MOODY'S
INVESTORS SERVICE

CREDIT OPINION
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Update

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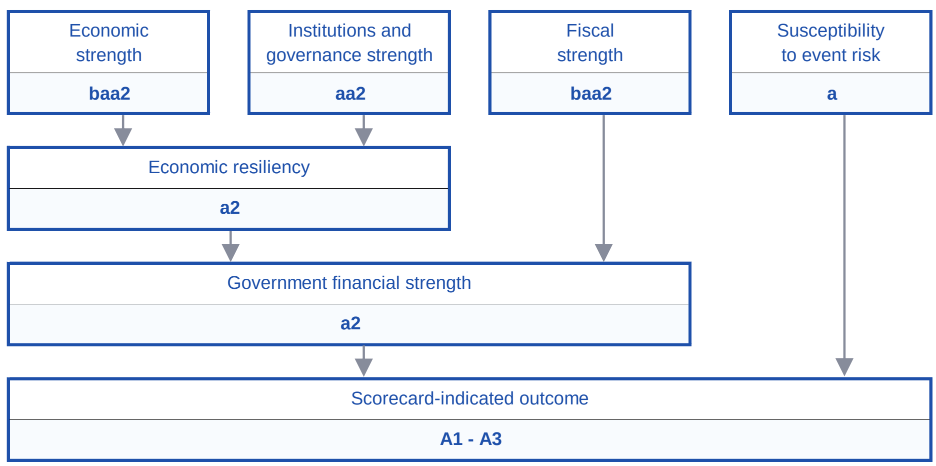
Government of Iceland – A2 stable

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 will be gradually reversed over the coming years, helped by robust economic growth. The credit profile is mainly 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

» Returning public debt to downward trend of recent years

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 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

Exhibit 2

Iceland	2016	2017	2018	2019E	2020E	2021F	2022F	2023F
Real GDP (% change)	6.3	4.2	4.9	2.4	-6.5	4.8	4.7	3.5
Inflation (CPI, % change, Dec/Dec)	1.9	1.9	3.7	2.0	3.6	5.1	5.0	3.8
Gen. gov. financial balance/GDP (%)[1]	12.5	1.0	0.9	-1.5	-8.6	-8.8	-6.1	-4.6
Gen. gov. primary balance/GDP (%)[1]	18.6	6.7	5.9	2.8	-4.6	-5.3	-2.3	-0.7
Gen. gov. debt/GDP (%)[1]	82.4	71.6	63.1	66.1	77.1	76.8	74.4	73.6
Gen. gov. debt/revenues (%)[1]	139.6	157.9	141.1	158.2	184.1	192.4	187.6	184.6
Gen. gov. interest payment/revenues (%)[1]	10.3	12.6	11.0	10.3	9.6	8.9	9.6	10.0
Current account balance/GDP (%)[2]	8.1	4.2	3.5	5.8	0.9	-0.7	1.5	1.0

[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

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 $69,722 in 2021 - higher than that of around 90% of our sovereign rating universe, having overcome 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 26th globally by the World Economic Forum's Global Competitiveness Index (data refer to 2019), – 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 (18% of total in 2020), marine products (27% of total) and aluminum (21% of total). The coronavirus pandemic caused a deep shock to tourism, causing one of the largest economic contractions among advanced economies in 2020. We estimate that the economy recovered strongly in 2021, with real GDP growth of 4.8%, supported by substantial policy support and strong external demand. The further recovery of the tourism sector will drive growth of 4.7% in 2022.

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 monetary policy framework has gained credibility, following a major revamp, and the central bank has been successful in reducing traditionally high and volatile inflation. Our assessment also recognizes the careful liberalisation of the capital account, that was achieved with minimal disruption.

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 below 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 start to decline from this year onwards, as strong GDP growth and the expiry of pandemic-related measures reduce the budget deficit. The Icelandic government 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, which has helped them absorb the pandemic-induced shock. We use publicly available information as we do not rate any Icelandic bank.

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 despite some degree of political instability at times.

