MOODY'S
INVESTORS SERVICE

CREDIT OPINION
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Update

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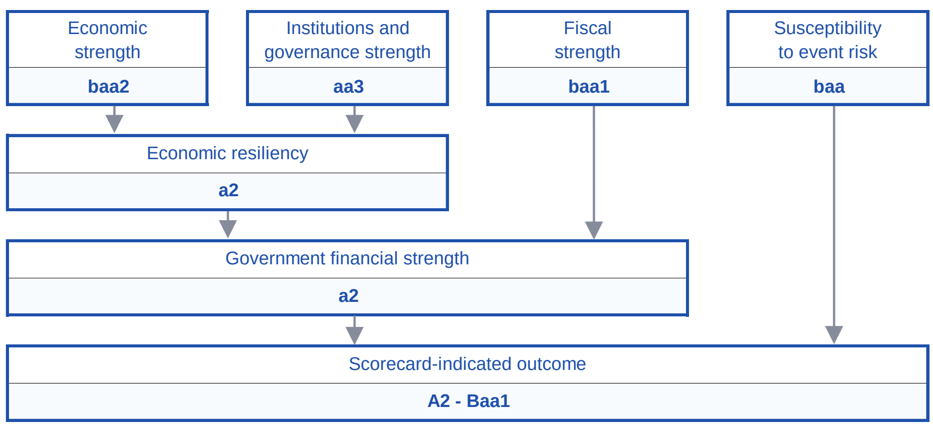
Government of Iceland – A2 stable

Update following assignment of ESG credit impact scores

Summary

The credit profile of Iceland is supported by its wealthy and flexible economy with favourable demographics which support its long-term growth prospects. Pre-pandamic, the government's debt burden has been reduced significantly since 2011, while consistent current-account surpluses have contributed to Iceland's net external creditor position. The credit profile is constrained by the economy's small size, high economic concentration and openness and small currency area, which increase the vulnerability to shocks and can cause volatility in growth. The authorities' swift policy response to the coronavirus shock should help the economy to recover this year.

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



Source: Moody's Investors Service

Credit strengths

» Economic flexibility and very high wealth provide buffers to deal with shocks

» Low share of foreign currency debt

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

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 fiscal and 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 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 HF-Fund (A3 stable). 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.

Factors that could lead to an upgrade

Iceland’s rating could be upgraded if the public debt burden was materially lowered in the coming years, implying consistently large primary surpluses or further sizeable one-off income flows, e.g from privatisations, dedicated to debt reduction. Such a strengthening of Iceland's public finances would provide important financial buffers against Iceland's elevated vulnerability to domestic and external shocks.

Factors that could lead to a downgrade

Conversely, a material and sustained further increase in government debt could place the rating under downward pressure. This could arise as a result of a slow economic recovery coupled with continued large budget deficits over several years. An economic shock which leads to substantial capital outflows, weakening Iceland’s external position and threatening financial stability, would also be negative, although this is not a likely scenario.

Key indicators

Exhibit 2

Iceland	2015	2016	2017	2018	2019	2020F	2021F	2022F
Real GDP (% change)	4.4	6.3	4.2	4.6	1.9	-8.2	4.0	3.0
Inflation (CPI, % change, Dec/Dec)	2.0	1.9	1.9	3.7	2.0	3.6	2.7	2.5
Gen. gov. financial balance/GDP (%)[1]	-0.2	12.9	1.0	0.9	-1.5	-10.4	-11.5	-7.8
Gen. gov. primary balance/GDP (%)[1]	6.7	19.0	6.8	6.0	2.9	-6.1	-7.1	-3.2
Gen. gov. debt/GDP (%)[1]	97.2	79.9	69.3	61.2	69.0	83.0	89.4	92.6
Gen. gov. debt/revenues (%)[1]	225.2	135.2	152.6	136.2	163.2	194.5	225.2	226.7
Gen. gov. interest payment/revenues (%)[1]	15.9	10.4	12.7	11.2	10.4	10.1	11.2	11.4
Current account balance/GDP (%)[2]	5.7	8.1	4.2	3.8	6.4	0.3	0.4	0.8

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

Source: Central Bank of Iceland, Statistics Iceland, Moody's Investors Service

Detailed credit considerations

We assess Iceland's **economic strength** as “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 $58,965 on a purchasing power basis in 2019 - higher than that of around 90% of our sovereign rating universe, having overcome the significant losses registered during the country's 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.

