MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Iceland's rating at A2, stable outlook

20 Aug 2021

London, 20 August 2021 -- Moody's Investors Service ("Moody's") has today affirmed the government of Iceland's local and foreign-currency issuer rating at A2. The senior unsecured foreign-currency rating has also been affirmed at A2, and the foreign-currency senior unsecured MTN program has been affirmed at (P)A2. The outlook on the ratings remains stable.

The rating affirmation at A2 balances the following key drivers:

1. The Icelandic economy is expected to post a solid recovery helped by a strong and pro-active policy response; over the coming years economic growth will be supported by strong investment and the continuing recovery in the tourism sector;

2. Institutions have been strengthened significantly and their credibility has materially improved over the past years; Moody's considers this driver to be a Governance consideration under its ESG framework;

3. The limited diversification of the economy due to its small size implies a high growth volatility and exposure to sector-specific shocks; while diversification efforts are ongoing this is unlikely to materially change over the coming years.

The stable outlook reflects broadly balanced risks. Apart from a solid economic recovery and a robust growth outlook, the government's strong track record on debt reduction gives confidence that it will manage to reverse the pandemic-induced fiscal deterioration over the coming years. Moreover, Iceland's relatively high public debt level is partly the result of an accounting reclassification in late 2020, which does not change the government's fundamental fiscal profile.

The local-currency ceilings remain unchanged at Aa1, set at four notches above the sovereign rating. The Aa1 local currency ceiling balances Iceland's very predictable and reliable institutions, low political risk and external imbalances and the relatively moderate footprint of the government in the economy with a very volatile currency. Its volatility exposes all issuers in the country to a higher level of exchange rate risks than is standard in most other advanced economies. Similarly, the limited diversification of the economy leads to a higher exposure to sector-specific shocks than in many other countries.

The foreign-currency ceilings have been raised to Aa2 from Aa3, to reflect the full abolition of capital controls with the updated Foreign Currency Act No 70/2021 in late June 2021. That said, Moody's maintains a one-notch gap between the local currency and the foreign currency ceiling because the Central Bank of Iceland (CBI) retains the option to reintroduce capital controls in an emergency situation in order to maintain economic and financial stability. As such, capital controls remain as a policy option in a situation of extreme stress.

RATINGS RATIONALE

RATIONALE FOR AFFIRMING THE A2 RATING

SOLID ECONOMIC RECOVERY HELPED BY STRONG AND PRO-ACTIVE POLICY RESPONSE

The first driver relates to Iceland's solid economic recovery helped by a strong and pro-active policy response, and the country's robust medium-term growth prospects. Iceland was hit hard by the collapse in tourism last year, recording a contraction in real GDP of 6.6%. That said, the contraction was less severe than initially feared as other sectors of the economy proved more resilient. The economy is now showing signs of recovery, supported by the authorities' large and swift policy action as well as a recovery in the tourism sector.

The Icelandic authorities used all available levers to support household incomes, protect employment and provide liquidity to enterprises in a coordinated and swift manner. The overall fiscal response is estimated by the International Monetary Fund (IMF) at over 9% of GDP, larger than in many other high-income countries, and many measures have been extended -- albeit in a more targeted fashion - until later this year. Other supportive measures include the central bank's monetary easing and regulatory measures to keep credit flowing. In contrast to the 2008 crisis, the Icelandic currency stabilized quickly and financial conditions remained favourable. The current account remained in a small surplus.

As of Q1 2021, private consumption was nearly 10% higher than at the trough in Q2 2020 in real terms, helped by the above-mentioned measures but also real wage increases of around 6% due to pre-pandemic wage agreements and tax cuts. Unemployment has started to decline again in recent months although it remains elevated for Icelandic standards at 6.1% in July (in non-seasonally adjusted terms) compared to the peak of 11.6% in January and 3.6% on average between 2015 and 2019. Moody's expects real GDP growth of 3.4% this year, accelerating to around 5% in 2022. Over the coming years, the Icelandic economy will benefit from strong investment, helped by the large public investment programme and tax incentives for private investment, in particular for R&D. The continuing recovery in the tourism sector should also support GDP growth.

