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ISSUER IN-DEPTH
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Government of Iceland

FAQ on recent credit developments

Iceland (A2 stable) has seen notable credit developments in 2019 including the collapse of its second biggest airline, the expiration of wage agreements that cover a large proportion of employment, the removal of the final capital controls and evolving risks posed by Brexit. We answer questions about how the authorities are managing these challenges.

» **What does the recent sharp decline in tourist arrivals mean for Iceland's economic strength?** Wow Air's collapse and the associated 15% decline in tourist arrivals will weigh on growth this year given tourism's importance to Iceland's economy. However, a prolonged contraction is unlikely as some of the 27 airlines that already fly to Iceland step in to pick up the slack. Moreover, the sector has robust growth potential given the scale of untapped markets and gradual move into higher margin segments. Other sectors of the economy like fishing and aluminum also benefit from robust prospects.

» **Does Moody's expect wage negotiations to worsen Iceland's competitiveness?** Agreements reached with the private sector in April and five public sector labour unions in October were more moderate than expected. Nevertheless, there remains the risk that wage drift could weigh on competitiveness and stoke inflation given the economy's openness and weak productivity growth, particularly if foreign labour inflows slow.

» **Did the removal of capital controls have any credit implications?** The government largely concluded the process in March by lifting the remaining restrictions on offshore-krona assets and the central bank reduced the special reserve requirements (SRR) ratio to zero, without triggering disruptive capital flows or exchange rate movements. The central bank's ability to lower the SRR to zero reflects the improvement achieved in monetary policy transmission since the crisis, the economy's narrower current-account surpluses and more market-determined exchange rate.

» **To what extent is Iceland exposed to Brexit?** A continuity agreement signed earlier this year with the UK (Aa2 negative) limits the direct exposure, but the effects could be more substantial if marine products exported to the UK but ultimately destined for the EU cannot be readily sold into other markets, or if there were to be a marked slowdown in tourists arriving from the UK. In addition, a no-deal Brexit would very likely weigh on the Icelandic economy indirectly via its European trading partners.

» **What is most likely to drive further improvements in Iceland's credit profile?** Steps which help to significantly further insulate the credit profile from both domestic shocks and global volatility would be positive. For example, further improvements in the sovereign's external position, the build-up of financial buffers or a further material reduction in the government's contingent liabilities could strengthen its credit profile.

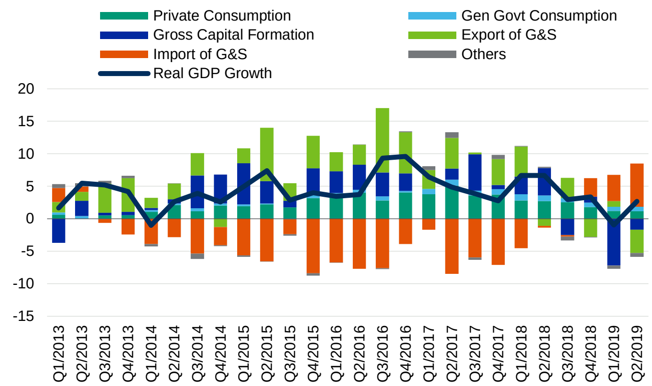
What does the recent sharp decline in tourist arrivals mean for Iceland's economic strength?

We expect the collapse of Iceland's second largest airline, Wow Air, in March will lead to a fall in tourist arrivals of around 15% year-on-year in 2019, bringing it in line with 2017 levels. Moreover, related job losses exceeding 1,000 in Wow Air and Keflavik Airport earlier this year have contributed to the increase in unemployment to 3.8% in October from 2.7% in December last year (see Exhibit 2). Together with a poor capelin fishing season, we expect this weakness in the tourism sector will slow GDP growth to 0.2% in 2019 from 4.8% in 2018.

Exhibit 1

Wow Air's collapse has weighed on 2019 growth...

