

CREDIT OPINION

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Update

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Government of Iceland – A2 stable

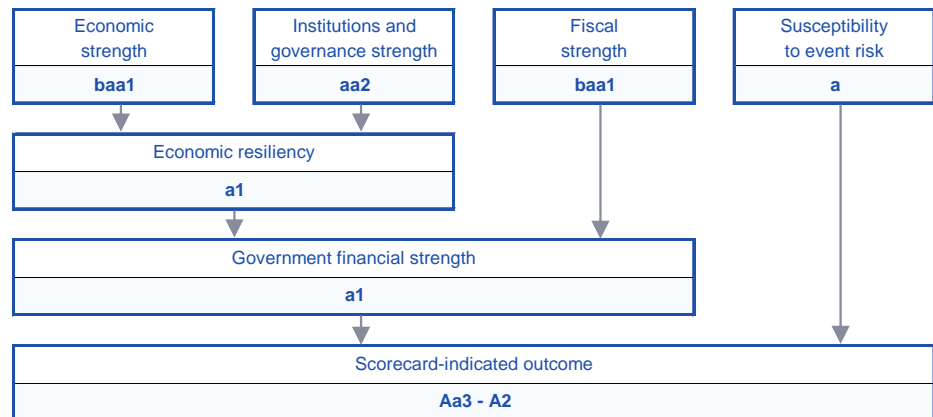
Regular update

Summary

The credit profile of [Iceland](#) is underpinned by its wealthy and flexible economy with favourable demographics that support its long-term growth prospects. The country has built significant buffers which help offset its vulnerability to shocks given its small size and concentration in a limited number of sectors. The pandemic-induced fiscal deterioration is being gradually reversed helped by strong economic growth.

Exhibit 1

Iceland's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

- » Very high wealth levels and labour market flexibility provide buffers to deal with shocks;
- » Well-funded pension system, long working lives and favourable demographics;
- » Very large foreign-currency reserves and net external creditor position.

Credit challenges

- » Volatile growth performance due to sectoral concentration and small currency area;
- » Rebuilding fiscal buffers after large pandemic-driven increase in public debt.

Rating outlook

The stable outlook reflects our view that downside risks stemming from the economy's small size and high sector concentration are mitigated by a robust external position as well as declining private sector indebtedness and a strong banking sector. The economy has recovered strongly from the pandemic shock and is relatively unaffected by the economic consequences of the invasion of Ukraine given its low reliance on imported energy. We expect the fiscal position to continue to improve in the coming years, helping to reverse the deterioration induced by the pandemic.

Factors that could lead to an upgrade

The outlook on Iceland's rating could move to positive and the rating could eventually be upgraded in case of faster-than-expected progress in restoring the government's fiscal buffers. Moreover, increased diversification which would lead to a less volatile economic performance would be positive for the rating.

Factors that could lead to a downgrade

Conversely, the outlook and subsequently the rating could come under downward pressure if the authorities deviated significantly from their current medium-term fiscal consolidation plans that target a stabilisation of the public debt ratio by the middle of the decade, resulting in a material increase in the public debt ratio.

An economic shock which would lead to a large and permanent damage to the important tourism industry, or to substantial capital outflows, weakening Iceland's external position and threatening financial stability, would also be credit negative, although the latter is not a likely scenario.

Key indicators

Iceland	2017	2018	2019	2020	2021	2022E	2023F	2024F
Real GDP (% change)	4.2	4.9	2.4	-6.8	4.4	5.5	2.5	2.8
Inflation (CPI, % change, Dec/Dec)	1.9	3.7	2.0	3.6	5.1	9.6	4.9	2.5
Gen. gov. financial balance/GDP (%) ^[1]	1.0	0.9	-1.5	-8.9	-7.9	-4.4	-3.5	-3.0
Gen. gov. primary balance/GDP (%) ^[1]	6.7	5.8	2.8	-4.9	-4.5	0.6	0.7	0.7
Gen. gov. debt/GDP (%) ^[1]	71.6	63.1	66.0	77.2	75.3	67.8	66.4	65.5
Gen. gov. debt/revenues (%) ^[1]	157.9	141.1	157.9	184.1	182.3	161.8	162.4	168.0
Gen. gov. interest payment/revenues (%) ^[1]	12.6	11.0	10.3	9.5	8.3	11.9	10.3	9.5
Current account balance/GDP (%)	4.2	4.1	6.5	1.9	-1.7	-2.7	-1.3	1.0

Source: Moody's Investors Service

Detailed credit considerations

We assess Iceland's **economic strength** at "baa1" 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 close to \$60,000 in PPP terms in 2021 - the 16th highest in our sovereign rating universe, having recovered the significant losses registered after the banking crisis in 2008. Iceland's economy is highly competitive, as evidenced by its ranking at 16th globally in the World Competitiveness Index in 2021, – standing out compared to close peers.

