MOODY'S
INVESTORS SERVICE

CREDIT OPINION
4 December 2018

Update

Rate this Research

Analyst Contacts

Kristin Lindow +1.212.553.3896
Senior Vice President
kristin.lindow@moodys.com

Michael S. Higgins +1.212.553.1619
Associate Analyst
michael.higgins@moodys.com

Evan Wohlmann +44.20.7772.5567
VP-Senior Analyst
evan.wohlmann@moodys.com

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

Yves Lemay +44.20.7772.5512
MD-Sovereign Risk
yves.lemay@moodys.com

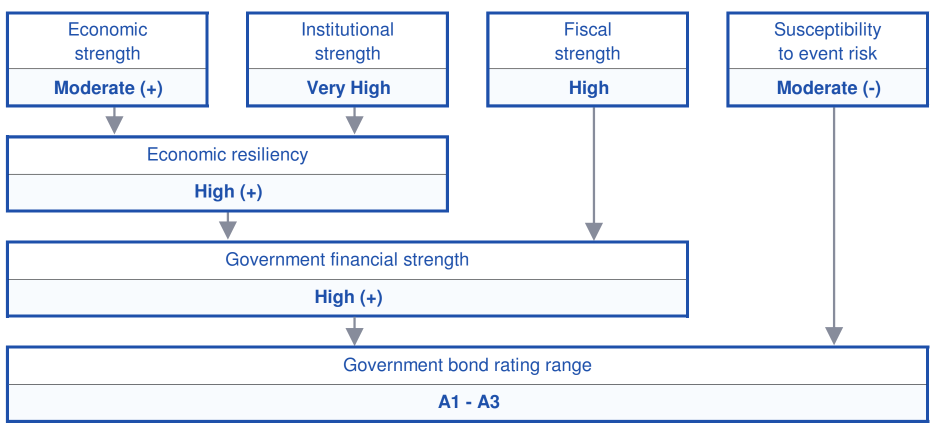
Government of Iceland - A3 positive

Regular update

Summary

The credit profile of Iceland (A3 positive) is supported by its wealthy, flexible economy, benefiting from a natural resource base that affords robust growth potential. The credit profile is constrained by the economy's small size, relatively limited diversification, openness and small currency area, which increase its vulnerability to shocks and can cause volatility in growth.

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 significant shock-absorption capacity

» Strong fiscal position and low share of foreign currency debt

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

Credit challenges

» Small, open economy and currency area subject to volatility

» Substantial, albeit significantly reduced, exposure to external risks

» Large contingent liabilities derived from state-owned companies

Rating outlook

The positive outlook reflects the Icelandic economy's improving economic resilience afforded by a net external creditor position, more balanced growth and ongoing strengthening of the country's banking system. The positive outlook also reflects the progress made in the past two years on the major preconditions we laid out at the time of the upgrade to A3 in September 2016, including the smooth removal of capital controls and the settlement of the offshore kronur debt.

Factors that could lead to an upgrade

We would consider upgrading Iceland's A3 ratings should the authorities achieve the expected further improvement in the government's debt metrics and be successful in managing a soft landing of the economy amidst the maturation of the tourism sector and upcoming wage round without a material degradation of the external position.

Factors that could lead to a downgrade

We would consider removing the positive outlook or taking a negative rating action if a disruptive slowdown or outright contraction in tourism revenues or other economic shocks were to weaken public or external debt sustainability or threaten financial stability, particularly should Iceland again have to resort to capital controls.

