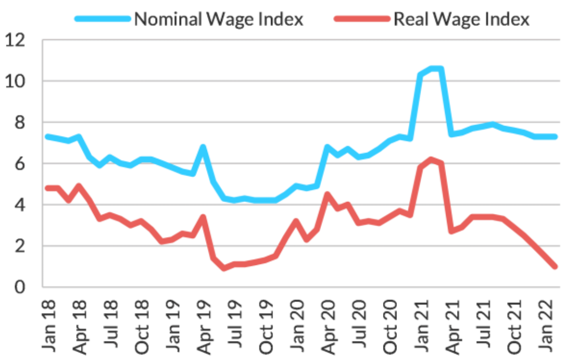
YoY Growth



Source: Fitch Ratings, Statistics Iceland, Haver Analytics

Wage Indices

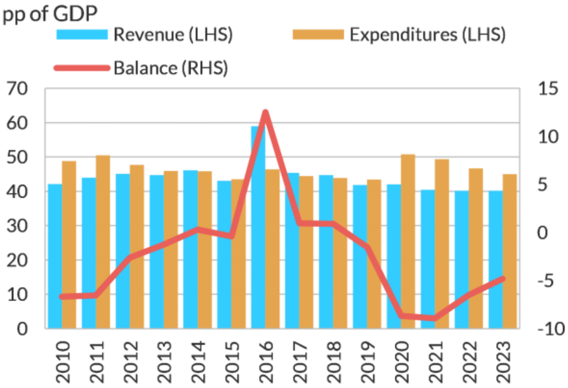
% Change over 12 months



Source: Fitch Ratings, Statistics Iceland, Haver Analytics

Fiscal Path

pp of GDP



Source: Fitch Ratings

Public Debt Dynamics

According to Fitch's baseline projections, GGGD should remain at around 75% of GDP in 2022-2023 and decline slowly thereafter. In a scenario of looser fiscal policy, the debt ratio would rise to 95% of GDP by 2026. A low-growth scenario would see debt continuing to rise and reach 82% of GDP by 2026. Conversely, further sales of government equity stakes could accelerate debt reduction in the coming years.

Debt Dynamics – Fitch's Baseline Assumptions

	2020	2021	2022	2023	2024	2025	2026
Gross general government debt (% of GDP)	77.4	75.0	74.7	74.9	74.9	74.7	74.2
Primary balance (% of GDP)	-4.6	-4.8	-2.5	-0.8	0.0	0.0	0.0
Real GDP growth (%)	-7.1	4.3	4.5	3.0	2.5	2.3	2.3
Average nominal effective interest rate (%)	5.9	5.8	5.8	5.7	5.0	4.6	4.2
ISK/USD (annual avg)	135.4	127.0	129.2	126.5	130.4	130.4	130.4
GDP deflator (%)	3.6	5.8	5.3	3.5	2.5	2.5	2.5
Stock-flow adjustments (% of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0

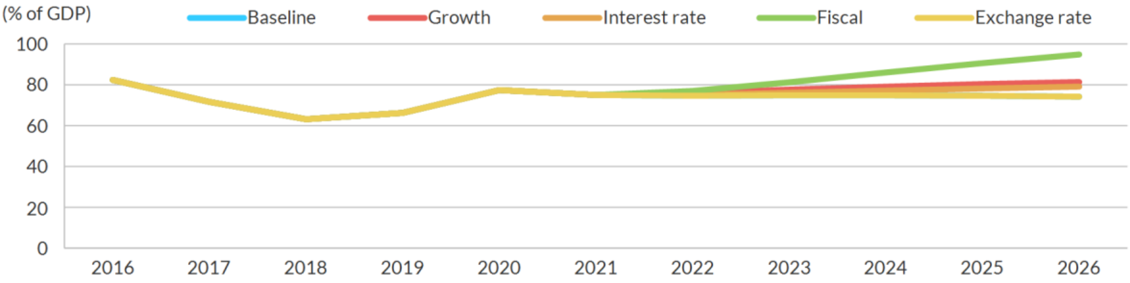
Source: Fitch Ratings

Debt Sensitivity Analysis: Fitch's Scenario Assumptions

Growth	GDP growth 1.9% lower (half standard deviation lower)
Interest rate	Marginal interest rate 250bp higher
Fiscal	Stable primary deficit of 4.8% of GDP at 2021 level