Real GDP growth and its contributors

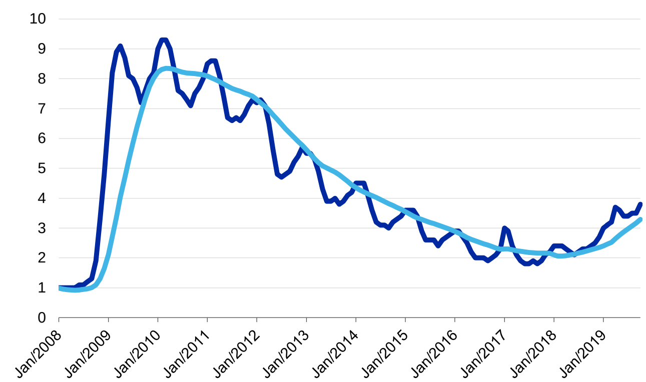


Sources: Eurostat, Moody's Investors Service

Exhibit 2

...and contributed to the recent rise in unemployment

Registered unemployment rate (NSA) and its trend



Sources: Directorate of Labour, Moody's Investor Services

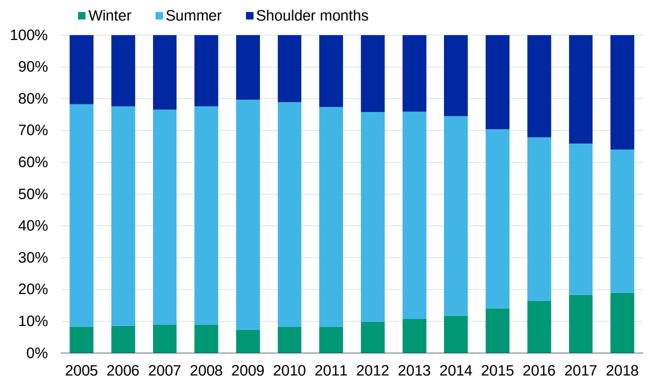
However, a prolonged contraction in the tourism industry is highly unlikely given that the shock was driven by a temporary disruption in supply rather than a fundamental change in Iceland's attractiveness as a tourism destination. Some of the 27 airlines that currently fly to Iceland have already increased seat capacity or redirected routes, and should largely fill the gap over the medium to long term. That said, the speed by which competitors can cover the slack in the coming months remains uncertain, especially given that the main domestic airline, Icelandair, has faced capacity constraints following the grounding of its Boeing 737 MAX aircrafts.

According to the IMF, countries that experienced a tourist boom tend to report durable increases thereafter unless rises were accompanied by political turmoil or crumbling infrastructure, which is not the case in Iceland. Tourism has already been resilient to króna appreciation, especially among British tourists despite sterling's depreciation following Brexit. There is also ample room for growth. Most visitors to Iceland still come from the US and western Europe, meaning it still only captures a fraction of the total market (around 0.5% of total travel and passenger transport among advanced European economies). Asia in particular remains untapped. News that four Chinese airlines are currently considering adding Iceland to their destinations could see a significant boost to numbers from a low base. We expect tourists arrivals will increase around 3 - 4% annually over the long term, which is more in line with global trends.

Margins in the sector also continue to improve thanks to a decline in arrival seasonality (see Exhibit 3) and better connectivity to other parts of the island, which helps to increase the revenue created by the sector across the year and reduces vulnerability to idiosyncratic shocks. Efforts by the authorities to establish Iceland as a luxury destination could provide a further boost – in October, the Icelandic Tourist Board announced that two hotels had secured 5-star status as well as plans for more to open in the coming years.

