MOODY'S INVESTORS SERVICE

ISSUER IN-DEPTH
25 August 2021

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RATINGS

**Iceland**

| | Foreign Currency | Local Currency |
|---|---|---|
| Gov. Bond Rating | A2/STA | A2/STA |
| Country Ceiling | Aa2 | Aa1 |

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Analyst Contacts

Kathrin Muehlbronner +44.20.7772.1383
*Senior Vice President*
kathrin.muehlbronner@moodys.com

Lenaic Couderc +44.20.7772.1799
*Associate Analyst*
lenaic.couderc@moodys.com

Dietmar Hornung +49.69.70730.790
*Associate Managing Director*
dietmar.hornung@moodys.com

Alejandro Olivo +1.212.553.3837
*Managing Director*
alejandro.olivo@moodys.com



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# Government of Iceland - A2 Stable

## Annual credit analysis

## OVERVIEW AND OUTLOOK

Iceland's credit strengths include the economy's flexibility, wealth, competitiveness and favourable demographics, all of which support its long-term growth prospects and help it to absorb shocks. The country's track record of effective macroeconomic management since its crisis in 2008 and carefully managed capital-account liberalization with minimal disruption in recent years underpin its strong institutions. Fiscal strength has been bolstered by the substantial decline in the government's debt burden over the past few years, notwithstanding the pandemic-induced reversal last year. A consistent net external creditor position and very large foreign-currency reserves help buffer against external shocks.

Iceland's main credit weakness is the economy's concentration in a limited number of sectors, which increases its vulnerability to sector-specific shocks. The coronavirus outbreak and its impact on the key tourism sector have led to a deep but temporary contraction. The sector is showing signs of recovery, but it remains at risk of renewed disruption. In our baseline scenario we expect the recovery to gather pace into next year, helped by the authorities' strong and swift policy action, high wealth buffers and stronger-than-expected resilience of Iceland's other key industries.

The government's debt burden has risen markedly to close to 80% of GDP in 2020, and no longer distinguishes Iceland positively from similarly rated peers. But Iceland's strong fiscal track record over the past years coupled with a solid medium-term fiscal framework give confidence that the debt burden will be reduced again over the coming years. Part of the higher debt load also reflects the reclassification of several public companies into the general government perimeter, which improves transparency without raising fiscal risks.

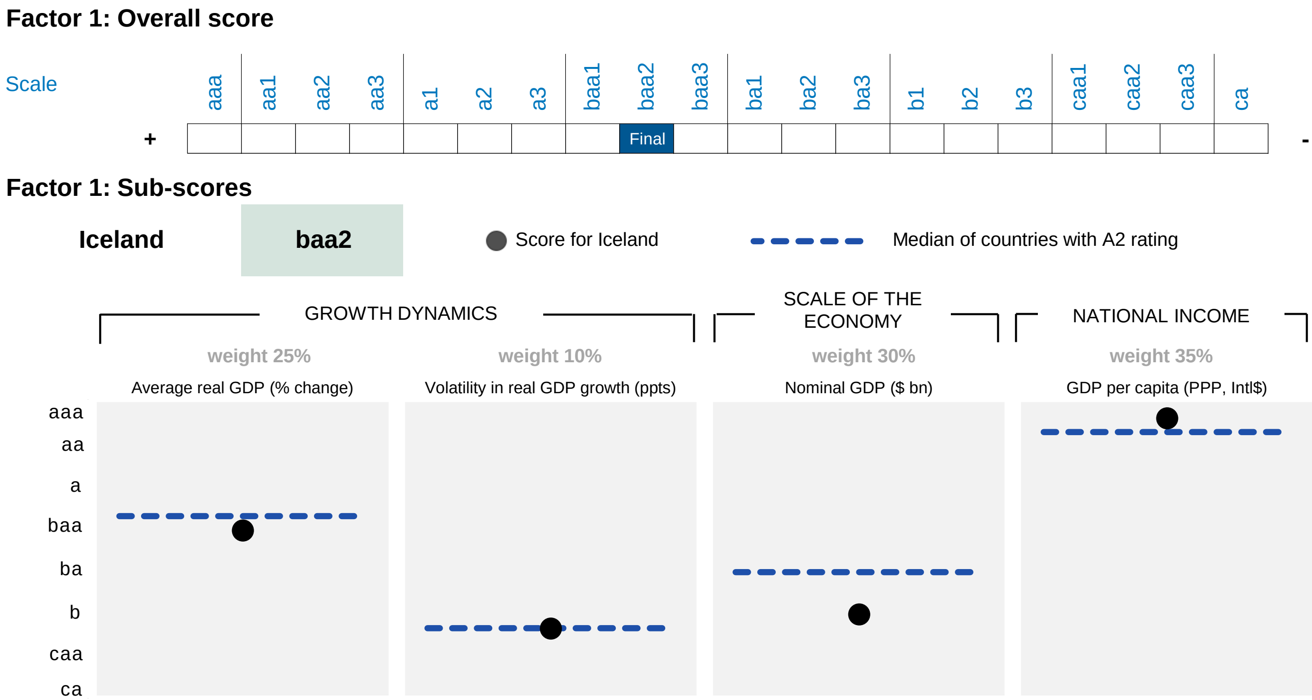
Iceland's rating would be upgraded in case of faster-than-expected progress in restoring the government's fiscal buffers. A push towards increased diversification leading to a less volatile economic performance would also be positive for the rating. Conversely, the rating would come under downward pressure if the government deviated significantly from its fiscal consolidation plan that aims to stabilise public debt by the middle of the decade, resulting in a continuous 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.

This credit analysis elaborates on Iceland's credit profile in terms of economic strength, institutions and governance strength, fiscal strength and susceptibility to event risk, which are the four main analytic factors in our Sovereign Ratings Methodology.

## CREDIT PROFILE

Our determination of a sovereign's government bond rating is based on the consideration of four rating factors: Economic strength, institutions and governance strength, fiscal strength and susceptibility to event risk. When a direct and imminent threat becomes a constraint, that can only lower the scorecard-indicated outcome. For more information please see our Sovereign Ratings Methodology.

### Economic strength score: baa2




Economic strength evaluates the economic structure, primarily reflected in economic growth, the scale of the economy and wealth, as well as in structural factors that point to a country's long-term economic robustness and shock-absorption capacity. Adjustments to the economic strength factor score most often reflect our judgement regarding the economy's flexibility, diversity, productivity and labour supply challenges.
*Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.*

We assess Iceland's economic strength as "baa2", which balances the country's small size and history of boom and bust episodes with its very high wealth levels and strong competitiveness in its core industries. Other sovereigns with the same assessment of economic strength include Latvia (A3 stable) and Peru (A3 negative).

Exhibit 1

**Peer comparison table factor 1: Economic strength**

| | Iceland | baa2 Median | Latvia | Peru | Macao | Estonia | Malta | Cyprus |
|---|---|---|---|---|---|---|---|---|
| | A2/STA | | A3/STA | A3/NEG | Aa3/STA | A1/STA | A2/NEG | Ba1/STA |
| **Final score** | baa2 | | baa2 | baa2 | baa2 | baa1 | baa1 | baa3 |
| **Initial score** | baa2 | | baa2 | baa3 | a3 | baa1 | baa2 | baa2 |
| Nominal GDP ($ billion) | 21.7 | 125.0 | 33.4 | 205.5 | 24.3 | 31.0 | 14.5 | 23.8 |
| GDP per capita (PPP, Intl$) | 55,965.8 | 27,453.1 | 31,509.1 | 11,871.2 | 56,077.9 | 37,745.1 | 42,856.4 | 40,107.1 |
| Average real GDP (% change) | 3.0 | 2.8 | 2.6 | 2.7 | 5.8 | 3.3 | 3.8 | 3.2 |
| Volatility in real GDP growth (ppts) | 3.6 | 3.1 | 2.7 | 5.0 | 22.1 | 2.8 | 5.0 | 4.7 |

*Source: National authorities, IMF, Moody's Investors Service*

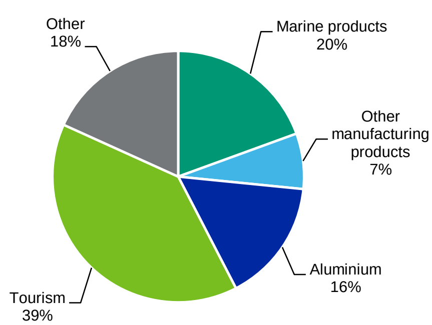
### Iceland's wealth and competitiveness mitigate the economy's small size and concentration

With nominal GDP of $21.7 billion in 2020, Iceland's economy is one of the smallest among the sovereigns we rate. Growth is also volatile, reflecting limited diversification and relatively high openness, which increases the economy's vulnerability to sector-specific and external shocks. Exports and imports accounted for 45% and 41% of GDP, respectively, in 2019 and over 70% of the country's export revenues come from three sectors: tourism (39% of total export revenues), marine products (20% of total export revenues) and aluminum (16% of total export revenues) (see Exhibit 2).

At the same time, the economy is susceptible to environmental risks, such as the potential for natural disasters to interrupt tourism or for ocean warming to disrupt fishing stocks. For example, in 2019, real GDP growth slowed to 2.6% from the average of close to 5% in the previous four years because of a combination of negative events in all three sectors: the collapse of a low-cost airline that affected the tourism industry, production issues at one of the aluminium smelters, and a ban on capelin catch so as to allow for the replenishment of fishing stocks.[1]

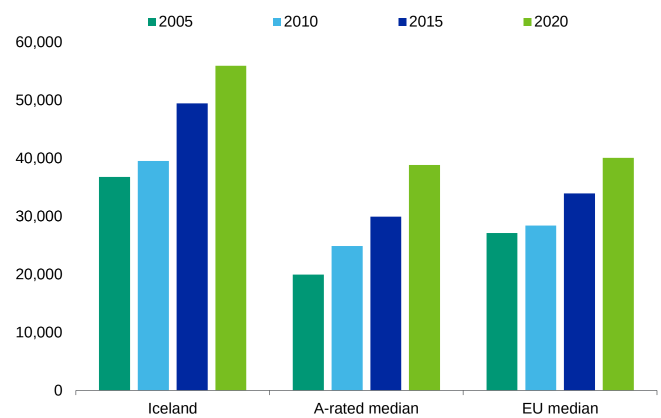
These challenges are mitigated by very high income levels, which are also comparatively evenly distributed.[2] GDP per-capita on a purchasing power parity basis stood at $55,966 in 2020, much higher than the median for A-rated sovereigns of $38,807 and the 16th highest in our rating universe (see Exhibit 3). In addition, Iceland stands out for the size of its accumulated pension savings, which together with high income levels provide an important shock absorber, as demonstrated during the banking crisis and again during last year's pandemic (more detail below).

Exhibit 2
**Three sectors dominate Iceland's exports**
**Exports of goods and services by sector (2019)**




*Sources: Statistics Iceland, Moody's Investors Service*

Exhibit 3
**Iceland's high income levels act as an important shock absorber**
**GDP per capita PPP (US$)**




*Source: IMF and Moody's Investors Service*

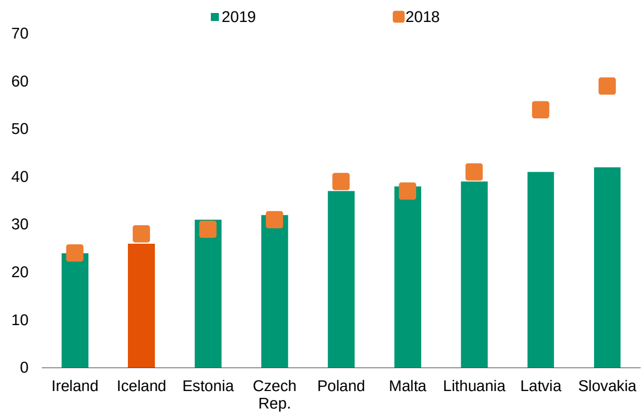
Iceland's economy is highly competitive, as demonstrated by its 26th position in the World Economic Forum's 2019 Global Competitiveness Index (see Exhibit 4). The country fares particularly well compared to peers on its institutions, technological readiness, educational environment and labour market efficiency. Iceland's demographic profile is also more favourable than in many other countries — particularly compared to continental Europe — because of exceptionally long working lives, higher fertility rates, a high participation of women to the labour force and the flexibility of the labour market. Iceland's old-age dependency ratio — defined as ratio of population aged 65+ divided by the population aged 20-64 — is projected to remain lower than all EU sovereigns over the next two decades (see Exhibit 5).[3]

### The pandemic has caused deep shock to tourism, other sectors are less affected

Despite low fatalities and a successful vaccination campaign, Iceland's economy has been deeply affected by the collapse in tourism driven by the pandemic. The sector directly and indirectly accounted for 22.8% of Iceland's GDP in 2019, 20% of employment and 30% of total exports according to the World Travel and Tourism Council (WTTC).[4] Overall, real GDP contracted 6.6% last year, which was among the larger drops recorded by advanced economies but less than feared initially because Iceland's other key industries have performed reasonably well.

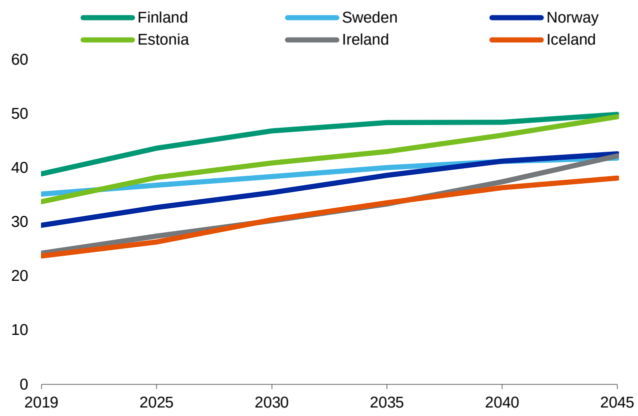
Other sectors benefitted from a weaker currency and in the fisheries sector from a high degree of flexibility, with fishing companies adapting their processes to freeze more fish. The value of marine exports increased by 3.7% last year, despite a 2.5% decline in export volumes. Similarly, the aluminium sector benefitted from increasing prices linked to the early recovery in China (A1 stable), with exports only down by 2% last year. Thus, despite the economy's limited diversification - with the three sectors accounting for 14% of gross value added (GVA) and 75% of exports - they generally follow very different business cycles.