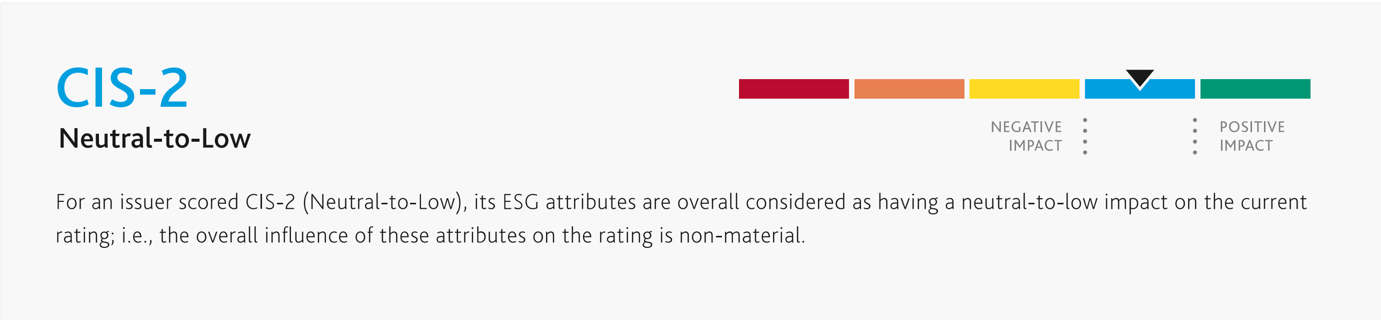
We assess government liquidity risk as “aa”. The previous marked reduction in government debt, prudent liquidity management, with significant cash buffers, and a stable and very large domestic investor base will help to mitigate the risks posed by the large increase in borrowing requirements over the next few years.

Iceland's external vulnerability risk assessment at “a” reflects its current-account surpluses between 2013 and 2020 which have contributed to Iceland's net external creditor position. Furthermore, positive balance of payments dynamics have allowed the Central Bank of Iceland to increase its level of foreign currency reserves to around 25% of GDP, a large buffer to help limit exchange rate volatility and support the country's external position.

ESG considerations

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

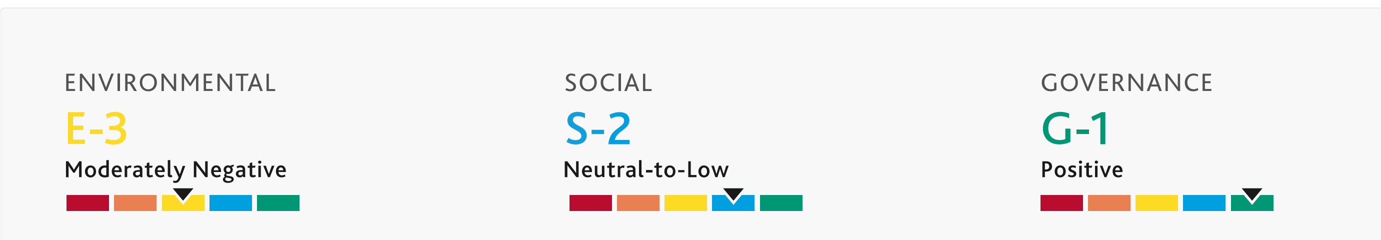
Exhibit 3
ESG Credit Impact Score



Source: Moody's Investors Service

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

Exhibit 4
ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Iceland's moderately negative exposure to environmental risks (**E-3**) primarily arises from the reliance of key sectors on Iceland's unique geological features, which exposes its credit profile to physical climate risks. In particular, the presence of active volcanoes on the island helps to attract tourism but can also significantly disrupt the economy. Warming seas can lead to the migration of fish stocks outside of Iceland's waters, as seen with the decline in capelin fish stocks in 2019. Around 11% of Iceland's land mass consists of glaciers which over time can expose the country to some risks from rising temperatures.