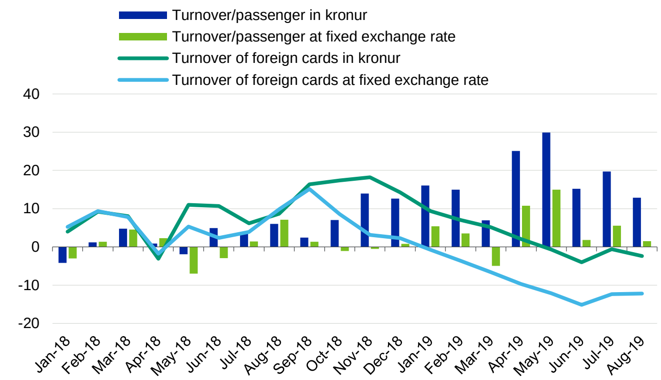
As a result of these efforts, the average revenue per available room has seen a continued increase. The collapse of Wow Air may serve to accelerate this trend given its focus on tourists using Iceland as a stop-over between the US (Aaa stable) and Europe who stayed for shorter periods and spent less than for other airlines. High-frequency data suggests that tourists travelling with the other domestic airline Icelandair spend more per capita and stay in the country longer. As a result, there is some evidence to suggest that the impact from the sharp decline in tourist arrivals has been offset somewhat by broad stability in spending (see Exhibit 4). Chinese arrivals could significantly boost margins given that they spend the second-most per head globally after South Koreans (see Exhibit 5).

Exhibit 3
Reduced seasonality helps to increase the industry's margin
Tourist arrivals by season, % of total



Sources: Statistics Iceland, Moody's Investors Service

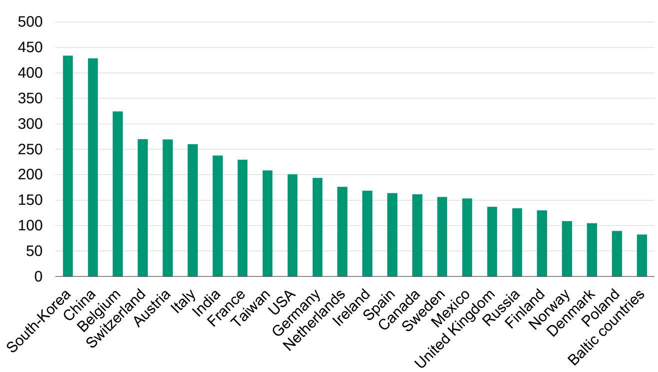
Exhibit 4
Increased spending per tourist cushions decline in tourist arrivals
% change, year-on-year



Sources: Central Bank of Iceland, Moody's Investors Service

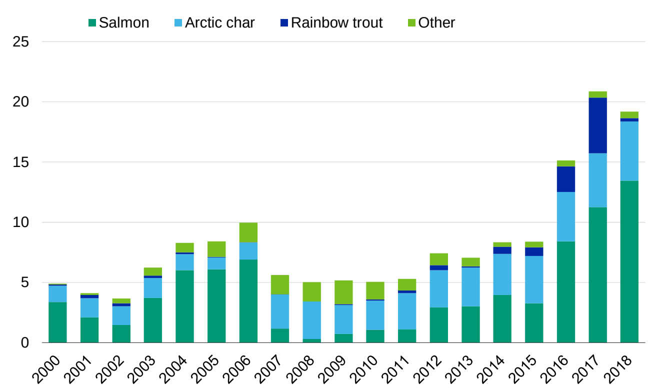
At the same time, other sectors of the economy continue to perform well. The Marine and Freshwater Research Institute's decision not to issue quotas on capelin this year in response to falling stocks will weigh on economic growth this year given the importance of capelin fishing to exports (0.6% on GDP in 2018) and incomes in some parts of Iceland. However, strong stocks of cod – which are the most valuable fish caught in Iceland's waters and account for around 45% of marine exports by value – and the continued growth in aquaculture, benefitting from foreign investments and a more streamlined regulatory process, should mitigate some of the impact on the fishing industry. While disagreements around farmed versus wild fish have held back the sector's growth in the past, exports from farmed-fishing are growing significantly (see Exhibit 6). Concurrently, long-term contracts with the domestic energy provider Landsvirkjun (Baa1 stable) have reinforced the comparative advantage that the aluminium industry derives from low energy costs.

Exhibit 5
Focus on increasing tourists which have higher average spending
Average spending per tourist, ISK thousand



Sources: Icelandic Tourist Board, Moody's Investors Service

Exhibit 6
Aquaculture is a new, prospective branch of the fishery sector
Aquaculture production, thousands of tones



Sources: Statistics Iceland, Moody's Investors Service

Do recent wage negotiations worsen Iceland's competitiveness?