Exhibit 4
**Iceland's economy is highly competitive compared to peers**
**Global Competitiveness Index (rank)**




Note: lower rank = higher competitiveness
*Sources: World Economic Forum, Moody's Investors Service*

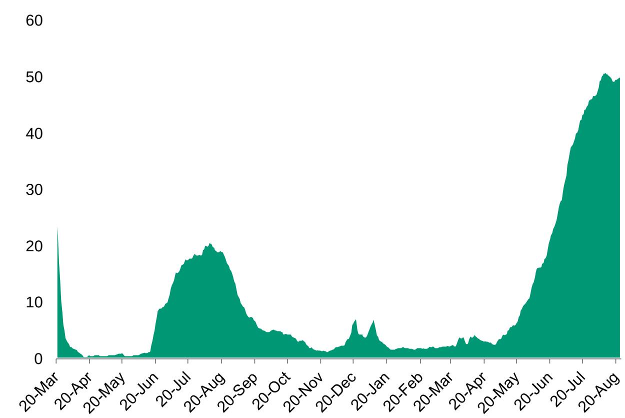
Exhibit 5
**Iceland is less exposed to population ageing than peers**
**Old-age dependency ratio (65+ / 20-64)**




*Source: 2020 Ageing Report, Statistics Iceland and Moody's Investors Service*

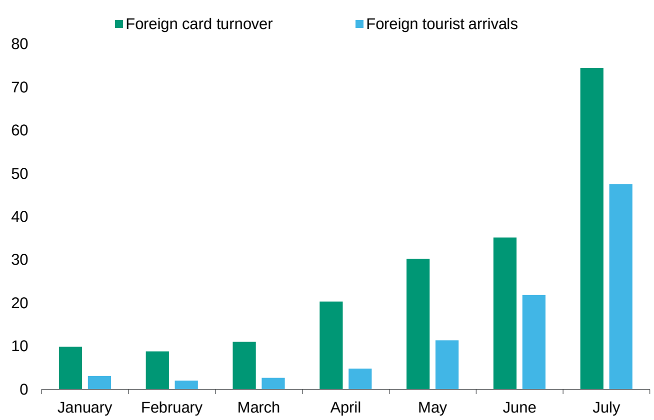
The tourism sector is now seeing the first signs of improvement since Iceland opened its borders to tourists that have been vaccinated or recovered from the disease in March 2021 (see Exhibit 6). In particular, the strong vaccination drive in the United States (US, Aaa stable), Iceland's key source market accounting for 18% of tourists in 2019, has led to a pick up in tourism demand to around 47% of 2019 levels in July. Tourists are also spending more, limiting the overall impact (see Exhibit 7). Other key sources markets such as the United Kingdom (Aa3 stable) and the member states of the EU (Aaa stable) have also started to relax travel restrictions. However, a full recovery of the sector is unlikely before 2023 and the spread of new variants constitutes a key risk to the speed of the recovery.

Exhibit 6
**Tourism is resuming after a year of low activity**
**Scheduled arrivals at Keflavik airport (7-day rolling average)**




*Source: Keflavik Airport and Moody's Investors Service*

Exhibit 7
**Tourists are spending more**
**Share of 2019 levels (%)**




*Source: Centre for Retail Studies, Icelandic Tourist Board and Moody's Investors Service*

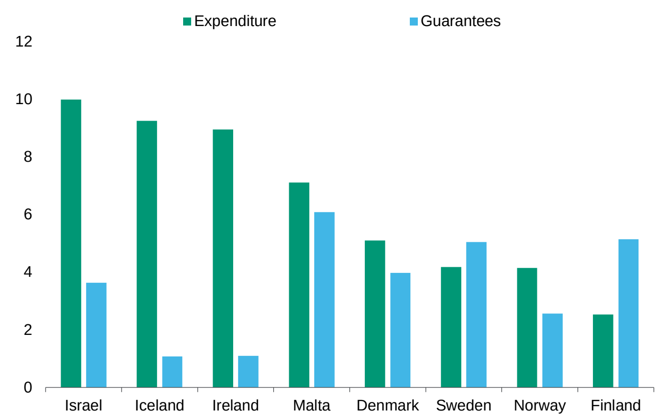
### Strong policy action and large buffers support recovery

Last year's contraction was also smaller than initially feared because domestic demand held up better than expected, thanks to a swift and comparatively large and well-coordinated policy response. Overall, the IMF estimates the government's fiscal response to exceed 9% of GDP, encompassing direct support measures, full use of automatic stabilizers, tax deferrals and guarantees (see Exhibit 8).

The central bank (CBI) reduced its policy interest rate by 200 basis points to 0.75%, lowered reserve requirements by one percentage point and in its role as macroprudential authority set the countercyclical capital buffer for banks at zero (from 2% before). It also announced a government bond-buying programme of up to ISK150 billion (5% of GDP or 20% of Treasury bonds outstanding at the end of 2019), which supported confidence and low interest rates when uncertainty was highest. Interventions were used to limit ISK volatility while facilitating capital outflows by foreign investors (of around 2.6% of GDP between March and December 2020); the currency quickly recovered again after a drop of 20% in April 2020. The country's pension funds also suspended foreign investments for a six-months period to contain pressure on the currency.

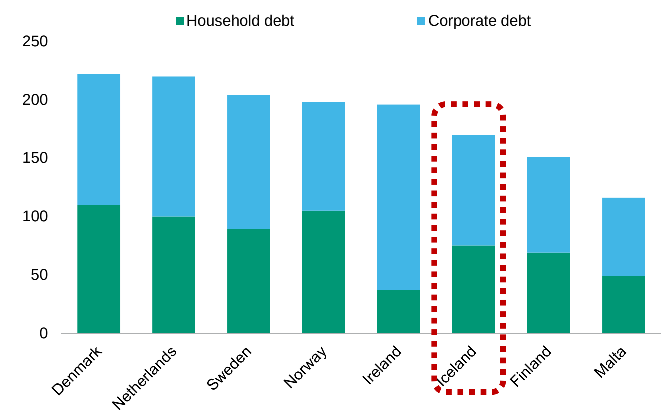
The authorities were able to implement such a large programme because public debt was low and the country had accumulated sizeable foreign-currency reserves before the pandemic hit. Also, private-sector debt had declined materially since the 2008 banking crisis and the banks are well capitalized. Pension system assets amount to around 200% of GDP, similar to Denmark (Aaa stable) and the Netherlands (Aaa stable) and much higher than most other OECD countries. Last year, households were allowed to make additional withdrawals from the voluntary third-pillar, amounting to close to 1% of GDP.[5]

Exhibit 8
**Fiscal response was one of the largest among peers**
**% of GDP in 2020**




*Source: IMF and Moody's Investors Service*

Exhibit 9
**Private sector is less leveraged than peers**
**Latest (% of GDP)**



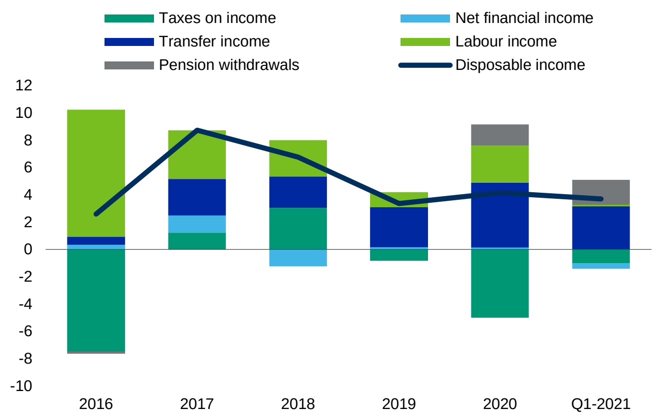

*Source: Eurostat, Statistics Iceland and Moody's Investors Service*

On the back of substantial policy support, the economy has started to show clear signs of recovery over the past few months beyond the tourism industry. We expect full-year growth of 3.4% this year and a much stronger 5% next year, with most of the tourism recovery expected to happen in 2022.[6]

In particular, we expect robust private consumption growth in the second half of this year, with households benefitting from an improving labour market and solid real wage growth of around 6%. As part of the multi-year tax reforms decided in 2019, personal income tax is being reduced further this year, focused on low-income households, with an estimated impact on government revenues of 0.7% of GDP, and several pandemic-related support mechanisms remain in place or have been extended until later this year.[7]Households can continue to withdraw savings from their voluntary third-pillar pensions this year, albeit to a smaller extent than in 2020.

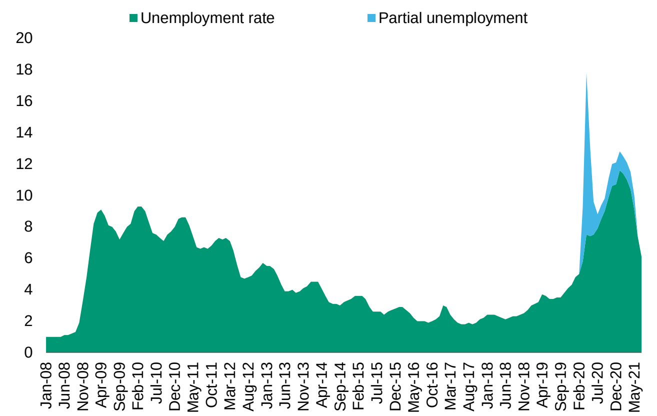
In the first quarter of 2021, household disposable incomes have risen by 4% in real terms compared to a year earlier, similar to the increase in 2020 and stronger than in 2019 (see Exhibit 10). The registered unemployment rate has declined to 6.1% in July (in non-seasonally adjusted terms) compared to the peak at 11.6% in January this year, while consumer confidence has risen to the highest level in many years in May and June, coinciding with the lifting of all restrictions on economic and social activities. Infection control has also been much stronger in Iceland than elsewhere with very few cases reported throughout June and a vaccination uptake among the highest in the world with over 90% of the adult population having received at least one dose as of mid-August 2021. However, cases have spiked again in recent weeks.

Exhibit 10
**Strong policy response limited the pandemic's impact on household incomes**
**Real disposable income (year-on-year % change)**




*Source: Statistics Iceland and Moody's Investors Service*

Exhibit 11
**Unemployment has declined sharply from peak in January**
**%**



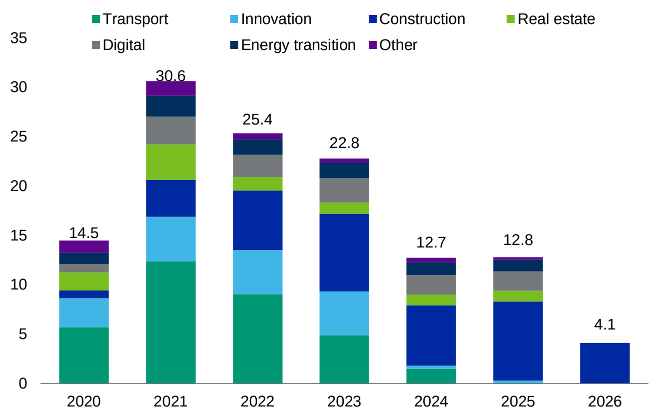

*Source: Directorate of Labour and Moody's Investors Service*

Moreover, the government's investment plan will gather pace this year after some delays in 2020, with ISK31 billion (1% of GDP) in investments planned and a focus on infrastructure, research and innovation (see Exhibit 12). The public investment program will continue until 2025, with average annual investments of around 0.5% of GDP. The OECD estimates the impact on per-capita GDP at around 1.5 percentage points (ppts) of GDP over a 10-year horizon. In addition, the government will provide tax incentives for private-sector research and development (R&D) investment which has risen sharply in recent years and bodes well for future economic growth. Overall, private investment should recover at a solid pace this year and in the coming years.

From the production side, the aluminium sector should continue to benefit from the rebound in commodity prices (see Exhibit 13). Rio Tinto (A2 stable), the operator of Iceland's third-largest aluminium smelter, reversed course in February over the strategic review of its operations in the country after striking a deal with power generation company Landsvirkjun (Baa1 stable) and now expects to ramp-up production. Iceland's aquaculture sector, though still small, has continued to grow despite the pandemic with a 13.1% increase in exports in 2020 with significant investment underway to increase the productive capacity. Higher aquaculture exports will help counteract variations in fishing quotas that have impacted GDP growth in recent years and provide significant opportunities for economic diversification.

Exhibit 12

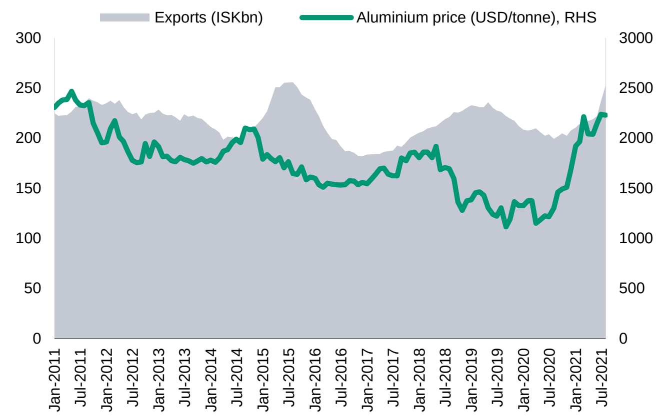
**Large public investment programme will support recovery and growth potential**
**ISK billion**




*Sources: Statistics Iceland, Fisheries Iceland and Moody's Investors Service*

Exhibit 13

**Higher aluminium price should support the sector's performance**




*Source: Statistics Iceland, Financial Times and Moody's Investors Service*

Earlier concerns over the economic impact of Brexit have been allayed by a new free trade agreement with the UK signed in early July 2021 that ensures access to the UK market on similar terms to before. The UK is Iceland's second-largest trading partner, accounting for a significant share of marine exports, and an important source of tourism.

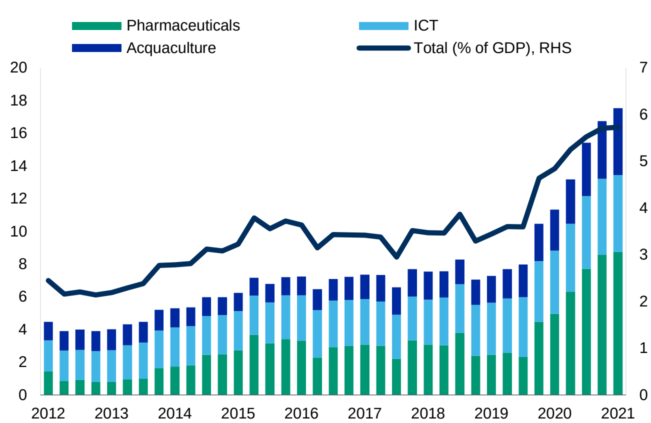
### Longer-term focus on economic diversification strategy

The overarching aim of the government's public investment programme 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 (see Exhibit 14). For the latter, a key comparative advantage is Iceland's cheap renewable energy and cool, windy climate (important for data processing and storage). The pandemic will probably also accelerate the trend towards high-value added segments to ensure the sustainability of tourism, which had already started before the pandemic.

