MOODY'S
INVESTORS SERVICE

CREDIT OPINION
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Update

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Contacts

Kathrin Muehlbronner +44.20.7772.1383
Senior Vice President
kathrin.muehlbronner@moodys.com

Lenaic Couderc +44.20.7772.1799
Associate Analyst 1
lenaic.couderc@moodys.com

Dietmar Hornung +49.69.70730.790
Associate Managing Director
dietmar.hornung@moodys.com

Alejandro Olivo +1.212.553.3837
MD-Sovereign/Sub Sovereign
alejandro.olivo@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

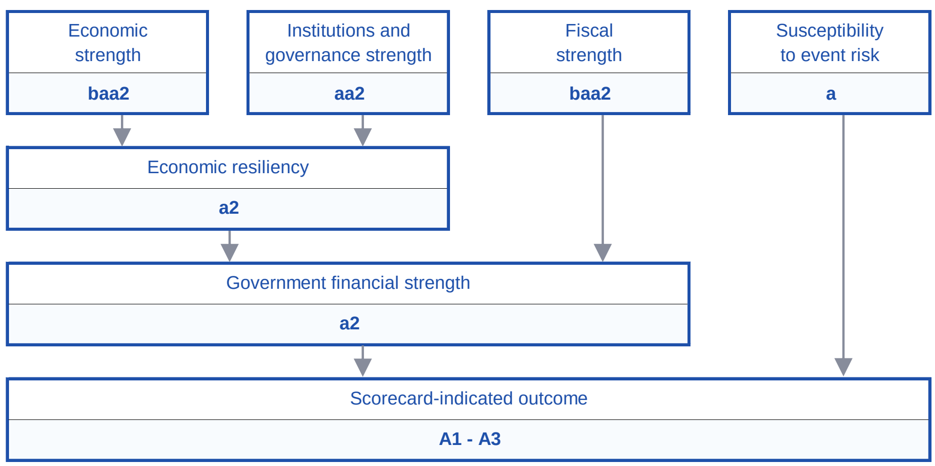
Government of Iceland – A2 stable

Regular update

Summary

The credit profile of Iceland is supported by its wealthy and flexible economy with favourable demographics that support its long-term growth prospects. Current-account surpluses have contributed to a net external creditor position and large foreign-currency reserves. The pandemic-induced fiscal deterioration is being gradually reversed, helped by robust economic growth. The credit profile is constrained by the economy's small size and concentration in a limited number of sectors, which increase its vulnerability to shocks and cause volatility in growth.

Exhibit 1
Iceland's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» Very high wealth levels and labour market flexibility provide buffers to deal with shocks;

» Well-funded pension system, long working lives and favourable demographics;

» Very large foreign-currency reserves and net external creditor position.

Credit challenges

» Volatile growth performance due to sector concentration and small currency area;

» Rebuilding fiscal buffers after large pandemic-driven increase in public debt.

Rating outlook

The stable outlook reflects our view that downside risks stemming from the economy's small size and high sector concentration are mitigated by a robust external position as well as reduced private sector indebtedness and the improved health of the banking sector. The economy has been recovering from the coronavirus shock broadly as expected, and we expect the fiscal deterioration of 2020-2021 to be gradually reversed over the coming years, in line with the government's plans.

Factors that could lead to an upgrade

The outlook on Iceland's rating could move to positive and the rating could eventually be upgraded in case of faster-than-expected progress in restoring the government's fiscal buffers. Moreover, a push towards increased diversification which would lead to a less volatile economic performance would be positive for the rating.

Factors that could lead to a downgrade

Conversely, the outlook and subsequently the rating would come under downward pressure if the authorities deviated significantly from their current medium-term fiscal consolidation plans that target a stabilisation of the public debt ratio by the middle of the decade, resulting in a material increase in the public debt ratio.

An economic shock which would lead to a large and permanent damage to the tourism industry, or to substantial capital outflows, weakening Iceland's external position and threatening financial stability, would also be credit negative, although the latter is not a likely scenario.