Iceland has undergone a major wage bargaining round across most sectors in 2019, following the expiration of agreements signed in 2015, which poses a key source of uncertainty for inflation and competitiveness, particularly if agreements for multi-year wage increases outstrip productivity growth.

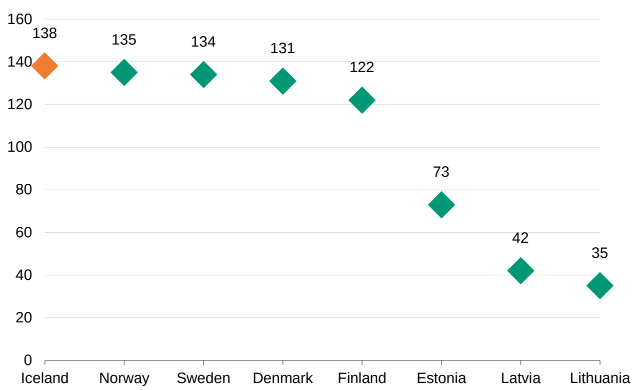
Strong wage growth is a risk to competitiveness because of the economy's openness and weak productivity growth, although wage pressures have been kept in check in recent years by inflows of foreign workers. The tourism sector is particularly exposed to wage increases because of its labour-intensity. According to World Economic Forum, Iceland already ranks third-lowest out of 140 countries in terms of price competitiveness in tourism sector (see Exhibit 7).

However, the agreement concluded with the private sector in April equates to around a 4% annual (net) wage rise until November 2022 (lower than in previous wage rounds) and specifies a set krona increase in wages rather than a percentage, which limits the inflationary impact from wage increases for higher earners. Furthermore, additional wage rises are linked to income growth. The government also concluded negotiations with five public sector labour unions in October that seem broadly in line with those reached earlier this year. Although the agreements only cover around 16% of all public sector employees, it should serve as a benchmark for the remaining negotiations. At the same time, real wage depreciation has helped to boost competitiveness (see Exhibit 8).

Exhibit 7

Price competitiveness of Iceland's tourism sector is weak

Price competitiveness of tourism sector (North European peers), rank out of 140

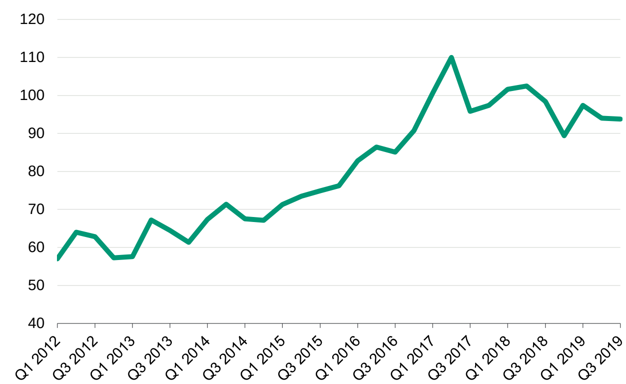


Sources: World Economic Forum, Moody's Investors Service

Exhibit 8

Weakening real exchange rate boosted the price competitiveness

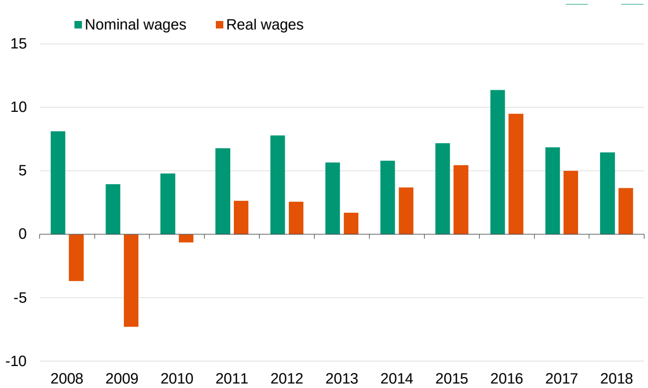
Real exchange rate deflated by unit labour costs, 2005=100