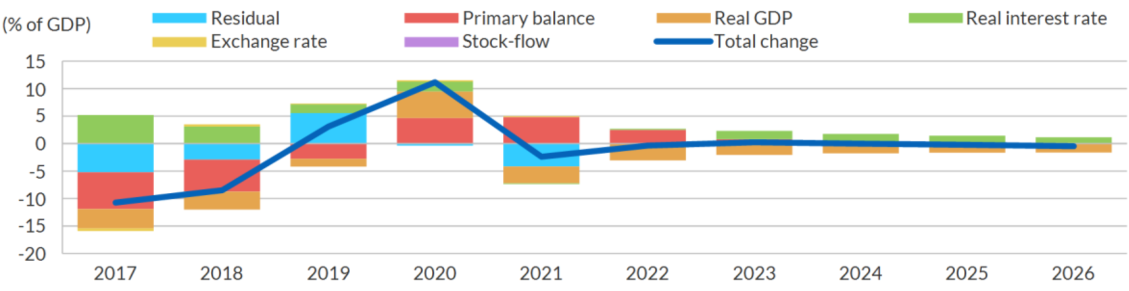
Source: Fitch Ratings

Sensitivity Analysis
Gross general government debt



Source: Fitch Ratings, Fitch Debt Dynamics Model

Baseline Scenario: Debt Creating Flows
Change in gross general government debt



Source: Fitch Ratings, Fitch Debt Dynamics Model

About the Public Debt Dynamics

Fitch uses stylised projections for a sovereign's gross general government debt/GDP ratio to illustrate the sustainability of its debt burden and its sensitivity to economic growth, the cost of borrowing, fiscal policy and the exchange rate.

Data Tables

General Government Summary

% GDP	2015	2016	2017	2018	2019	2020	2021E	2022F	2023F
Revenue	43.1	59.0	45.4	44.8	41.9	42.1	40.4	40.2	40.2
Expenditure	43.5	46.4	44.4	43.8	43.4	50.7	49.3	46.7	45.0
o/w interest payments	6.8	6.1	5.7	4.9	4.3	4.0	4.1	4.0	4.0
Interest payments (% revenue)	15.7	10.3	12.6	11.0	10.2	9.6	10.1	10.0	10.0
Primary balance	6.4	18.6	6.7	5.9	2.8	-4.6	-4.8	-2.5	-0.8
Overall balance	-0.4	12.5	1.0	0.9	-1.5	-8.7	-8.9	-6.5	-4.8
Gross government debt	97.2	82.4	71.6	63.1	66.2	77.4	75.0	74.7	74.9
% of government revenue	225.7	139.6	157.9	141.1	158.2	184.1	185.6	185.8	186.4
Domestic debt	83.9	74.3	67.2	58.8	60.1	69.0	64.4	62.6	62.8
External debt	13.3	8.1	4.4	4.4	6.1	8.4	10.6	12.1	12.1
Local currency	83.9	74.3	67.2	58.8	60.1	69.0	64.4	62.6	62.8
Foreign currency	13.3	8.1	4.4	4.4	6.1	8.4	10.6	12.1	12.1
Central government deposits	18.9	11.4	7.2	7.9	8.4	16.7	14.7	13.4	12.6
Net government debt	78.3	71.0	64.5	55.3	57.9	60.7	60.3	61.3	62.4
Financing		-12.5	-1.0	-0.9	1.5	8.7	8.9	6.5	4.8
Domestic borrowing		-2.9	-3.4	-3.7	5.2	6.5	1.9	4.1	4.0
External borrowing		-4.1	-3.3	0.3	2.0	2.0	3.0	2.4	0.8
Other financing		-5.5	5.7	2.5	-5.7	0.1	4.0	-0.0	-0.0
Change in deposits (- = increase)		6.0	3.6	-1.2	-1.0	-8.0	0.4	-0.0	-0.0
Privatisation		0.0	0.0	0.0	0.0	0.0	1.7	0.0	0.0
Other		-11.5	2.1	3.7	-4.7	8.1	1.9	-0.0	0.0