Key indicators

Iceland	2016	2017	2018	2019	2020	2021	2022F	2023F
Real GDP (% change)	6.3	4.2	4.9	2.4	-7.1	4.3	4.8	2.8
Inflation (CPI, % change, Dec/Dec)	1.9	1.9	3.7	2.0	3.6	5.1	9.8	4.7
Gen. gov. financial balance/GDP (%)[1]	12.5	1.0	0.9	-1.5	-8.7	-8.9	-4.9	-3.4
Gen. gov. primary balance/GDP (%)[1]	18.6	6.7	5.8	2.8	-4.6	-4.8	-0.9	0.5
Gen. gov. debt/GDP (%)[1]	82.4	71.6	63.1	66.2	77.4	75.0	70.2	69.4
Gen. gov. debt/revenues (%)[1]	139.6	157.9	141.1	158.2	184.1	185.6	173.0	173.8
Gen. gov. interest payment/revenues (%)[1]	10.3	12.6	11.0	10.2	9.6	10.1	9.9	9.6
Current account balance/GDP (%)[2]	8.1	4.2	3.5	5.8	0.8	-2.7	-0.2	0.1

[1] Includes public entities previously excluded from the scope of the general government
[2] Excludes DMBs undergoing winding up in 2008-2015

Source: Moody's Investors Service

ESG considerations

Iceland's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 3
ESG Credit Impact Score

CIS-2
Neutral-to-Low

NEGATIVE IMPACT
POSITIVE IMPACT

For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

Source: Moody's Investors Service

Iceland's ESG Credit Impact Score is neutral to low (**CIS-2**), reflecting neutral to low exposure to environmental and social risks and very strong institutions.

Exhibit 4
ESG Issuer Profile Scores

ENVIRONMENTAL	SOCIAL	GOVERNANCE
E-2	**S-2**	**G-1**
Neutral-to-Low	Neutral-to-Low	Positive

Source: Moody's Investors Service

Environmental

Iceland's exposure to environmental risks is neutral to low (**E-2**) as the country derives nearly all of its energy generation and use from renewable sources, in particular hydroelectric power and geothermal energy. Iceland's unique geological features imply some exposure to physical climate risks but also offer opportunities for the country's key sectors. The impact of warming seas on fish stocks in Icelandic waters is not yet clear; while some varieties may migrate out of Iceland's waters as seen with the decline in capelin fish stocks in 2019, other species have migrated into Icelandic waters. Also, the sector has considerable flexibility to adapt to changing stocks and has proven so many times. Warmer temperatures are favourable for plant productivity and agriculture. Around 11% of Iceland's land mass consists of glaciers; while the melting of glaciers increases the risk of landslides it also increases availability of hydropower, at least for several decades.

Social

We assess its S issuer profile score as neutral to low (**S-2**). Iceland's demographic profile is more favourable than in many other countries because of long working lives, high participation rates of women and the flexibility of the labour force. Iceland also benefits from high-quality education, access to basic services and housing availability. Indicators for access to healthcare are very strong, as seen in the fast response to the coronavirus pandemic. Social risks exert themselves through intensive wage negotiations between employers and trade unions every four years which can impact on Iceland's competitiveness.

Governance

Iceland's very high institutions and governance strength is reflected in a positive G issuer profile score (**G-1**). This is underpinned by its strong scores in most of the Worldwide Governance Indicators, which reflects the high credibility of its institutions and the country's well-developed macroeconomic policy environment. This contributes to its relatively strong resilience to E and S risks, along with very high wealth levels.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the "Credit profile" section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Detailed credit considerations

We assess Iceland's **economic strength** at "baa2" which balances the country's small size and associated history of economic boom and bust episodes with very high wealth levels and strong competitiveness. Iceland's GDP per-capita is - at an estimated $59,792 in 2021 - the 15th highest in our sovereign rating universe, having recovered the significant losses registered during the country's 2008 banking and currency crisis. Iceland's economy is highly competitive, as evidenced by its ranking at 16th globally in the World Competitiveness Index in 2021, – standing out compared with close peers.

Growth is also volatile, reflecting limited diversification and relatively high openness, which increases the economy's vulnerability to sector-specific and external shocks. More than 70% of the country's export revenues come from three sectors: tourism (23% of total in 2021), marine products (24% of total) and aluminum (23% of total). The coronavirus pandemic and its impact on tourism caused one of the largest economic contractions among advanced economies in 2020 but the recovery is well underway, helped by a pickup in tourism and significant government support.

We assess Iceland's **institutions and governance strength** as "aa2", reflecting the country's solid track record in restoring economic and financial stability after the banking crisis. For example, the considerable strengthening in supervision and regulation of the banking sector has helped to improve the resilience of the system. The authorities achieved a careful liberalisation of the capital account with minimal disruption. The monetary policy framework has gained credibility, following a major revamp, and the central bank has been successful in reducing traditionally high and volatile inflation despite a recent spike driven by housing prices.