Growth is also volatile, reflecting limited diversification and relatively high openness, which increases the economy's vulnerability to sector-specific and external shocks. More than 70% of the country's export revenues come from three sectors: tourism (23% of total in 2021), marine products (24% of total) and aluminum (23% of total). The economy continues to recover from the pandemic shock, which caused a deep contraction because of travel restrictions, but has been relatively less affected by the Russian invasion of Ukraine given Iceland's low reliance on imported energy.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on <https://ratings.moody's.com> for the most updated credit rating action information and rating history.

We assess Iceland's **institutions and governance strength** as "aa2", reflecting the country's solid track record in restoring economic and financial stability after the banking crisis. For example, the considerable strengthening in supervision and regulation of the banking sector has helped to improve the resilience of the system. The authorities achieved a careful liberalisation of the capital account with minimal disruption. The monetary policy framework has gained credibility, following a major revamp, and the central bank has been successful in reducing traditionally high and volatile inflation despite a recent spike driven by house prices.

Iceland scores strongly on the Worldwide Governance Indicators and our assessment also takes into account Iceland's high-quality education system, an innovative business sector, an efficient and flexible labour market and well-developed infrastructure. Iceland has a long tradition of broad cooperation and consensus on economic matters between the government, employer and employee associations, which contributes positively to policy effectiveness.

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. Between the peak in 2011 and 2018 general government debt more than halved, and stood at 66% of GDP in 2019. We expect that general government debt will continue to decline thanks to strong GDP growth, declining budget deficits and asset sales. The government holds significant equity stakes in two of the three largest domestic banks, and sale proceeds will likely continue to serve for debt reduction purposes. Iceland's multi-year fiscal framework with clear and credible fiscal rules is on par with the best practices among highly rated sovereigns and is accepted across the political spectrum, giving high confidence that debt will continue to be reduced in the coming years.

The reclassification of 24 public-sector corporations into the general government sector in 2020, in line with Eurostat statistical rules, raised the government debt ratio by around 32 percentage points of GDP, in particular the debt of the [HF-Fund](#) (A2 stable), which benefits from an explicit government guarantee and is in a government-directed winding-down process. The reclassification also implies much smaller contingent liabilities, which we had previously taken into account qualitatively.

We assess Iceland's **susceptibility to event** risk as "a", driven by our banking system and external vulnerability risk assessments. We assess banking sector risk at "a". The three large banks have solid levels of capitalisation and liquidity. The sharp rise in house prices has been accompanied by an increase in household indebtedness, which could pose risks to financial stability but the authorities have put in place a number of macroprudential measures to reduce such risks.

Similarly, we assess external vulnerability risks at "a". This reflects Iceland's net external creditor position and very large foreign-currency reserves, which can be used to help buffer external shocks. External surpluses have allowed the central bank to build substantial foreign-currency reserves equivalent to around 20% of GDP or 27% of the country's total external debt as of the third quarter of 2022, a large buffer to help limit exchange rate volatility and support the country's external position. The current account has slipped into a deficit since 2020 because of weaker tourism demand and large dividend payments of foreign-owned companies, but is expected to return close to balance again next year.

Political event risk is low, and scored at "aa" given consistent policy in key areas important to safeguarding the government's credit profile. Political consensus on the economic and fiscal direction for the country is strong.