Source: Fitch Ratings, Ministry of Finance

Balance of Payments

(USDbn)	2015	2016	2017	2018	2019	2020	2021E	2022F	2023F
Current account	1.0	1.7	1.0	0.9	1.4	0.2	-0.7	-0.3	-0.1
% GDP	5.6	8.1	4.2	3.5	5.8	0.8	-2.8	-1.1	-0.4
Goods	-0.2	-0.8	-1.5	-1.5	-1.0	-0.7	-1.3	-1.5	-1.3
Services	1.6	2.2	2.6	2.4	2.1	0.5	0.7	1.0	1.0
Primary income	-0.0	0.4	0.1	0.3	0.5	0.5	0.1	0.3	0.3
Secondary income	-0.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.3	-0.1	-0.1
Capital account	-0.0	-0.0	-0.0	-0.0	-0.0	-0.0	-0.0	-0.0	-0.0
Financial account	0.8	1.9	0.3	1.4	1.5	1.4	0.3	0.7	0.9
Direct investment	-0.7	-0.7	-0.2	0.5	0.7	0.7	-0.2	0.1	0.1
Portfolio investment	3.9	1.9	2.3	1.0	0.6	0.9	0.1	0.9	0.7
Derivatives	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other investments	-3.5	-1.8	-1.1	-0.1	-0.5	-0.0	-0.0	-0.0	-0.0
Net errors and omissions	-0.1	0.2	-0.7	0.5	0.0	1.2	1.0	1.0	1.0
Change in reserves (+ = increase)	1.1	2.4	-0.8	0.0	0.6	-0.2	0.3	-0.3	0.1
International reserves, incl. gold	5.0	7.2	6.6	6.3	6.8	6.4	7.1	6.7	6.9
Liquidity ratio (%)	13.5	54.7	191.5	167.1	190.1	209.1	227.3	192.7	220.4
Memo									
Current external receipts (CXR)	10.1	11.1	12.3	13.2	12.0	8.2	10.4	11.9	13.1
Current external payments (CXP)	9.1	9.5	11.3	12.3	10.6	8.0	11.1	12.2	13.2
CXR growth (%)	-2.0	10.8	10.7	7.3	-9.3	-31.6	27.0	14.1	10.6
CXP growth (%)	-4.3	4.3	19.3	9.0	-14.2	-23.9	38.6	9.5	8.7
Gross external financing requirement	23.9	-0.9	-0.0	1.2	0.2	1.1	1.6	2.0	1.0
% International reserves	573.4	-17.6	-0.5	18.2	3.5	16.5	25.2	28.8	14.9
Net external borrowing	-6.2	-5.5	-5.9	-1.3	-0.9	-1.0	1.7	0.0	0.4

Source: Fitch Ratings, IMF

External Debt and Assets

(USDbn)	2015	2016	2017	2018	2019	2020	2021E	2022F	2023F
Gross external debt	30.5	26.0	22.5	20.1	19.4	19.3	21.1	21.1	21.5
% GDP	174.2	125.2	91.1	76.5	78.3	89.5	82.9	76.8	71.8
% CXR	303.6	233.8	182.8	152.0	161.9	235.8	202.5	177.9	163.6
Short-term debt (% GXD)	37.5	6.4	6.9	7.1	6.8	7.5	7.5	7.5	7.5
By debtor									
Sovereign	4.6	4.0	2.8	2.6	3.0	2.8	3.5	3.4	3.5
Monetary authorities	0.3	0.4	0.4	0.4	0.5	0.4	0.8	0.8	0.9
General government	4.3	3.6	2.5	2.2	2.5	2.4	2.8	2.5	2.5
Banks	2.2	4.2	5.8	5.9	5.5	5.9	6.3	6.6	6.9
Other sectors	23.7	17.8	13.9	11.6	10.8	10.7	11.3	11.1	11.2
Gross external assets (non-equity)	23.6	19.3	14.6	14.9	14.4	14.5	15.1	15.1	15.6
Sovereign	5.0	7.2	6.6	6.3	6.8	6.4	7.1	6.7	6.9
International reserves, incl. gold	5.0	7.2	6.6	6.3	6.8	6.4	7.1	6.7	6.9
Other sovereign assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks	2.8	2.3	3.1	3.6	3.1	3.4	3.3	3.3	3.3
Other sectors	15.9	9.8	5.1	5.1	4.6	4.7	4.6	4.5	4.4
Net external debt	7.0	6.8	7.9	5.2	5.0	4.9	6.0	6.0	5.9
% GDP	39.7	32.6	31.8	19.7	20.2	22.6	23.4	21.9	19.8
Sovereign	-0.4	-3.2	-3.7	-3.7	-3.8	-3.7	-3.2	-3.0	-3.0
Banks	-0.5	2.0	2.8	2.3	2.5	2.6	2.5	2.4	2.2
Other sectors	7.9	8.0	8.8	6.6	6.2	6.0	6.7	6.6	6.8
International investment position									
Assets	38.0	35.0	29.2	29.2	32.1	35.1	39.1	-	-
Liabilities	38.9	34.6	28.7	26.9	27.2	27.3	29.2	-	-
Net	-0.9	0.4	0.5	2.3	4.9	7.7	10.0	-	-
Net sovereign	0.4	3.2	3.7	3.7	3.8	3.7	3.2	3.0	3.0
% GDP	2.4	15.6	15.1	14.2	15.1	17.0	12.5	10.9	10.0
External debt service (principal + interest)	25.9	1.5	1.6	2.6	2.1	1.7	1.2	2.2	1.3
Interest (% CXR)	9.3	5.9	4.6	3.4	3.7	4.8	2.5	3.6	3.3

