MOODY'S INVESTORS SERVICE

CREDIT OPINION
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Update

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Contacts

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

Alastair Wilson +44.20.7772.1372
MD-Global Sovereign Risk
alastair.wilson@moodys.com

Lenaic Couderc +33.1.5330.1038
Associate Analyst
lenaic.couderc@moodys.com

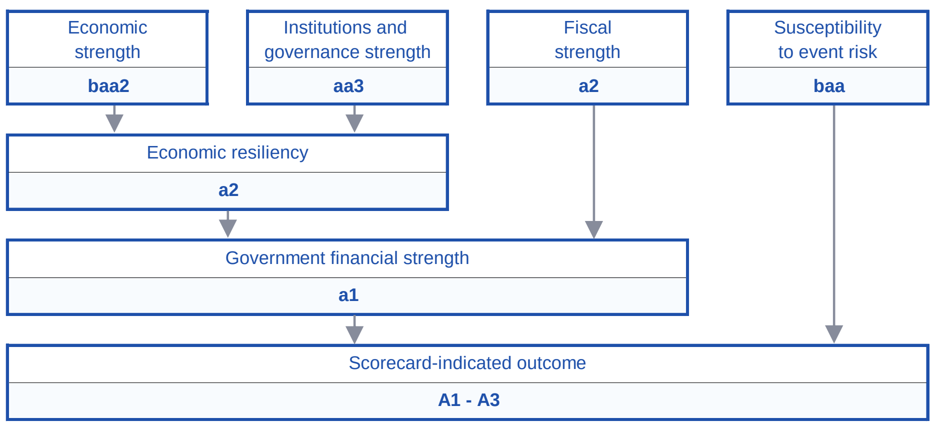
Government of Iceland – A2 stable

Update after forecast changes

Summary

The credit profile of Iceland (A2 stable) is supported by its wealthy and 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 and 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 with high economic concentration and hence volatile growth
- » Substantial, albeit significantly reduced, exposure to external risks
- » Large contingent liabilities derived from state-owned companies

Rating outlook

The stable outlook reflects our view that downside risks stemming from the economy's small size and high concentration are mitigated by Iceland's relative macroeconomic and financial robustness, based on reduced indebtedness and improved external balance.

As such, we expect high wealth buffers, robust institutions, a track record of macroeconomic management and relative economic resilience will support Iceland's credit profile through the significant but temporary impact on economic and fiscal performance from the coronavirus outbreak. While the country's exposure to the disruption in the tourism sector will likely weigh on economic performance beyond 2020, we do not expect the temporary shock to weaken public or external debt sustainability or threaten financial stability.

Factors that could lead to an upgrade

While unlikely in light of the coronavirus outbreak, Iceland's rating would 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 and sustained 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 and sustained 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	2014	2015	2016	2017E	2018E	2019E	2020F	2021F
Real GDP (% change)	2.1	4.7	6.6	4.5	3.8	1.9	-4.0	1.6
Inflation (CPI, % change, Dec/Dec)	0.8	2.0	1.9	1.9	3.7	2.6	1.2	1.8
Gen. gov. financial balance/GDP (%)	-0.1	-0.8	12.4	0.6	0.8	-1.0	-4.6	-3.6
Gen. gov. primary balance/GDP (%)	4.5	3.6	16.4	4.5	3.7	1.4	-2.5	-0.9
Gen. gov. debt/GDP (%)	80.9	65.0	52.2	44.0	38.8	36.0	41.6	42.7
Gen. gov. debt/revenues (%)	184.9	160.2	91.7	101.1	90.1	88.0	102.9	103.9
Gen. gov. interest payment/revenues (%)	10.4	10.9	6.9	8.9	6.6	5.8	5.3	6.5
Current account balance/GDP (%)[1]	5.2	5.8	7.6	3.8	3.1	2.2	1.3	1.5

[1] Excludes DMBs undergoing winding up until 2015

Source: Eurostat, Statistics Iceland, Moody's Investors Service

Detailed credit considerations

We assess Iceland's **economic strength** as "baa2" given the country's small size and associated history of economic boom and bust episodes. That said, at $56,066 in 2019 on a purchasing power basis, Iceland's GDP per capita is higher than that of around 90% of our sovereign rating universe, having overcome the significant losses registered during the country's banking and currency crisis. As evidenced by its ranking at 26th globally by the World Economic Forum's Global Competitiveness Index for 2019, Iceland's economy is highly competitive – standing out compared with close peers, particularly given its small size.