The IMF notes that Iceland is well ahead of many other advanced economies in terms of digital skills and infrastructure and ICT adoption, and thus has scope to boost value added in ICT sectors further (see Exhibit 15). The government's tax incentives for private-sector R&D investment and the recently created public venture capital fund should help in this regard.

Exhibit 14

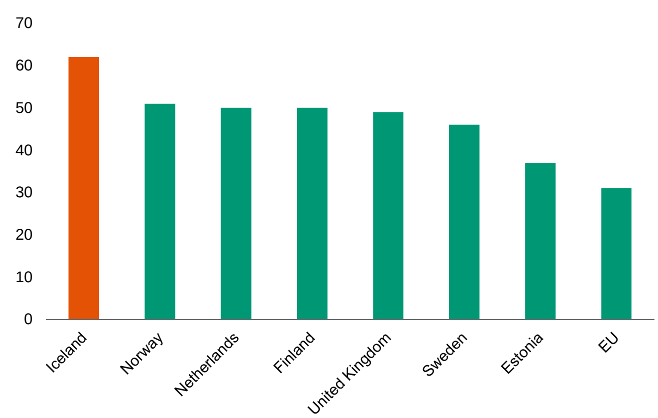
**Some sectors offer diversification opportunities**
**4-quarter rolling exports (% of total exports)**




*Source: Statistics Iceland and Moody's Investors Service*

Exhibit 15

**Iceland is ahead of peers in terms of ICT adoption**
**Adults with above basic digital skills (% of total)**



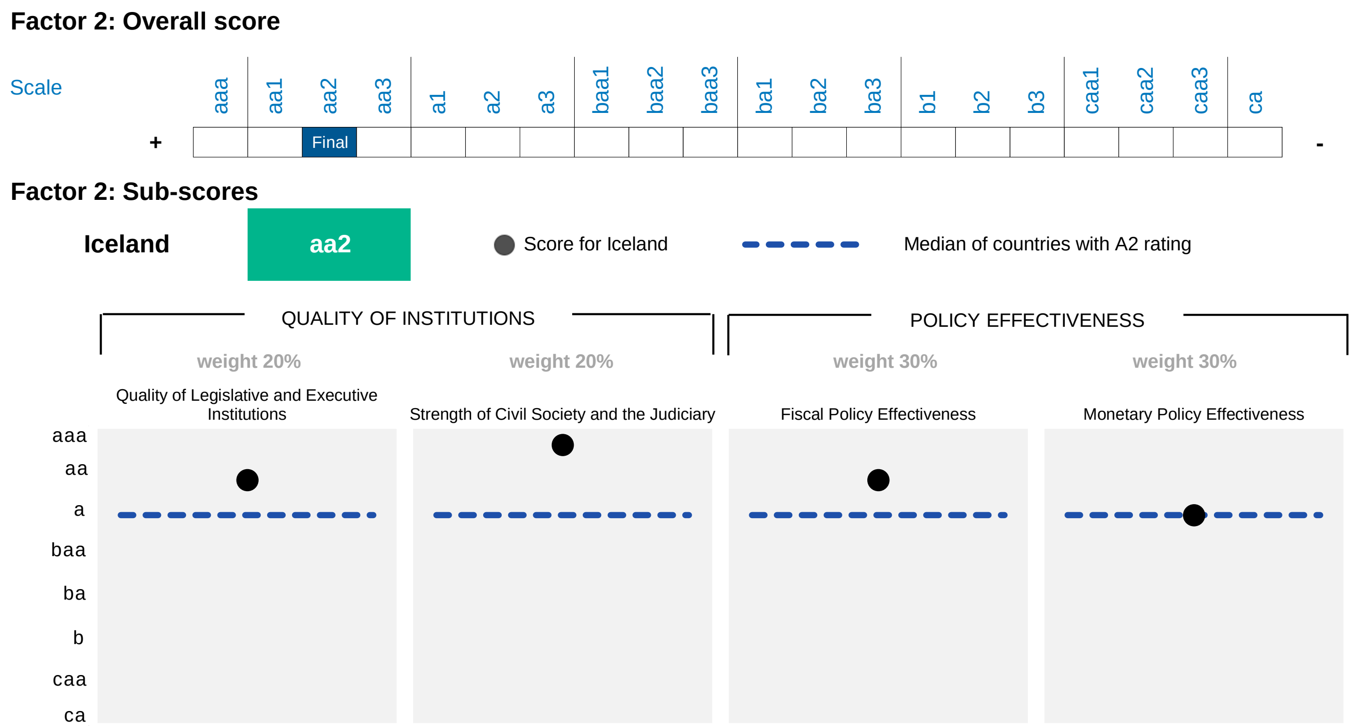

*Source: Eurostat and Moody's Investors Service*

Also, Iceland's labour market is flexible, with a diverse labour force and high labour participation rates, and the highly centralized wage bargaining system has proven to be swift and flexible in past crises. Strong wage increases in the past have raised concerns over declining price competitiveness and an increasing misalignment between wages and productivity growth, but the latest three-year wage agreement from 2019 is generally considered to have helped support private consumption during the pandemic. That said, both the OECD and the IMF advocate linking future wage increases more directly to productivity growth rather than growth in per-capita income as in the 2019 wage agreement.

Materially changing the structure of the economy will take time, and the three key sectors – tourism, marine products and aluminum – will likely remain dominant over the medium term. The IMF and the OECD point to other areas that could help Iceland to further raise its growth potential, in particular by improving education outcomes. Iceland's spending on education is similar to other countries but educational attainment lags other high-income peers. An education reform is ongoing and the government has recently announced a retraining and upskilling programme for professions in short supply. The government also plans to ease access to work permits for high-skilled workers from outside the European Economic Area, to ease labour shortages.

The two institutions also point to stringent regulations, in particular in tourism and construction, that tend to stifle competition. Barriers to entry are high, and administrative burdens and an extensive licensing and permit system protect incumbents and slow new and innovative start-ups. The OECD estimates that reducing administrative burdens would raise per-capita GDP by 1 percentage point over a 10-year period.[8].

## Institutions and governance strength score: aa2




Institutions and governance strength evaluates whether the country's institutional features are conducive to supporting a country's ability and willingness to repay its debt. A related aspect is the government's capacity to conduct sound economic policies that foster economic growth and prosperity. Institutions and governance strength is most often adjusted for the track record of default, which can only lower the final score.
*Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.*

Our assessment of Iceland's institutions and governance strength as "aa2" is supported by the country's strong scores in the Worldwide Governance Indicators (WGI) and a track record of effective macroeconomic management to restore economic and financial stability after the banking crisis. The latter was demonstrated by the careful liberalization of the capital account and the increased maturation of financial regulation and supervision in line with global best practices. The reforms introduced following the crisis have also strengthened the macro-policy mix.

Iceland's institutions have proven their solidity in the pandemic with a well-thought out and coordinated policy response. The health response was good with fast containment measures, good progress on vaccination and generally good and transparent policies and guidelines. Other sovereigns with the same assessment of institutional strength include Austria (Aa1 stable) and Ireland (A2 positive).

Exhibit 16

**Peer comparison table factor 2: Institutions and governance strength**

| | Iceland A2/STA | aa2 Median | Austria Aa1/STA | Belgium Aa3/STA | Ireland A2/POS | Switzerland Aaa/STA | Chile A1/NEG | Estonia A1/STA |
|---|---|---|---|---|---|---|---|---|
| **Final score** | aa2 | | aa2 | aa2 | aa2 | aa1 | aa3 | aa3 |
| **Initial score** | aa2 | | aa2 | aa2 | aa2 | aa1 | aa3 | aa3 |
| Quality of legislative & executive institutions | aa | aa | aa | aa | aa | aa | aa | aa |
| Strength of civil society & judiciary | aaa | aaa | aaa | aa | aa | aaa | a | a |
| Fiscal policy effectiveness | aa | aa | aa | aa | aa | aaa | a | aaa |
| Monetary & macro policy effectiveness | a | aa | aa | aa | aa | aa | aa | a |
| Fiscal balance/GDP (3-year average) | -8.2 | -7.9 | -6.6 | -8.2 | -4.2 | -1.2 | -5.2 | -4.8 |
| Average inflation (% change) | 2.6 | 1.7 | 1.8 | 1.7 | 1.0 | 0.5 | 2.8 | 2.0 |
| Volatility of inflation (ppts) | 1.2 | 0.8 | 0.8 | 1.0 | 0.7 | 0.6 | 1.0 | 2.0 |

*Source: National authorities, World Bank, Moody's Investors Service*

**Robust survey scores demonstrate Iceland's strengthened institutions**

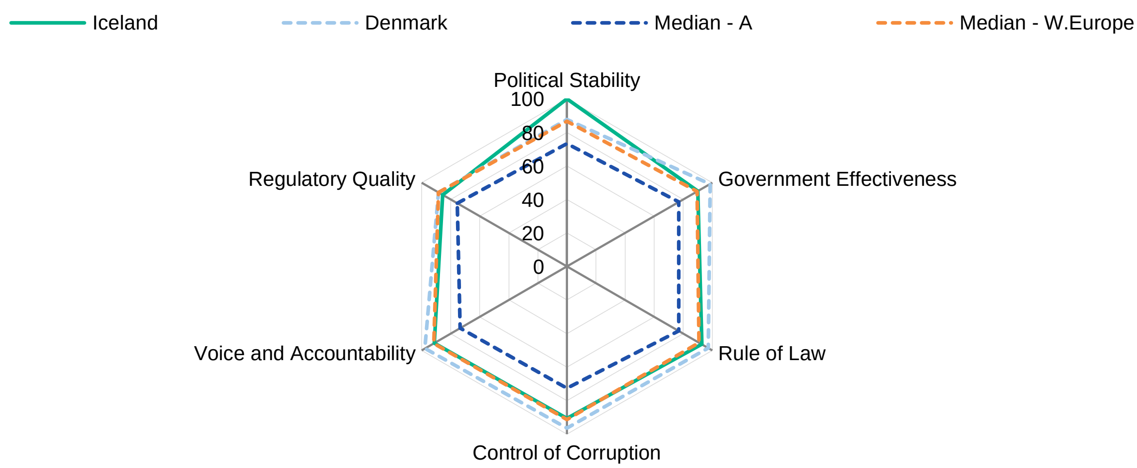
Iceland ranks highly compared to A-rated peers on the Worldwide Governance Indicators (WGI), supporting our strong assessment of the country's institutions. It ranks in the 90th percentile of the WGI's measure of government effectiveness and 86th for regulatory quality, reflecting its highly professional and capable public administration as well as a transparent and predictable legislative framework, underpinning our "aa" assessment for the quality of legislative and executive institutions although key economic data series can be subject to large revisions.

Furthermore, Iceland's rankings in the 91st percentile for control of corruption and 93rd percentile for rule of law reflect limited instances of corruption and that society acts as an effective check on the exercise of government power, supporting our "aaa" assessment for the strength of the civil society and the judiciary. Iceland also scores very strongly on political stability given its long tradition of broad cooperation and consensus on economic matters between the government, employers and employee associations, which contribute positively to policy effectiveness.

Exhibit 17

**Iceland's governance indicators rank above A-rated peers**

**Percentile rank among our rating universe (2019)**




*Source: Worldwide Governance Indicators and Moody's Investors Service*

Following the collapse of the banking system in 2008, the authorities have made significant progress in bringing the economy, the financial system and public finances back onto a sustainable path. In conjunction with a three-year IMF Stand-By Arrangement and post-monitoring programmes, the authorities introduced a number of reforms, such as revised fiscal and monetary policy frameworks, a flexible exchange rate and significant improvements to banking system supervision and regulation to prevent such distortions from happening again. On 1 January 2020, the central bank and the Financial Stability Authority were merged, with the aim to achieve greater efficiency, operational independence, and powers in financial oversight.

A further example of Iceland's strengthened institutions is the swift reaction to the country being placed on the grey list of the Financial Action Task Force (FATF) in October 2019 for gaps in its anti-money laundering framework. In October 2020 already, Iceland was removed from the grey list, having implemented the FATF's required actions such as ensuring the availability of accurate beneficial ownership information and strengthening the monitoring of financial institutions.

**Credible monetary policy framework allowed sizeable policy response to the pandemic shock**

The central bank reacted swiftly to the pandemic shock, using all available tools to provide liquidity while maintaining favourable funding conditions and limiting pressure on the currency. It had already gained significant credibility following a major revision of the monetary policy framework and its governance and decision-making structure, mostly implemented by 2012. The transparency of monetary policy decisions has been significantly enhanced and is now on par with other advanced economies with an inflation-targeting framework.[9]

In recent months, inflation has risen above the 2.5% target and upper limit of 4%, which mostly reflects the impact of earlier ISK depreciation and rising house prices (see Exhibit 18).[10] In July, consumer price inflation was 4.2% after peaking at 4.5% in April. The CBI has started to raise its key policy rate in May and August by a cumulative 50 basis points to 1.25%, one of the first central banks to do so, and earlier than domestic observers had expected. We expect further interest rate increases in the coming months, as near-term inflation expectations have recently risen (see Exhibit 19).