Our assessment also takes into account Iceland's high-quality education system, an innovative business sector, an efficient and flexible labour market and well-developed infrastructure. Iceland has a long tradition of broad cooperation and consensus on economic matters between the government, employer and employee associations, which contributes positively to policy effectiveness. The score has been raised last year from "aa3" to reflect our view that the strength of civil society and the judiciary is on par with the strongest sovereigns at "aaa". Iceland also scores strongly in the Worldwide Governance Indicators.

We assess Iceland's **fiscal strength** as "baa2", reflecting the government's strong track record in reducing its large budget deficits and very high debt burden after the 2008 crisis. Between the peak in 2011 and 2018 general government debt more than halved, and stood at 66% of GDP in 2019. The re-classification of 24 public-sector corporations into the general government sector in 2020, in line with Eurostat statistical rules, raised the government debt ratio by around 32 percentage points of GDP for the past years but also implies much smaller contingent liabilities. As such, the reclassification does not fundamentally alter our view of Iceland's fiscal strength. We had previously taken the debt of these companies into account qualitatively, in particular the debt of the HF-Fund (A2 stable), which benefitted from an explicit government guarantee and is in a government-directed winding-down process.

We expect that general government debt will continue to decline thanks to strong GDP growth, declining budget deficits and asset sales. The Icelandic government still holds significant equity stakes in two of the three largest domestic banks, and sale proceeds will likely continue to serve debt reduction purposes. Iceland's multi-year fiscal framework with clear and credible fiscal rules is on par with the best practices among highly rated sovereigns and is accepted across the political spectrum, giving high confidence that debt will again be reduced in the coming years. The final score is therefore higher than the initial score of "baa3".

We assess Iceland's **susceptibility to event** risk as "a", driven by our banking system and external vulnerability risk assessments. As for the banking sector, the three large banks have solid levels of capitalisation and liquidity. The sharp rise in house prices has been accompanied by an increase in household indebtedness, which could pose risks to financial stability but the authorities have put in place a number of macroprudential measures to reduce risks.

Political event risk is low, and scored at “aa” given consistent policy in key areas important to safeguarding the government's credit profile. Political consensus on the economic and fiscal direction for the country is strong.

We assess government liquidity risk as “aa”. The previous marked reduction in government debt, prudent liquidity management, with significant cash buffers, and a large domestic investor base have mitigated the risks posed by markedly higher borrowing requirements in the context of the pandemic.

Iceland's external vulnerability risk assessment at “a” , reflects Iceland's net external creditor position and very large foreign-currency reserves, which help to buffer external shocks. The current account has slipped into a deficit since 2020 because of weaker tourism demand and large dividend payments of foreign-owned companies, but is expected to return close to balance again this year. External surpluses have allowed the central bank to build substantial foreign-currency reserves equivalent to around 25% of GDP or 29% of the country's total external debt, a large buffer to help limit exchange rate volatility and support the country's external position.

All of these considerations are further discussed in the “Detailed credit considerations” section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Recent developments

Strong recovery under way thanks to tourism rebound

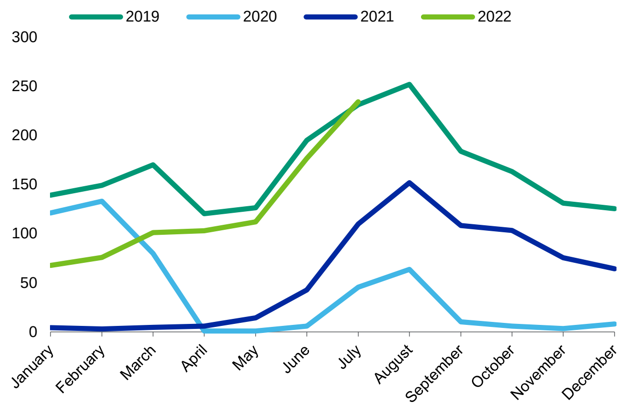
The economic recovery has been accelerating in early 2022, with real GDP growth of 7.3% year-on-year in the first quarter, helped by domestic demand and strong export growth, in particular of services, which were up nearly 70% year-over-year. We expect the continued recovery in tourism alongside strong consumption and investment will lead to real GDP growth of 4.8% for the year as a whole. Although the omicron variant dented the recovery at the beginning of the year, tourist arrivals surpassed their 2019 levels in July and foreign credit card spending in real terms is now higher than before the pandemic (see Exhibit 5). Export growth of marine products and aluminium will also be strong, both supported by strong demand and favourable price dynamics. Higher aluminum and fish prices will more than offset higher input costs, leading to an improvement in Iceland's terms of trade.

