MOODY'S
INVESTORS SERVICE

Rating Action: Moody's upgrades Iceland's government ratings to A2; outlook stable

08 Nov 2019

London, 08 November 2019 -- Moody's Investors Service ("Moody's") has today upgraded Iceland's long term issuer and senior unsecured ratings to A2 from A3, Iceland's senior unsecured MTN rating to (P)A2 from (P)A3 and other short term rating to (P)P-1 from (P)P-2. The outlook on the ratings has been changed to stable from positive.

The key drivers for the upgrade in the ratings:

1. Iceland's sizeable debt reduction gains will be sustained, positioning the country favourably relative to A2-rated peers; and

2. Improvements in economic resilience reduces the country's inherent vulnerability to shocks.

The stable outlook reflects Moody's expectation that the improvements to Iceland's credit profile since the crisis, which have improved its macroeconomic and financial stability, will be sustained. The stable outlook also reflects the inherent structural credit constraint arising from its small size and still sizeable economic concentration.

Moody's has today also raised Iceland's local currency bond and deposit ceilings to Aa3 from A1, long-term foreign currency bond ceiling to A1 from A3 and long-term foreign currency deposit ceiling to A2 from A3. Moody's has also raised the short-term foreign currency bond and deposit ceilings to P-1 from P-2.

RATINGS RATIONALE

RATIONALE FOR THE UPGRADE TO A2

FIRST DRIVER: ICELAND'S SIZEABLE DEBT REDUCTION GAINS WILL BE SUSTAINED

Iceland's general government debt is expected to reach 36% of GDP at the end of 2019, a more than 8 percentage points (pp) reduction over the last two years. The strong fiscal performance is in line with the expected further decline in government debt outlined at the time of assigning the positive outlook in July 2018, and positions Iceland's government debt to GDP ratio favourably relative to the median of A2-rated sovereigns.

Iceland's government debt has fallen by around 75 pp since 2011, the largest reduction of rated sovereigns in the post-crisis era, helped by significant fiscal consolidation and the early repayment of debt using the receipts from the estates of failed banks. Given the small size of the economy and its currency area, Iceland is vulnerable to shifts in the global economy that would leave larger countries unaffected. The budget has achieved large primary surpluses in recent years supported by buoyant tax receipts on the back of very strong economic growth and expenditure restraint.

Going forward, Moody's expects the substantial improvement in fiscal strength to be preserved as the country's accumulated fiscal space helps to cushion the impact of the temporary economic shock. The government's liquid financial assets, with deposits averaging more than 7% of GDP in the last two years, will help to accommodate the negative impact on government revenues from slower growth in 2019, as the budget moves to a modest deficit, while the strong underlying fundamentals in Iceland's economy will continue to support healthy nominal GDP growth in the coming years.

Furthermore, Moody's considers the risk of a significant upward spike in government indebtedness is now lower given the substantial reduction in foreign currency debt exposure, which has declined to around 12% of general government debt in 2018 from around 42% in 2011. In addition, there has been a marked improvement in the government's debt affordability due to the retirement of higher-cost debt and the rebuilding of the government's revenue base, and Moody's expects debt affordability will continue to improve as the government's cost of new funding is expected to be favourable relative to the coupons on existing debt. Furthermore, only 16% of total treasury debt is held by foreign investors, limiting the risk of volatile funding

conditions.

The debt burden remains most susceptible to a primary balance shock, although refinements to Iceland's fiscal framework, including the Organic Budget Law which ensures net lending must be positive over a 5 year period, will further help to preserve these fiscal improvements, even as the government's priority shifts from consolidation to efforts to improve social conditions and infrastructure. At the same time, the government's contingent liabilities remain very large and concentrated in a couple of entities. That said, the government's exposure through outstanding guarantees has roughly halved since the peak of the crisis while the operating performance of the largest enterprises has improved.

Finally, while cash inflows from the estates' of the failed Icelandic banks will be minimal going forward, the prospect for notable privatisation proceeds in the future could help to further strengthen the government's balance sheet. In addition, the authorities have outlined plans for a sovereign wealth fund to help buffer against unforeseen events impacting the small island economy.

SECOND DRIVER: IMPROVEMENTS IN ECONOMIC RESILIENCE REDUCES INHERENT VULNERABILITY TO SHOCKS

Iceland's improved (albeit still limited) economic diversification, strong wealth levels, ongoing refinements to its institutional framework and strong external position has increased its resilience to shocks.

The very strong growth in Iceland's tourism sector, with tourists arrivals expanding around 5 times over the last 15 years, has meant there are now three rather than two main pillars contributing to exports. Given positive spill-overs from the buoyant tourism sector to the broader economy, Iceland has enjoyed one of the longest periods of uninterrupted growth, averaging 3.7% between 2011 and 2018, and supporting a 35% increase in GDP per capita (on a PPP basis). The tourism boom has also supported a structural improvement in Iceland's external position, with the country moving to a net creditor from a large debtor position in recent years, helping to reduce external vulnerability.