Sources: Central Bank of Iceland, Moody's Investors Service

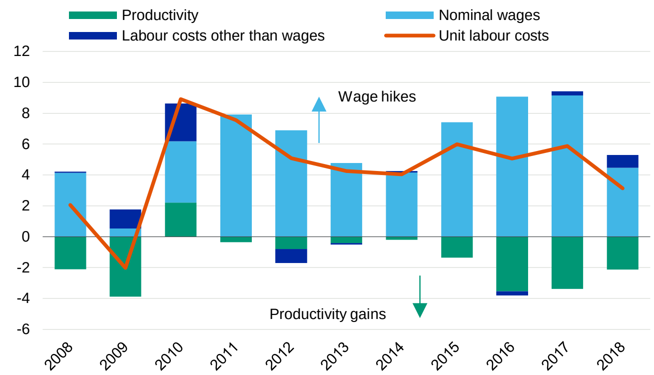
Nevertheless, despite a more moderate than expected outcome from these wage negotiations, there remains the risk that wage drift could still weigh on inflation and competitiveness, particularly if not accompanied by significant inflows of foreign labour. In nominal terms, wages in Iceland have already increased by around 45% over the last five years, according to the wage index published by Statistics Iceland (see Exhibit 9). This pace is much faster than Iceland's main trading partners. The central bank expects unit labour costs to grow 6% this year as productivity gains weaken.

Exhibit 9
Wage growth accelerated in recent years
% change



Sources: Statistics Iceland, Moody's Investors Service

Exhibit 10
Unit labour costs are set to accelerate given weakening productivity gains
% change, year-on-year



Sources: Central Bank of Iceland, Moody's Investors Service

What are the implications of the removal of capital controls on the sovereign's credit profile?

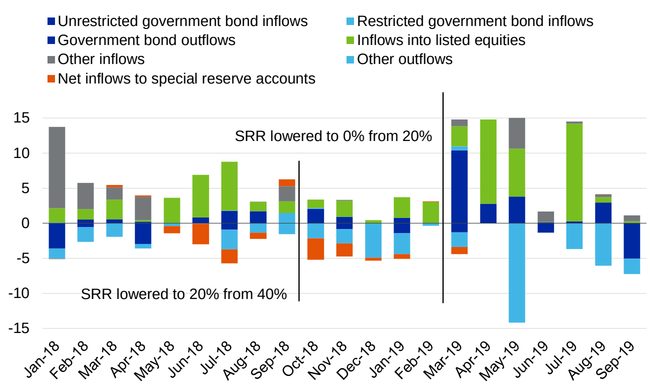
The government largely concluded the process in March when it lifted the remaining restrictions on offshore-krona assets and the central bank reduced the special reserve requirements (SRR) ratio (which had been used to discourage speculative capital inflows and protect the exchange rate) to zero, without material disruption.

The central bank's ability to lower the SRR to zero reflects the improvement achieved in monetary policy transmission since the crisis, the economy's narrower current-account surpluses and more market-determined exchange rate.

Although it is difficult to disentangle any impact from the news around the same time of the more moderate than expected wage agreements and the collapse of Wow Air, the lifting of the controls has not resulted in any sustained material or destabilizing outflows or abrupt exchange rate movements (see Exhibits 11 & 12).

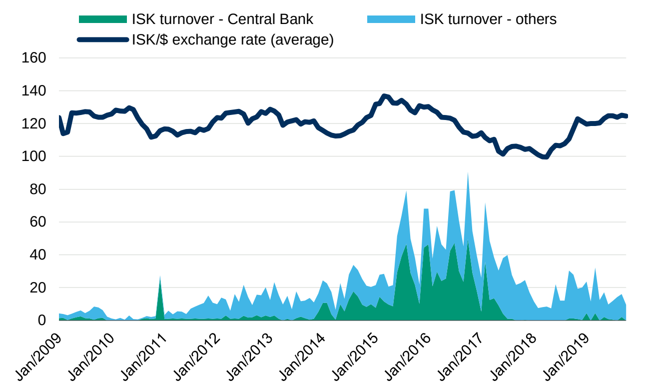
Furthermore, the removal of capital controls should make it easier for the investors to buy króna-denominated eurobonds, which should lower the cost of financing for the Icelandic government and private sector.