Source: Fitch Ratings, central bank, IMF, World Bank

Full Rating Derivation

Long-Term Foreign-Currency Issuer Default Rating (SRM + QO)									A
Sovereign Rating Model					**Applied Rating[d]**				**A**
					Model Result and Predicted Rating				10.21 = A-
Input Indicator	**Weight (%)**	**2020**	**2021**	**2022**	**Adjustment to Final Data**	**Final Data**	**Coefficient**		**Output (notches)**
Structural features									**9.53**
Governance indicators (percentile)	20.0	n.a.	94.2	n.a.	-	94.2	0.073		6.90
GDP per capita (USD)	13.3	n.a.	69,033	n.a.	Percentile	95.8	0.042		4.04
Nominal GDP (% world GDP)	12.8	n.a.	0.03	n.a.	Natural log	-3.6	0.583		-2.10
Most recent default or restructuring	5.4	n.a.	None	n.a.	Inverse 0-1[a]	0.0	-2.108		0
Broad money (% GDP)	1.3	n.a.	51.5	n.a.	Natural log	3.9	0.175		0.69
Macroeconomic performance, policies and prospects									**-1.47**
Real GDP growth volatility	5.5	n.a.	4.3	n.a.	Natural log	1.5	-0.886		-1.30
Consumer price inflation	3.0	2.9	4.5	5.3	3-yr avg.[b]	4.2	-0.053		-0.22
Real GDP growth	2.6	-7.1	4.3	4.5	3-yr avg.	0.6	0.084		0.05
Public finances									**-2.60**
Gross general govt debt (% GDP)	8.3	77.4	75.0	74.7	3-yr avg.	75.7	-0.022		-1.64
General govt interest (% revenue)	4.9	9.6	10.1	12.2	3-yr avg.	10.6	-0.047		-0.50
General govt fiscal balance (% GDP)	2.5	-8.7	-8.9	-6.5	3-yr avg.	-8.0	0.047		-0.38
FC debt (% of total general govt debt)	2.5	11.5	13.8	9.1	3-yr avg.	11.5	-0.007		-0.08
External finances									**0.17**
Reserve currency (RC) flexibility	7.6	n.a.	0.0	n.a.	RC score 0 - 4.5[c]	0.0	0.542		0
SNFA (% of GDP)	7.1	17.0	12.5	10.9	3-yr avg.	13.5	0.012		0.16
Commodity dependence	1.1	n.a.	51.4	n.a.	Latest	51.4	-0.004		-0.21
FX reserves (months of CXP)	1.5	n.a.	7.6	n.a.	n.a. if RC score> 0	7.6	0.032		0.25
External interest service (% CXR)	0.4	4.8	2.5	3.6	3-yr avg.	3.6	-0.006		-0.02
CAB + net FDI (% GDP)	0.1	-2.3	-2.2	-1.3	3-yr avg.	-1.9	0.002		-0.00
Intercept Term (constant across all sovereigns)									**4.58**

[a] Inverse 0-1 scale, declining weight; [b] of truncated value (2%-50%); [c] Declining weight; [d] Sovereign rating committee can override SRM Predicted Rating if a marginal change in the Model Result leads to a notch change which is judged to be temporary or caused by a re-estimation of the SRM, a process that Fitch undertakes on at least an annual basis. Please refer to the Rating Action Commentary for further information when the Applied Rating differs from the Predicted Rating.