The economic recovery as well as the significant support that the government provided to businesses and households during the pandemic has led to a sharp drop in unemployment, which stood at 4% in June (seasonally adjusted terms). Labour shortages, particularly in the tourism industry, may somewhat hold back the pace of the recovery but immigration has picked up and is expected to help fill some of the increased demand for labour.

The good labour market performance will continue to support domestic demand. Although most of the pandemic-related support will be phased out this year, positive real wage growth of around 0.7% on average in the first six months of the year will continue to support private consumption. That said, the import content of domestic demand is high in Iceland and imports will also increase materially.

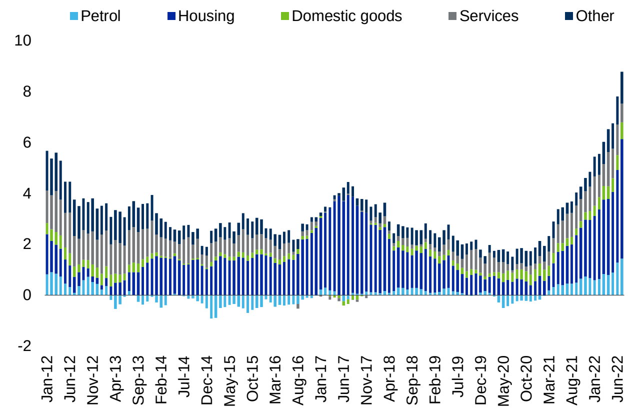
Russia's invasion of Ukraine (Caa3 negative) has a minimal direct impact on Iceland. Domestic energy prices have not been affected by the spike in commodity prices given that most of Iceland's energy is generated from domestic geothermal and hydropower sources. Iceland also has one of the highest shares of electric cars in Europe, reducing the impact of higher fuel costs. In addition, the government has put in place measures in response to higher inflation targeted to poorer households such as bringing forward increases in housing, social and child benefits as well as pension increases. Overall trade exposure to Russia and Ukraine accounts for only 1% of total exports and 0.5% of imports. Iceland will be more affected by the slowdown in growth in its key trading partners, particularly in Europe.

Exhibit 5
Tourism activity has surpassed pre-pandemic levels
Foreign tourist arrivals ('000)



Source: Statistics Iceland and Moody's Investors Service

Exhibit 6
House prices are the main driver of accelerating inflation
CPI and components (year-on-year % change)



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

Inflation far exceeds expectations and target, triggering swift monetary policy action

Like other economies, inflation has accelerated and has been above the central bank's 2.5% target since May 2020 (see Exhibit 6). The drivers of price growth have shifted from imported inflation during the pandemic, which mostly resulted from the depreciation of the krona, to house prices. In July 2022, consumer price inflation was 9.9%, of which about half was on account of house price increases. We expect inflation will continue to increase in the coming months before slowing to a still high 9.8% by the end of 2022. The strength of the krona will reduce the contribution of imported inflation somewhat. As stated above, Iceland remains relatively insulated from rising energy prices, and a strengthening of the krona could help moderate inflation in the coming months given the high pass-through from the exchange rate to inflation.

The CBI started to raise its key policy rate in May 2020, one of the first central banks to do so, and has hiked by a cumulative 400 basis points to 4.75%. Longer-term inflation expectations have risen as well but to a smaller extent, indicating confidence of economic actors that inflation will be brought back to target within 2-5 years. Iceland's performance on inflation has materially strengthened compared to the past, when the CBI rarely managed to hit its inflation target.

In addition, the Financial Stability Committee has lowered the maximum loan-to-value (LTV) ratio to 80% from 85% and to 85% from 90% for first-time buyers, capped the debt-service to income ratio at 35% and 40% for first-time buyers and restored the countercyclical capital buffer to 2% for banks from September 2022, with the aim of dampening house price inflation.

Upcoming wage negotiations scheduled for November 2022 will be a key determinant for the monetary policy outlook. Higher wages will support private consumption in the short term, but could also fuel already elevated inflationary pressures and lead to a tighter monetary policy stance. We expect the agreements will at least compensate for inflation to keep real wage growth positive. Strong wage increases in the past have raised concerns over declining price competitiveness and an increasing misalignment between wages and productivity growth, but the latest three-year wage agreement from 2019 is generally considered to have helped support private consumption during the pandemic. That said, both the OECD and the IMF advocate linking future wage increases more directly to productivity growth rather than growth in per-capita income as in the 2019 wage agreement.