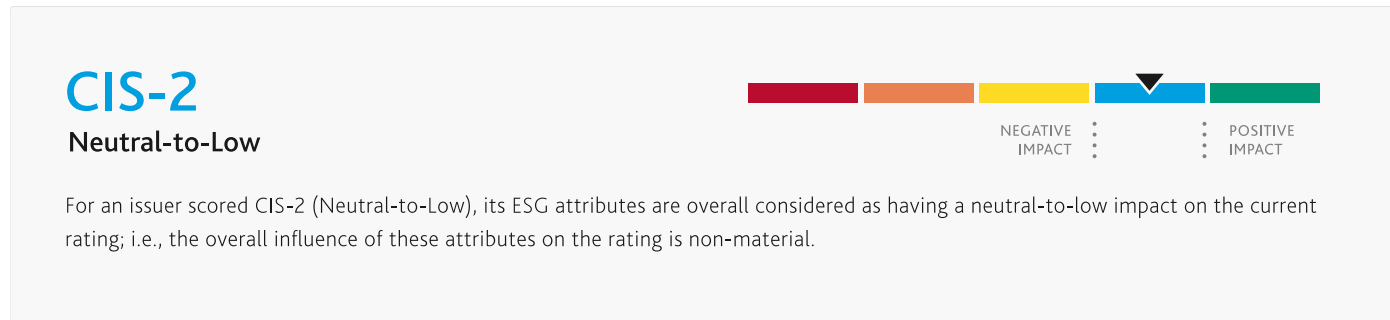
We also assess government liquidity risk as "aa". The previous marked reduction in government debt has reduced refinancing needs while prudent liquidity management, including significant cash buffers, and a large domestic investor base are key mitigants to the government's financing needs.

ESG considerations

Iceland's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 3

ESG Credit Impact Score

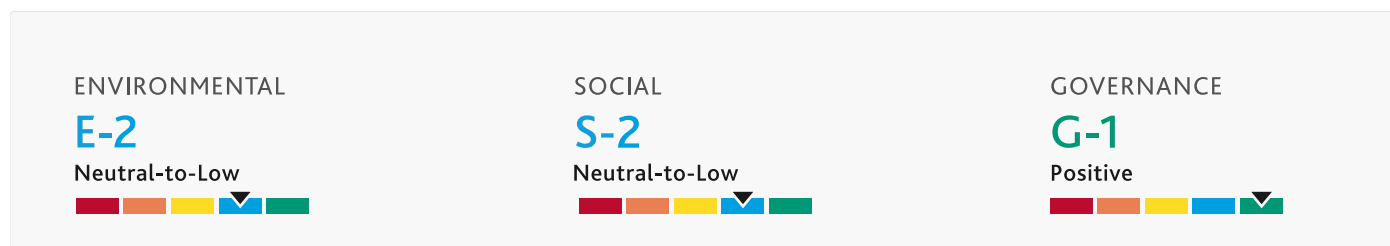


Source: Moody's Investors Service

Iceland's ESG Credit Impact Score is neutral to low (**CIS-2**), reflecting neutral to low exposure to environmental and social risks and very strong institutions.

Exhibit 4

ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Iceland's exposure to environmental risks is neutral to low (**E-2**) as the country derives nearly all of its energy generation and use from renewable sources, in particular hydroelectric power and geothermal energy. Iceland's unique geological features imply some exposure to physical climate risks but also offer opportunities for the country's key sectors. The impact of warming seas on fish stocks in Icelandic waters is not yet clear; while some varieties may migrate out of Iceland's waters as seen with the decline in capelin fish stocks in 2019, other species have migrated into Icelandic waters. Also, the sector has considerable flexibility to adapt to changing stocks and has proven so many times. Warmer temperatures are favourable for plant productivity and agriculture. Around 11% of Iceland's land mass consists of glaciers; while the melting of glaciers increases the risk of landslides, it also increases availability of hydropower, at least for several decades.

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 countries because of long working lives, high participation rates of women and the flexibility of the labour force. Iceland also benefits from high-quality education, access to basic services and housing availability. Indicators for access to healthcare are very strong, as seen in the fast response to the coronavirus pandemic. 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.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click [here](#) to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the "Credit profile" 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

Economy continues to grow, supported by tourism

We estimate that the economy grew by 5.5% in 2022, supported by the strong recovery in tourism as well as dynamic private consumption. Domestic demand has grown strongly thanks to a continued increase in purchasing power, pent-up demand coming out of the pandemic and a strong labour market, with unemployment reaching its lowest level since 2018 in October 2022 at 2.8%. Exports have grown substantially, mostly as a result of the recovery in tourism activity with arrivals in line with 2019 levels since May 2022. On the other hand, exports of fish and aluminium, Iceland's other two main export products, have not increased much in volume terms due to capacity constraints although higher prices have led to high growth in value terms. Import growth has been strong, owing to Iceland's high reliance on imported inputs for domestic production as well as strong outward travel by Icelanders.

