MOODY'S
INVESTORS SERVICE

CREDIT OPINION
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Update

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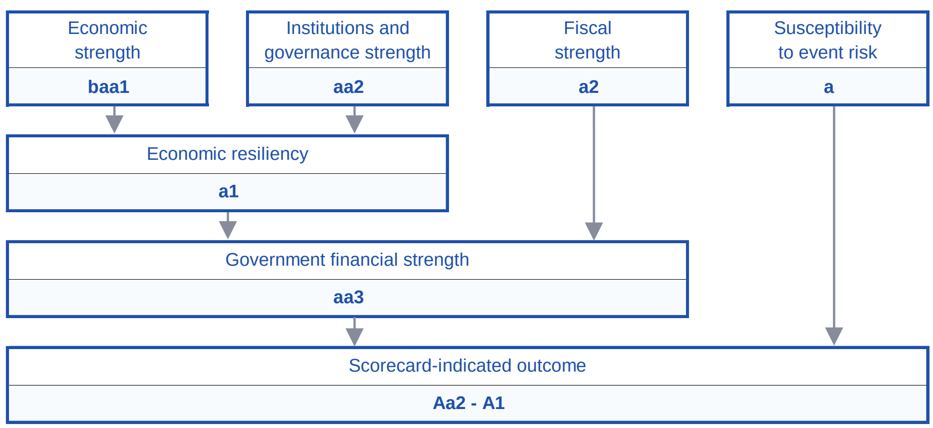
Government of Iceland – A2 positive

Update following change in outlook to positive; rating affirmation

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 mitigate its vulnerability to shocks given its small size and concentration in a limited number of sectors. Public debt is relatively high but the government is pursuing significant fiscal consolidation that will bring debt metrics closer to peers.

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;

» Larger and more expensive debt burden relative to peers.

Rating outlook

The positive outlook reflects the prospects that fiscal buffers will be rebuilt faster than anticipated as evidenced by the rapid decline in the budget deficit and the declining the debt ratio. Moreover, the strong growth prospects of key economic sectors and the ongoing efforts to further diversify the economic base may reduce the impact of shocks on the economy in the future.

Factors that could lead to an upgrade

The rating could be upgraded if fiscal consolidation continues at the expected pace and the public debt is reduced further in line with expectations. An early consensual resolution to the HF Fund (A2 stable) guarantee would help accelerate the declining debt trend and would also be positive for the rating. Progress in reducing inflation and re-anchoring inflation expectations while ensuring continued robust economic growth would support our assessment of Iceland's strong institutions and would be credit positive. Further evidence that the economic diversification efforts are contributing to reduced growth volatility would also support a higher rating.

Factors that could lead to a downgrade

The positive outlook signals that the rating is unlikely to be downgraded in the near term. However, the outlook would likely be returned to stable if our expectations for the rebuilding of fiscal and economic buffers did not materialise. The rating could face downward pressure if the authorities deviated significantly from their current medium-term fiscal consolidation plans, resulting in a material increase in the public debt ratio.

Key indicators

Exhibit 2

Iceland	2017	2018	2019	2020	2021	2022E	2023F	2024F
Real GDP (% change)	4.2	4.9	1.8	-7.2	4.3	6.4	4.0	2.5
Inflation rate (% change average)	1.8	2.7	3.0	2.8	4.5	8.3	8.8	5.8
Gen. gov. financial balance/GDP (%)[1]	1.0	0.9	-1.5	-8.4	-7.6	-4.3	-2.0	-1.5
Gen. gov. primary balance/GDP (%)[1]	6.7	5.8	2.8	-5.8	-5.3	-1.6	0.5	0.8
Gen. gov. debt/GDP (%)[1]	71.7	63.2	66.6	77.8	75.6	68.7	63.8	58.2
Gen. gov. debt/revenues (%)[1]	158.1	141.3	158.2	189.3	188.2	172.1	160.1	148.0
Gen. gov. interest payment/revenues (%)[2]	12.6	11.0	10.3	6.3	5.5	6.6	6.1	5.8
Current account balance/GDP (%)[3]	4.2	4.3	6.5	0.9	-2.4	-1.6	-0.6	-0.1