Moody's rating methodology and scorecard factors: Iceland - A2 stable

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				baa2	baa2	50%
Growth dynamics	Average real GDP growth (%)	2017-2026F	2.4	baa3		25%
	Volatility in real GDP growth (%)	2012-2021	3.8	caa1		10%
Scale of the economy	Nominal GDP ($ billion)	2021	25.5	b2		30%
National income	GDP per capita (PPP, Intl$)	2021	59,791.5	aaa		35%
Adjustment to factor 1	*# notches*				0	max ±9
Factor 2: Institutions and governance strength				aa2	aa2	50%
Quality of institutions	Quality of legislative and executive institutions			aa		20%
	Strength of civil society and the judiciary			aaa		20%
Policy effectiveness	Fiscal policy effectiveness			aa		30%
	Monetary and macroeconomic policy effectiveness			a		30%
Specified adjustment	Government default history and track record of arrears				0	max -3
Other adjustment to factor 2	*# notches*				0	max ±3
F1 x F2: Economic resiliency				a2	a2	
Factor 3: Fiscal strength				baa3	baa2	
Debt burden	General government debt/GDP (%)	2021	75.0	ba3		25%
	General government debt/revenue (%)	2021	185.6	a3		25%
Debt affordability	General government interest payments/revenue (%)	2021	10.1	baa1		25%
	General government interest payments/GDP (%)	2021	4.1	b1		25%
Specified adjustments	*Total of specified adjustment (# notches)*			0	0	max ±6
	Debt trend	2017-2022F	-1.4	0	0	
	Foreign currency debt/general government debt	2021	14.7	0	0	
	Other non-financial public sector debt/GDP	2021	0.0	0	0	
	Public sector assets/general government debt	2021	0.0	0	0	
Other adjustment to factor 3	*# notches*				1	max ±3
F1 x F2 x F3: Government financial strength				a2	a2	
Factor 4: Susceptibility to event risk				a	a	Min
Political risk				aa		
	Domestic political risk and geopolitical risk			aa		
Government liquidity risk				aa	aa	
	Ease of access to funding			aa		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				a	a	
	Risk of banking sector credit event (BSCE)	Latest available	baa3	baa3		
	Total domestic bank assets/GDP	2021	152.2	80-180		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				a	a	
	External vulnerability risk			a		
Adjustment to F4 EVR	*# notches*				0	max ±2
Overall adjustment to F4	*# notches*				0	max -2
F1 x F2 x F3 x F4: Scorecard-indicated outcome				A1 - A3	A1 - A3	

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the scorecard-indicated outcome. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

Footnotes: (1) Initial factor score: scorecard indicators combine with the automatic adjustments to produce an initial factor score for every rating factor, as detailed in Moody's Sovereign Ratings Methodology. **(2) Final factor score:** where additional analytical considerations exist, initial factor scores are augmented to produce a final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Ratings Methodology; details on country-specific considerations are provided in Moody's research. **(3) Scorecard-indicated outcome:** Factor 1: Economic Strength, and Factor 2: Institutions and Governance Strength, combine with equal weight into a construct we designate as Economic Resiliency (ER). An aggregation function then combines ER and Factor 3: Fiscal Strength, following a non-linear pattern where Fiscal Strength has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the government financial strength as given by combining the first three factors. **(4) There are 20 ranking categories for quantitative sub-factors:** aaa, aa1, aa2, aa3, a1, a2, a3, baa1, baa2, baa3, ba1, ba2, ba3, b1, b2, b3, caa1, caa2, caa3, ca and 8 ranking categories for qualitative sub-factors: aaa, aa, a, baa, ba, b, caa, ca **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

» **Issuer In-Depth:** Government of Iceland – A2 stable: Annual credit analysis, 29 July 2022

» **Sector in-Depth:** Banking - Iceland: Iceland Macro Profile: Strong -, 24 May 2022

» **Credit Opinion:** Government of Iceland - A2 stable: Regular update, 22 February 2022

» **Outlook:** Sovereigns – Global: Stable 2022 outlook as economic recovery eases credit pressures, but long-term costs of the pandemic weigh on sovereigns, 3 November 2021

» **Sector Comment:** Banking – Iceland: Iceland restores countercyclical buffer and introduces debt service cap in mortgages, a credit positive for banks, 6 October 2021

» **Rating Methodology**: Sovereign Ratings Methodology, 25 November 2019

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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