Our final assessment of economic strength is lower than the initial score of “baa1” to reflect the high degree of concentration. While more diversified than in the past, Iceland's very open economy still relies on three main export sectors, which suggests a smaller degree of diversification, and hence shock absorption, than implied by the economy's size. The tourism sector - accounting for 22.8% of GDP and 30% of exports in 2019 according to the World Travel & Tourism Council - has been hit hard by the coronavirus pandemic, leading to a stronger GDP contraction in 2020 than in most A-rated peers. We also expect the recovery to be relatively more moderate as tourism arrivals are not expected to recover fully before 2022.

We assess Iceland's **institutions and governance strength** as “aa3”, 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 2008 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.

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 supervision and regulation of the banking system has helped increase the resilience of the system. The monetary policy framework has also gained credibility and has achieved relatively subdued inflation since 2008, supporting macroeconomic stability. Our assessment also recognizes the careful and successful liberalisation of the capital account, largely concluded in early 2019 with minimal disruption.

We assess Iceland's **institutions and governance strength** as “aa3”, 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 2008 banking crisis. Our assessment of the quality of institutions reflects Iceland's generally professional and capable public administration as well as a transparent and predictable legislative framework. 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.

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 regulatory framework for the banking sector has strengthened considerably. Improvements to the monetary policy framework have also helped to support relatively subdued inflation since 2008. Our assessment also recognizes the careful and successful liberalisation of the capital account, with the process of removing capital restrictions largely concluded in early 2019.

We assess Iceland's **fiscal strength** as “baa1”, reflecting the government's strong track record in reducing its large budget deficits and very high debt burden after the 2008 crisis. Since reaching a peak of 138.2% of GDP in 2011, general government debt more than halved to 61.2% of GDP in 2018. 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 but also implies much smaller contingent liabilities. General government debt will start to decline only from 2022 onwards, given the coronavirus shock and continued expansionary fiscal policy in 2021. The final score is higher than the initial score of “baa3” as 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 assess Iceland's **susceptibility to event** risk as “baa”, driven by our banking system risk assessment. While the sector's concentrated exposures, including to the hard-hit tourism sector, are a key downside risk, 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 banks.

Political event risk is low, and scored at “aa” given consistent policy in key areas important to safeguarding the government's credit profile. Although only one government has served an entire term since 2007, political consensus on the economic and fiscal direction for the country has remained strong such that we don’t expect a notable change in policy direction.

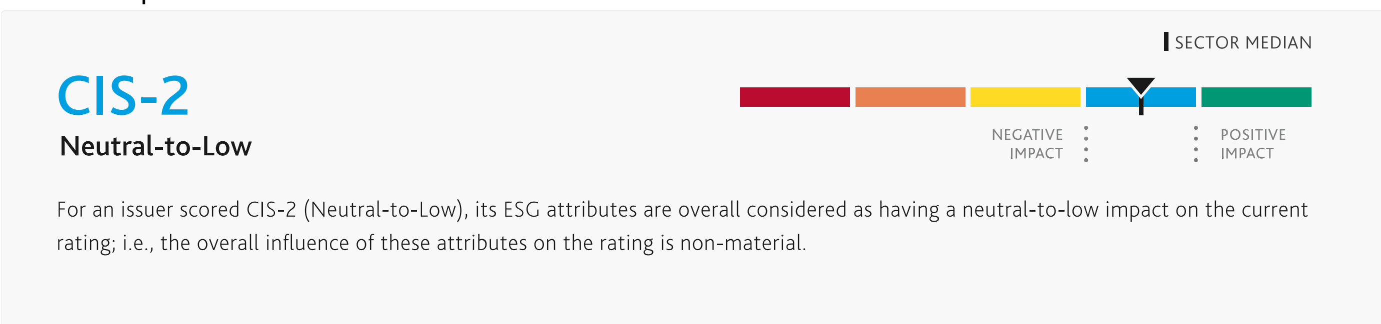
We assess government liquidity risk as “aa”. The previous marked reduction in government debt, prudent liquidity management, with significant cash buffers, and a stable domestic investor base will help to mitigate the risks posed by a large increase in borrowing requirements this year.

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 purchase substantial foreign currency reserves which will help to support the country's external position through the sharp but temporary economic shock. The current account is expected to remain in a small surplus in 2020 as a weaker currency helps to support exports at the same time as the reduction in consumption weighs heavily on imports.