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, high housing availability, and good quality healthcare and basic services. 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 "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, but pandemic remains a risk to tourism recovery

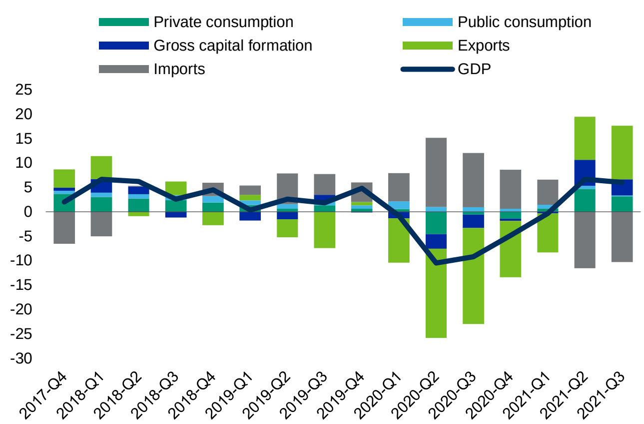
In the first nine months of 2021, real GDP grew by 2.8% on average compared to the previous year period, with growth being broad-based. Indicators for Q4 were uniformly strong, and we estimate full-year GDP growth at around 4.8%. In 2022, growth will likely remain strong, reflecting the continuing recovery from the pandemic shock. Private consumption will continue to benefit from a combination of strong wage growth (3.7% in 2021 in real terms), the robust labour market, personal income tax cuts and still high savings. Unemployment declined from a peak of 11.6% in January 2021 to 4.9% in December, helped by a wage subsidy scheme for companies that rehire workers that was introduced after the earlier and broader short-time work scheme was terminated in May.

Investment has also been strong in 2021 and should continue to contribute positively to growth this year helped by strong external and domestic demand and government tax incentives for private-sector research and development (R&D) investment. At the same time, public investment has not grown as strongly as we expected in 2021 given some delays in the implementation of the government's investment plan, which envisages average annual investments of around 0.5% of GDP until 2025. Lastly, exports have performed strongly in 2021 with all three key export sectors - tourism, fish and aluminium - seeing strong growth. Tourist arrivals increased by 49% compared to 2020 but remained 65% below their pre-pandemic levels. That said, tourists have spent more and stayed longer than in the past, limiting the overall impact. Fish exports grew by 9.3% in nominal terms, supported by increased quotas for capelin after two years of zero quota and despite a reduction in cod quotas. Aluminium exports increased by 15.8% as a result of historically high prices. We expect those trends will continue into 2022 and support export growth. Pandemic developments continue to pose some risks to the otherwise positive outlook for tourism in 2022.

Exhibit 5

Economic recovery has been broad based

Real GDP growth (% change) and components (pp)

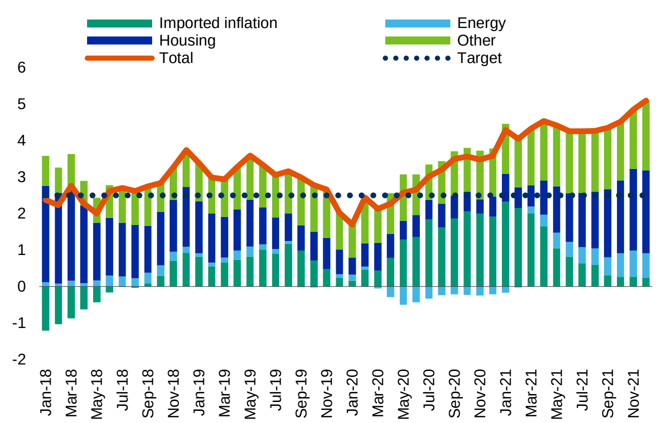


Source: Statistics Iceland and Moody's Investors Service

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 has far exceeded expectations and target, triggering swift monetary policy action

Inflation has continued to rise faster than we expected and stood at 5.7% in January 2022. House prices have been the main driver, contributing close to half of the increase in prices since the second half of 2021. Lower interest rates and increased savings have led to a surge in mortgage lending while house supply has fallen. We expect the strong monetary policy reaction, with the Central Bank of Iceland (CBI) having raised its key policy rates by a cumulative 200 basis points since May 2021, as well as tighter macroprudential measures will help ease house price growth. The CBI's key policy rate now stands at 2.75%. Moreover, the Financial Stability Committee lowered the maximum loan-to-value (LTV) ratio to 80% from 85%, capped the debt-service to income ratio to 35% and restored the countercyclical capital buffer to 2% for banks from September 2022.