Exhibit 11
Capital flows following the lifting of the final controls were limited
ISK billion



Sources: Central Bank of Iceland, Moody's Investors Service

Exhibit 12
Foreign exchange interventions slowed following the removal of most capital controls in March 2017
ISK/$ exchange rate, ISK turnover



Sources: Central Bank of Iceland, Moody's Investors Service

Net inflows of foreign capital over the first nine months of 2019 have been broadly in line with 2018. Inflows into bonds and equities rose after the relaxation in March but had largely abated by the summer months. This likely reflects a smaller interest-rate differential compared to foreign assets than in the past – the spread between interest rates on 10-year Icelandic and US Treasury bonds narrowed by 1 percentage point in Q1/2019 and has hovered around 2% recently.

Inflows into the domestic equity market have been reasonably brisk thus far in 2019, although the figures are strongly affected by transactions with shares in Arion Bank (in July, another Islandic bank Kaupthing sold its 20% stake in Arion Bank, the buyers were domestic and foreign investors). Excluding Arion Bank, new investment in equities totalled around ISK 25 billion over the first nine months of the year, about the same as in all of 2018 (also excluding Arion).

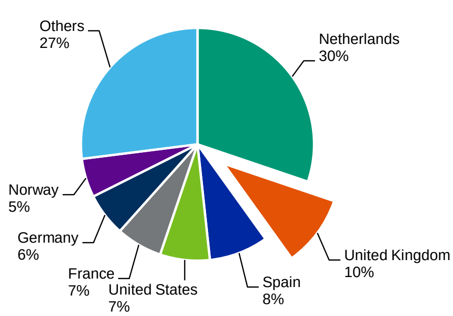
Furthermore, the steps taken have now largely removed the risks posed by the stock of offshore krónur. After the capital controls on holders of offshore krónur were lifted in March, the stock of offshore krónur shrank by ISK 11 billion. Most of this capital was converted to foreign currency and exported from Iceland. Since then, the offshore stock has shrunk by another ISK 10 billion, to around ISK 62 billion as of end-September. At the end of May, interest rates on the Central Bank's CBI2016 certificates of deposit were lowered from 0.5% to 0%; therefore, the vast majority of remaining offshore krónur now bears no interest.

These developments further demonstrate Iceland's progress in restoring macroeconomic and external normalcy following the crisis. If poorly handled, the capital account liberalization process could have led to renewed financial volatility and had negative repercussions for the government's credit metrics.

To what extent is Iceland exposed to Brexit-related risks?

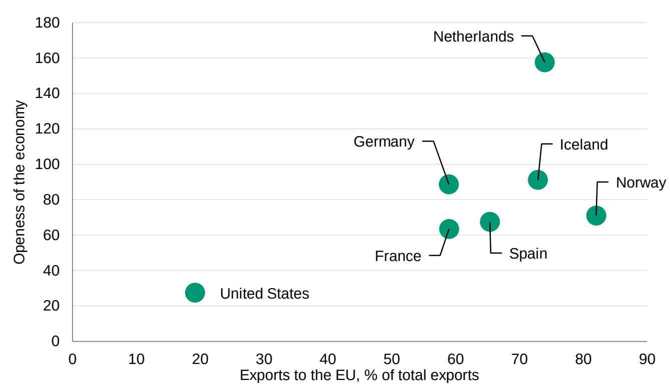
The UK (Aa2 negative) is Iceland's second-largest trading partner (10% of its goods exports in 2018, see Exhibit 13), accounting for a significant share of marine exports. That said, a continuity agreement signed between the two countries earlier this year, that broadly preserves their current trading arrangements if the UK fails to reach an agreement with the EU, helps to limit the direct risks from a no-deal Brexit. However, the effects could be more substantial if marine products exported to the UK but ultimately destined for the EU cannot be readily sold into other markets. Also, tourism from the UK could also slow if Brexit leads to a sharper than expected downturn in the UK economy (13% of all visitors to Iceland in 2018 were from the UK).

