MOODY'S INVESTORS SERVICE

CREDIT OPINION

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Update

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Analyst Contacts

Evan Wohlmann +44.20.7772.5567
VP-Sr Credit Officer
evan.wohlmann@moodys.com

Malgorzata Glowacka +49.69.70730.938
Associate Analyst
malgorzata.glowacka@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 - A2 stable

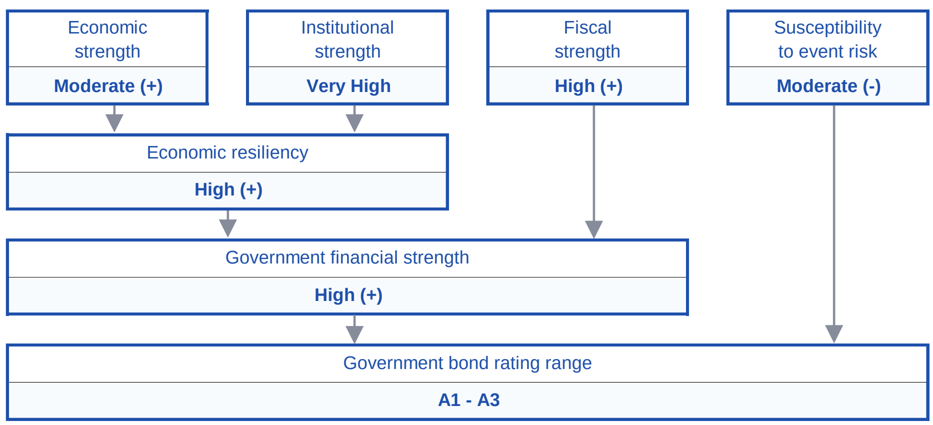
Update following upgrade and outlook change

Summary

The credit profile of Iceland (A2 stable) 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, high economic concentration 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 stable outlook reflects our 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.

Factors that could lead to an upgrade

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.

Factors that could lead to a downgrade

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.

Key indicators

Exhibit 2

Iceland	2013	2014	2015	2016	2017	2018	2019E	2020F
Real GDP (% change)	4.1	2.1	4.7	6.6	4.4	4.8	0.2	1.9
Inflation (CPI, % change, Dec/Dec)	4.1	0.8	2.0	1.9	1.9	3.7	2.9	2.4
Gen. gov. financial balance/GDP (%)	-1.8	-0.1	-0.8	12.4	0.5	0.8	-0.4	-0.2
Gen. gov. primary balance/GDP (%)	2.6	4.5	3.6	16.4	4.4	3.7	2.0	2.0
Gen. gov. debt/GDP (%)	88.0	80.9	65.0	52.2	44.0	36.8	36.0	34.5
Gen. gov. debt/revenues (%)	216.8	184.9	160.2	91.7	101.1	86.0	84.2	80.3
Gen. gov. interest payment/revenues (%)	10.9	10.4	10.9	6.9	8.9	6.6	5.7	5.2
Current account balance/GDP (%)[1]	7.2	5.2	5.8	7.6	3.8	2.8	2.2	1.3

[1] Excludes DMBs undergoing winding up in 2008-2015
Sources: Central Bank of Iceland, Statistics Iceland, Moody's Investors Service

Detailed credit considerations

On 8 November, we upgraded Iceland's issuer ratings to A2 from A3 and changed the outlook to stable from positive. The key drivers of the action were (1) Iceland's sizeable debt reduction gains that we expect to be sustained despite the ongoing economic slowdown, and (2) improvements to the sovereign's economic resilience that reduces its susceptibility to shocks.

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 $55,941 as of 2018 on a purchasing power basis, Iceland's GDP per-capita is higher than that of around 90% 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.

We assess Iceland's **institutional strength** as “Very High”, mainly reflecting the country's strong scores in the Worldwide Governance Indicators (WGI) and track record of effective macroeconomic management to restore financial stability after the banking crisis. 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.