While economic growth will slow in 2019/20, primarily due to lower tourist arrivals following the collapse of a domestic airline, the temporary shock will not weaken public or external debt sustainability or threaten financial stability.

Indeed, Moody's expects the economy's strong fundamentals will support robust economic growth in the medium term. The tourism sector will benefit from a gradual transition to higher value segments, with evidence that higher spending per tourist is helping to cushion some of the negative impact on arrivals this year, helping the sector to grow at a more economically sustainable pace. Cod stocks, which account for a large share of marine exports, are expected to remain abundant, supporting Iceland's important fishing sector, while farmed fishing presents an export growth opportunity. Furthermore, the aluminum industry's comparative advantage in terms of low energy costs has been reinforced by the recent signing of long-term contracts with the domestic energy provider.

Iceland's economic resilience also reflects improvements to the country's economic and financial stability, supported by the abatement of the risks outlined at the time of assigning the positive outlook last year. In particular, the authorities largely concluded the process of lifting capital controls in early 2019 without any material destabilising capital flows or abrupt exchange rate movements, a further step in restoring macroeconomic normalcy following the crisis. Furthermore, the multi-year wage agreements reached between employers and labour unions were more moderate than expected, helping to reduce risks to competitiveness. Finally, plans to merge the central bank and the Financial Stability Authority to improve financial sector oversight helps to assure the restoration of the banking system's health will be maintained.

That said, while improving, Iceland's resilience remains constrained by the economy's small size and still sizeable concentration, with more than 70% of the country's exports coming from just three sectors.

RATIONALE FOR ASSIGNING A STABLE OUTLOOK

The stable outlook reflects Moody's expectation that the improvements to Iceland's credit profile since the crisis, which have improved its macroeconomic and financial stability, including reduced indebtedness and improved external balances, will be sustained. The stable outlook also reflects the inherent structural credit constraint arising from its small size and still sizeable economic concentration, despite improved resilience in recent years, such that Iceland's credit profile will continue to be structurally more exposed to shocks than for many peers. Iceland's vulnerability to shocks also features some exposure to environmental risks in its key sectors of tourism and fishing.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Moody's takes account of the impact of environmental (E), social (S), and governance (G) factors when assessing sovereign issuers' economic, institutional and fiscal strength and their susceptibility to event risk. In the case of Iceland, the materiality of ESG to the credit profile is as follows.

Iceland faces some exposure to environmental risks in its key sectors of tourism and fishing, particularly given the presence of active volcanoes on the island and the possible migration of fish stocks due to warming seas.

Social risks currently exert limited impact on Iceland' credit profile, with some social pressures exerting themselves through intensive wage negotiations every four years which can impact on Iceland's competitiveness.

In terms of governance, while Iceland's institutions are very strong, there are still some weaknesses in the financial supervisory framework that remain unaddressed, including deficiencies in anti-money laundering processes after Iceland was recently placed on the Financial Action Task Force's "grey list".

WHAT COULD CHANGE THE RATING UP/DOWN

Iceland's rating would likely be upgraded if economic or institutional reforms help to significantly further insulate the credit profile from the risks posed by its small size and concentrated economy, including through a marked improvement in its external position and the build-up of financial buffers which materially further reduce its vulnerability to domestic and external shocks. For instance, a further and substantial strengthening of the government's balance sheet, through a track record of large primary surpluses or further sizeable one-off income flows, including from privatisations, would be positive, as would a further material reduction in the government's contingent liabilities.

Conversely, a sharp increase in government debt would weigh on the credit profile given the economy's structural vulnerability to shifts in the global economy and risks posed by its concentrated economic model. This could result from the crystallisation of Iceland's still sizeable contingent liabilities, including from the large banking system, or from a substantial weakening in the country's fiscal performance if, for example, offsetting budgetary measures are not forthcoming in the event that a significant economic shock weighs on government revenues. A disruptive slowdown or other economic shock which leads to substantial capital outflows, weakening Iceland's external position and threatening financial stability, would be negative.

GDP per capita (PPP basis, US$): 55,941 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4.8% (2018 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 3.7% (2018 Actual)

Gen. Gov. Financial Balance/GDP: 0.8% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 2.8% (2018 Actual) (also known as External Balance)

External debt/GDP: [not available]

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 5 November 2019, a rating committee was called to discuss the rating of the Government of Iceland. The main points raised during the discussion were: The issuer's economic resilience, including its economic and institutional strength, have increased. The issuer's fiscal or financial strength, including its debt profile, has increased. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in November 2018. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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