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INVESTORS SERVICE

CREDIT OPINION
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Update

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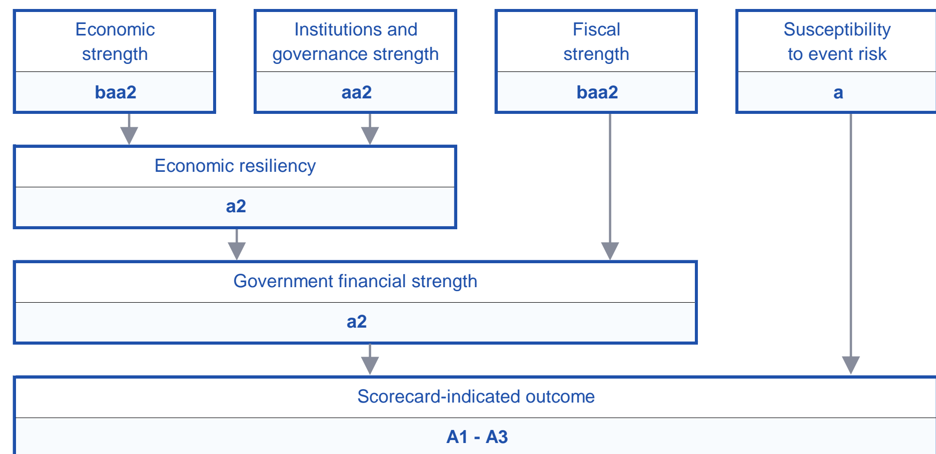
Government of Iceland – A2 stable

Update following rating affirmation; outlook unchanged

Summary

The credit profile of Iceland is supported by its wealthy and flexible economy with favourable demographics which support its long-term growth prospects. Prior to the pandemic, the government's debt burden has been reduced significantly, while consistent current-account surpluses have contributed to a net external creditor position. The credit profile is constrained by the economy's small size and sector concentration, which increase the vulnerability to shocks and cause volatility in growth. The authorities' swift policy response helps the economy recover well from the pandemic shock.

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



Source: Moody's Investors Service

Credit strengths

» Very high wealth and labour 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 structural features of the economy, including high 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 concentration are mitigated by a robust external position as well as reduced private sector indebtedness and improved health of the banking sector. We also believe that the coronavirus shock will not result in material permanent damage to the Icelandic economy, despite the disruption to the important tourism sector.

General government debt levels have been revised significantly higher for the past several years due to the inclusion of the debt of several state-owned companies, the largest of which is the HF-Fund (A2 stable). However, this does not fundamentally change our assessment of Iceland's fiscal strength, given that we have in the past incorporated these liabilities qualitatively as contingent liabilities for the government. The stable outlook also reflects the Icelandic authorities' solid fiscal track record of the past several years, which gives confidence that the recent debt increase will be reversed again in the coming years.

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, outlook and 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	2015	2016	2017	2018	2019	2020	2021F	2022F
Real GDP (% change)	4.4	6.3	4.2	4.7	2.6	-6.6	3.4	5.0
Inflation (CPI, % change, Dec/Dec)	2.0	1.9	1.9	3.7	2.0	3.6	3.1	2.6
Gen. gov. financial balance/GDP (%)[1]	-0.4	12.5	1.0	0.9	-1.5	-7.3	-9.8	-7.5
Gen. gov. primary balance/GDP (%)[1]	6.5	18.7	6.7	5.9	2.8	-3.3	-5.7	-3.4
Gen. gov. debt/GDP (%)[1]	97.2	79.9	69.4	61.1	68.3	79.9	82.6	83.4
Gen. gov. debt/revenues (%)[1]	225.2	135.2	152.6	136.2	163.0	188.5	211.1	214.6
Gen. gov. interest payment/revenues (%)[1]	15.9	10.4	12.7	11.2	10.4	9.5	10.5	10.5
Current account balance/GDP (%)[2]	5.7	8.1	4.2	3.8	6.4	1.1	1.6	1.4

[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

On 20 August 2021, we affirmed Iceland's ratings with a stable outlook. The affirmation was driven by our view that the Icelandic economy will post a solid recovery helped by a strong and pro-active policy response; over the coming years economic growth will be supported by strong investment and the continuing recovery in the tourism sector. In addition, institutions have been strengthened significantly and their credibility has materially improved over the past years, which gives a high level of confidence that the current fiscal deterioration will again be reversed over the coming years.

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Finally, the limited diversification of the economy due to its small size is unlikely to materially change over the coming years, a structural feature that limits upside rating potential. That said, the government has outlined an ambitious strategy to support the diversification and digitalisation of the economy via a large public investment programme and support for private investment. which could result in structurally lower growth volatility over time.