Over the course of the year, growth rates have slowed, from 8% year-over-year in the first quarter of 2022, to 5.4% in the third quarter. We estimate that growth momentum slowed further in the last quarter of 2022, reflecting mainly the slowdown in exports as global demand weakened.

In 2023, we expect the slowdown to continue, in particular in the first half of the year. For the year as a whole we forecast real GDP growth of 2.5%, as tighter monetary policy and more moderate economic activity in Iceland's key trading partners impact the economy. Higher cost of funding (the central bank's policy rate now stands at 6%) will weigh on the domestic economy, particularly through lower investment. We also expect domestic consumption to be somewhat weaker as inflation continues to weigh on purchasing power (real wage growth turned negative in June), although saving rates are still higher than before the pandemic and could support consumption. The marked economic slowdown we forecast in the [US](#) (Aaa stable) and Europe, Iceland's two largest tourism markets, will likely weigh on demand for travel though we continue to expect arrivals will remain near record high.

Wage agreements do not add to inflation, removing a key source of uncertainty

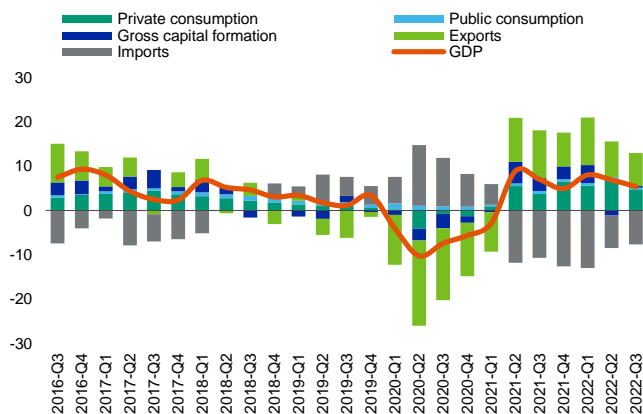
The signing of new wage agreements in December 2022 by the majority of private sector employees following the expiration of those signed in 2019 has reduced a key source of uncertainty around the inflation outlook. Wages are set to increase by 6.75% in 2023 (with a cap for higher incomes), which will broadly keep purchasing power constant in real terms. In addition, additional wage increases related to strong economic growth planned in the 2019 agreements will not be implemented.

As a result, we forecast inflation will gradually decline in 2023 to below 5% by the end of the year down from 9.6% in December 2022. House prices are the main driver of inflation and we expect the strong monetary policy reaction, tighter macroprudential measures as well as higher dwelling completions will help ease house price growth in 2023. That said, the short-term nature of the wage agreement, which expires in early 2024, has not fully alleviated the risks to the inflation outlook in particular if inflation surprises on the upside during the year, leading to higher wage demands.

Exhibit 5

Growth will likely slow down in coming quarters, but remain positive

Real GDP growth (% change) and components (pp)

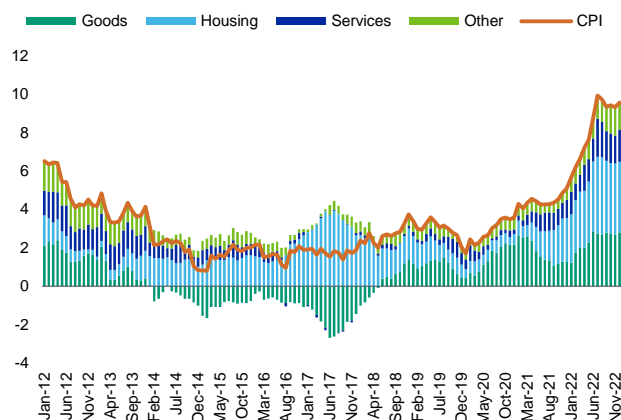


Source: Statistics Iceland and Moody's Investors Service

Exhibit 6

Inflation has peaked following strong action by the central bank

Consumer price index (% change) and components (pp)