[1] Includes public entities previously excluded from the scope of the general government
[2] Series break in 2020; After 2020, interest payments are net of interest income from HF Fund
[3] Excludes DMBs undergoing winding up in 2008-2015

Source: Moody's Investors Service

Detailed credit considerations

On 14 July, we changed the outlook on Iceland's ratings to positive. The rating action was driven by (1) the government's rapid progress in reducing its budget deficit and bringing the public debt ratio onto a declining trend which increase the probability of a faster-than-expected rebuilding of fiscal buffers; and (2) the increased chances that strong growth prospects of key economic sectors and the ongoing efforts to further diversify the economic base will reduce the impact of shocks on the economy in the future.

We assess Iceland's **economic strength** at “baa1” which balances the country's small size and volatile growth performance with very high wealth levels and strong competitiveness. Iceland's GDP per-capita is - at over $66,000 in PPP terms in 2022 - the 18th highest in our sovereign rating universe, having recovered the significant losses registered after the banking crisis in 2008 and the pandemic shock. Iceland's economy is highly competitive, as evidenced by its ranking at 16th place globally in the World Competitiveness Index in 2022, 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 three quarters of the country's export revenues come from three sectors: tourism (32%

of total in 2022), marine products (20% of total) and aluminum (23% of total). The economy has weathered well the twin shocks of the pandemic and the war in Ukraine, helped by a strong policy response and Iceland's energy independence. Diversification efforts are showing first signs of success in some sectors, which should strengthen the economy's resilience to shocks.

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 financial supervision and regulation has helped to improve the resilience of the banking 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. That said, as a small currency area, Iceland remains exposed to inflationary shocks. Fiscal policy effectiveness has also strengthened with the establishment of a strong fiscal policy framework including a set of fiscal rules, a multi-year budgeting process and an independent fiscal council.

We assess Iceland's **fiscal strength** as “a2”, reflecting improving fiscal metrics, with a rapidly declining budget deficit and firmly established downward debt trend. Compared to a recent peak of 77.8% of GDP in 2020, the public debt has already declined by nine percentage points to 68.7% in 2022. In addition, Iceland has a very strong track record in reducing its very high debt burden after the 2008 crisis. Between the peak in 2011 and 2018 general government debt more than halved, and stood at 66.6% of GDP in 2019. Prospects for a further material reduction in the debt ratio are good, given our expectation of continued strong GDP growth and the government's fiscal consolidation plans.

The fiscal framework is accepted across the political spectrum, giving high confidence that debt will continue to be reduced in the coming years. In addition, the government holds significant equity stakes in two of the three largest domestic banks, and sale proceeds would likely be used for debt reduction purposes.

Debt affordability is weaker than peers due to the large share of inflation-indexed debt as well as higher domestic funding costs. We recently raised the score from “baa1” to reflect stronger debt affordability metrics than assessed before. We now net out the interest income that the HF Fund receives on its large loan portfolio from our calculations of interest expenses, because the interest income is used to service the debt of the Fund. We fully incorporate the value of the government's guarantee on the HF Fund's debt into our general government debt calculations, in line with Statistics Iceland, which in 2020 decided to reclassify 24 public-sector corporations into the general government sector. The HF Fund is by far the largest of these, with the government's guarantee amounting to around 19% of GDP.

We assess Iceland's **susceptibility to event** risk as “a”, driven by our banking system assessment.

Political event risk is low, and scored at “aa” given consistent policy in key areas important to safeguarding the government's credit profile. 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. Political consensus on the economic and fiscal direction for the country is strong. In contrast to other European sovereigns, Iceland is not exposed to elevated geopolitical risks due to Russia's invasion of Ukraine (Ca stable); while the country is a founding member of NATO, it has no standing army and is besides Korea (Aa2 stable) the only country with a Bilateral Defence Agreement with the US, in force since 1951.

We assess **government liquidity risk** as “aa”. The marked reduction in government debt after the banking crisis 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.