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 $55,966 on a purchasing power basis in 2020 - 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. Also, Iceland's economy is highly competitive, as evidenced by its ranking at 26th globally by the World Economic Forum's Global Competitiveness Index for 2019, – standing out compared with close peers.

We assess Iceland's **institutions and governance strength** as “aa2”, reflecting the country's strong scores in the Worldwide Governance Indicators and the government's good track record of restoring economic and financial stability after the banking crisis. Our assessment of the quality of institutions reflects Iceland's high-quality education system, an innovative business sector, an efficient and flexible labour market and well-developed infrastructure. Iceland also has a long tradition of broad cooperation and consensus on economic matters between the government, employers and employee associations, which contributes positively to policy effectiveness. The score has recently been raised from “aa3” to reflect our view that the strength of civil society and the judiciary is on par with the strongest sovereigns at “aaa”.

Moreover, the progress that the authorities have achieved in restoring macroeconomic, financial, and fiscal health informs our assessment of Iceland's institutions. For example, the considerable strengthening in supervision and regulation of the banking system has helped increase the resilience of the system. The monetary policy framework has also gained credibility and the central bank has managed to achieved moderate inflation since 2014, supporting macroeconomic stability. Our assessment also recognizes the careful and successful liberalisation of the capital account with minimal disruption.

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 30% of GDP in 2019. In December 2020, the authorities included 24 public-sector corporations into the general government sector, to align Iceland's sector classification with European Union rules. This reclassification 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, 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 2022 onwards, as strong GDP growth and the termination of pandemic-related measures reduce the budget deficit. Also, the Icelandic government still holds significant equity stakes in two of the three domestic banks, and sale proceeds will likely be used for 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 should help to 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 such that we don’t expect a notable change in policy direction after the next parliamentary elections due in September.

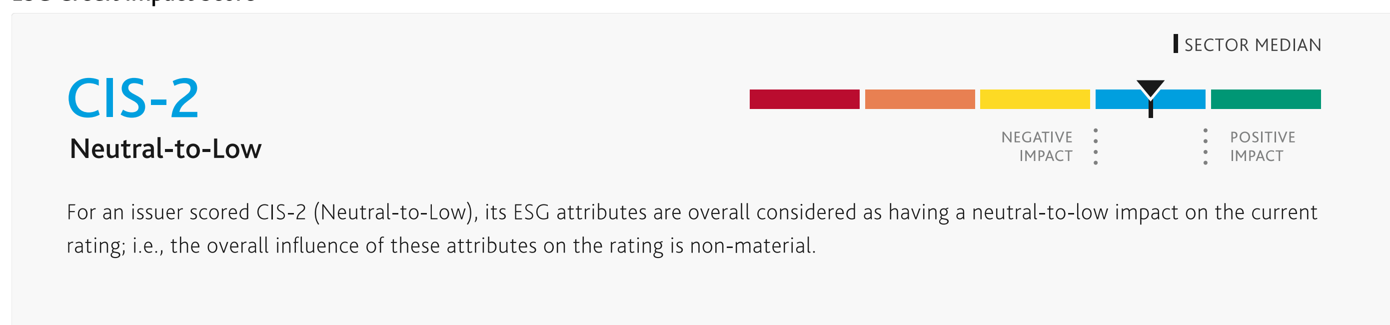
We assess government liquidity risk as “aa”. The previous marked reduction in government debt, prudent liquidity management, with significant cash buffers, and a stable and very large domestic investor base will help to mitigate the risks posed by the large increase in borrowing requirements this year.

Iceland's external vulnerability risk assessment at “a” reflects its current-account surpluses since 2013 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 26% 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 risk which is balanced somewhat by neutral to low exposure to social risks and very strong institutions which also contributes to its relatively strong resilience to E and S risks.

Exhibit 4
ESG Issuer Profile Scores

Source: Moody's Investors Service

Environmental

Iceland’s moderate exposure to environmental risks primarily reflects that Iceland's economy to a large degree relies on its unique geological features, particularly its key sectors of tourism and fishing, which exposes its credit profile to physical climate risks. In particular, the presence of active volcanoes on the island helps to attract tourism but could potentially also disrupt economic activity. Furthermore, warming seas can lead to the possible migration of fish stocks outside of Iceland’s waters, as seen with the decline in valuable capelin fish stocks in 2019. However, Iceland’s effective management of its fish stocks – including temporary suspension of fishing quotas to help stocks recover – is an important mitigating factor. Around 11% of Iceland’s land mass consists of glaciers which also exposes the country to risks from rising temperatures. Its overall E issuer profile score is therefore moderately negative (**E-3**).

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 advanced or developing nations — particularly in continental Europe — because of exceptionally long working lives, higher fertility rates, high share of women who work and the flexibility of the labour force. Iceland also benefits from high-quality education, high housing availability, and good quality health care and basic services. That said, 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.