Note: This table contains data as at the date of the most recent rating action. There may be minor differences to data presented elsewhere in this report, which may have been updated where appropriate, for example in the event of subsequent data releases.

Source: Fitch Ratings

Qualitative Overlay (notch adjustment, range +/-3)	0
Structural features	0
Macroeconomic outlook, policies and prospects	0
Public finances	0
External finances	0

About the SRM and QO

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.

Supplementary Ratings

Local-Currency Rating

Iceland's credit profile does not support uplift of the Long-Term Local-Currency IDR above the Long-Term Foreign-Currency IDR. In Fitch's view, neither of the two key factors supporting upward notching of the Long-Term Local-Currency IDR cited in the criteria is present: strong public finance fundamentals relative to external finance fundamentals; and previous preferential treatment of local-currency creditors relative to foreign-currency creditors

Country Ceiling

Fitch lifted Iceland's Country Ceiling to 'A+' at the May 2019 rating review, one notch above Iceland's Long-Term Foreign-Currency IDR. This reflects the record of liberalisation of capital controls since 2016. In March 2019, the remaining offshore Icelandic krona assets that were restricted from conversion into foreign-currency assets at marker rates were released

Full Rating History

	Foreign-Currency Rating			Local-Currency Rating			
Date	Long-Term	Short-Term	Outlook/Watch	Long-Term	Short-Term	Outlook/Watch	Country Ceiling
18 Mar 2022	A	F1+	Stable	A	F1+	Stable	A+
22 May 2020	A	F1+	Negative	A	F1+	Negative	A+
24 May 2019	A	F1+	Stable	A	F1+	Stable	A+
08 Dec 2017	A	F1	Stable	A	F1	Stable	A
07 Jul 2017	A-	F2	Positive	A-	F1	Positive	A-
13 Jan 2017	BBB+	F2	Positive	BBB+	F2	Positive	BBB+
22 Jul 2016	BBB+	F2	Stable	BBB+	F2	Stable	BBB+
24 Jul 2015	BBB+	F2	Stable	A-	-	Stable	BBB+
30 Jan 2015	BBB	F3	Positive	BBB+	-	Positive	BBB
14 Feb 2013	BBB	F3	Stable	BBB+	-	Stable	BBB
17 Feb 2012	BBB-	F3	Stable	BBB+	-	Stable	BBB-
16 May 2011	BB+	B	Stable	BBB+	-	Stable	BB+
05 Jan 2010	BB+	B	Negative	BBB+	-	Negative	BB+
23 Dec 2009	BBB-	F3	Negative	A-	-	Negative	BBB-
08 Oct 2008	BBB-	F3	Watch Negative	A-	-	Watch Negative	BBB-
30 Sep 2008	A-	F2	Watch Negative	AA	-	Watch Negative	A
01 Apr 2008	A+	F1	Negative	AA+	-	Negative	AA-
15 Mar 2007	A+	F1	Stable	AA+	-	Stable	AA-
21 Feb 2006	AA-	F1+	Negative	AAA	-	Negative	AA
17 Jun 2004	AA-	F1+	Stable	AAA	-	Stable	AA
31 Mar 2003	AA-	F1+	Stable	AAA	-	Stable	-
15 Feb 2002	AA-	F1+	Negative	AAA	-	Negative	-
26 Feb 2001	AA-	F1+	Stable	AAA	-	-	-
21 Sep 2000	AA-	F1+	Stable	AAA	-	Stable	-
03 Feb 2000	AA-	F1+	-	AAA	-	-	-

Source Fitch Ratings

Appendix 1: Environmental, Social and Governance (ESG)