A tourism boom has led to strong real GDP growth over the past five years, averaging 4.0% between 2013 and 2019. However, the coronavirus outbreak will push the Icelandic economy into recession in 2020 and we now expect a contraction in real GDP of 4.0% this year before a gradual recovery in growth to 1.6% in 2021. Similar to other countries around the world, substantial policy measures announced by the authorities will help to support consumption through the temporary shock, although the recovery will likely be gradual given Iceland's very high dependence on tourism, wit the sector expected to be negatively impacted for some time. These forecasts are subject to considerable uncertainty around the duration and scale of the unprecedented shock.

We assess Iceland's **institutions and governance strength** as "aa3", mainly reflecting the country's solid institutions and recent track record of effective macroeconomic management to restore financial stability after the banking crisis. Our assessment of the quality of institutions reflects Iceland's clear competitive strengths in areas such as its high-quality education system, an innovative and high-tech oriented business sector, an efficient and flexible labour market and well-developed infrastructure. Iceland also has a long tradition of broad cooperation and consensus on economic matters between the government, employers and employee associations, which contributes positively to policy effectiveness.

Moreover, 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 successful liberalisation of capital account, with all capital restrictions lifted since April 2019.

We assess Iceland's **fiscal strength** as "a2" reflecting the country'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 rapidly thanks to persistent budget surpluses, debt buybacks and rapid economic growth, to stand at 36.0% in 2019.

We expect the contraction in economic activity as a result of the coronavirus outbreak and the government's sizeable policy response will result in a weakening in fiscal performance, which will push up government debt to 41.6% in 2020. However, Iceland's improved fiscal headroom will help support its credit profile through a temporary rise in government debt, which is far smaller than seen during the global financial crisis when the banking system required substantial support. In addition, the substantial improvement in the structure of government debt leaves it less exposed to currency fluctuations and sudden capital outflows.

We assess Iceland's **susceptibility to event** risk as "baa", driven by our banking system risk assessment.

We assess political risk as "aa" due to relatively consistent policy in key areas important to safeguarding the government's credit profile. Although only one government has served an entire term since 2007, political consensus on the economic and fiscal direction for Iceland has remained strong such that we don't expect a notable change in policy direction.

We assess government liquidity risk as "aa" given the government's very comfortable funding situation with low borrowing requirements given fiscal surpluses in recent years and much reduced government debt.

Our assessment of Iceland's banking sector risk as "baa" reflects the system's strong capitalisation and liquidity, which have significantly lowered risks to financial stability since the 2008 banking crisis. Given our lack of a published Baseline Credit Assessment (BCA) for the Icelandic banking system, which leads to incomplete data for the calculation of an initial banking sector risk score, we incorporate our aggregate analysis of the Icelandic banking system developed from publicly available information into the final score.

Although, nonperforming loans (NPL) have been reduced and operating performance restored at the three main domestic money banks, the sector remains concentrated in these three institutions, all successors of the old failed banks.

Iceland's external vulnerability risk assessment at "a" accounts for the country's favourable external position given that it has been running current-account surpluses since 2013 on the back of a boom in tourism and the Central Bank has established comfortable foreign exchange reserves which will support the external position through the sharp economic shock in 2020. The current account is expected to remain in a small surplus in 2020 as a weaker currency helps to support exports at the same time as the reduction in consumption weighs heavily on imports.

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, institutions and governance 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 some impact on Iceland' credit profile. Social pressures exert themselves through intensive wage negotiations every four years which can impact on Iceland's competitiveness. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety.

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".