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

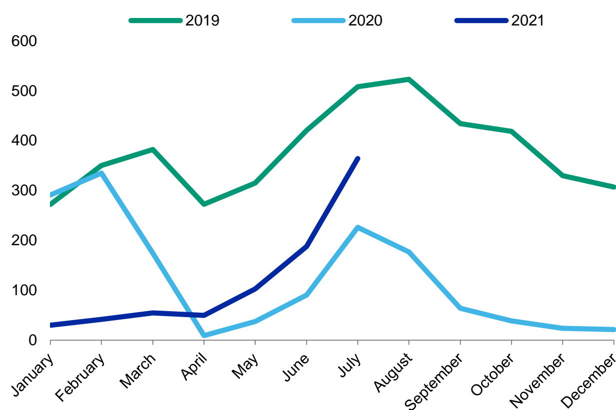
Strong tourism recovery under way but pandemic continues to pose risks

The demand and supply shock caused by the coronavirus outbreak has significantly impacted economic activity in Iceland, particularly Iceland's important tourism sector. While the sector directly accounted for 12.4% of production in 2019, the importance of the sector is bigger at 22.8% of total GDP according to the World Travel and Tourism Council (WTTCT) if both direct and indirect impact are taken into account. Also, tourism accounts for around 14% of total employment and 40% of total exports (data refer to 2019). Overall, real GDP contracted by 6.6% last year, which was among the larger drops recorded by advanced economies but less than feared initially because Iceland's other key industries have performed reasonably well and the significant government support helped cushion the shock for households and businesses.

The tourism sector is now seeing the first signs of improvement since Iceland opened its borders to tourists that have been vaccinated or recovered from the disease in March 2021 (see Exhibit 5). Consequently, we expect a reasonably solid recovery this year, with real GDP growth of 3.4% and a much stronger 5% next year, with most of the tourism recovery expected to happen in 2022. Overnight stays were around 70% of 2019 levels in July (54% for foreign tourists). Tourists also tend to spend more and stay longer than in the past, limiting the overall impact. The return of tourism activity has also led to a sharp reduction in unemployment from a peak of 11.6% in January 2021 to 6.1% in July. Despite the end of the short-time work scheme in May, the decline is helped by the introduction of a wage subsidy scheme for companies that rehire workers with more than 13,000 jobs (6% of the labour force) registered into the scheme since it started.

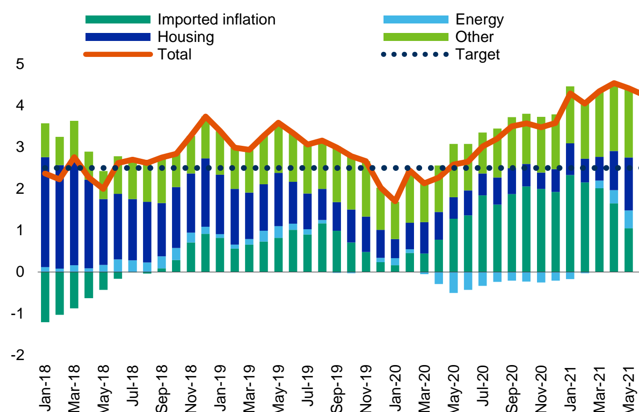
However, a full recovery of the tourism sector is unlikely before 2023 and the spread of new variants constitutes a key risk to the speed of the recovery. Iceland has recently been facing a surge in infections and although the country's high vaccination rate (about 90% of the population is fully vaccinated) has limited bad health outcomes, this could pose risks to travelers' confidence and lead to a slowdown in the pace of tourist arrivals.

Exhibit 5
Tourism is picking up strongly and was approaching pre-crisis levels
Thousands



Source: Statistics Iceland and Moody's Investors Service

Exhibit 6
Inflation has risen above target because of imported inflation and housing prices
CPI and components (year-on-year % change)



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

GDP growth in Q1 2021 was weaker than expected (-5.2% qoq), but quarterly GDP numbers have always been volatile in Iceland and the weakness in Q1 follows very strong growth in Q3 and Q4 2020, with quarterly growth averaging 4.3%. On the back of the substantial policy support we expect the economy to recover in the remainder of the year. In particular, we expect robust private consumption growth in the second half of 2021, with households benefitting from the improving labour market and solid real wage growth of around 6%. As part of the multi-year tax reforms decided in 2019, personal income tax is being reduced further this year, focused on low-income households, with an estimated impact on government revenues of 0.7% of GDP, and several pandemic-related support mechanisms remain in place or have been extended until later this year. Households can continue to withdraw savings from their voluntary third-pillar pensions this year, albeit to a smaller extent than in 2020.