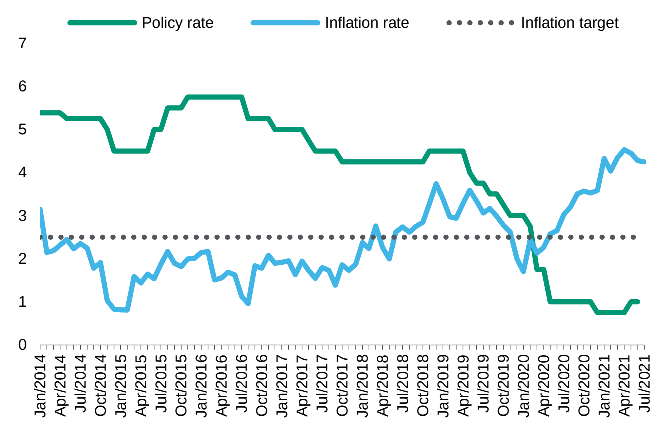
However, longer-term inflation expectations remain close to target, indicating continued confidence of economic actors that inflation will be brought back to target in the coming months. The CBI expects inflation to return to target from Q3/Q4 2022 onwards. Rising house prices warrant close monitoring and while real house prices are not materially out of sync with their long-term trend, the CBI has recently lowered the maximum loan-to-value (LTV) ratio to 80% from 85%. The average LTV ratio on new mortgages was substantially lower at 62% in January 2021 (65% in December 2019).

The recent inflation performance is in sharp contrast to Iceland's historic performance, when the CBI rarely managed to hit its inflation target. After the introduction of an inflation-targeting framework in March 2001, inflation was at or below the target in only 13 months between 2002 and 2013, generally moving between 4% and 7%, mostly because of exchange-rate volatility. Since 2014, inflation has been close to target and the standard deviation of inflation came down to 0.9 ppts for the 2014-2021 period, compared to a very high 4.1 ppts in 2007-2014.

Exhibit 18

**The central bank hiked its policy rate to counter rising inflation**

**%**

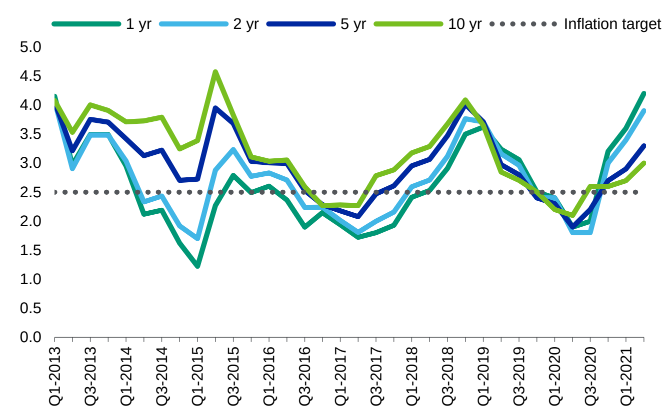



*Sources: Central Bank of Iceland and Moody's Investors Service*

Exhibit 19

**Longer-term inflation expectations remain well anchored**

**Breakeven inflation rate (%)**

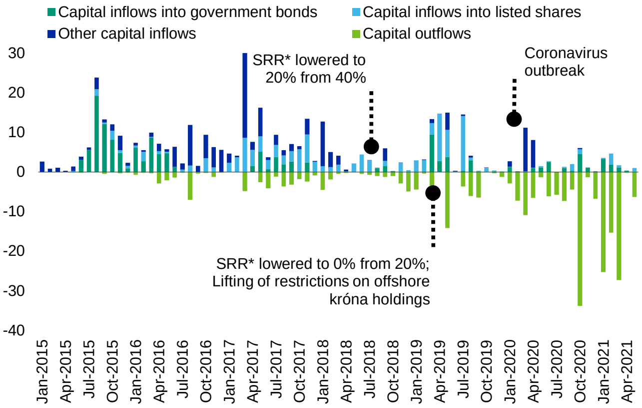



*Sources: Central Bank of Iceland and Moody's Investors Service*

In addition, the central bank's toolkit has been expanded, including transparent and clearly communicated foreign-currency interventions to smooth excessive ISK volatility because of the small size of the foreign-currency market (used since 2014). Foreign-currency reserves are very large at around 30% of GDP and significantly higher than the IMF's various reserve adequacy metrics. The decision of the large pension fund sector to refrain from purchasing foreign currency for six months also limited downward pressure on the exchange rate in a relatively shallow currency market.

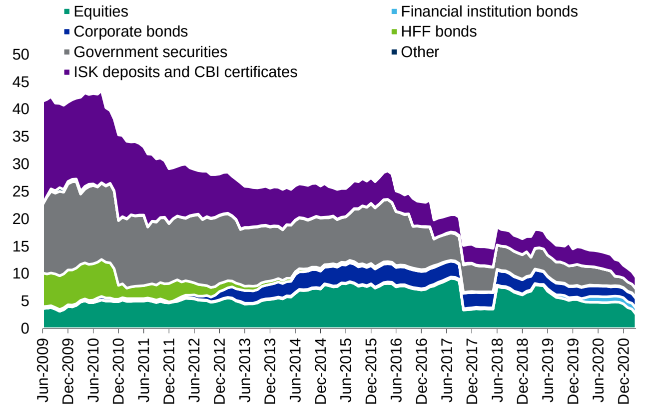
Moderate capital outflows over the past several months as some foreign investors have exited the country have been effectively managed without material disruption and exchange-rate pressures (see Exhibit 20). The share of foreign investors has declined to around 10% of GDP as of March 2021, compared to 15% at the end of 2019 and over 40% before 2010 (see Exhibit 21). Most capital controls were lifted in March 2019; the Foreign Exchange Act passed in June 2021 removed the last remaining restrictions on the capital account and paves the way for increased capital movements while providing tools to the central bank to limit the risks to financial stability of excessive flows.

Exhibit 20
### Outflows following the lifting of capital controls have remained limited
**ISK billion**




* SRR = Special Reserve Requirement. Data refer to new investments in Icelandic assets by foreigners.
*Sources: Central Bank of Iceland and Moody's Investors Service*

Exhibit 21
### Low levels of non-resident holdings reduce risk of disruptive capital outflows
**% of GDP**



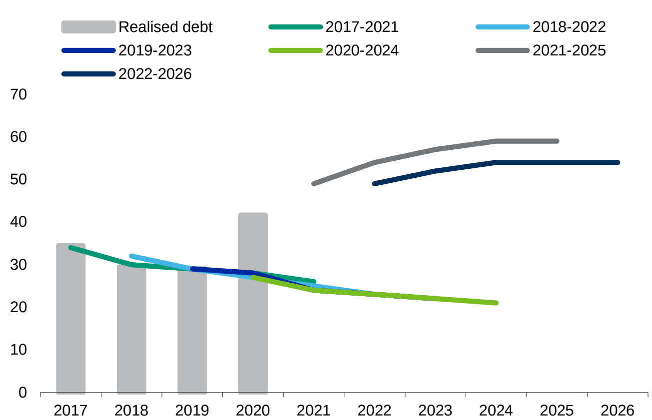

*Source: Central Bank of Iceland and Moody's Investors Service*

## Strengthening of the fiscal framework supports policy credibility and effectiveness

Before the banking crisis, weaknesses in the budgetary framework resulted in an often procyclical fiscal stance, weak budget discipline and inadequate surveillance and management of fiscal risks. However, a strong set of fiscal rules has been in place since the Organic Budget Law was passed in 2015. The rules target a balanced budget over a five-year horizon with a maximum deficit of 2.5% of GDP in any given year and a net debt ceiling of 30% of GDP.[11] The law also requires the government to publish a five-year Fiscal Policy Statement at the beginning of each electoral term, as well as a rolling five-year Fiscal Strategy Plan on an annual basis.

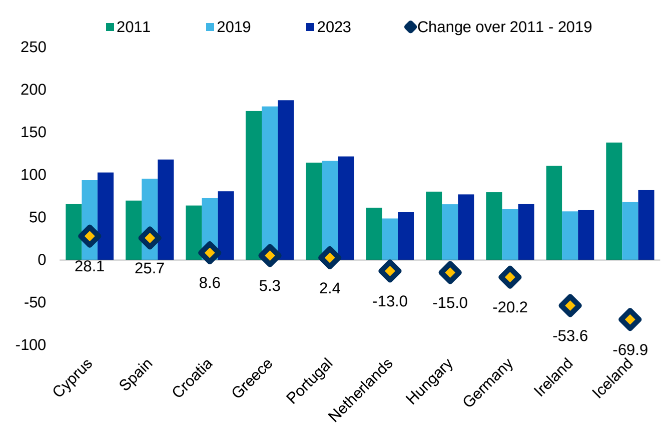
The authorities have demonstrated their adherence to the rules even before the formal entry into force of the law. As a result of solid budgetary outturns and the use of windfall profits for debt reduction, Iceland's public debt declined by more than 50 ppts of GDP between the peak in 2011 and 2018 (see Exhibit 22). In 2019, the central government's debt ratio stood at 29.1% of GDP (before the reclassification exercise, more detail below), one of the strongest debt reductions globally. Sizeable fiscal buffers provided space for the current countercyclical fiscal response to the pandemic. Parliament has suspended its fiscal rules until 2025 to support the economy. The government's Fiscal Plan presented in March 2021 aims to return to compliance with the fiscal rules from 2026 onwards and targets a deficit of 1.5% of GDP in 2025. Net debt is expected to reach its peak at 46.5% of GDP in 2025.

Exhibit 22
### Iceland has established a track record of adherence to fiscal rules
**Central government debt targets and outturn (% of GDP)**



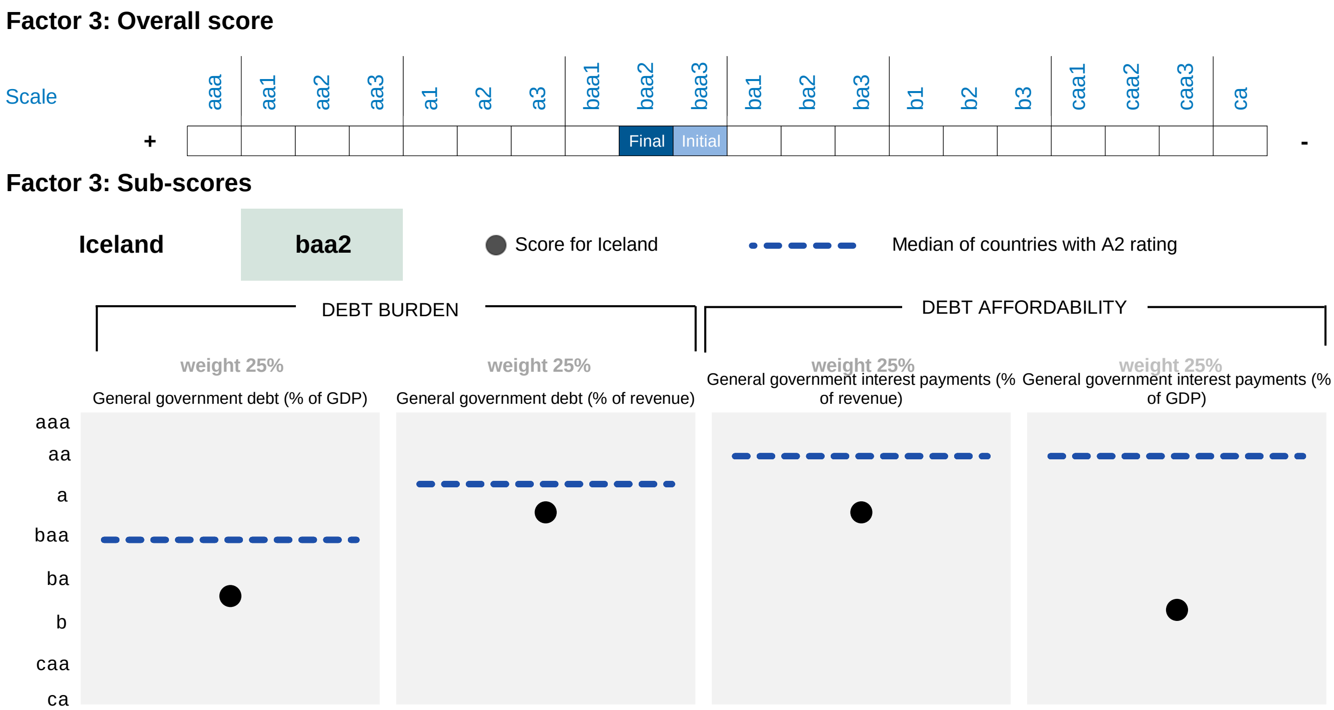

*Source: Ministry of Finance and Moody's Investors Service*

Exhibit 23
### Debt reduction points to strong fiscal policy effectiveness
**General government debt (% of GDP)**




*Source: National authorities and Moody's Investors Service*

## Fiscal strength score: baa2




Fiscal strength captures the overall health of government finances, incorporating the assessment of relative debt burdens and debt affordability as well as the structure of government debt. Some governments have a greater ability to carry a higher debt burden at affordable rates than others. Fiscal strength is adjusted for the debt trend, the share of foreign currency debt in government debt, other public sector debt and for cases in which public sector financial assets or sovereign wealth funds are present. Depending on the adjustment factor, the overall score of fiscal strength can be lowered or increased.
*Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.*

We assess Iceland's fiscal strength as "baa2", reflecting the government's strong track record in reducing its large budget deficits and very high debt burden after the 2008 crisis but also the recent increase in the debt ratio due to the pandemic impact. The recent reclassification of 24 public-sector corporations into the general government perimeter has raised the government debt ratio by around 32 percentage points of GDP but also implies much smaller contingent liabilities and improves fiscal transparency, without creating additional fiscal risks. The final score is higher than the initial score of "baa3" because of the high level of confidence that the debt will again be reduced in coming years. Also, the reclassification does not fundamentally alter our view of Iceland's fiscal strength; we had previously taken the debt of these companies into account qualitatively, in particular the debt of the HF-Fund (A2 stable), which benefitted from an explicit government guarantee and is in a government-directed winding-down process.

Other sovereigns with a "baa2" assessment of fiscal strength include Bermuda (A2 stable), Hungary (Baa3 positive) and Ireland.