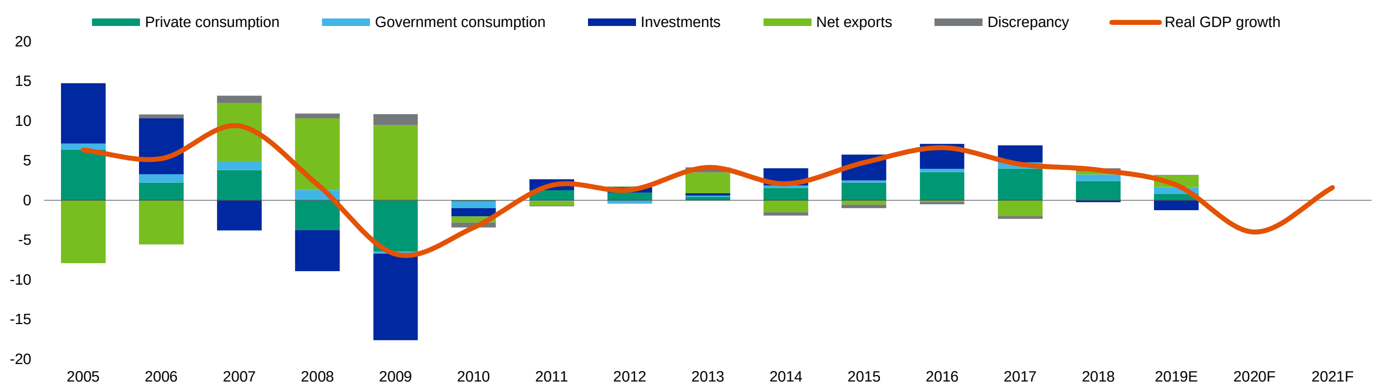
All of these considerations are further discussed in the "Detailed credit considerations" section above. Our approach to ESG is explained in our report on how ESG risks influence sovereign credit profiles and our cross-sector methodology General Principles for Assessing ESG Risks.

Recent developments

Coronavirus outbreak will have a significant temporary economic impact

We expect the demand and supply shock caused by the coronavirus outbreak to significantly lower economic activity in Iceland this year, particularly in the first and second quarters. Consequently, we have revised down our real GDP growth forecasts and now expect a contraction of 4.0% in 2020 before a gradual recovery next year, though this forecast is subject to significant uncertainty, with the final impact depending in part on the duration of the coronavirus outbreak (see Exhibit 3).

Exhibit 3
We expect a sharp contraction in growth this year and a gradual recovery in 2021
Real GDP growth (%) and contributions (pp)



Note: Moody's forecasts
Source: Statistics Iceland, Moody's Investors Service

Iceland's limited economic diversification, with the three largest sectors accounting for around 70% of total export revenue, and high degree of trade openness means it is particularly susceptible to shocks which disrupt international trade.

In particular, significant travel restrictions worldwide will suppress demand for Iceland's important tourism sector at least during the first two quarters of 2020, although this coincides with the low season for visitor arrivals. According to the World Travel and Tourism

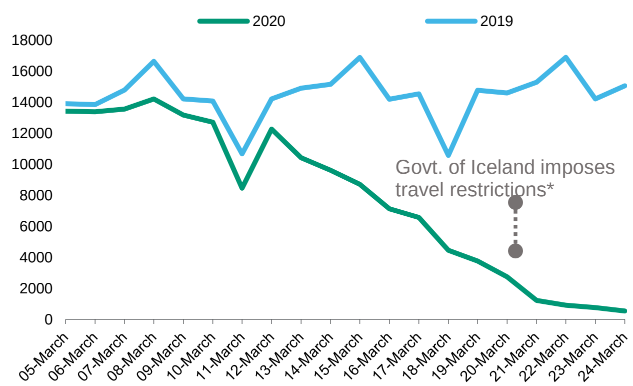
Council, travel and tourism accounted directly and indirectly for 32.6% of Iceland's GDP in 2018, 33.8% of employment and 34.6% of total exports.

On 25 March, the number of tourists arriving through Keflavik airport, Iceland's main airport, was down 95% compared to the same time last year (see Exhibit 4). This drop in tourism activity will amplify the shock Iceland experienced in 2019 after the collapse of Wow Air[1]. Following the collapse of the airline, tourist arrivals decreased by 14.2% last year which had a significant impact on overall growth, which halved to 1.9% from 3.8% in 2018, with growth largely due to residential investments and exports of intellectual property. The unemployment rate increased by 1.8 percentage points over last year to 3.9% in December 2019. With the disruption to tourism from the coronavirus outbreak, we expect tourist arrivals to drop by a further 25% in 2020 which assumes no arrivals for almost 3 months of the year, although there remains significant uncertainty around these estimates with the possibility of a more prolonged tourism slump posing downside risks to our growth forecasts.

At the same time, a decline in demand for exports of fresh fish will negatively impact Iceland's fishery sector, which account for 18% of the country's exports, further weakening economic momentum. While some of the exports may be replaced by demand for less expensive frozen fish, we still expect the value of fishing exports to be lower over the course of the year.