ESG considerations

Iceland's ESG Credit Impact Score is neutral to low (CIS-2).

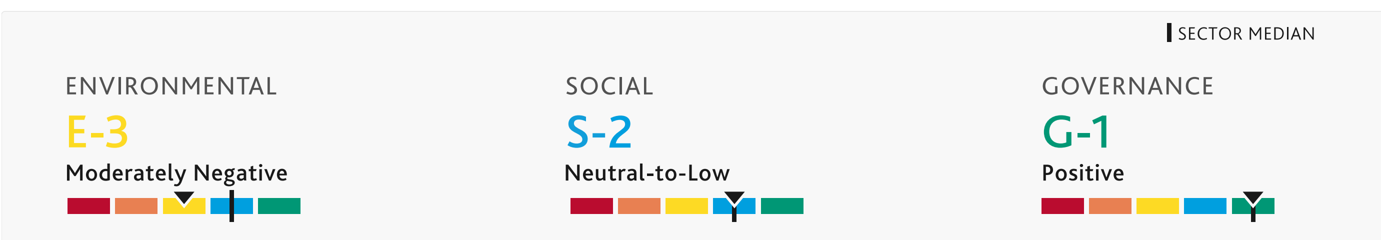
Exhibit 3
ESG Credit Impact Score



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 by neutral to low exposure to social risks and very strong institutions which also contribute 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 expose 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 as seen in 2010 with the eruption of the Eyjafjallajökull volcano. 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. 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

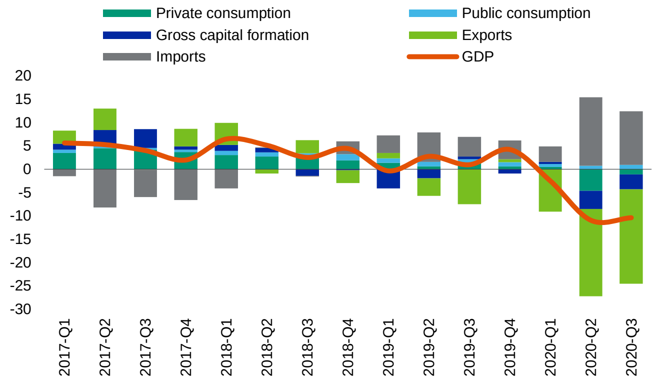
Pandemic developments abroad will continue to weigh on domestic activity

The demand and supply shock caused by the coronavirus outbreak has significantly impacted economic activity in Iceland and we estimate that real GDP declined by 8.2% in 2020. After falling by 2.5% in the first quarter, restrictions on economic and social activities led to a real GDP contraction of 10.9% year-on-year in the second quarter, mainly driven by lower private consumption, investment and exports. Significant travel restrictions worldwide suppressed demand for Iceland's important tourism sector, which accounted directly and indirectly for 22.8% of Iceland's GDP in 2019, 21.9% of employment and 30% of total exports according to the World Travel and Tourism Council (WTTC).

The large wealth buffers of Icelandic households and the government's support measures contributed to a strong rebound in private consumption of 8% in the third quarter after the restrictions were gradually lifted in May. Travel restrictions have also redirected to the domestic economy the significant proportion of household consumption which is usually spent abroad (12% of private consumption in 2019). Although the number of tourist arrivals improved in the summer to around 40% of their 2019 levels, the tightening of border restrictions in August halted the nascent recovery of the tourism industry. As a result, real GDP contracted by 10.4% year-on-year (+2.6% quarter-on-quarter) in the third quarter with exports being the main drag on growth.

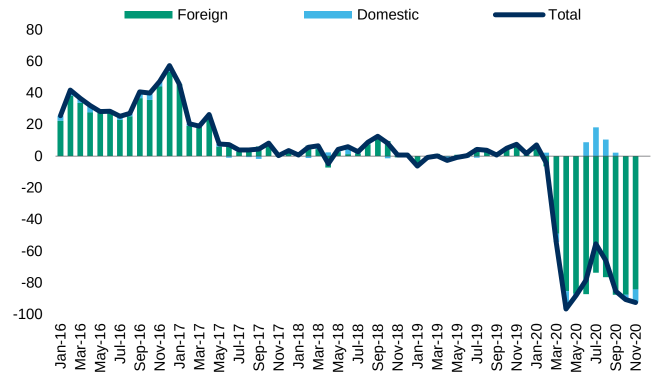
A renewed rise in infection rates and the subsequent tightening of restrictions in October is likely to have slowed the growth momentum in the fourth quarter. For example, domestic payment card turnover was up 5.9% year-on-year in the fourth quarter compared to 9.7% in the third quarter. As a result, we expect real GDP growth moderated to around 1.5% quarter-on-quarter, bringing the full year contraction to 8.2% for 2020.