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, with almost all remaining controls removed by April 2019. 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.

The final score of “Very High” is one notch lower than the scorecard-indicated outcome of “Very High (+)” as the depth of the financial crisis and the weaknesses in the country's regulatory framework and policy toolkit it exposed indicate a level of institutional strength below our highest possible assessment. Significant progress has been made by Iceland in rebuilding the policy toolkit, although the improved framework remains untested and some gaps are still being addressed, especially in the area of financial sector oversight.

We assess Iceland's **fiscal strength** as “High (+)” reflecting Iceland's relatively low debt burden and high debt affordability, although contingent liabilities remain sizeable. After peaking at 111.5% of GDP in 2011, Iceland’s gross government debt burden declined precipitously, with persistent budget surpluses, debt buybacks and rapid economic growth, to stand at 36.8% in 2018. 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 12% in 2018 from around 42% in 2011, and the debt's maturity remains relatively long.

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 for the Icelandic banking system, which leads to incomplete data for the calculation of an indicative banking sector risk score, we incorporate our aggregate analysis of the Icelandic banking system developed from publicly 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 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 at “Low” and political risk and government liquidity risk “Very Low”, because they pose minimal risks to Iceland's credit profile.

Iceland's “Low” external vulnerability risk is set above the indicative score of “Very Low” to reflect the still high volatility in FDI and the ongoing vulnerability to shocks given the small size of its economy and currency area, despite the favourable NIIP. Government liquidity risk is assessed at “Very Low” which is below the final score of “Very Low (+)” as the market funding stress indicator likely overstates the government liquidity risk given the government's low refinancing needs, low levels of government foreign debt, and otherwise significantly improved debt management framework.

ESG considerations

How environmental, social and governance risks inform our credit analysis of Iceland

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 around deficiencies in anti-money laundering processes after Iceland was recently placed on the Financial Action Task Force's "grey list".

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 ESG risks influence sovereign credit profiles and our cross-sector methodology General Principles for Assessing ESG Risks.

Recent developments

The collapse of Wow Air and poor capelin season will weigh on growth temporarily, with some offset from higher tourist spending and rapid growth in aquaculture

Following robust growth of 4.8% in 2018, the economy is experiencing a substantial slowdown (see Exhibit 3) following the bankruptcy of Iceland's low-cost airline Wow Air, which has led to a fall in tourist arrivals during the important summer season. At the same time, the fishery sector has been affected by the zero quotas issued for the capelin season for the first time since Icelanders started fishing for capelin in 1963. While we expect the impact on growth to be transitory, the shock does demonstrate the significant concentration of activity in a limited number of sectors within the Icelandic economy.

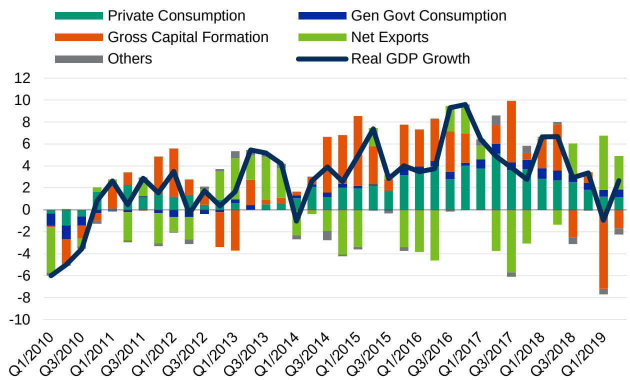
That said, while we continue to expect a material slowdown in economic activity, some factors have helped to cushion the economy in the first half of 2019, which resulted in an upward revision of our forecasts this year, to 0.2% from -0.8% in 2019.