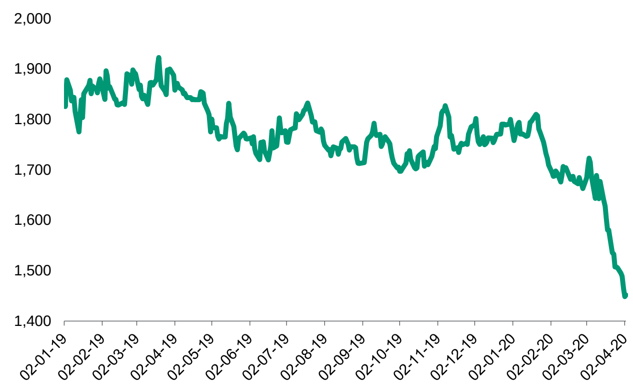
Finally, although Iceland's aluminium industry benefits from a comparative advantage in terms of low energy costs, the risk of a prolonged downturn in aluminium prices could threaten the long-term viability of plants. Rio Tinto (A2 stable), the operator of Iceland's third largest aluminium smelter, announced in February that it was undergoing a strategic review of its Icelandic operations and could cut production or shutdown its smelter as it struggles to generate profits. The company had already reduced production at the smelter to 85%. As outlined in our outlook for base metals, slower manufacturing activity will lead to inventory buildup, absent any mining or production curtailments, maintaining pressure on aluminium prices, which are down 19% since the first case of coronavirus was reported on 31 December 2019 (see Exhibit 5).

Exhibit 4
Drop in tourist arrivals will further weigh on the tourism industry
Traffic at Keflavik airport (daily number of passengers)



* On 20 March 2020, the government restricted tourist arrivals from countries outside the European Economic Area, the European Free Trade Association and the United Kingdom (Aa2 negative) until at least 17 April 2020.
Note: Wow Air passengers are excluded from 2019 numbers.
Source: Isavia, Moody's Investors Service

Exhibit 5
Aluminium prices have declined substantially since the outbreak
Aluminium high grade ($/metric ton)



Source: Factset, Moody's Investors Service

In addition to a significant supply shock, we expect all demand components, with the exception of public consumption, to experience a severe contraction, mostly concentrated in the second quarter. In line with our current expectation that the virus outbreak constitutes a severe but temporary dislocation, we expect the economy to recover partially in the second half of 2020 as the policy measures announced by the government (see below) help to support private consumption. While Iceland's labour market benefits from a large share of foreign workers, we expect much weaker economic activity will lead to an increase in unemployment, which had already been on an upward trend given last year's shock to the tourism sector, to reach around 8% by year end, from 3.3% in 2019.

We expect the economic recovery to be more gradual in Iceland compared to other countries which are not as exposed to tourism, and forecast real GDP growth to rise to 1.6% in 2021 while unemployment will fall but still remain elevated next year. That said, the underlying fundamentals of Iceland's economic model remain strong, supporting healthy medium-term growth, given its strong untapped potential in the tourism sector, still abundant stocks of fish and the comparative energy cost advantages of the Icelandic aluminium industry.

Iceland's fiscal headroom will help support its credit profile through a temporary deterioration of its fiscal metrics

The fiscal support package announced by the government on 21 March is estimated at around ISK230 billion (8% of GDP). The focus of the fiscal measures, as seen in other countries, is on avoiding large-scale labour shedding and corporate defaults as a result of temporarily lower revenue and liquidity problems. The measures announced include partial unemployment benefits for those unable to work, a deferral of corporate and property tax payments, withdrawals from voluntary pension savings and an ISK20 billion increase in planned public investment (see Exhibit 6). Moreover, the government will provide ISK81 billion in credit guarantees, which will be a contingent liability that does not affect its public finances directly and immediately.

Based on the announced measures to date, we expect the impact of additional fiscal expenditures of around ISK69 billion and lower tax revenues (from the economic contraction and tax deferrals) will be to weaken Iceland's fiscal performance in 2020 to a primary deficit of 2.5%, after a consistent track record of primary surpluses in recent years. These forecasts are, however, subject to considerable uncertainty as the evolution of the coronavirus outbreak could lead to additional support measures.