Credit Relevance Scores

General Issues	Key Sovereign Issues	SRM	QO	Score[a]
Environmental (E)				
GHG Emissions and Air Quality	Emissions and air pollution as a constraint on GDP growth	2	2	2
Energy Management	Energy resource management, including potential for 'stranded assets', affecting exports, government revenues and GDP	3	2	3
Water Resources and Management	Water resource availability and management as a constraint on GDP growth	2	2	2
Biodiversity and Natural Resource Management	Natural resource management, including potential for 'stranded assets', affecting exports, government revenues and GDP	3	3	3
Natural Disasters and Climate Change	Impact of adverse climate trends, and likelihood of and resilience to shocks	3	3	3
Social (S)				
Human Rights and Political Freedoms	Social stability, voice and accountability, regime legitimacy	4	2	4 +
Human Development, Health and Education	Impact of human development, health and education on GDP per capita and GDP growth	3	2	3
Employment and Income Equality	Impact of unemployment and income equality on GDP per capita, GDP growth and political and social stability	3	2	3
Public Safety and Security	Impact of public safety and security on business environment and/or economic performance	3	2	3
Demographic Trends	Population decline or aging, rapidly rising youth population; pensions sustainability	3	2	3
Governance (G)				
Political Stability and Rights	Political divisions and vested interests; geo-political risks including conflict, security threats and violence; policy capacity: unpredictable policy shifts or stasis	5	2	5 +
Rule of Law, Institutional & Regulatory Quality, Control of Corruption	Government effectiveness, control of corruption, rule of law, regulatory quality	5	2	5 +
International Relations and Trade	Trade agreements, membership of international organisations, bilateral relations; sanctions or other costly international actions	3	2	3
Creditor Rights	Willingness to service and repay debt	4	2	4 +
Data Quality and Transparency	Availability, limitations and reliability of economic and financial data, including transparency of public debt and contingent liabilities	3	2	3

Source: Fitch Ratings

About ESG Credit Relevance Scores

The scores signify the credit relevance of the respective E, S and G issues to the sovereign entity's credit rating, according to the following scale:

- 5 – Highly relevant to the rating, a key rating driver with a high weight.
- 4 – Relevant to the rating, a rating driver.
- 3 – Relevant, but only has an impact on the entity rating in combination with other factors.
- 2 – Irrelevant to the entity rating but relevant to the sector (sovereigns).
- 1 – Irrelevant to the entity rating and irrelevant to the sector (sovereigns).

The score for each 'General Issue' is comprised of a component SRM and QO score, and is simply the higher of the two. SRM scores are fixed across all sovereigns as the weights in the SRM are the same for all sovereigns; QO component scores vary across all sovereigns.

All scores of '4' or '5' result in a negative impact on the rating, unless indicated otherwise. Where a positive impact is occurring, the score of '4' or '5' is appended with a '+' symbol. Scores of '3', '2' and '1' do not have a direction of impact assigned.

Please refer to ESG Relevance Scores for Sovereigns for further information on the framework, including 'Sovereign Rating Criteria References' (which identify specific potentially related SRM variables and QO factors for each 'General Issue').

Credit-Relevant ESG Derivation

Iceland has an ESG Relevance Score of '5[+]' for Political Stability and Rights as World Bank Worldwide 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 Worldwide 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 Worldwide 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.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of '3'. This means ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Appendix 2: Data Notes and Conventions

Acronyms

Acronyms used in the above table and elsewhere in report are: Gross Domestic Product (GDP), Current External Receipts (CXR), Current External Payments (CXP), Current Account Balance (CAB), Foreign Direct Investment (FDI), World Bank Worldwide Governance Indicators (WBGI), Sovereign Rating Model (SRM), Qualitative Overlay (QO). For a full list of indicator definitions, please refer to the most recent Sovereign Data Comparator.

Medians

Medians underlying the SRM relative to rating category chart on the Rating Summary page and as reported in the Peer Analysis table on page 4 are long-term historical medians. These are based on actual data since 2000 for all sovereign-year observations when the sovereign was in the respective rating category at year-end. Current year ratings and data are excluded.

Chart medians on page 3 are based on data for sovereigns in the respective rating category at the end of each year. Latest ratings are used for the current year and forecast period.

Notes for Iceland

All data are on a calendar-year basis, which aligns with the domestic fiscal year for this sovereign.

Public finances data referenced in this report relate to the consolidated general government, as per our principal approach, unless specifically noted otherwise where cited.

The external balance sheet data referenced in this report are derived from the international investment position dataset, as per our principal approach.

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