Despite the substantial decline in tourist arrivals, by an estimated 15% this year, spending by tourists has held up relatively well given the depreciation of the krona and the sector's gradual move towards a higher value tourism offering. Foreign card turnover data shows that tourism receipts remained close to their 2018 levels, albeit declined moderately in September (see Exhibit 4). At the same time, real GDP growth in Q2 (the first quarter that includes the Wow Air bankruptcy) was stronger than expected, at 2.7% year-on-year, following a contraction of 0.9% in the first quarter.

On the other hand, the aluminium sector has been experiencing some temporary hardship due to transitory supply constraints. One of the smelters was forced to shut down temporarily this summer due to a malfunction, while another smelter reduced its production due to maintenance.

We now expect growth in 2020 to be slightly slower than previously, at 1.9% down from 2.5%, as the anticipated redistribution of airline seating capacity has been impacted by Icelandair's grounding of its Boeing 737 MAX aircraft which form a substantial part of its fleet. Furthermore, the more pronounced-than-expected decline in imports in H1 2019, falling by 10.6%, suggests consumption and investment will be lower than expected (although also likely reflecting the fact that Wow Air's leased aircraft are also recorded as imports). For example, consumption decelerated to 2.5% in H1 2019, down from 4.4% in 2018.

Exhibit 3
Icelandic economy is experiencing a sharp slowdown amid Wow air's collapse
Real GDP growth and its contributions (%), year-on-year



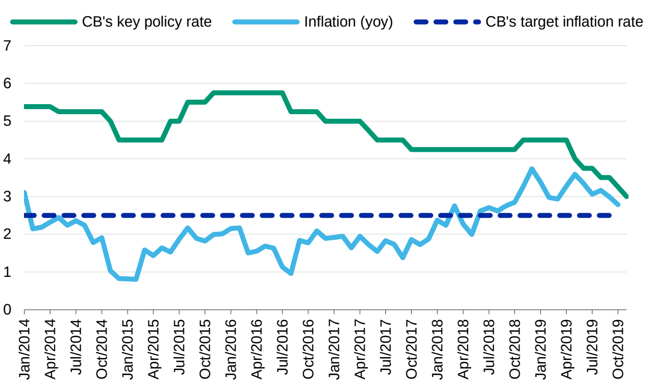
Sources: Eurostat, Moody's Investors Service

Exhibit 4
Decline in tourist arrivals is cushioned by increased spending per tourist
% change, year on year

Sources: Icelandic Centre for Retail Studies, Statistics Iceland, Moody's Investors Service

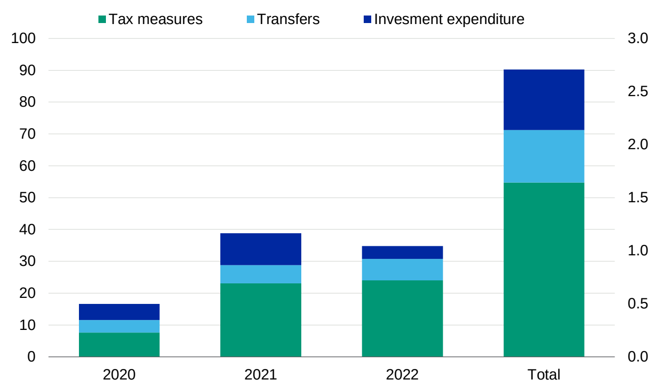
Our expectation of an improving growth trend in 2020 and 2021 also reflects supportive fiscal and monetary policy. The central bank's key interest rate has fallen to 3%, which is 150 basis points lower than its level in April (see Exhibit 5). In addition, the government's generous fiscal package associated with the private wage agreement from May will also support disposable incomes and stimulate demand (see Exhibit 6). On top of this, the authorities plan to increase investment spending by ISK 19 billion (0.6% of GDP) over the next three years.