Exhibit 13
The UK is an important trade partner for Iceland
Merchandise exports, % of total, 2018



Sources: International Trade Centre, Moody's Investors Service

Exhibit 14
Iceland's main trading partners are highly open economies with high exposure to the EU
Merchandise exports to the EU (% of total merchandise exports), openness of the economy[1]



Openness of the economy is defined as sum of exports and imports of goods and services divided by the nominal GDP
Sources: IMF, Moody's Investors Service

In addition, a no-deal Brexit would very likely weigh on the Icelandic economy indirectly via its European trading partners (73% of Icelandic merchandise exports are directed to the European Union). According to the central bank's estimates, the adverse trade effects of a no-deal Brexit would lower GDP growth in Iceland by 0.4 percentage points in 2020. We believe Iceland's open economy will realize these spillover effects more greatly, particularly as Iceland's largest trading partners – the Netherlands (Aaa stable), Spain (Baa1 stable), France (Aa2 positive), Germany (Aaa stable) and Norway (Aaa stable) – are also very open and concentrated within Europe (see Exhibit 14).

UK's exit from the EU could further complicate negotiations between costal countries on fishing quotas

Brexit also poses some additional uncertainty to Iceland's fishery sector. Following the UK's exit from the EU and its departure from the common fisheries policy, negotiations on the international fishing agreement between the coastal countries in the north Atlantic are likely to become more complicated with the addition of the UK as a potential stand-alone negotiating partner. These negotiations are already complex, which a recent dispute with the EU and Norway on mackerel quotas demonstrates.[1] Changes to volume of the fish catch in the post-Brexit era could also spark tensions between the members of North East Atlantic Fisheries Commission (NEAFC) – the European Union (EU, Aaa stable), Norway (Aaa stable), Russia (Baa3 stable), Greenland and Faroe Islands – which are responsible for management and enforcement of the limits set by the International Council for the Exploration of the Seas.

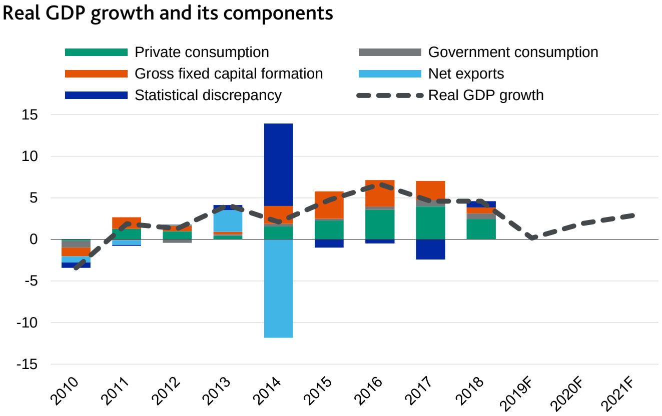
What is most likely to drive further improvements in Iceland's credit profile?

The improved resilience of Iceland's economy together with the sharp reduction in government debt has helped reduced vulnerability to shocks. For example, the increased (albeit still limited) economic diversification, strong wealth levels and ongoing refinements to its institutional framework and strong external position will support the credit profile. With a maturing tourism sector, economic growth is set to moderate. Government debt is markedly reduced, at 36% of GDP in 2018, while further material declines in indebtedness are now less likely, particularly given the Ministry of Finance's intention to remain a benchmark issuer for domestic corporates.

That said, Iceland's inherent structural credit constraint arising from its small size and still sizeable economic concentration means that its credit profile will continue to be structurally more exposed to shocks than for many peers.

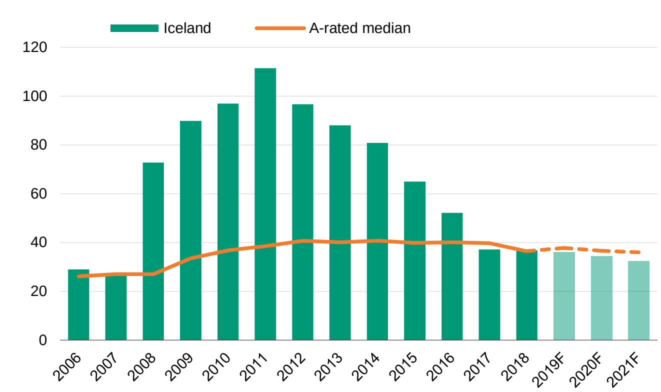
As such, steps which help to significantly further insulate the credit profile from both domestic shocks and global volatility would be positive. For example, a further marked improvement in the sovereign's external position, or the build-up of financial buffers could strengthen its credit profile.