Key indicators

Exhibit 2

Iceland	2013	2014	2015	2016	2017E	2018F	2019F	2020F
Real GDP (% change)	4.1	2.1	4.5	7.4	4.0	3.8	2.0	2.0
Inflation (CPI, % change, Dec/Dec)	4.1	0.8	2.0	1.9	1.9	2.9	6.0	4.0
Gen. gov. financial balance/GDP (%)	-1.8	-0.1	-0.8	12.3	0.0	1.5	0.9	1.0
Gen. gov. primary balance/GDP (%)	2.6	4.5	3.7	16.2	3.8	4.3	2.9	2.8
Gen. gov. debt/GDP (%)	88.0	81.8	66.0	52.7	42.3	39.5	35.9	33.4
Gen. gov. debt/revenues (%)	216.8	187.1	162.2	92.9	99.4	90.8	83.1	77.5
Gen. gov. interest payment/revenues (%)	10.9	10.4	10.9	6.9	8.9	6.5	4.6	4.2
Current account balance/GDP (%)[1]	7.2	5.2	5.8	7.5	3.3	2.0	2.2	1.9

[1] Excludes DMBs undergoing winding up in 2008-2015
Source: Moody's Investors Service

Detailed credit considerations

The credit profile of Iceland reflects its “Moderate (+)” **economic strength**, “Very High” **institutional strength**, “High” **fiscal strength**, and “Moderate (-)” **susceptibility to event risk**.

We assess Iceland's **economic strength** as “Moderate (+)”, which is below the indicative score of “High (-)” because of the country's small size and associated history of economic boom and bust episodes. That said, at $51,842 as of 2017 on a purchasing power basis, Iceland's GDP per-capita is higher than that of over 89% of the universe of Moody's rated sovereigns, having overcome significant losses registered during the country's banking and currency crisis. As evidenced by its ranking at 28th globally by the World Economic Forum's Global Competitiveness Index for 2017-2018, Iceland's economy is highly competitive – standing out compared with close peers, particularly given the economy's small size and overvalued currency.

We assess Iceland's **institutional strength** as “Very High”, mainly reflecting the country's very high scores in the Worldwide Governance Indicators (WGI) and track record of effective macroeconomic management to restore financial stability after the banking crisis. Iceland ranks in the 86th percentile of the WGI's measure of government effectiveness, in the 87th percentile for rule of law, and in the 94th for control of corruption, well above the A-rating category median. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative and high tech-oriented business sector, an efficient and flexible labor market and well-developed infrastructure. Iceland's peers with the same “Very High” assessment are all higher rated, including Austria (Aa1 stable), Belgium (Aa3 stable), and Ireland (A2 stable).

The progress that the authorities have achieved in restoring macroeconomic, financial, and fiscal health also informs our assessment of Iceland's institutions. For example, the regulatory framework for the banking sector has strengthened considerably – with domestic banks focusing inward to mitigate risk. Our assessment also recognizes the careful and ultimately successful liberalization of capital account restrictions over the years until March 2017, when nearly all such controls were removed. Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between the government, employers and employee associations, which contribute positively to policy effectiveness.

We assess Iceland's **fiscal strength** as “High”, below the indicative score of “High (+)” to signal that debt affordability is likely to weaken now that interest rates are headed up rather than falling. Still, after peaking at 114.7% of GDP in 2011, Iceland's gross government debt burden declined precipitously, with persistent budget surpluses, debt buybacks and rapid economic growth. Compositionally, the government's debt burden is now significantly less exposed to exchange rate risk, because the foreign currency share of gross government debt has declined to 13% from 41.9% in 2011, and the debt's maturity remains relatively long. Peers with a similar fiscal strength assessment include higher rated Bermuda (A2 stable) and France (Aa2 positive).

We assess Iceland's **susceptibility to event risk** as “Moderate (-)”. The “Moderate (-)” score is driven by our banking system risk assessment, which is set below the indicative score of “Moderate (+) ”. Given our lack of a published baseline credit assessment (bca) for the Icelandic banking system, which leads to incomplete data for calculation of an indicative banking sector risk score, we incorporate our aggregate analysis of the Icelandic banking system developed from publically available information into the final score. As a consequence, we believe banking sector risk is lower than the indicative score produced by the scorecard.

Furthermore, risks to financial stability from the banking sector have diminished significantly since the 2008 banking sector crisis. Strong capitalization and liquidity, lower NPLs and otherwise solid operating performance at the three main domestic money banks (DMBs) are however somewhat tempered by the banking sector's concentration within three institutions, all successors of the old failed banks.