Exhibit 5
Monetary easing has been significant
Central Bank's key interest rate, inflation and inflation target



Sources: Statistics Iceland, Moody's Investors Service

Exhibit 6
Fiscal measures will also support growth
ISK billion (lhs), % of GDP (rhs)



Sources: Central Bank, Moody's Investors Service

More labour unions have concluded their wage negotiations which seem broadly in line with the moderate increases agreed earlier this year

In October, wage negotiations were concluded with five public sector labour unions, which cover around 3,200 public employees out of 20,000 (16% of total). The agreements seem broadly in line with the agreements reached in the private sector earlier this year.

While the wage agreements cover only a small portion of public employees, they represent a further step towards finalization of the wage negotiations and serve as a benchmark for the remaining parts of the labour market.

The private sector wage agreements reached in May were more moderate than expected, particularly given the outcome of previous wage negotiations, helping to contain risks to inflation and overall competitiveness in a weakening growth environment.

Given the openness of the economy and expected weak productivity growth, Iceland can face notable risks to competitiveness from strong wage growth. For example, wages in Iceland have increased by an estimated cumulative 45% over the last 5 years, according to the wage index published by Statistics Iceland, although part of this increase is due to catching up with pre-crisis levels.

Following a small deficit in 2019, the government expects a balanced budget in 2020

According to the government's estimates, the central government budget deficit is expected to reach -0.5% of GDP in 2019, which differs from the zero net lending balance target set in the revised Fiscal Strategy from June. A large part of this deviation is due to increased unemployment benefits and bankruptcy compensation due to the recent economic slowdown (about ISK 7.6 billion, or 0.3% of GDP) as well as some one-off factors. These include the expectation of temporarily lower dividends from the state-owned banks in 2019 and higher spending on social benefits following court rulings on the calculation of social benefits. We also forecast a modest deficit of -0.4% of GDP in 2019 (on a general government basis).

According to the 2020 draft budget document, the government expects the fiscal deficit to return to balance next year. Revenues are expected to be ISK 26 billion (around 0.9% of GDP) lower than projected in the fiscal plan introduced in March. To some extent, this decrease will be offset by some new revenue measures, such as a 10% increase in the carbon tax and further anti-tax fraud measures (ISK 3.4 billion or 0.1% of GDP). The government is continuing with its plans to reduce taxes, such as the second phase of the 0.5 percentage point reduction in the payroll tax and the first part of its revision of the personal income tax system, in order to counterbalance the worsening economic outlook by boosting household demand.

In a bid to further stimulate the economy, the government also plans to increase public investment to ISK 78 billion next year (16% increase from 2018, similar level to 2017), which includes investment in transportation (ISK 28 billion), increased investment into Landspítali hospital (ISK 8.5 billion) and the purchase of helicopters for the Coast Guard. Overall, we expect the fiscal position to be in a slight deficit of -0.2% of GDP in 2020, broadly in line with the forecast by the authorities.

Looking ahead, the authorities plan to accelerate the lowering of the Personal Income Tax (PIT) rate to achieve the full planned reduction by 2021 instead of 2022, which is expected to increase the disposable income of lowest-income households by ISK 120,000 (around $1,036).

Overall, we expect Iceland's accumulated fiscal space will help to cushion the negative effect of the temporary economic shock on the budget, limiting the need for additional borrowing. We note that despite the increased spending and planned tax cuts, the IMF's structural balance forecast points towards a balanced budget this year and a slight surplus in the coming years. Furthermore, under the Organic Budget Law, the government's net lending must be positive over a 5 year period and the fiscal deficit cannot exceed 2.5% of GDP.

Despite strong institutional strength, deficiencies in money laundering policies highlight some weaknesses in governance

Iceland was placed on the Financial Action Task Force's (FATF) "grey list" in October due to insufficient progress in meeting their recommendations for improving Iceland's anti-money laundering and counter-terrorist financing measures. Following the announcements, the government implemented two laws to assure further compliance with FATF framework. The first bill ensures that all public mandate organizations that operate across borders must be registered with tax authorities. The second law enables the government to sell the assets, which have been frozen or confiscated due to a criminal investigation. While significantly improved, these developments highlight that there are still some weaknesses in Iceland's financial supervisory framework that remain unaddressed.