Exhibit 24

**Peer comparison table factor 3: Fiscal strength**

| | Iceland | baa2 Median | Bermuda | Hungary | Ireland | Israel | Cyprus | Montenegro |
|---|---|---|---|---|---|---|---|---|
| | A2/STA | | A2/STA | Baa3/POS | A2/POS | A1/STA | Ba1/STA | B1/STA |
| **Final score** | baa2 | | baa2 | baa2 | baa2 | baa1 | baa3 | baa3 |
| **Initial score** | baa3 | | baa3 | baa2 | a2 | baa2 | baa3 | ba1 |
| Gen. gov. debt (% of GDP) | 79.9 | 44.1 | 49.1 | 80.4 | 58.5 | 72.4 | 119.1 | 103.3 |
| Gen. gov. debt (% of revenue) | 188.5 | 186.7 | 366.5 | 184.9 | 258.1 | 211.6 | 291.3 | 231.7 |
| Gen. gov. interest payments (% of GDP) | 4.0 | 1.2 | 1.9 | 2.4 | 1.0 | 2.3 | 2.2 | 2.7 |
| Gen. gov. int. payments (% of revenue) | 9.5 | 4.9 | 14.0 | 5.4 | 4.4 | 6.8 | 5.3 | 6.1 |

*Source: National authorities, Moody's Investors Service*

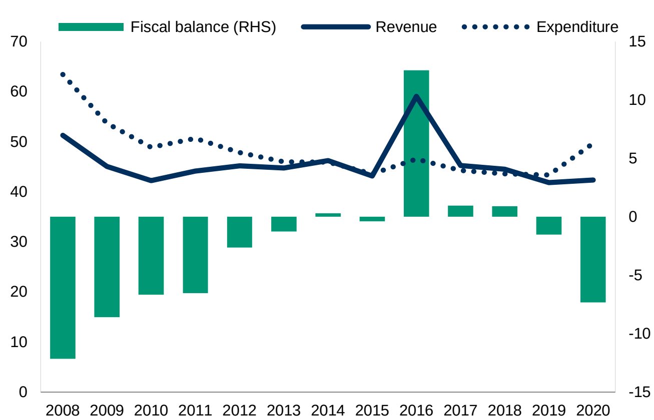
### Budget deficit will remain high in 2021 to support the recovery from the pandemic

The large economic contraction and the fiscal measures adopted by the authorities to counteract the effects of the pandemic have caused a significant widening of Iceland's general government budget deficit to 7.3% of GDP in 2020. This compares to a deficit of 1.5% of GDP in 2019 and an average budget surplus of 3.5% of GDP in the preceding four years (see Exhibit 25). The deterioration was driven by both revenue (-2.2%) and expenditure sides (+10.7%). Still, last year's budgetary outturn was 2.5 ppts of GDP better than the government had expected earlier because of a smaller economic contraction and lower uptake of the support measures than initially budgeted.

The government presented three fiscal packages totaling ISK88.9 billion (3% of GDP) to provide individuals and companies with liquidity support during the acute phase of the pandemic and to support the subsequent economic recovery. Automatic stabilizers accounted for a further 3.2% of GDP last year. The focus of the initial measures, which were similar in nature to those seen in other countries, was on avoiding large-scale labour shedding and corporate defaults and included a short-time work scheme, tax reductions and deferrals and third-pillar pension withdrawals. The subsequent packages were aimed at supporting the recovery with measures such as a wage subsidy for employees during their notice period, a large investment initiative and incentives for innovation, private investment and training. Given the substantial support the government put in place, the loan-guarantee programmes were not used as much as expected, with only ISK12.3 billion used at the end of April 2021 out of the total of ISK110 billion available (11% of total).

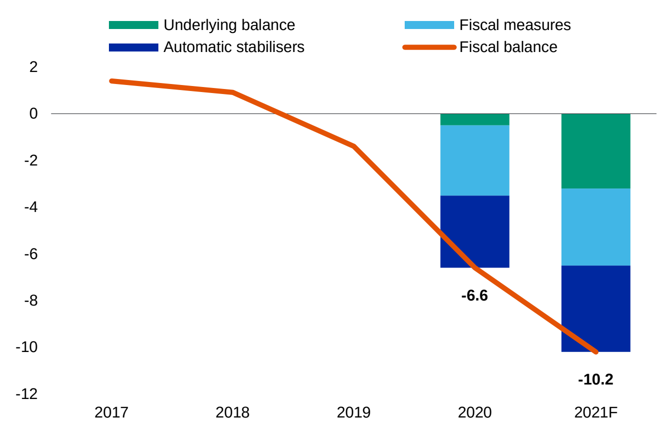
We expect Iceland's budget deficit to remain large this year as substantial fiscal support remains in place, before declining gradually in the coming years. A fourth package was introduced in April 2021 which renewed some of the existing measures until later this year and introduced wage subsidies for companies that rehire workers. The fiscal impact of the measures is expected to reach ISK111 billion (3.5% of GDP) for 2021 (see Exhibit 26), with automatic stabilizers accounting for a further 3.7% of GDP. The public investment initiative, with projects totaling ISK100 billion (3.3% of GDP) over 2021-25, will pick up strongly this year as some projects that faced delays in 2020 come online. Overall, we expect the budget deficit to increase to close to 10% of GDP in 2021 somewhat lower than the government's expectation of 11.4% because our GDP growth forecast is higher than the assumption underpinning the budget. Also, the budget execution for the first quarter of 2021 again points to a stronger performance of revenues than assumed in the budget. The target is composed of a deficit of 10.2% of GDP at the central government level and a deficit of 1.1% of GDP at the local government level.

Exhibit 25
**The pandemic had a deep impact on fiscal accounts**
**% of GDP**




*Source: IMF and Moody's Investors Service*

Exhibit 26
**Sizeable support will remain in place in 2021**
**Central government budget balance (% of GDP)**

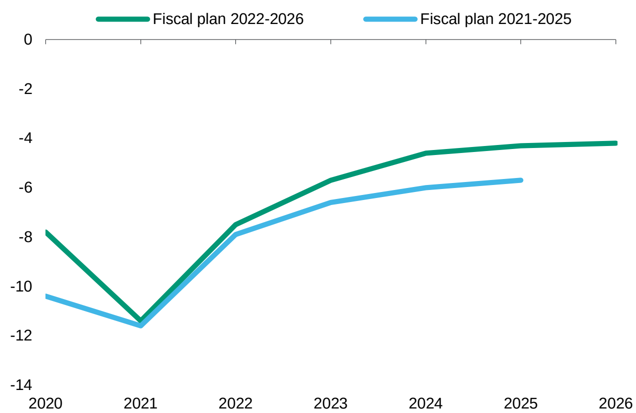



Note: Authorities' forecast
*Source: Ministry of Finance and Moody's Investors Service*

### Medium-term fiscal strategy points to manageable fiscal-consolidation needs

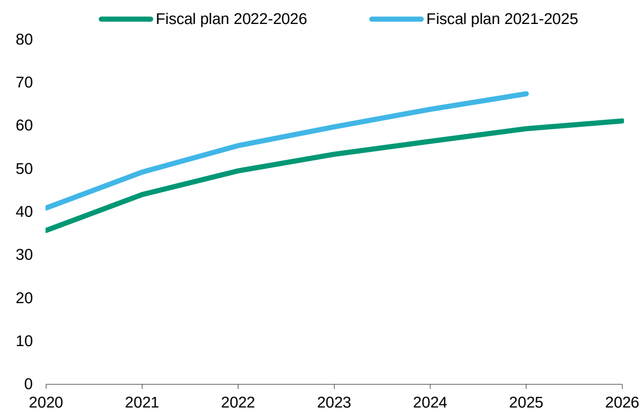
Although the government's medium-term fiscal plan for 2022-26 does not forecast active fiscal-consolidation measures until 2023, the budget deficit will start to decline next year. We forecast a deficit of around 7.5% of GDP, as the economic recovery gathers pace and the bulk of pandemic-related fiscal support measures expires. Spending on the investment programme will also be somewhat smaller than this year, and will gradually decline in the following years (see Exhibit 12). According to the Ministry of Finance, the fiscal effort required between 2023 and 2025 to achieve the targets set out in its fiscal plan is manageable at around 1% of GDP per year. This would equate to an increase in revenues of 1% per annum and a reduction of expenditure of 1.2%. The fiscal effort required over the 2023-25 period is now estimated to be around 20% lower than the projections in last year's fiscal plan because (1) last year's economic contraction was materially lower than it had been expected; and (2) disposable incomes, an important driver of tax revenues, have continued to grow. The fiscal targets are set so as to stabilize the debt ratio by the end of 2025, and have been approved by parliament. From 2026 onwards, the fiscal rules are expected to be in place again, requiring a budgetary surplus on average over a rolling five-year horizon and a 5% annual reduction of the debt in excess of 30% of GDP debt over a three-year period as long as the public debt ratio is above 30% of GDP.[12]

Exhibit 27
**Budget deficit targets were improved in latest plan...**
**General Government Financial Balance (% of GDP)**




*Source: Ministry of Finance and Moody's Investors Service*

Exhibit 28
**... and aim to stabilize debt by 2025**
**Central Government Debt (% of GDP)**




*Source: Ministry of Finance and Moody's Investors Service*

Uncertainty around the medium-term forecasts remains high, and the government recognizes that consolidation needs could be materially higher if the recovery was delayed and fiscal support had to be extended further. However, Iceland has established a solid fiscal track record over the past decade which gives us a high level of confidence that the current fiscal deterioration will be reversed over the coming years. The fiscal rules provide an important medium-term policy anchor and are firmly embedded and accepted across the political spectrum. The independent fiscal council is tasked with assessing the compliance with the fiscal objectives and whether public finances are on a path where the numerical rules can be reinstated in 2026. Although the new incoming government after the September elections will present its own five-year fiscal plan in addition to a 2022 budget, we do not expect a material change to the medium-term fiscal trajectory.

### Sector reclassification does not materially alter our assessment of Iceland's fiscal strength

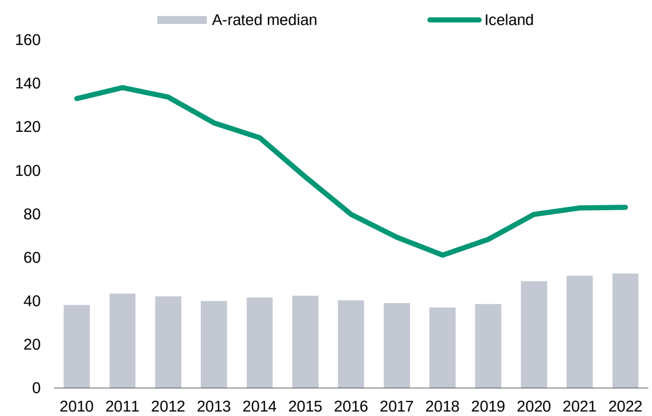
Statistics Iceland reclassified 24 public-sector entities late last year to include them under the general government perimeter, which in turn led to a significant increase in Iceland's debt ratio and weakened debt affordability. The debt-to-GDP ratio increased by about 32 ppts mainly as a result of the inclusion of the liabilities of the HF-Fund and to a lesser extent the Student Loan Fund. However, we had long incorporated these entities into our qualitative analysis as contingent liabilities for the government. Also, the government's assets have increased by a similar amount, meaning the government's obligations have not materially changed on a net basis. As a result of the reclassification, the previously large contingent liabilities are now materially lower at around 2.4% of GDP as of July 2021.[13]

HF-Fund is an asset management vehicle in wind-down overseen by the Ministry of Finance and Economic Affairs, responsible for legacy mortgages and the servicing of the remaining outstanding HFF bonds (around ISK 480 billion or 15% of GDP outstanding as of August 2021). HF-Fund has faced a significant maturity mismatch between its assets and liabilities, as borrowers have been prepaying HFF mortgages, while the Fund cannot accelerate repayment of its bonds, which have long maturities of up to 23 years. Currently, cash inflows and HF-Fund's cash position are more than sufficient to cover its debt repayments. Although this favourable position will start to reverse in the early 2030s, we expect that the government will have returned its debt burden on a steady downward trajectory by that time, providing ample room to cover the annual payments which amount to about 1% of GDP.

### Public debt has risen but is resilient to most stress scenarios

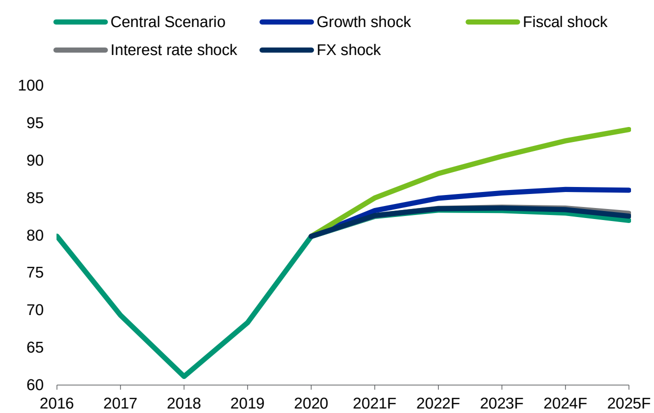
As a result of the sharp economic contraction and the very budget deficit, the public debt ratio increased by 11.5 ppts of GDP last year, reversing the declining debt trend of previous years. We expect the debt ratio to continue to increase this year, but to remain well below the levels seen during the last crisis. We expect debt to peak in 2022 at above 83% of GDP before declining slowly to 82% in 2025. The government's medium-term plan assumes that the debt ratio (as per its definition[14]) will peak at 54% of GDP in 2025. The ratio will remain above the median for A-rated sovereigns (see Exhibit 29). The debt trend is relatively resilient to shocks, with the exception of a fiscal shock and would stabilise below 90% of GDP under most scenarios. The low share of foreign-currency debt reduces risks stemming from exchange-rate movements.

Exhibit 29
**Iceland's debt burden has declined rapidly over past years but remains higher than peers**
**Gen. Gov. Debt (% of GDP)**




*Source: National authorities and Moody's Investors Service*

Exhibit 30
**Debt trajectory is resilient to shocks**
**General government debt (% of GDP)**




Note: Standardized shocks are based on a 0.5 standard deviation calculated for 10 years over the course of the forecast period.
*Sources: Moody's Investors Service*

The government's balance sheet is stronger than peers when taking assets of 84% of GDP into account (see Exhibit 31). The most important of these are the state's remaining equity stakes in the domestic banks, the HF-Fund's loan book and substantial cash deposits, with the latter amounting to around 16% of GDP. The government receives dividends worth around 1% of GDP every year from its equity participations. In 2016, when the estates of the failed banks were settled, the government received ISK384.2 billion (15.4% of GDP) in stability contributions from the banks, contributing to the rapid decline in government gross debt.

In 2018, the Treasury sold its 14% stake in Arion banki, with the total gains on financial interest in Arion banki and transactions with the Kaupthing estate estimated at just over ISK150 billion. In June 2021, the government listed 35% of its stake in Islandsbanki, raising ISK55.3 billion (1.7% of GDP) and valuing the company at ISK158 billion. Moreover, the government also owns 98.2% of Landsbankinn, valued at around ISK196 billion (6.6% of GDP). We expect further divesture of the government's stake in the coming years, which should help accelerate the reduction in the debt burden.