We assess external vulnerability risk and political risk at “Low” and “Very Low”, respectively, because both pose minimal risks to Iceland's credit profile. External vulnerability risk is set at “Low”, which is below the indicative score of “Moderate (+)” to reflect a data-driven aberration of a large decline in gross FDI liabilities during 2017 owing to accounting treatment of ownership changes in the pharmaceuticals sector and the winding-up of special purpose entities established before the financial crisis, which are fully netted out elsewhere in the capital account. Peers sharing the “Low” assessment of external vulnerability risk include Ireland, Lithuania (A3 stable), and Poland. Government liquidity risk is assessed at “Very Low”, consistent with the government's low refinancing needs, low levels of government foreign debt, and otherwise a significantly improved debt management framework. Peers with the same assessment include Botswana (A2 stable) and Romania (Baa3 stable).

Recent developments

Stronger growth anticipated for 2018, yet somewhat sharper deceleration ahead

Real GDP growth accelerated during the first half of 2018, expanding 6.4% year-over-year compared to 5.4% over the same period in 2017 and an upwardly revised 4% for the full year 2017. Household consumption growth was up 5% in January-June, reflecting a tightening labor market, complemented by solid investment spending growth, both business investment and residential construction.

Capacity challenges in the tourism industry are starting to abate with the opening of new hotels, which together with the roughly 15% depreciation of the exchange rate could lead to renewed uptick in arrivals in the year ahead. Foreign tourist arrivals in the year through October rose 7% over the same period a year earlier, a substantially slower rate than in 2017. Still, the current account has stayed in surplus this year mainly thanks to tourism receipts.

Liquidity problems have emerged with one of the Icelandic budget air carriers, likely due to too-rapid expansion of routes and a squeeze on earnings per passenger relative to 2015-16 levels. A plan floated to merge the airline with Icelandair was abandoned but other European airlines have expressed interest in taking it over. That said, 24 airlines now fly to Iceland so the expectation is that other airlines will gradually take up the slack if that airline ultimately fails. Airfares are likely to increase both because of the budget airline's woes and also due to higher aviation fuel prices.

We continue to expect that positive growth in the tourism sector will be maintained, albeit down from recent years' torrid rates, portending a soft landing for the economy. With somewhat stronger real economic growth realized already this year, we have revised up our 2018 growth forecast to 3.8% from 3.5% and revised down our 2019 growth forecast to 2.0% from 3.0%.

Higher inflation and stronger growth lead to monetary tightening

With respect to monetary policy, the Central Bank of Iceland (CBI) raised its policy rate by 25 basis points on 7 November, noting that a combination of faster-than-anticipated growth as well as declining real interest rates, in light of higher inflation and inflation expectations, warranted a tighter near-term monetary stance. The rate decision followed CBI's amendment to the special reserve requirements, both of which are likely to temper further depreciation in the króna into 2019. The monetary policy committee noted that upcoming wage negotiations set for 2019 (the lion's share of agreements are set to expire in March 2019) will be a key consideration in further interest rate moves: should wage settlements outstrip productivity growth, the CBI would be likely to raise interest rates still further.

2019 budget continues prudent fiscal stance

On 11 September, Finance Minister Benediktsson presented the national budget proposal for 2019, which assumes an overall surplus of 1% of GDP, in line with the fiscal strategies adopted by recent administrations. Expenditures are slated to rise by 7% year-over-year in nominal terms, with sectors such as health care – the construction of the new Landspitali hospital in Reykjavik – and residential construction the target of still higher increases.

Then in late November, the Treasury purchased ISK25 billion of outstanding government bonds with a combination of leftover proceeds from stability contributions and other cash on hand. As a consequence, gross Treasury debt fell to approximately ISK843 billion, or just over 30% of GDP. We expect a slower pace of debt reduction going forward than in recent years, but we expect Treasury debt to drop below 30% of GDP next year while general government gross debt will be somewhat higher, at around 35% of GDP.