Iceland could afford such a large and swift response because it had accumulated significant buffers in the years prior to the pandemic, including low government debt (at below 30% of GDP in 2019) and overall budgetary surpluses in most years between 2014 and 2018. Moreover, the very large foreign-currency reserves at the central bank -- of around 26% of GDP -- allowed the central bank to contain currency volatility while accommodating capital outflows from foreign investors which amounted to around 2.6% of GDP between March and December 2020. The country's pension funds refrained from investments abroad between mid-March and mid-September 2020, to support the central bank's effort at limiting currency volatility. The very large pension savings, amounting to close to 200% of GDP, provide an important buffer for households in a shock. The government authorized a temporary withdrawal from voluntary third-pillar pension savings, amounting to around 0.9% of GDP last year and somewhat less this year in support of household incomes and consumption.

SIGNIFICANTLY STRENGTHENED INSTITUTIONS WHICH HAVE GAINED CREDIBILITY IN PAST YEARS

The second driver for the rating affirmation is the significant strengthening of Iceland's institutions over the past several years, which Moody's expects to be maintained in the coming years. Most recently, Iceland's institutions have proven their solidity in the pandemic with a well-thought out and coordinated policy response from the government, central bank and other key economic actors. The response to preserve public health was exemplary with fast containment measures, solid progress on vaccination and transparent policies and guidelines. In recent weeks, cases have risen again though, similar to other countries.

Following wholesale changes in banking supervision and regulation and an overhaul of the monetary policy framework and governance at the CBI in the wake of the 2008 banking crisis, the central bank's credibility has materially improved. Longer-term inflation expectations are well anchored, notwithstanding the recent acceleration in inflation above the upper target threshold of 4%. In the broader context, inflation has been close to target since 2014, in sharp contrast to Iceland's historic inflation performance. The CBI has been effective in limiting ISK volatility, while successfully managing the full liberalization of the capital account without disruptive capital outflows.

In early 2020, the banking regulator was merged with the CBI, with the aim to achieve greater efficiency, operational independence, and powers in financial oversight. Macro-prudential tools are actively used and contribute to financial stability, such as strong capital and liquidity buffers for banks (including a countercyclical capital buffer, which has been reduced to zero last year), limits on foreign currency exposure of bank balance sheets, a loan-to-value limit for mortgages, and restrictions on foreign currency borrowing by unhedged domestic agents.

In a similar vein, fiscal policy credibility has materially improved in recent years, with the largest reduction in public debt in Europe between 2011 and 2019 on the back of primary surpluses since 2012, and the introduction of transparent and credible fiscal rules in 2015. Last autumn, parliament authorized the temporary suspension of the rules until 2025, and the government continues to provide targeted fiscal support this year to deal with the economic fallout of the pandemic. That said, the government has already presented and parliament approved a medium-term fiscal strategy to reduce the budget deficit significantly from 2022 onwards and to stabilize the net public debt ratio by 2025 at around 54% of GDP, which shows that the fiscal rules provide an important medium-term anchor for Iceland's fiscal policy. The rules are supported across the political spectrum, giving confidence that the current fiscal deterioration and debt increase will again be reversed over the coming years. Also, the revenue and spending measures required for the fiscal consolidation plan are manageable.

LIMITED ECONOMIC DIVERSIFICATION WHICH IMPLIES CONTINUED HIGH GROWTH VOLATILITY AND EXPOSURE TO SECTOR-SPECIFIC SHOCKS

The third driver of today's rating affirmation is Moody's view that Iceland's structural economic constraints are unlikely to change materially over the medium term, namely the concentration on a limited number of sectors to drive economic growth. Tourism, fishing and aluminium smelting together accounted for 75% of total exports and 14% of Gross Value Added before the pandemic (2019 data).

The economy is among the smallest in our rated universe with a nominal GDP of just below $22 billion in 2020, and its limited diversification leads to high growth volatility and makes the country vulnerable to sector-specific shocks. Iceland represents the smallest currency area in the world, exposing the economy to the risk of high exchange rate volatility and imported inflation, although these risks are well understood by the authorities and effectively managed.

That said, the government has outlined an ambitious public investment programme, amounting to around 0.5% of GDP per year over the 2020-2025 period. Its overarching aim is to help the economy diversify and transition to a knowledge-based economy, emphasizing biotechnology, aquaculture and information technology and communication. Iceland has a tradition in the first two, with exports growing vigorously in both sectors over the past few years. For the latter, a key comparative advantage is Iceland's cheap renewable energy and cool, windy climate which is important for data processing and storage.

The IMF notes that Iceland is well ahead of many other advanced economies in terms of digital skills, infrastructure and ICT adoption, and thus has scope to boost value added in ICT sectors further. The government's tax incentives for private-sector R&D investment and the recently created public venture capital fund should also help in this regard.