### Debt affordability remains weaker than peers but is expected to improve

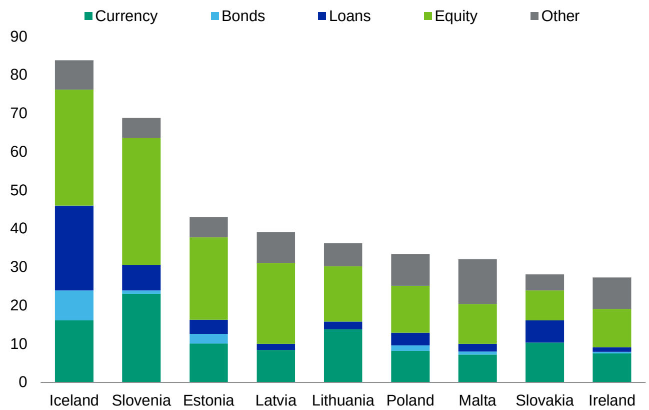
The retirement of higher-cost debt and the rebuilding of the revenue base since the banking crisis have helped to improve the affordability of government debt. After more than doubling to 27% of government revenue in 2009 from 12.7% in 2007, interest payments dropped to 9.5% of revenue in 2020 (see Exhibit 32). However, debt affordability remains weaker than in many similarly rated peers like Poland (A2 stable) and Slovakia (A2 stable). In addition, the revision of the fiscal accounts in 2020 led to a material weakening of debt affordability, mostly as a result of the outstanding HFF bonds which carry high annual interest costs of around

ISK50 billion (4% of revenue). Iceland's debt affordability metrics are also weaker than peers, because we do not take into account the sizeable interest receipts that the Icelandic government receives from its large assets. On a net basis, interest payments-to-revenues stand at around 5.5%, a ratio that is much more comparable to peers.

The significant monetary policy easing undertaken in response to the pandemic led to a sharp decline in treasury yields in 2020 despite much higher borrowing requirements. Even with somewhat tighter monetary policy, we expect debt affordability to remain much more favourable than in the past and continue to improve gradually over the coming years, which will mitigate the impact of the increase in government debt on our assessment of Iceland's fiscal strength.

Exhibit 31

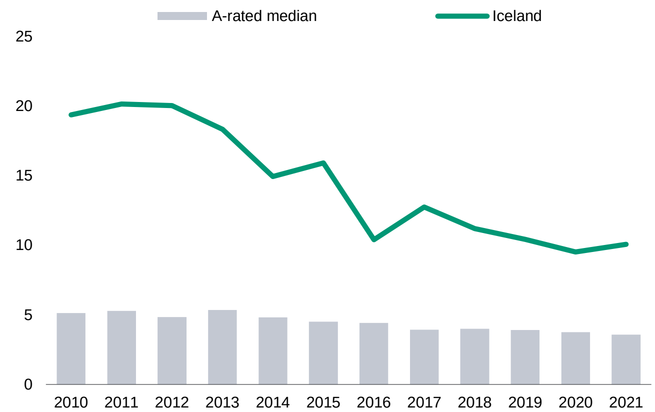
**Government assets are much larger than peers**
**2020 (% of GDP)**




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

Exhibit 32

**Debt affordability has been improving, but remains weak compared to peers...**
**Interest payments (% of revenue)**




*Source: National authorities, Moody's Investors Service*

## Susceptibility to event risk score: a

**Factor 4: Overall score**

| Scale | aaa | aa | a | baa | ba | b | caa | ca | |
|---|---|---|---|---|---|---|---|---|---|
| + | | | Final | | | | | | - |

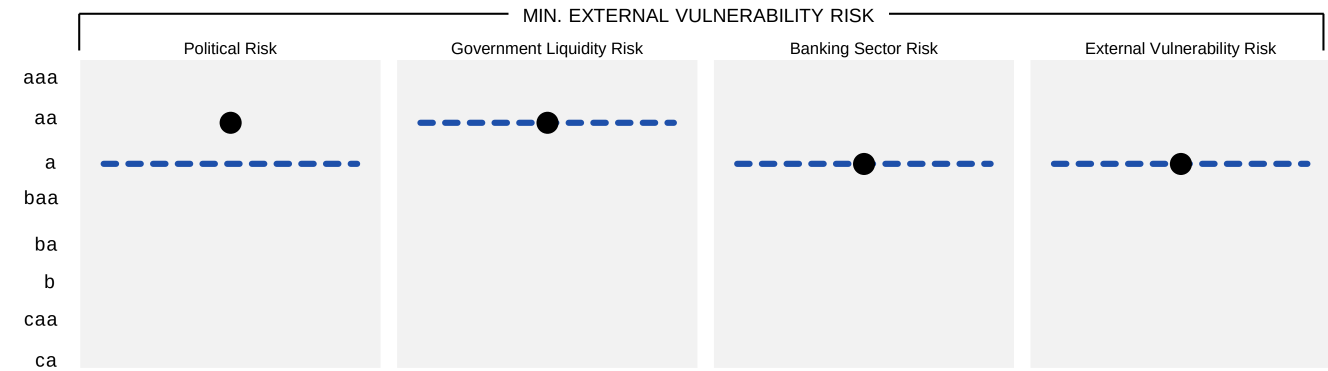
**Factor 4: Sub-scores**

**Iceland** **a**

Score for Iceland

Median of countries with A2 rating

**Overall adjustment to Factor 4 Susceptibility to Event Risk: 0**




Susceptibility to event risk evaluates a country's vulnerability to the risk that sudden events may severely strain public finances, thus increasing the country's probability of default. Such risks include political, government liquidity, banking sector and external vulnerability risks. Susceptibility of event risk is a constraint which can only lower the scorecard-indicated outcome.

*Note: the initial factor score is shown in light blue in the scale above. In case the initial and final factor scores are the same, only the final score will appear in the table above.*

Our assessment of susceptibility to event risk is “a”, driven by banking system and external vulnerability risk. Icelandic banks have successfully emerged as healthy financial institutions since the economic crisis and with their large capital and liquidity buffers should be able to weather the pandemic impact. Ongoing current account surpluses and large foreign-currency reserves limit external vulnerability risk at “a”, while government liquidity and political risks are even lower at “aa”.

### Frequent elections over the past decade have not impacted policy continuity

Political event risk, which we assess at “aa”, are low in Iceland, which reflects relatively consistent policy in key areas important to safeguarding the credit profile despite several changes in government since 2008. Peers sharing this assessment include Sweden (Aaa stable) and Denmark (Aaa stable).

Exhibit 33

**Peer comparison table factor 4a: Political risk**

| | Iceland A2/STA | aa Median | Denmark Aaa/STA | Netherlands Aaa/STA | Sweden Aaa/STA | Luxembourg Aaa/STA | New Zealand Aaa/STA | Chile A1/NEG |
|---|---|---|---|---|---|---|---|---|
| **Final score** | aa | | aa | aa | aa | aaa | aaa | a |
| Voice & accountability, score[1] | 1.3 | 1.3 | 1.6 | 1.6 | 1.6 | 1.5 | 1.6 | 1.0 |
| Political stability, score[1] | 1.7 | 1.0 | 1.0 | 0.9 | 1.1 | 1.4 | 1.5 | 0.2 |

[1] Composite index with values from about -2.50 to 2.50: higher values correspond to better governance.
*Source: Worldwide Governance Indicators, Moody's Investors Service*

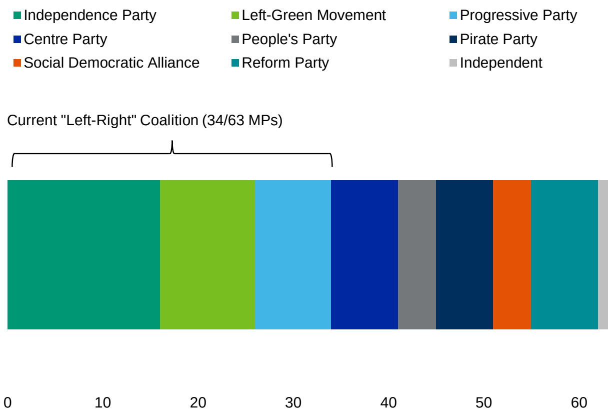
Since 2007, only two of the four governing coalitions have served a full four-year term: the centre-left coalition that lasted from 2009-2013 immediately after the crisis, and the current government coalition which is led by the Left-Green Party under current Prime Minister Katrín Jakobsdóttir and supported by the center/centre-right Progressive and Independence Parties.

The next parliamentary elections are due on 25 September. The decisive policy response following the collapse of Wow Air in 2019 and the coronavirus outbreak in 2020 has helped the coalition government to maintain broad support in polls (see Exhibit 3). Although the government composition may change after the elections, we do not expect a notable change in policy direction as political consensus on the economic and fiscal direction of Iceland has remained strong since the banking crisis.

Exhibit 34

**A broad coalition but with a narrow majority**

**Current government (2021)**

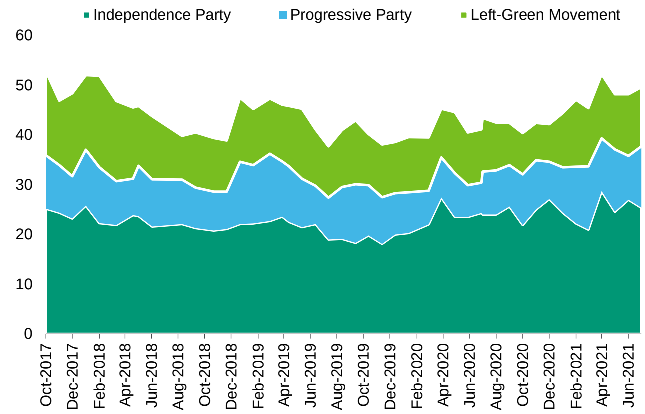



*Sources: Alþingi and Moody's Investors Service*

Exhibit 35

**Support for the governing coalition has remained broadly stable**

**Share of respondents favourable to a particular party**




*Sources: MMR and Moody's Investors Service*

## Government liquidity risk is low given strong fiscal credibility, sizeable cash buffer and large domestic investor base

We assess government liquidity risk as "aa". The previous marked reduction in government debt, prudent liquidity management, with significant cash buffers, and a large domestic investor base will help to mitigate the risks posed by higher borrowing requirements over the next few years. Other sovereigns sharing a "aa" assessment are Estonia (A1 stable), Saudi Arabia (A1 negative) and Slovakia.

Exhibit 36

**Peer comparison table factor 4b: Government liquidity risk**

| | Iceland A2/STA | aa Median | Estonia A1/STA | Saudi Arabia A1/NEG | Slovakia A2/STA | Chile A1/NEG | Ireland A2/POS | Lithuania A2/STA |
|---|---|---|---|---|---|---|---|---|
| **Final score** | aa | | aa | aa | aa | aaa | aaa | a |
| **Initial score** | aa | | aa | aa | aa | aaa | aaa | a |
| Ease of access to funding | aa | aa | aa | aa | aa | aaa | aaa | a |
| Gross borrowing requirements (% of GDP) | 11.3 | 11.0 | -- | 6.0 | 10.7 | 7.0 | 4.9 | 3.2 |

*Source: National authorities, IMF, Moody's Investors Service*

Iceland's gross borrowing requirements are likely to remain elevated over the next few years We estimate the government's borrowing needs for this year at around 11% of GDP, which includes our estimate for the central government budget deficit and maturing medium and long-term debt, compared to a mere 1% of GDP in the three years before the pandemic-induced crisis. We also assume that the Islandsbanki sale receipts of around 1.7% of GDP will be used for debt-reduction purposes. In addition, the government can rely on the HF-Fund's liquid assets to manage its liquidity needs and reduce short-term market borrowing.

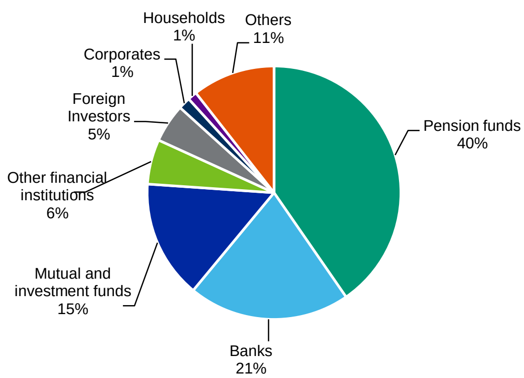
Despite high issuance volumes since the beginning of the coronavirus crisis, demand has remained robust, reflecting Iceland's strong market access and large domestic investor base, in the form of the pension funds which hold around 40% of total Treasury bonds.

Foreign investors are much less present than they used to be, holding just 5% of Icelandic government bonds in June, compared to over 40% in 2009 (see Exhibit 37).

Refinancing risks are relatively moderate with an average maturity of central government debt of 4.7 years as of July 2021 (see Exhibit 38). Average maturity has increased this year, as the government has reduced the stock of short-dated Treasury bills to 5.7% of total marketable debt from 9% in December 2020.

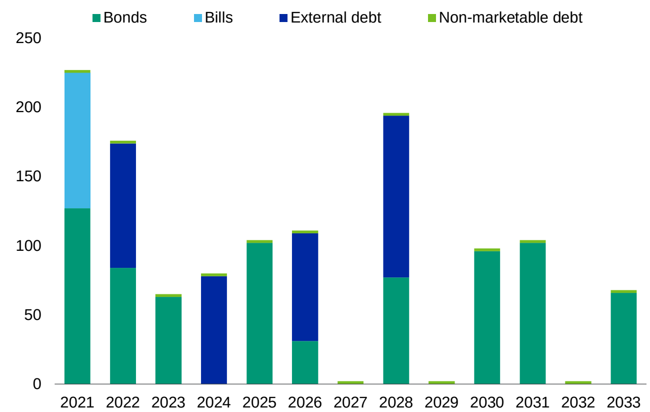
The government also holds significant cash buffers at the central bank, helping to mitigate liquidity risks. The government set guidance in 2017 to keep at least ISK40 billion in deposits at the central bank. At the end of July 2021, the total balance stood at ISK47.1 billion (1.4% of GDP) with an additional ISK307 billion held as foreign exchange deposits, which partly reflects the issuance of a €750 million Eurobond in January 2021, with a zero coupon.