Exhibit 15
Growth is set to moderate, following years of tourism-led economic boom...
Real GDP growth and its components



Sources: Statistics Iceland, Moody's Investors Service

Exhibit 16
... as will the reduction in debt
General government debt, % of GDP



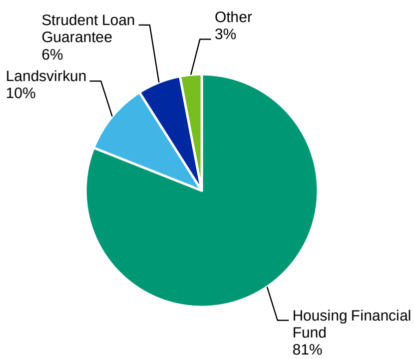
Sources: National authorities, IMF, Moody's Investors Service

Given that we expect the pace of debt reduction will slow, a strengthening of the sovereign's balance sheet through the build-up of a sovereign wealth fund (SWF) would be credit positive. The government hopes to implement legislation for the SWF before the end of 2019, with sizeable dividend inflows, including from the large domestic energy company, forecast to build the fund. Furthermore, the sale of public stakes in the banking system, to be used to reduce government debt or pension liabilities, could also lead to sizeable improvements in the government's balance sheet.

Iceland's rating could also come under positive pressure from a further material reduction in the government's contingent liabilities. Although the government's contingent liabilities have roughly halved in both nominal and relative terms since the peak of the crisis, they are still very large and concentrated. Most of the guarantees are for the Housing Financing Fund (HFF, A3 stable) and Landsvirkjun (LV, Baa1 stable), which account for around 81% and 10% of all outstanding guarantees, respectively. Both companies are of strategic importance for the Icelandic economy, for example, as mentioned above, the dividends from the national power company have been identified as a potential revenue source for a future SWF.

Exhibit 17

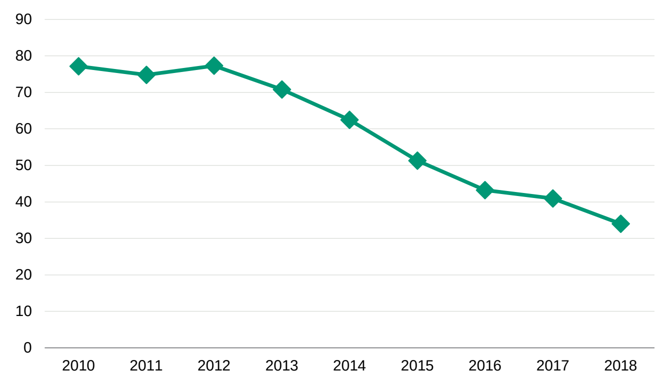
Large and concentrated government guarantees
% of total guarantees, as of 2018



Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

Exhibit 18

Although total government guarantees have been declining
Stock of outstanding guarantees, % of GDP



Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

At the same time, 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.

Moody's related publications

» **Credit Opinion**: Government of Iceland - A2 stable: Update following upgrade and outlook change, 11 November 2019

» **Rating Action**: Moody's upgrades Iceland's government ratings to A2; outlook stable, 8 November 2019

» **Issuer In-Depth**: Government of Iceland – A3 positive: Annual credit analysis, 29 July 2019

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

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Endnotes

1 The EU, Norway (Aaa stable) and Faroe Islands have argued that Iceland's decision to increase mackerel quotas by 30% in excess of its previous claims undermined their efforts to promote the long-term sustainability of the stock. The total mackerel catch in the north Atlantic already exceeds the International Council for the Exploration of the Sea's (ICES) advice by around 70%.

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