Exhibit 5
Exports have remained the main drag on economic activity...
Real GDP growth (%) and components (pp)



Source: Statistics Iceland, Moody's Investors Service

Exhibit 6
... due to low tourism activity
Overnight stays (year-on-year % change)



Source: Statistics Iceland, Moody's Investors Service

The recovery is likely to resume in the first quarter of 2021 given that most restrictions were eased in early February and household disposable income and consumption will be boosted by tax cuts this year. However, the limited degree of diversification of the economy and its high degree of trade openness will continue to expose Iceland's recovery to pandemic developments in the rest of the world. We forecast the economy to post real GDP growth of 4% in 2021, which is slower compared to countries which are not as exposed to tourism.

Tourist arrivals will only recovery very gradually and we expect them to remain around 50% lower than their 2019 levels based on the assumption that Schengen border restrictions will be eased, particularly with the United States (Aaa stable) and the United Kingdom (Aa3 stable), Iceland's two main source markets. Moreover, the government expects to ease entry requirements in May for European countries deemed to be at lower risk.

At the same time, the impact of the pandemic on the fishing industry has been milder than we initially expected. The weaker krona and higher demand for fresh fish in the summer have supported a 3.7% increase in the value of exports of marine products over 2020. We expect the sector's performance to be comparable in 2021 with quotas being the most likely constrain rather than demand. Although lower cod quotas will weigh on exports given the importance of the fish for Iceland's fisheries, the Marine and Freshwater Research Institute issued capelin quotas, which will support the sector's performance after two years of zero quotas. In addition, Iceland's aquaculture sector, though still small, has continued to grow despite the pandemic with a 17.5% increase in exports in 2020. Stronger aquaculture exports will help counteract variations in fishing quotas which have impacted on GDP growth in recent years.

The early recovery in China and voluntary curtailments contributed to an increase in the price of aluminium. Exports of Iceland's third largest sector recovered in the second half of 2020 and were down 2% over the year. As highlighted in our outlook for base metals, slow global economic recovery will cap how much prices can rise and supply will likely remain in surplus. The sector also faces challenges as Rio Tinto Plc (A2 stable), the operator of Iceland's third-largest aluminium smelter, announced in February that it was undergoing a strategic review of its Icelandic operations which could result in it shutting down its smelter altogether as it struggles to generate profits. Negotiations with Landsvirkjun (Baa1 stable), Iceland's power generation company, are still ongoing but the extension of the smelter's operating licence in August and the collective wage agreement was signed in February 2021 for three years suggest that the smelter could return to full operation after having operated at 85% of capacity.

Iceland's sizeable fiscal response will weaken fiscal metrics further in 2021

The large economic contraction and the fiscal measures adopted by the authorities to counteract the effects of the pandemic have caused a marked deterioration of Iceland's public finances. We estimate that the general government budget deficit widened to about 10.4% of GDP in 2020 from 1.5% in 2019. A number of fiscal measures were taken to provide individuals and companies with liquidity support during the acute phase of the pandemic and support the subsequent economic recovery. The focus of the immediate fiscal measures, which have been similar in nature to that seen in other countries, has been on avoiding large-scale labour shedding and corporate defaults as a result of temporarily lower revenue, to which the government has responded with a combination of wage subsidies, tax reductions and deferrals, guaranteed credit lines, allowing individuals greater access to their pension savings and sector specific measures, including for the large tourism sector.

In line with the government's fiscal plan for 2021-2025, we expect Iceland's fiscal deficit to remain large over the coming years as the government supports the recovery with additional measures. We expect the fiscal deficit to increase to 11.5% of GDP in 2021, in line with the government's medium-term fiscal plan and narrow to 7.8% in 2022. Although a number of temporary measures have now expired, planned tax reforms, continued recovery measures and higher unemployment will keep the budget deficit elevated. In addition to temporary tax cuts and deferrals this year, large public investment and tax incentives on private investment and innovation are planned to support the economy. Public infrastructure projects total ISK100 billion (3.3% of GDP) over 2021-2025 and will be front-loaded over the next three years. The government's revised medium-term fiscal plan now envisages to stabilise the public debt in 2025.