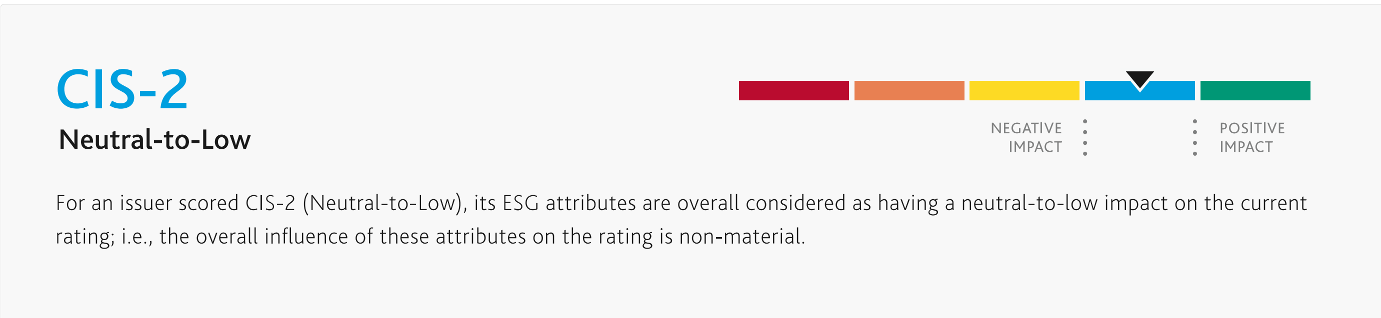
We assess **banking sector risk** at “a”. The three largest banks have solid levels of capitalisation and liquidity. Aggressive monetary tightening and the introduction of several borrower-focused macroprudential measures have started to cool the housing market. The Financial Stability Committee at the central bank has also repeatedly raised the counter-cyclical capital buffer for banks (to 2.5% from March 2024 onwards) to raise the resilience of the banking system.

We assess **external vulnerability risks** at “aa”. 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 18% of GDP or 25% of the country's total external debt as of the end of 2022, a large buffer to help limit exchange rate volatility and support the country's external position. The current account has been in deficit since 2020 because of weaker tourism demand, large dividend payments of foreign-owned companies and strong domestic demand, but we expect it to return close to balance in the coming years. The score has recently been raised from “a” previously to better reflect the size of external buffers.

ESG considerations

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

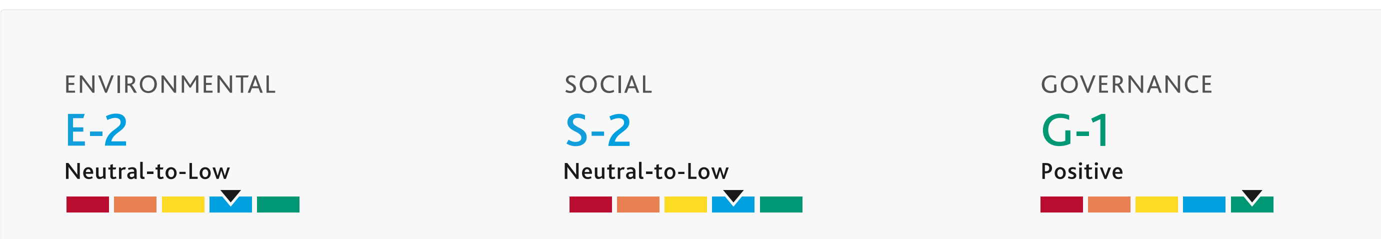
Exhibit 3
ESG Credit Impact Score



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.

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Social

Similarly, Iceland faces neutral to low social risks (**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. Strong inward migration further supports the economy, as immigrants' participation rate exceeds that of the domestic population. In contrast to some of the Nordic countries, immigrants and refugees are widely perceived to benefit the Icelandic economy and society. Iceland also benefits from high-quality education, access to basic services and housing availability, similar to other Scandinavian countries. Indicators for access to healthcare are very strong, as seen in the fast response to the coronavirus pandemic. While wage negotiations between employers and trade unions can impact on Iceland's competitiveness, the highly coordinated collective bargaining has generally been a stabilizing factor, ensuring relatively contained wage differentials and contributing to limited income disparities and social peace.