Exhibit 37
**The government can rely on a large domestic investor base**
**Owners of Treasury securities (end of July 2020)**




*Sources: Government Debt Management and Moody's Investors Service*

Exhibit 38
**Favourable maturity profile limits refinancing risks**
**ISK billion**




*Source: Government Debt Management, Moody's Investors Service*

## Strong capitalization and liquidity help alleviate concentration risks in the banking system

We assess Iceland's banking sector risk at "a" reflecting the sizeable capital and liquidity buffers of the three large domestic banks. The score was recently raised from "baa"; we believe that despite the negative impact of the pandemic, the banks' buffers are sizeable enough to withstand the expected deterioration in their asset quality.[15] Other peers with a similar assessment of banking sector risk include Bermuda, Estonia, and Ireland.

Exhibit 39

**Peer comparison table factor 4c: Banking sector risk**

| | Iceland | a Median | Bermuda | Estonia | Ireland | Cayman Islands | Malta | Slovenia |
|---|---|---|---|---|---|---|---|---|
| | A2/STA | | A2/STA | A1/STA | A2/POS | Aa3/STA | A2/NEG | A3/STA |
| **Final score** | a | | a | a | a | aa | baa | baa |
| **Initial score** | a | | a | a | a | aa | baa | baa |
| BCA[1] | -- | baa1 | baa2 | ba1 | baa2 | -- | -- | ba1 |
| BSCE[2] | baa3 | baa2 | baa2 | baa3 | baa3 | baa2 | baa2 | ba1-ba2 |
| Total domestic bank assets (% of GDP) | 152.0 | 155.9 | 353.4 | 126.5 | 129.8 | 46.4 | 238.9 | 99.7 |

[1] BCA is an average of Baseline Credit Assessments (BCAs) for rated domestic banks, weighted by bank assets.
[2] Where we have no or small rating coverage in a system, we estimate the risk of Banking Sector Credit Event (BSCE) based on available data for aggregate banking system.
*Source: National authorities, IMF, Moody's Investors Service*

Following the banking crisis in 2008, Icelandic banks have successfully emerged as healthy – and much smaller – financial institutions, underpinned by a rapid economic recovery and the increased maturation of the regulatory framework under the supervision of the

Financial Supervisory Authority and the Central Bank of Iceland (see F2: Institutional Strength for more details). Some of the key measures undertaken under the IMF-supported programme were the introduction of strict limits on banks' scope of activity and high capital requirements including the introduction of a countercyclical capital buffer, which helped increase the resilience of the system.

As a result, banks entered the pandemic with very strong buffers, providing considerable scope to withstand increased write-offs and maintain lending capacity to support the economic recovery. The average CET1 capital ratio stood at 25.6% at the end of 2020, significantly higher than most rating peers (see Exhibit 40). The central bank's actions ensured the availability of ample liquidity, by among others reducing the policy interest rate by 200 basis points to 0.75%, lowering reserve requirements by one percentage point and the countercyclical capital buffer to zero from 2%.

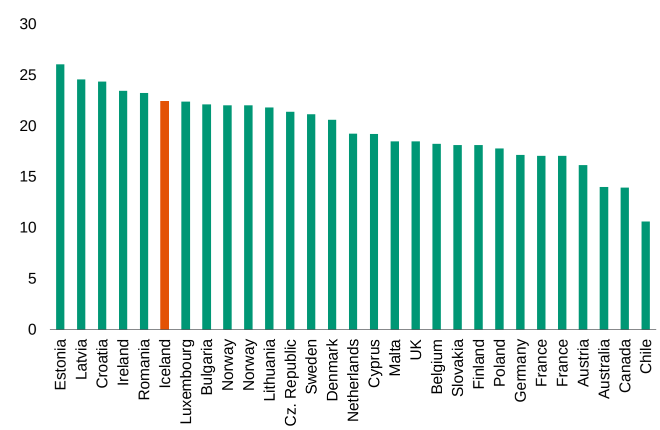
The pandemic has put pressure on banks' asset quality, in particular loans to tourism-related borrowers, which account for slightly less than 10% of total loans. While arrears overall have only increased marginally so far – as of Q1 2021, the nonperforming loan (NPL) ratio (on a facility basis) has only increased to 2.8% from 2.6% in 2019 – the NPL ratio is much higher at above 10% if a broader definition is used. According to the cross-default method all of a borrower's loans are considered nonperforming if one loan is frozen or in arrears by 90 days or more, or if the borrower is deemed unlikely to pay their obligations when due. Also, the NPL ratio in the broader definition is much higher in the tourism sector (broadly identical to services in the chart below), at above 40% (see Exhibit 41). Furthermore, the share of frozen loans to real-estate firms has risen markedly.

Under our standard stress testing for banking systems, the capital replenishment needs in case of a crisis in Iceland would be moderate. This tallies with similar stress testing exercises of the CBI and the IMF, which both concluded that the banks would be able to deal with the pandemic shock while maintaining capital ratios above the regulatory requirements even under scenarios of further and prolonged stress.[16] Banks have proactively provisioned for expected losses on all their loans to the tourism sector, reclassifying them as in forbearance, yet have managed to improve their capital ratios last year. In addition, the CBI has put in place dividend constraints during the pandemic.

Exhibit 40

**Banks have strong capital buffers to withstand stress**

**Capital ratio (% of risk-weighted assets), latest**

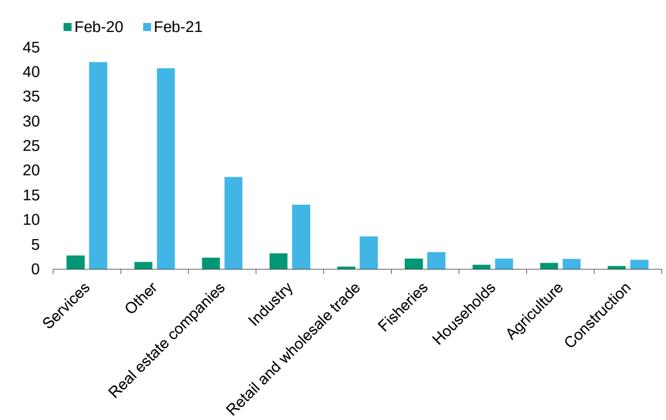



*Source: IMF and Moody's Investors Service*

Exhibit 41

**Asset quality has deteriorated in sectors most affected by the crisis**

**Loans under forbearance by sector (% of total)**




Other sectors account for only 7% of total loans.

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

## Iceland benefits from strong external buffers, including a net external creditor position and large foreign-currency reserves

External vulnerability risk is set as "a", reflecting consistent current-account surpluses which contribute to Iceland's net external creditor position, and very large foreign-currency reserves, which help to buffer external shocks. Peers sharing the same risk assessment include Estonia, Poland and Slovakia.

Exhibit 42

**Peer comparison table factor 4d: External vulnerability risk**

| | Iceland A2/STA | a Median | Estonia A1/STA | Slovakia A2/STA | Poland A2/STA | Peru A3/NEG | Lithuania A2/STA | Chile A1/NEG |
|---|---|---|---|---|---|---|---|---|
| **Final score** | a | | a | a | a | aa | aa | baa |
| **Initial score** | a | | a | a | a | aa | aa | baa |
| Current account balance (% of GDP) | 1.1 | -1.2 | -0.6 | -0.4 | 3.4 | 0.7 | 8.4 | 1.3 |
| Net IIP (% of GDP)[1] | 38.4 | -45.9 | -20.8 | -66.0 | -45.9 | -38.5 | -15.7 | -9.9 |

[1] Net international investment position (% of GDP).
*Source: National authorities, IMF, Moody's Investors Service*

Iceland has been recording current-account surpluses since 2012, mainly driven by the long boom in tourism, which has started to slow since 2019 and came to an abrupt halt last year. The country nevertheless managed to record a surplus last year, albeit much diminished at just 1.1% of GDP compared to the peak of 8.1% of GDP in 2016. The contraction in domestic demand led to lower imports of goods, while Icelanders spent significant amounts domestically that would otherwise have been done abroad. Residents' purchases abroad dropped by 60% to account for only 4% of total household consumption in 2020, down from 11% in 2019.

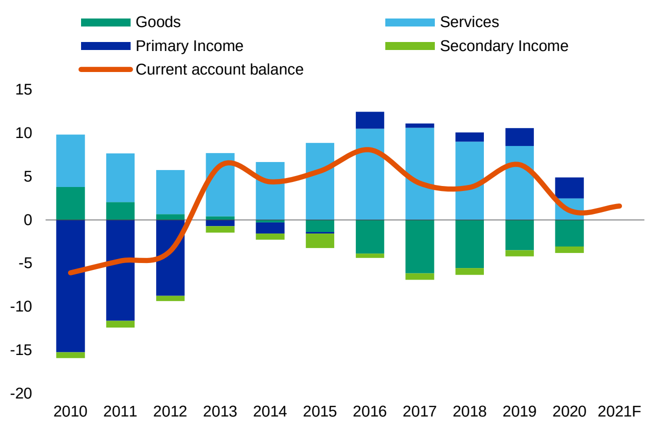
We expect the current-account surplus to increase this year to around 1.6% of GDP, helped by the recovery in tourism (see Exhibit 43). For the coming years, we pencil in surpluses in the order of 1.5-2% of GDP; the tourism recovery will be counterbalanced by stronger growth in goods imports.

Iceland's net international investment position (NIIP) has improved significantly since the banking crisis, helping to buffer shocks to its small open economy. The resolution of the failed bank estates in 2015 led to a sharp improvement in Iceland's NIIP, which stood at -5.1% of GDP in 2015 versus -373% a year earlier. The lifting of capital controls in 2017 and further in 2019 resulted in a further improvement of Iceland's net creditor position, partly because of an increase in the pension funds' foreign investments and commercial banks' foreign bond issuance. The NIIP stood at 38.4% of GDP in 2020 (see Exhibit 44).

Exhibit 43

**Current account has remained in surplus since 2012**

**Current account balance and its components (% of GDP)**

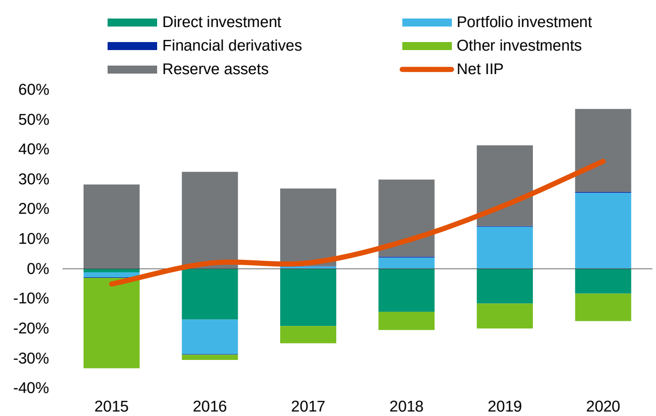



Note: Excludes the banks undergoing winding up. Moody's forecasts
*Source: Central Bank of Iceland, Statistics Iceland and Moody's Investors Service*

Exhibit 44

**Resolution of the bank estates in 2015 turned net IIP positive**

**% of GDP**



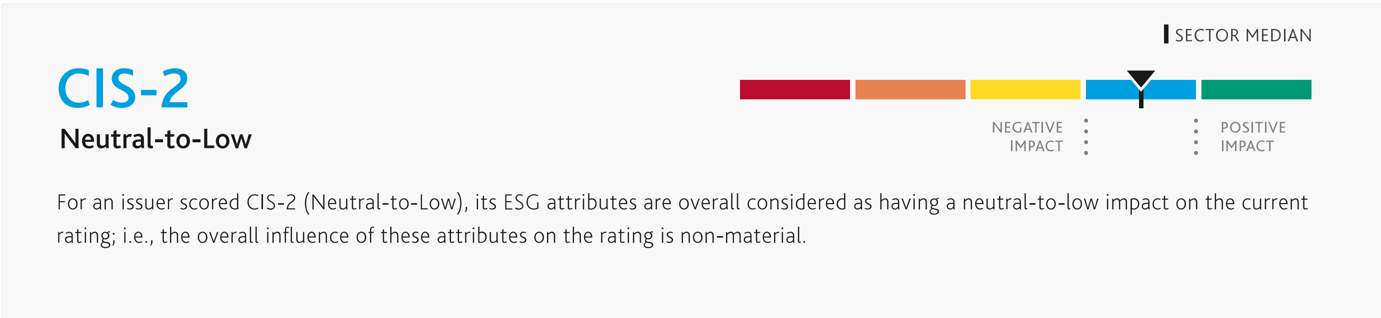

*Source: Central Bank of Iceland, Statistics Iceland and Moody's Investors Service*

The external surpluses have allowed the central bank to build substantial foreign-currency reserves, which are actively being used to smooth otherwise excessive volatility of the exchange rate. Reserves stood at $6.6 billion at the end of July 2021, equivalent to around 30% of GDP or 38% of the country's total external debt. Reserves have been increased continuously over the past few years; they stood at less than $5 billion at the end of 2015. Using the IMF's reserve-adequacy metrics, the reserves are at ample levels, equivalent to 1.68 times the recommended level at the end of 2020 and, according to a sensitivity analysis performed by the central bank at the beginning of 2021, they would still remain more than adequate even if reserves were needed to cover outflows of all highly liquid króna assets held by nonresidents which amounted to ISK114 billion or 3.9% of GDP at the end of February 2021.

## ESG considerations

### Iceland's ESG Credit Impact Score is moderately negative (CIS-3).

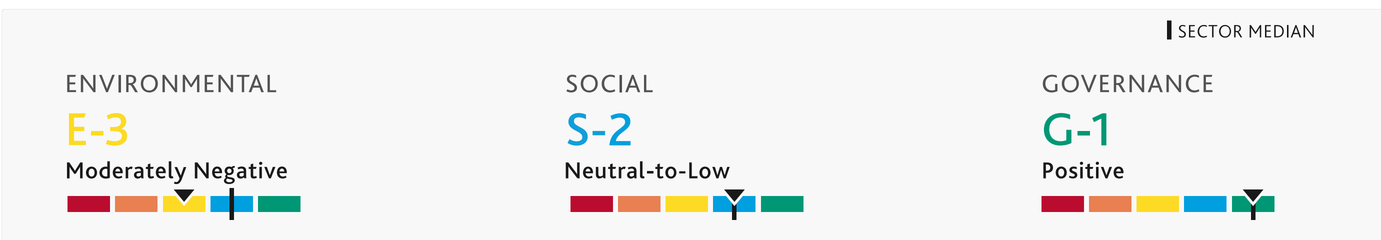
Exhibit 45
**ESG Credit Impact Score**




*Source: Moody's Investors Service*

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

Exhibit 46
**ESG Issuer Profile Scores**




*Source: Moody's Investors Service*

### Environmental

Iceland's moderate exposure to environmental risks primarily reflects the Icelandic economy's reliance on its unique geological features, particularly its key sectors of tourism and fishing, which exposes its credit profile to physical-climate risks. In particular, the presence of active volcanoes on the island helps to attract tourism but could also disrupt economic activity. Furthermore, warming seas can lead to the 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**).