Source: Central Bank of Iceland and Moody's Investors Service

2023 budget underscores commitment to fiscal consolidation

In December 2022, the Icelandic Parliament approved the 2023 budget targeting a deficit of 3.0% of GDP at the central government level down from a revised target of 3.9% in 2022. The strong economic recovery as well as higher inflation have increased revenues more strongly than budgeted, which is partly offset by higher interest payments given the large share of inflation-linked debt at around 25% of the stock of Treasury debt. The decline in the deficit this year will be chiefly driven by higher revenue while expenditure will increase at a slower pace, mostly driven by inflation-indexed spending such as benefits and wages. We pencil in budget deficits at the general government level of around 4.4% of GDP in 2022 and 3.5% in 2023, reflecting the deficit of local authorities as well as interest costs paid on the inflation-linked bonds of the HF-Fund. For the purpose of the fiscal rules, the reclassified companies are excluded.

The government's objective to put debt on a downward trajectory by 2026 is likely to have already been met in 2022 with central government debt standing at around 43% of GDP as of end-2022, down from 45% in 2021. According to our definition (which includes the HF-Fund and smaller reclassified entities), the public debt ratio was significantly higher at 68% of GDP in 2022. We expect the debt ratio to continue to decline and return to its 2019 level by the end of 2023.

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						
Growth dynamics	Average real GDP growth (%)	2017-2026F	2.5	baa3		25%
	MAD Volatility in Real GDP Growth (%)	2012-2021	1.2	baa3		10%
Scale of the economy	Nominal GDP (\$ billion)	2021	25.6	b2		30%
National income	GDP per capita (PPP, Int\$)	2021	59,965.5	aaa		35%
Adjustment to factor 1	# notches				0	max ±9
Factor 2: Institutions and governance strength						
Quality of institutions	Quality of legislative and executive institutions			aa		20%
	Strength of civil society and the judiciary			aaa		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						
Factor 3: Fiscal strength						
Debt burden	General government debt/GDP (%)	2021	75.3	ba3		25%
	General government debt/revenue (%)	2021	182.3	a3		25%
Debt affordability	General government interest payments/revenue (%)	2021	8.3	a2		25%
	General government interest payments/GDP (%)	2021	3.4	ba2		25%
Specified adjustments	Total of specified adjustment (# notches)			1	1	max ±6
	Debt Trend - Historical Change in Debt Burden	2013-2021	-46.7	0	0	
	Debt Trend - Expected Change in Debt Burden	2021-2023F	-8.3	1	1	
	General Government Foreign Currency Debt/ GDP	2021	11.0	-1	-1	
	Other non-financial public sector debt/GDP	2021	2.1	0	0	
	Government Financial Assets including Sovereign Wealth Funds / GDP	2021	11.2	1	1	
Other adjustment to factor 3	# notches				0	max ±3
F1 x F2 x F3: Government financial strength						
Factor 4: Susceptibility to event risk						
Political risk	Domestic political risk and geopolitical risk			aa		
Government liquidity risk	Ease of access to funding			aa	aa	
	High refinancing risk			aa		
Specified adjustment					0	max -2
Banking sector risk	Risk of banking sector credit event (BSCE)	Latest available	baa3	baa3		
	Total domestic bank assets/GDP	2021	151.4	80-180		
Adjustment to F4 BSR	# notches				0	max ±2
External vulnerability risk	External vulnerability risk			a	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						
				Aa3 - A2	Aa3 - 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 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

- » **Sector in-Depth:** [Banks - Europe: Domestic focus and strong capital buffers support Icelandic banks' strong performance](#), 8 November 2022
- » **Credit Opinion:** [Government of Iceland - A2 stable: Update following methodology update](#), 29 November 2022
- » **Credit Opinion:** [Government of Iceland - A2 stable: Regular update](#), 23 August 2022
- » **Issuer In-Depth:** [Government of Iceland – A2 stable: Annual credit analysis](#), 29 July 2022
- » **Sector in-Depth:** [Banking - Iceland: Iceland Macro Profile: Strong -](#), 24 May 2022
- » **Rating Methodology:** [Rating Methodology: Sovereigns](#), 22 November 2022

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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