Moody's

Rating Action: **Moody's changes outlook on Iceland's ratings to positive, affirms A2 ratings**

15 Jul 2023

London, July 14, 2023 -- Moody's Investors Service (Moody's) has today changed the outlook on Government of Iceland's ratings to positive from stable and affirmed the local and foreign-currency issuer ratings at A2. Concurrently, the foreign-currency senior unsecured rating has also been affirmed at A2, and the foreign-currency senior unsecured MTN program rating has been affirmed at (P)A2.

The key drivers for the outlook change to positive are:

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.

The affirmation of the A2 ratings balances the very high wealth levels and very strong institutions with the small size of the economy and elevated volatility of growth as a consequence. Despite the ongoing diversification efforts Iceland remains vulnerable to key sector-specific shocks, in particular to those that affect the tourism sector. Also, despite the recent and expected fiscal improvements, the Government of Iceland's debt metrics still compare unfavourably to peers.

The local-currency ceiling remains 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 ceiling remains unchanged at Aa2, one notch below the local-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 OUTLOOK CHANGE TO POSITIVE FROM STABLE

RAPID REDUCTION IN BUDGET DEFICIT AND DECLINE IN DEBT RATIO RAISE PROSPECTS FOR REBUILDING OF FISCAL BUFFERS

The Government of Iceland is rebuilding its fiscal buffers much more rapidly than expected, with the budget deficit declining faster than planned and the public debt ratio expected to be at 63.8% of GDP at the end of this year, 14 percentage points lower than at its peak in 2020. Solid public finances and low debt are more important for a small economy such as Iceland's which is vulnerable to sector-specific shocks.

The government recently decided to tighten its fiscal stance compared to its 2023 budget in an effort to support the central bank's disinflation efforts, targeting a deficit of just 1.3% of GDP for this year, compared to a target of 3% in the approved 2023 budget. For the general government (including local governments and the social security system), Moody's forecasts a budget deficit of 2% of GDP in 2023, less than half last year's shortfall of 4.3% of GDP.

The country's fiscal rules require the government to present a medium-term fiscal plan beside an annual budget. 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 an overall surplus in 2027. The government has announced that it will bring forward by a year to 2025 when the fiscal rules apply again.

Iceland's strong track record of sustained deficit reduction and the broad political acceptance of the medium-term fiscal framework give a high level of confidence that the targets will be achieved and possibly exceeded again. The country has strong fiscal rules in place now in contrast to the years prior to the global financial crisis when fiscal policy was much more discretionary and ad hoc, and generally overly expansionary.

INCREASED CHANCE THAT STRONG GROWTH OF KEY SECTORS AND ONGOING DIVERSIFICATION WILL REDUCE VULNERABILITY TO SHOCKS

The second driver for the outlook change to positive is Moody's expectation that the strong competitiveness of Iceland's key export sectors – tourism, fishing and energy-intensive industries such as aluminium smelting – will allow the country to recover swiftly from shocks in the future, as has been seen in the aftermath of the pandemic. Moreover, efforts to diversify the economic base are showing progress, in particular in pharmaceuticals, information technology and also aquaculture.

Iceland's growth prospects are further supported by strong immigration of predominantly working-age population groups. Real GDP growth averaged 5.4% over 2021-2022, supported by very strong growth in exports, investment and private consumption. Iceland's energy independence has guarded it against being affected directly by the economic impact of Russia's invasion of Ukraine (Government of Ukraine, Ca stable).

Moody's expects the economy to continue to grow at a robust rate of around 4% this year. Following very strong GDP growth of 6.1% in the first quarter of this year, Moody's expects domestic demand to cool down significantly, reflecting tighter monetary and also fiscal policy, while exports will continue to expand strongly. The significant monetary tightening – the Central Bank of Iceland has raised its key policy rates by a full eight percentage points to 8.75% since May 2021 – has started to cool the overheated housing market. Moody's estimates Iceland's growth potential at 2.2-2.5% which is higher than that of many other advanced economies.

Iceland's resilience to economic shocks is further underpinned by the household sector's strong balance sheet with very large pension assets which amount to 183% of GDP as of 2021 and comparatively low debt levels. At times of crisis – such as the pandemic shock – the government is able to authorize a temporary withdrawal from voluntary third-pillar pension savings, which supports household incomes and consumption.

A third aspect of Iceland's resilience to shocks comes from the very large foreign-currency reserves that the central bank has built up since the banking crisis in 2008. Reserves amount to around 20% of GDP, allowing the central bank to contain currency volatility and provide foreign-currency liquidity in a stress situation. External debt is low and the country as a whole has turned into a net external creditor, to the tune of 20-25% of GDP, in sharp contrast to the period before the 2008 banking crisis.

RATIONALE FOR AFFIRMATION OF A2 RATING

The affirmation of the A2 ratings balances the very high wealth levels and very strong institutions with the small size of the economy, limited diversification and consequently high sensitivity to external shocks. Despite the ongoing diversification efforts, Iceland remains vulnerable to sector-specific shocks, in particular to those that affect tourism, which accounts for a third of exports and 9% of domestic employment.

Also, despite the recent and expected fiscal improvements, the Government of Iceland's debt metrics compare unfavourably to peers. General government debt was at 68.7% of GDP last year, compared to a median of 49% of GDP for A-rated sovereigns. Also, around 25% of the government's outstanding debt is in the form of inflation-indexed bonds, leading to somewhat weaker debt affordability metrics than higher rated peers. An early resolution of the government guarantee for the financial obligations of the HF Fund (A2 stable) could result in a sharp reduction of the government debt ratio, given that Moody's currently includes the full value of the guarantee into the government's debt metrics. The HF Fund's debt amounts to close to 20% of GDP. The government aims to reach a consensual agreement on an early settlement of the guarantee with the HF Fund's bondholders, the large majority of which are the country's pension funds.

The Government of Iceland spends around 6.6% of its revenues on debt interest, compared to a median ratio of 2.8% for A-rated peers. Moody's expects the ratio to start declining from this year onwards as inflation declines on the back of tighter monetary policy. Slower-than-expected progress in reducing inflation presents a risk for the public finances but also for the upcoming wage negotiations.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Iceland's ESG Credit Impact Score is neutral to low (CIS-2), reflecting low exposure to environmental risks, limited social risks and very strong governance and forward-looking policymaking.

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.

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.

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$): 66,512 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 6.4% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 9.6% (2022)

Gen. Gov. Financial Balance/GDP: -4.3% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.6% (2022) (also known as External Balance)

External debt/GDP: 74.1% (2022)

Economic resiliency: a1

Default history: No default events (on bonds or loans) have been recorded since 1983, the year Moody's database started.

On 11 July 2023, a rating committee was called to discuss the rating of the Government of Iceland. 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, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially increased. The issuer's susceptibility to event risks has not materially changed.

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

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 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 Moody's 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.

The outlook would likely be returned to stable if Moody's 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.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at

https://ratings.moodys.com/rmc-documents/395819. Alternatively, please see the Rating Methodologies page on https://ratings.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 on https://ratings.moodys.com/rating-definitions.

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