Iceland has seen a marked increase in its fiscal space in recent years, bringing its debt metrics below the median of A-rated peers, which will help its credit profile to withstand the resulting rise in the government debt ratio to 41.6% of GDP in 2020 from 36% in 2019. We see the risk of a much sharper increase in the debt-to-GDP ratio to be relatively contained, due in part to the substantial improvement in the structure of government debt that leaves it less exposed to currency fluctuations and sudden capital outflows.

Exhibit 6

Main measures of Iceland's response to the coronavirus outbreak

	ISK billion
Measures to support workers	
Partial unemployment benefits	22
Wages during quarantine	1
Supplementary child benefits	3
Third-pillar pension withdrawal	10
Measures to support businesses	
Bridge loans	81
Tax deferrals	75
Facilitation of imports	14
Measures to support the economy	
VAT refund for construction	8
Measures in tourism	5
Investment in 2020	20
Total	**237**

Source: Government of Iceland, Moody's Investors Service

The Central Bank of Iceland is also contributing to limit the effects of the coronavirus outbreak. It reduced its policy rate by 50 basis points (bps) on 11 March and by a further 100 bps on 18 March and the rate now stands at 1.75%. To further enhance banks' liquidity, the Housing Financing Fund (A3 stable) will transfer its deposits, which account for around 1% of GDP, from the central bank to commercial banks. Finally, the central bank also announced it would start a treasury bond purchase programme to support liquidity in funding markets.

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

				Initial	Final	Weights
				Factor score		
Factor 1: Economic strength				**baa2**	**baa2**	**50%**
Growth dynamics	Average real GDP growth (%)	2014-2023F	2.7	baa2		25%
	Volatility in real GDP growth (%)	2009-2018	4.1	caa2		10%
Scale of the economy	Nominal GDP ($ billion)	2018	25.7	b2		30%
National income	GDP per capita (PPP, Intl$)	2018	55,941	aaa		35%
Adjustment to factor 1	*# notches*				0	max ±9
Factor 2: Institutions and governance strength				**aa3**	**aa3**	**50%**
Quality of institutions	Quality of legislative and executive institutions			aa		20%
	Strength of civil society and the judiciary			aa		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				**a2**	**a2**	
Factor 3: Fiscal strength				**a2**	**a2**	
Debt burden	General government debt/GDP (%)	2018	38.8	a1		25%
	General government debt/revenue (%)	2018	90.1	aa2		25%
Debt affordability	General government interest payments/revenue (%)	2018	6.6	aa3		25%
	General government interest payments/GDP (%)	2018	2.9	baa2		25%
Specified adjustments	*Total of specified adjustment (# notches)*			-1	-1	max ±6
	Debt trend	2015-2020F	-23.4	0	0	
	Foreign currency debt/general government debt	2018	11.6	0	0	
	Other non-financial public sector debt/GDP	2018	21.1	-1	-1	
	Public sector assets/general government debt	2018	0.0	0	0	
Other adjustment to factor 3	*# notches*				0	max ±3
F1 x F2 x F3: Government financial strength				**a1**	**a1**	
Factor 4: Susceptibility to event risk				**baa**	**baa**	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				baa	baa	
	Risk of banking sector credit event (BSCE)	Latest available	--	baa3		
	Total domestic bank assets/GDP	2018	180.0	180-230		
Adjustment to F4 BSR	*# notches*				0	max ±2
External vulnerability risk				a	a	
	External vulnerability risk			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				**A1 - A3**	**A1 - A3**	

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

» **Outlook:** Global Macro Outlook 2020-21 (March 25, 2020 Update): The coronavirus will cause unprecedented shock to the global economy, 25 March 2020

» **Sector In-Depth:** Sovereigns – Global Coronavirus and oil price shock magnify weaknesses highlighted in negative 2020 outlook, 20 March 2020

» **Sector Comment:** Macroeconomics – Global: Global economy continues to slide as coronavirus outbreak worsens, 20 March 2020

» **Issuer in-Depth:** Government of Iceland: FAQ on recent credit developments, 12 December 2019

» **Outlook:** Sovereigns – Global: 2020 outlook is negative as unpredictable, disruptive political environment exacerbates credit challenges, 11 November 2019

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

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

» **Sector In-Depth:** Sovereigns – Global: Ageing-related credit pressure to rise in 2030s in advanced economies, 23 October 2019

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

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

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.

Endnotes

1 See **Wow Air's collapse poses downside risks for Iceland's 2019 economic growth, a credit negative**, 3 April 2019

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