Rating methodology and scorecard factors

Rating factors grid - Iceland

Rating factors	Sub-factor weighting	Indicator	Indicative factor score	Final factor score
Factor 1: Economic strength			H-	M+
Growth Dynamics	**50%**			
Average real GDP growth (2013-2022F)		3.7		
Volatility in real GDP growth (standard deviation, 2008-2017)		4.1		
WEF Global Competitiveness index (2017)		5.0		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2017)		24.5		
National income	**25%**			
GDP per capita (PPP, US$, 2017)		52,178		
Automatic adjustments	**[-3; 0]**	Scores applied		
Credit boom		0		
Factor 2: Institutional strength			VH	VH
Institutional framework and effectiveness	**75%**			
Worldwide Government Effectiveness index (2017)		1.5		
Worldwide Rule of Law index (2017)		1.6		
Worldwide Control of Corruption index (2017)		1.8		
Policy credibility and effectiveness	**25%**			
Inflation level (%, 2013-2022F)		2.8		
Inflation volatility (standard deviation, 2008-2017)		4.1		
Automatic adjustments	**[-3; 0]**	Scores applied		
Track record of default		0		
Economic Resiliency (F1xF2)			**H+**	**H+**
Factor 3: Fiscal strength			H+	H
Debt burden	**50%**			
General government debt/GDP (2017)		42.3		
General government debt/revenue (2017)		99.4		
Debt affordability	**50%**			
General government interest payments/revenue (2017)		8.9		
General government interest payments/GDP (2017)		3.8		
Automatic adjustments	**[-6; +4]**	Scores applied		
Debt trend (2014-2019F)		0		
Foreign currency debt/general government debt (2017)		0		
Other non-financial public sector debt/GDP (2017)		0		
Public sector assets/general government debt (2017)		0		
Government financial strength (F1xF2xF3)			**H+**	**H+**
Factor 4: Susceptibility to event risk	**Max. function**		M+	M-
Political risk			*VL*	*VL*
Worldwide voice & accountability index (2017)		1.4		
Government liquidity risk			*VL-*	*VL*
Gross borrowing requirements/GDP		2.2		
Non-resident share of general government debt (%)		22.2		
Market-Implied Ratings		A1		
Banking sector risk			*M+*	*M-*
Average baseline credit assessment (BCA)		--		
Total domestic bank assets/GDP		184		
Banking system loan-to-deposit ratio		143		
External vulnerability risk			*M+*	*L*
(Current account balance + FDI Inflows)/GDP		-25.1		
External vulnerability indicator (EVI)		--		
Net international investment position/GDP		5.3		
Government bond rating range (F1xF2xF3xF4)			**A2 - Baa1**	**A1 - A3**
Assigned foreign currency government bond rating		**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 rating range. 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 indicative rating range. For more information please see our Sovereign Bond Rating Methodology.

Footnotes: **(1) Indicative factor score: r**ating sub-factors combine with the automatic adjustments to produce an Indicative factor score for every rating factor, as detailed in Moody's Sovereign Bond Methodology. **(2) Final factor score: w**here additional analytical considerations exist, Indicative factor scores are augmented to produce a Final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Bond Methodology; details on country-specific considerations are provided in Moody's research. **(3) Rating range:** Factors 1: Economic strength, and Factor 2: Institutional strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3: Fiscal strength (FS), following a non-linear pattern where FS 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 preliminary government financial strength rating range as given by combining the first three factors. **(4) 15 Ranking categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

Rating Action

» Moody's changes Iceland's outlook to positive from stable and affirms A3 ratings, July 2018

Issuer Comment

» Government of Iceland: Central bank's reduced reserve requirements on capital inflows are credit positive, November 2018

Sector Comment

» Banks - Arion Bank's IPO plans help further restore confidence in Iceland's banks, a credit positive, May 2018

Outlook

» Sovereigns - Global: 2019 outlook still stable, but slowing growth signals increasingly diverging prospects, November 2018

Country Statistics

» Iceland, Government of, November 2018

Methodology

» Sovereign Bond Ratings, November 2018

REPORT NUMBER 1152097

MOODY'S
INVESTORS SERVICE