Fiscal account revision does not materially alter our assessment of Iceland's fiscal strength

Following a benchmark revision in December, 24 public entities have been reclassified and included under the general government, leading to a significant increase in Iceland's debt metrics and weaker debt affordability. The debt-to-GDP ratio increased by about 32 percentage points mainly as a result of the inclusion of the liabilities of HF-Fund and the Student Loan Fund. However, we had long incorporated these entities into our qualitative analysis.

HF-Fund is an asset management vehicle in wind-down overseen by the Ministry of Finance and Economic Affairs, responsible for legacy mortgages and the servicing of the remaining oustanding HFF bonds (ISK 379 billion outstanding as of June 2019). HF-Fund has been faced with a significant maturity mismatch between its assets and liabilities, as its borrowers have pre-paid HFF mortgages, while the Fund could not accelerate repayment of its bonds, which have long maturities of up to 23 years. Currently, cash inflows and HF-Fund's cash position are more than sufficient to cover the fund's debt repayments. This favourable position will start to reverse in the early 2030s. By that time, we expect the government to have returned its debt burden on a steady downward trajectory, providing ample room to cover the annual payments which amount to about 1% of GDP.

As a result of the fiscal measures and the deterioration in the economic environment, we expect government debt will rise to 83% of GDP in 2020 from 69% in 2019, and stabilise at around 90% in the medium term. That said, inflows from the failed banks could lead to a smaller-than-expected increase in the debt burden. In December 2020, the government announced its plan to sell 25% of its stake in Islandsbanki. The fully government-owned bank is valued at over ISK180 billion (6% of GDP) and the transaction is expected to be completed in the course of this year, with proceeds to be used to pay down debt and increase social investment.

Moreover, Iceland’s track record of a marked post-crisis consolidation support our view that the government accounts will return to a more sustainable footing in the medium term. After the global financial crisis, Iceland undertook significant tax reforms and spending cuts which, together with a buoyant economic environment, led to a 69 percentage point reduction in the debt-to-GDP ratio between 2011 and 2019. As a result, Iceland’s fiscal position coming into the crisis was strong with a primary surplus of over 6% of GDP in 2018. At the same time, the structure of Iceland’s debt has improved substantially since the financial crisis, leaving it less exposed to exchange rate risk and sudden capital outflows. Moreover, the retirement of higher-cost debt and the rebuilding of the government’s revenue base since the banking crisis have helped to improve the affordability of Iceland's government debt.

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				baa1	baa2	50%
Growth dynamics	Average real GDP growth (%)	2015-2024F	2.6	baa3		25%
	Volatility in real GDP growth (%)	2010-2019	2.6	ba1		10%
Scale of the economy	Nominal GDP ($ billion)	2019	24.6	b2		30%
National income	GDP per capita (PPP, Intl$)	2019	58,965	aaa		35%
Adjustment to factor 1	*# notches*				-1	max ±9
Factor 2: Institutions and governance strength				aa3	aa3	50%
Quality of institutions	Quality of legislative and executive institutions			aa		20%
	Strength of civil society and the judiciary			aa		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	baa1	
Debt burden	General government debt/GDP (%)	2019	69.0	ba1		25%
	General government debt/revenue (%)	2019	163.2	a2		25%
Debt affordability	General government interest payments/revenue (%)	2019	10.4	baa1		25%
	General government interest payments/GDP (%)	2019	4.4	b1		25%
Specified adjustments	*Total of specified adjustment (# notches)*			0	0	max ±6
	Debt trend	2016-2021F	9.5	0	0	
	Foreign currency debt/general government debt	2019	9.3	0	0	
	Other non-financial public sector debt/GDP	2019	18.3	0	0	
	Public sector assets/general government debt	2019	0.0	0	0	
Other adjustment to factor 3	*# notches*				2	max ±3
F1 x F2 x F3: Government financial strength				a2	a2	
Factor 4: Susceptibility to event risk				baa	baa	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				baa	baa	
	Risk of banking sector credit event (BSCE)	Latest available	--	baa3		
	Total domestic bank assets/GDP	2019	165.8	180-230		
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				A2 - Baa1	A2 - Baa1	

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:** 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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