The relative stability of the krona over 2021 has reduced the contribution of imported inflation somewhat. Iceland has also been relatively insulated from rising energy prices because it solely relies on domestic hydropower and geothermal sources for its energy mix.

We expect inflation will continue to increase in the coming months before slowing to a still high 5.0% by the end of 2022. Strong wage growth poses upside risks. The general wage index increased by 3.7% in 2021 in real terms and will likely rise further because of strong per capita GDP growth, which will trigger additional wage increases in line with collective agreements signed in 2019. Moreover, the upcoming round of wage negotiations after current agreements expire in November this year could lead to further inflationary pressures. That said, the tightening of the labour market could mitigate the impact of wage growth by encouraging companies to hire more foreign workers, which has historically helped keep wage pressures at bay in some sectors such as tourism and construction.

Economic recovery and government's fiscal consolidation plan will support deficit reduction over coming years

The central government's budget deficit is expected to have been around 1.5 percentage points of GDP lower than budgeted, with the government expecting its shortfall at 9.1% of GDP for 2021. The strong economic recovery increased revenue collection, which more than compensated for higher spending on unemployment benefits and additional support measures. The fiscal impact of the support measures in 2021 totalled around 3.7% of GDP. The strong recovery combined with the termination of most covid-related support measures will drive a material reduction in deficit this year; in its recently approved 2022 budget the government targets a deficit of 5.2% of GDP, versus 6.6% expected earlier. Our deficit forecasts also include the deficit of local authorities, compensated for partly by the surplus in the social security system.

Following the parliamentary elections that took place in September 2021, the ruling coalition was reelected. In line with the requirements under the Organic Budget Law, the new government presented a five-year Fiscal Policy Statement and reaffirmed its willingness to stabilise public debt over the medium term. But government debt was around five percentage points of GDP lower last year than the government had expected, and it consequently decided to push back its target to stabilise the debt ratio by one year to 2026 at the latest. For the purpose of the fiscal rules, the reclassified companies are excluded (and only reported for information purposes); central government debt stands at around 45% of GDP as of end-2021.

According to our definition (which includes the HF-Fund and smaller reclassified entities), the public debt ratio was significantly higher at 77% of GDP in 2021. We expect the debt ratio to decline to around 73% of GDP by 2023, compared to a peak at 77.1% in 2020. We include further sales of the government's stake in Islandsbanki over the coming two years, helping to accelerate the reduction in the debt burden. The government listed an initial 35% stake in June 2021, rasing IK55.3 billion (1.7%of GDP) and valuing the company at ISK158 billion (4.4% of estimated 2022 GDP). Starting in 2026, the fiscal rules - which have been suspended due to the pandemic - will be fully in place again, requiring a budgetary surplus on average over a rolling five-year horizon and a five percentage point annual debt reduction as long as the net debt ratio is above 30% of GDP.

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

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial	Final	Weights
				Factor score		
Factor 1: Economic strength				baa2	baa2	50%
Growth dynamics	Average real GDP growth (%)	2016-2025F	2.9	baa2		25%
	Volatility in real GDP growth (%)	2011-2020	3.6	b3		10%
Scale of the economy	Nominal GDP ($ billion)	2020	21.7	b2		30%
National income	GDP per capita (PPP, Intl$)	2020	56,066	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 (%)	2020	77.1	ba3		25%
	General government debt/revenue (%)	2020	184.1	a3		25%
Debt affordability	General government interest payments/revenue (%)	2020	9.6	a3		25%
	General government interest payments/GDP (%)	2020	4.0	b1		25%
Specified adjustments	*Total of specified adjustment (# notches)*			0	0	max ±6
	Debt trend	2016-2021F	-5.6	0	0	
	Foreign currency debt/general government debt	2020	11.3	0	0	
	Other non-financial public sector debt/GDP	2020	18.2	0	0	
	Public sector assets/general government debt	2020	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		
	Total domestic bank assets/GDP	2020	152.0	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

» **Outlook:** S 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

» **Issuer In-Depth:** Government of Iceland – A2 stable: Annual credit analysis, 25 August 2021

» **Issuer Comment:** Government of Iceland – A2 stable: Easing of travel restrictions could accelerate tourism recovery, 25 March 2021

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

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