Moreover, the government's investment plan will gather pace this year after some delays in 2020, with ISK31 billion (1% of GDP) in investments planned and focused on infrastructure, research and innovation. The public investment program will continue until 2025, with average annual investments of around 0.5%. The OECD estimates the impact on per-capita GDP at around 1.5 percentage points of GDP over a 10-year horizon. In addition, the government provides tax incentives for private-sector research and development (R&D) investment which has risen sharply in recent years and bodes well for future economic growth. Overall, private investment should recover at a solid pace this year and in the coming years.

Iceland's sizeable fiscal response will keep budget deficit high in 2021

The large economic contraction and the fiscal measures adopted by the authorities to counteract the effects of the pandemic have caused a significant widening of Iceland's general government budget deficit to 7.3% of GDP in 2020. The government presented three fiscal packages totaling ISK88.9 billion (3% of GDP) to provide individuals and companies with liquidity support during the acute phase of the pandemic and to support the subsequent economic recovery. Automatic stabilizers accounted for a further 3.2% of GDP last year. The budget outcome was nevertheless around 2.5 percentage points of GDP better than budgeted, as pandemic-related spending was lower than budgeted and tax revenues held up better than expected.

We expect Iceland's budget deficit to remain large this year as substantial fiscal support remains in place, before declining at a relatively fast pace in the coming years, as the government turns to fiscal consolidation. A fourth package was introduced in April 2021 which renewed some of the existing measures and introduced wage subsidies for companies that rehire workers. The government estimates the fiscal impact of its measures at ISK111 billion (3.5% of GDP) for 2021, with automatic stabilizers accounting for a further 3.7% of GDP. Overall, we expect the budget deficit to increase to close to 10% of GDP this year, somewhat lower than the government's expectation of 11.4% because our GDP growth forecast is higher than the assumption underpinning the budget. Also, the budget execution for the first quarter of 2021 again points to a stronger performance of revenues than assumed in the budget.

Although the government's medium-term fiscal plan for 2022-26 does not forecast active fiscal-consolidation measures until 2023, the budget deficit will start to decline next year. We forecast a deficit of around 7.5% of GDP, as the economic recovery gathers pace and the bulk of pandemic-related fiscal support measures expires. Spending on the investment programme will also be somewhat smaller than this year, and will gradually decline in the following years. According to the Ministry of Finance, the fiscal effort required from 2023 onwards to achieve the targets set out in its fiscal plan is manageable at around 1% of GDP per year. This would equate to an increase in revenues of 1% per annum and a reduction of expenditure of 1.2%.

The fiscal targets are set so as to stabilize the net public debt ratio by the end of 2025. From 2026 onwards, the fiscal rules are expected to be 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.

Central bank interest rate hikes should bring inflation back to target

In recent months, inflation has risen above the 2.5% target and upper threshold of 4%, which mostly reflects the impact of earlier ISK depreciation and rising house prices (see Exhibit 6). Consequently, the Central Bank of Iceland (CBI) raised its key policy rates by 25 basis points to 1% in May, earlier than most observers had expected. It may raise rates further, given that near-term inflation expectations have risen above 4%. In July, consumer price inflation was 4.2% after peaking at 4.5% in April; the CBI expects inflation to decline back towards its central target from Q2/Q3 2022 onwards.

In addition, the CBI has reacted to rising house prices - up by 10.7% on average between January and May 2021 in the greater capita city area - by introducing targeted macroprudential tools. Its Financial Stability Committee lowered the maximum loan-to-value (LTV) ratio to 80% from 85% in June. The average LTV ratio on new mortgages was substantially lower at 62% in January 2021 (65% in December 2019).

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 (%)	2016-2025F	3.0	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	55,966	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	79.9	ba3		25%
	General government debt/revenue (%)	2020	188.5	a3		25%
Debt affordability	General government interest payments/revenue (%)	2020	9.5	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	2.7	0	0	
	Foreign currency debt/general government debt	2020	10.9	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

- **Issuer Comment:** Government of Iceland – A2 stable: Easing of travel restrictions could accelerate tourism recovery, 25 March 2021
- **Credit Opinion:** Government of Iceland – A2 stable: Update following assignment of ESG scores, 11 February 2021
- **Outlook:** Sovereign – Global: Negative 2021 outlook as pandemic fallout weighs on economic activity, government finances, complicates policy choices, 10 November 2020
- **Credit Opinion:** Government of Iceland – A2 stable: Regular update, 6 October 2020
- **Issuer In-Depth:** Government of Iceland – A2 stable: Annual credit analysis, 29 July 2020
- **Sector in-Depth:** Sovereigns – Global: Lack of economic diversification and fiscal space leave small, island economies vulnerable to sustained drop in tourism, 22 June 2020
- **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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