RATIONALE FOR STABLE OUTLOOK

The stable outlook reflects broadly balanced risks. Firstly, last year's contraction was less severe than initially feared also because other key sectors beyond tourism of the economy proved more resilient. That said, the Icelandic economy was hit hard by the collapse in tourism last year; the sector accounted for 40% of export revenues and 14% of employment prior to the pandemic, but is recovering now. Tourist arrivals have been rising lately -- helped by a successful vaccination campaign and the early reopening to its main markets. Yet, a full recovery of the sector and the economy at large will likely only happen next year and rising infection rates in key countries of origin remain a key risk.

Secondly, the government's strong track record on debt reduction gives confidence that it will manage to reverse the pandemic-induced fiscal deterioration and debt increase again over the coming years. Iceland's public debt ratio remains higher than similarly rated peers at 79.9% of GDP as of end-2020, having risen by 11 percentage points of GDP last year. But the high debt level is to an important extent due to the reclassification of 24 public companies' debt into general government debt implemented in late 2020, which raised the government debt ratio by around 32 percentage points of GDP. Prior to the reclassification Iceland's public debt burden was below 30% of GDP and had declined by over 70 percentage points of GDP between the peak in 2011 and 2018, one of the largest debt reductions globally. The risks associated with this additional debt now captured are low and had already been incorporated into Moody's analysis as contingent liabilities.

While the government's plan for a large public investment programme and tax cuts will keep the budget deficit elevated this year at close to 10% of GDP, Moody's expects the public debt ratio to start declining from 2023 onwards, on the back of solid fiscal consolidation efforts and robust GDP growth.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Iceland's ESG Credit Impact Score is neutral to low (CIS-2), reflecting moderate exposure to environmental risk which is balanced by neutral-to-low exposure to social risks and very strong institutions which also contribute to its relatively strong resilience to E and S risks.

Iceland's overall E issuer profile score is moderately negative (E-3) and primarily reflects that the economy relies to an important extent on its unique geological features, particularly its key sectors of tourism and fishing, which exposes its credit profile to physical climate risks. The presence of active volcanoes on the island helps to attract tourism but could potentially also disrupt economic activity. Furthermore, warming seas can lead to the possible migration of fish stocks outside of Iceland's waters, as seen with the decline in valuable capelin fish stocks in 2019. However, Iceland's effective management of its fish stocks -- including temporary suspension of fishing quotas to help stocks recover -- is an important mitigating factor. Around 11% of Iceland's land mass consists of glaciers which also exposes the country to risks from rising temperatures. Its overall E issuer profile score is therefore moderately negative (E-3).

Iceland has pledged to fulfil the EU emission reduction target of 55% below 1990 levels by 2030 and achieve carbon neutrality by 2040. However, greenhouse gas emissions are higher than in comparable EU countries in per-capita terms, with aluminium-related industries the largest source of greenhouse gases. The government has announced a climate action plan which emphasized clean transport, technologies for carbon capture and tax incentives for low-emission vehicles, among others.

Moody's assesses Iceland's S issuer profile score as neutral to low (S-2). The country's demographic profile is more favourable than in many other advanced nations — particularly in continental Europe — because of exceptionally long working lives, higher fertility rates, high share of women who work and the flexibility of the labour force. Iceland also benefits from high-quality education, high housing availability, and good quality healthcare and basic services. That said, social risks exert themselves through intensive wage negotiations between employers and trade unions every four years which can impact on Iceland's competitiveness.

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.

GDP per capita (PPP basis, US$): 55,966 (2020 Actual) (also known as Per Capita Income)

Real GDP growth (% change): -6.6% (2020 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 3.6% (2020 Actual)

Gen. Gov. Financial Balance/GDP: -7.3% (2020 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 1.1% (2020 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: a2

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 17 August 2021, a rating committee was called to discuss the rating of the Iceland, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, has somewhat increased. The issuer's fiscal or financial strength, including its debt profile, has decreased. The issuer has become less susceptible to event risks.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

WHAT COULD CHANGE THE RATINGS UP

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, a push towards increased diversification which would lead to a less volatile economic performance would be positive for the rating.

WHAT COULD CHANGE THE RATING DOWN

Conversely, outlook and rating would 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 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.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1288435 .

At least one ESG consideration was material to the credit rating action(s) announced and described above.

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