Rating methodology and scorecard factors

Rating factors grid - Iceland

Rating factors	Sub-factor weighting	Indicator	Scorecard-indicated outcome	Final factor score
Factor 1: Economic strength			H-	M+
Growth Dynamics	**50%**			
Average real GDP growth (2014-2023F)		3.4		
Volatility in real GDP growth (standard deviation, 2009-2018)		4.1		
WEF Global Competitiveness index (2017)		5.0		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2018)		26.0		
National income	**25%**			
GDP per capita (PPP, US$, 2018)		55,941		
Automatic adjustments	**[-3; 0]**	Scores applied		
Credit boom		0		
Factor 2: Institutional strength			VH+	VH
Institutional framework and effectiveness	**75%**			
Worldwide Government Effectiveness index (2018)		1.5		
Worldwide Rule of Law index (2018)		1.7		
Worldwide Control of Corruption index (2018)		1.8		
Policy credibility and effectiveness	**25%**			
Inflation level (%, 2014-2023F)		2.3		
Inflation volatility (standard deviation, 2009-2018)		3.1		
Automatic adjustments	**[-3; 0]**	Scores applied		
Track record of default		0		
Economic Resiliency (F1xF2)			**VH-**	**H+**
Factor 3: Fiscal strength			H+	H+
Debt burden	**50%**			
General government debt/GDP (2018)		36.8		
General government debt/revenue (2018)		86.0		
Debt affordability	**50%**			
General government interest payments/revenue (2018)		6.6		
General government interest payments/GDP (2018)		2.8		
Automatic adjustments	**[-6; +4]**	Scores applied		
Debt trend (2015-2020F)		0		
Foreign currency debt/general government debt (2018)		0		
Other non-financial public sector debt/GDP (2018)		-1		
Public sector assets/general government debt (2018)		0		
Government financial strength (F1xF2xF3)			**VH-**	**H+**
Factor 4: Susceptibility to event risk	**Max. function**		M+	M-
Political risk			*VL*	*VL*
Worldwide voice & accountability index (2018)		1.4		
Government liquidity risk			*VL+*	*VL*
Gross borrowing requirements/GDP		3.3		
Non-resident share of general government debt (%)		24.1		
Market-Implied Ratings		Baa3		
Banking sector risk			*M+*	*M-*
Average baseline credit assessment (BCA)		--		
Total domestic bank assets/GDP		178		
Banking system loan-to-deposit ratio		151		
External vulnerability risk			*VL*	*L*
(Current account balance + FDI Inflows)/GDP		1.2		
External vulnerability indicator (EVI)		--		
Net international investment position/GDP		10.8		
Government bond rating range (F1xF2xF3xF4)			**A1 - A3**	**A1 - A3**
Assigned foreign currency government bond rating		**A2**		

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 Scorecard-indicated outcome rating range. For more information please see our Sovereign Bond Rating Methodology.

Footnotes: **(1) Scorecard-indicated outcome:** rating sub-factors combine with the automatic adjustments to produce a Scorecard-indicated outcome for every rating factor, as detailed in Moody's Sovereign Bond Methodology. **(2) Final factor score:** where additional analytical considerations exist, Scorecard-indicated outcome 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 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
- **Issuer Comment:** Government of Iceland: Wow Air's collapse poses downside risks for Iceland's 2019 economic growth, a credit negative, 3 April 2019
- **Issuer Comment:** Government of Iceland: Stronger-than-expected growth will support decline in Iceland's debt/GDP ratio, a credit positive, 6 March 2019
- **Issuer In-Depth:** Government of Iceland – A3 positive: Annual credit analysis, 3 August 2018
- **Methodology:** Sovereign Bond Ratings, 27 November 2018

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