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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 expect economic growth to remain robust in 2023 and real GDP to grow by 4%, supported by strong tourism demand. Real GDP grew by a very strong 6.1% year-over-year in the first quarter of 2023 but we expect growth to slow down in the remainder of the year, reflecting tighter monetary and fiscal policies. Domestic card turnover suggests that domestic demand has started to soften as high inflation is increasingly weighing on household purchasing power. That said, elevated nominal wage growth and a strong labour market will support consumption.

Exports will continue to grow, mostly as a result of tourism. The tourism sector is on track for its strongest year ever, with up to 2.4 million visitors expected compared to 2.3 million in 2018. Revenues in the sector have risen to around ISK220 billion (5.3% of GDP) in the first four months of 2023, compared to ISK170 billion in 2018. There is evidence to suggest that visitors are spending more and staying longer compared to previous years. Labour demand in the sector is being met with foreign workers.

On the other hand, exports of fish and aluminium, Iceland's other two main export products, will not contribute much to growth due to capacity constraints in the sectors. Quotas for the next fishing season have not changed significantly although prices remain elevated, which will increase revenues in the sector. Import growth is strong, owing to Iceland's high reliance on imported inputs for domestic production, elevated domestic demand as well as outward travel by Icelanders.

Inflationary pressures have broadened and more tightening is likely

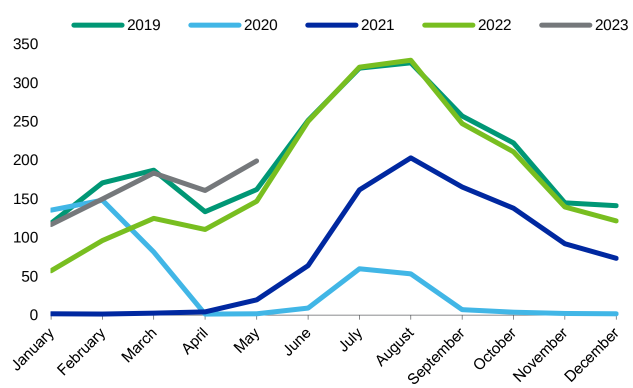
Inflation has started to slow over the past few months, after hitting a peak of 10.2% in February. As of June 2023, consumer price inflation stands at 8.9%. Inflation in Iceland was originally driven by surging house prices after the pandemic while the energy crisis had limited impact on inflation because of the country's energy independence. Substantial rate hikes of a cumulative 800 basis points since 2021 as well as tighter macroprudential measures have started to cool house price growth.

However, inflationary pressures remain high and have broadened over recent months, with most categories now showing high inflation. In particular, the weakening of the krona in 2022 has led to an increase in imported inflation and there are also signs that strong wage growth is feeding through to services prices. Long-term inflation expectations have also risen, which will keep pressure on the central bank to hike further.

Exhibit 5

Tourism demand has surpassed pre-pandemic levels

Foreign tourist arrivals ('000)

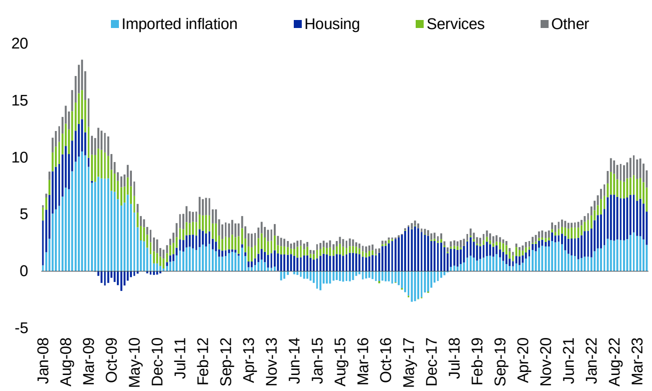


Source: Statistics Iceland and Moody's Investors Service

Exhibit 6

Headline inflation is coming down but broadening to more categories

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



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

We expect inflation to average 8.8% in 2023 and decline slowly towards the central bank's target of 2.5%. There is significant uncertainty around the inflation outlook because wage agreements expire in early 2024 and the result of upcoming negotiations will affect developments in inflation, in particular if inflation surprises on the upside during the year, leading to higher wage demands.

Medium-term fiscal plan confirms commitment to fiscal consolidation

In March, the government presented its fiscal plan for 2024-2028 and lowered significantly its budgetary targets. The authorities now target a deficit of 1.3% of GDP (central government) for this year, compared to a target of 3% in the approved 2023 budget. The lower deficit target reflects both a stronger outturn in 2022 - the budget deficit was nearly two percentage points of GDP lower than budgeted - and the government's recent decision for additional fiscal tightening, in an effort to support the central bank's disinflation efforts.

The government has also decided to bring forward by a year to 2025 when the fiscal rules will apply again. For the general government (including local governments and the social security system), we forecast a budget deficit of 2% of GDP in 2023. The plan envisages a further improvement for the central government deficit to 1.1% and 0.8% of GDP in 2024 and 2025 with the budget targeted to return to balance in 2027 and overall surplus in 2028. To reach the targets, the government plans to limit spending growth to less than nominal GDP growth while the revenue ratio will be kept broadly stable as a share of GDP.

Provided the plans will be implemented as planned, government debt will decline more rapidly than we expected so far. In the 2021-2025 fiscal plan, the government had aimed to stabilise the public debt ratio no later than 2026 and targeted a debt ratio of 55%

of GDP at year-end 2022. The debt ratio – as defined in the fiscal framework – instead stood at 40% of GDP and the government will likely stabilise debt already in 2023.

While at higher levels, we also expect a declining debt trend with the debt ratio forecast at 64% in 2024, compared to the peak of 77.8% in 2020. An early settlement of the government's guarantee for HF Fund's liabilities could result in a sharp reduction in the debt ratio while further asset sales could also reduce the public debt. A planned sale of the state's remaining stake in Islandsbanki was halted last year and the bank recently fined after the conclusion of a central bank investigation into the process around the share sale. We expect the divesture of the remaining 42.5% government share to be delayed until at least next year.

Moody's rating methodology and scorecard factors: Iceland - A2 positive

Factor / Sub-Factor	Metric	Indicator Year	Indicator	Initial Factor Score	Final Factor Score	Weights
Factor 1: Economic strength				baa1	baa1	50%
Growth dynamics	Average real GDP growth (%)	2018-2027F	2.4	baa3		25%
	MAD Volatility in Real GDP Growth (%)	2013-2022	1.2	baa3		10%
Scale of the economy	Nominal GDP ($ billion)	2022	27.8	b1		30%
National income	GDP per capita (PPP, Intl$)	2022	66,512.4	aaa		35%
Adjustment to factor 1	*# notches*				0	max ±9
Factor 2: Institutions and governance strength				aa2	aa2	50%
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				a1	a1	
Factor 3: Fiscal strength				a2	a2	
Debt burden	General government debt/GDP (%)	2022	68.7	ba1		25%
	General government debt/revenue (%)	2022	172.1	a2		25%
Debt affordability	General government interest payments/revenue (%)	2022	6.6	aa3		25%
	General government interest payments/GDP (%)	2022	2.7	baa1		25%
Specified adjustments	*Total of specified adjustment (# notches)*			1	1	max ±6
	Debt Trend - Historical Change in Debt Burden	2014-2022	-46.6	0	0	
	Debt Trend - Expected Change in Debt Burden	2022-2024F	-10.5	1	1	
	General Government Foreign Currency Debt/ GDP	2022	8.9	0	0	
	Other non-financial public sector debt/GDP	2022	1.0	0	0	
	Government Financial Assets including Sovereign Wealth Funds / GDP	2022	8.4	0	0	
Other adjustment to factor 3	*# notches*				0	max ±3
F1 x F2 x F3: Government financial strength				aa3	aa3	
Factor 4: Susceptibility to event risk				a	a	Min
Political risk				aa		
	Domestic political risk and geopolitical risk			aa		
Government liquidity risk				aa	aa	
	Ease of access to funding			aa		
Specified adjustment	High refinancing risk				0	max -2
Banking sector risk				a	a	
	Risk of banking sector credit event (BSCE)	Latest available	baa3	baa3		
	Total domestic bank assets/GDP	2022	141.6	80-180		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				aa	aa	
	External vulnerability risk			aa		
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				Aa2 - A1	Aa2 - A1	

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.

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