### 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 advanced or developing 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.

### 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.

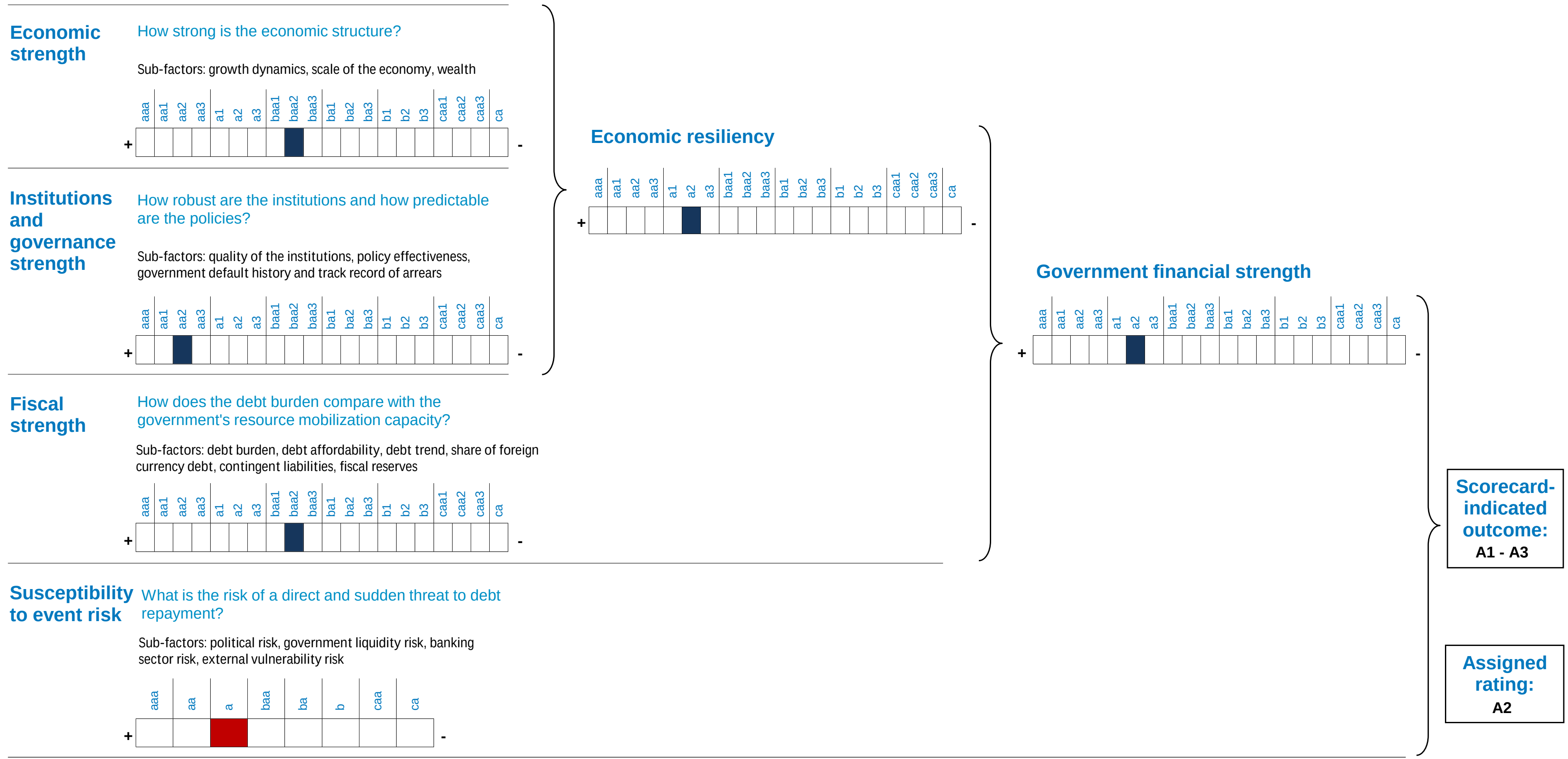
All of these considerations are further discussed in the "Credit profile" section above. Our approach to ESG is explained in our report on how the scores depict varied and largely credit-negative impact of ESG factors and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

## Scorecard-indicated outcome

Combining the scores for individual factors provides the scorecard-indicated outcome. While the 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.

Exhibit 47

**Sovereign rating metrics: Iceland**




*Source: Moody's Investors Service*

## Comparatives

This section compares credit relevant information regarding Iceland with other sovereigns that we rate. It focuses on a comparison with sovereigns within the same scorecard-indicated outcome and shows the relevant credit metrics and factor scores.

Icelands' close peers are similarly small countries, such as Lithuania, Malta and Slovenia, with Iceland's high institutional and governance strength the main differentiating factor. Ireland is a much larger economy but otherwise shares many similarities with Ireland, in particular the strength of its institutions and relatively low susceptibility to event risks. Fiscal strength is also comparable.

Exhibit 48

**Iceland's key peers**

| | Year | Iceland | Slovenia | Malta | Lithuania | Chile | Ireland | A2 Median | Western Europe Median |
|---|---|---|---|---|---|---|---|---|---|
| Rating/outlook | | A2/STA | A3/STA | A2/NEG | A2/STA | A1/NEG | A2/POS | A2 | Aa2 |
| Scorecard-indicated outcome | | A1 - A3 | A2 - Baa1 | A2 - Baa1 | A1 - A3 | A1 - A3 | Aa2 - A1 | A1 - A3 | Aa1 - Aa3 |
| **Factor 1** | | **baa2** | **baa1** | **baa1** | **baa1** | **baa1** | **a2** | **baa1** | **a2** |
| Nominal GDP ($ bn) | 2020 | 21.7 | 52.8 | 14.5 | 55.8 | 252.9 | 425.0 | 55.8 | 427.5 |
| GDP per capita (PPP, Intl$) | 2020 | 55,966 | 38,807 | 42,856 | 38,824 | 23,366 | 94,392 | 42,856 | 54,076 |
| Avg. real GDP (% change) | 2016 - 2025F | 3.0 | 2.9 | 3.8 | 3.1 | 2.2 | 5.4 | 3.1 | 1.7 |
| Volatility in real GDP growth (ppts) | 2011 - 2020 | 3.6 | 3.3 | 5.0 | 1.8 | 3.3 | 7.4 | 3.5 | 2.6 |
| **Factor 2** | | **aa2** | **a2** | **a3** | **a1** | **aa3** | **aa2** | **a2** | **aa2** |
| Quality of legislative & executive institutions | Latest available | aa | a | baa | a | aa | aa | a | aa |
| Strength of civil society & judiciary | Latest available | aaa | a | baa | a | a | aa | a | aaa |
| Fiscal policy effectiveness | Latest available | aa | a | a | aa | a | aa | a | aa |
| Monetary & macro policy effectiveness | Latest available | a | a | a | a | aa | aa | a | aa |
| Gen. gov. fiscal balance (% of GDP) | 2020 - 2022F | -8.2 | -7.2 | -9.6 | -6.4 | -7.3 | -4.4 | -6.1 | -4.5 |
| Average inflation (% change) | 2016 - 2025F | 2.6 | 1.3 | 1.3 | 2.1 | 3.0 | 1.0 | 2.1 | 1.4 |
| Volatility of inflation (ppts) | 2011 - 2020 | 1.2 | 1.1 | 0.8 | 1.6 | 1.0 | 0.7 | 1.2 | 1.0 |
| **Factor 3** | | **baa2** | **a3** | **a2** | **a1** | **a1** | **baa2** | **a2** | **a2** |
| Gen. gov. debt (% of GDP) | 2020 | 79.9 | 80.8 | 54.8 | 47.1 | 32.5 | 58.5 | 57.5 | 69.1 |
| Gen. gov. debt (% of revenue) | 2020 | 188.5 | 185.5 | 148.8 | 130.9 | 162.3 | 258.1 | 148.8 | 160.0 |
| Gen. gov. interest payments (% of revenue) | 2020 | 9.5 | 3.7 | 3.6 | 1.9 | 4.8 | 4.4 | 3.6 | 2.6 |
| Gen. gov. interest payments (% of GDP) | 2020 | 4.0 | 1.6 | 1.3 | 0.7 | 1.0 | 1.0 | 1.3 | 1.1 |
| **Factor 4** | | **a** | **baa** | **baa** | **baa** | **baa** | **a** | **a** | **a** |
| **Political risk** | Latest available | **aa** | **baa** | **a** | **baa** | **a** | **a** | **a** | **aa** |
| **Government liquidity risk** | Latest available | **aa** | **aaa** | **aa** | **a** | **aaa** | **aaa** | **aa** | **aaa** |
| Gross borrowing requirements (% of GDP) | 2021F | 11.3 | -- | 15.9 | 3.2 | 7.0 | 4.9 | 9.5 | 12.9 |
| **Banking sector risk** | Latest available | **a** | **baa** | **baa** | **a** | **a** | **a** | **a** | **a** |
| BSCE[1] | Latest available | baa3 | ba1-ba2 | baa2 | baa3 | baa2 | baa3 | baa3 | baa1 |
| Total domestic bank assets (% of GDP) | 2020 | 152.0 | 99.7 | 238.9 | 77.1 | 161.2 | 129.8 | 129.8 | 255.4 |
| **External vulnerability risk** | Latest available | **a** | **a** | **aa** | **aa** | **baa** | **a** | **a** | **aaa** |
| Current account balance (% of GDP) | 2020 | 1.1 | 7.1 | -3.6 | 8.4 | 1.3 | -2.7 | 1.1 | 1.1 |
| External vulnerability indicator (EVI) | 2022F | -- | -- | -- | -- | 210.5 | -- | 82.7 | -- |
| External debt (% of current account receipts) | 2020 | 229.5 | 132.3 | 359.0 | -- | 233.3 | 474.7 | 275.5 | 434.9 |
| Net international investment position (% of GDP) | 2020 | 38.4 | -16.3 | 61.3 | -15.7 | -9.9 | -169.8 | -15.7 | 17.9 |

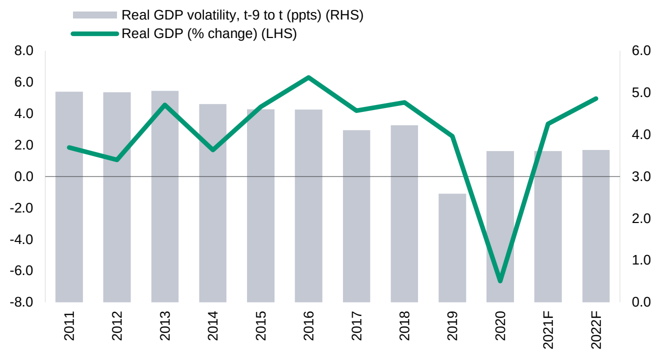
[1] BSCE is our estimate of the risk of a Banking Sector Credit Event (BSCE), which we use for sovereigns where we have no or very limited rating coverage of a system. Otherwise, we use the Baseline Credit Assessment (BCA) for rated domestic banks, weighted by bank assets.

*Sources: National authorities, IMF, Moody's Investors Service*

## DATA, CHARTS AND REFERENCES

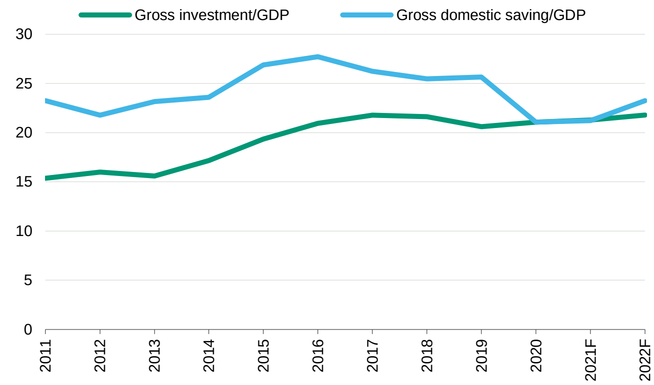
### Chart pack: Iceland

Exhibit 49
**Economic growth**



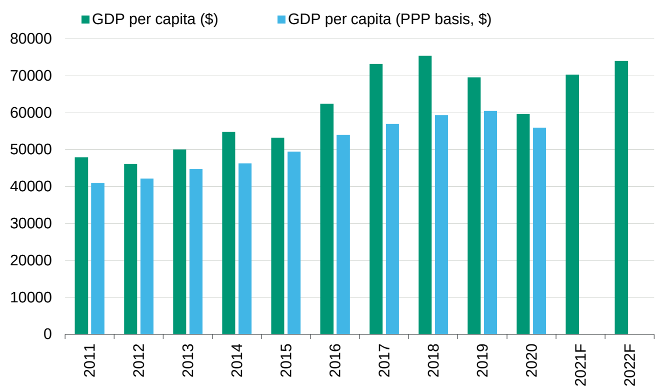

*Source: Moody's Investors Service*

Exhibit 50
**Investment and saving**



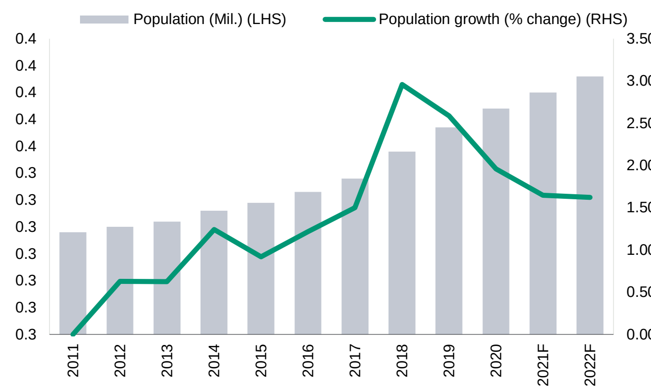

*Source: Moody's Investors Service*

Exhibit 51
**National income**



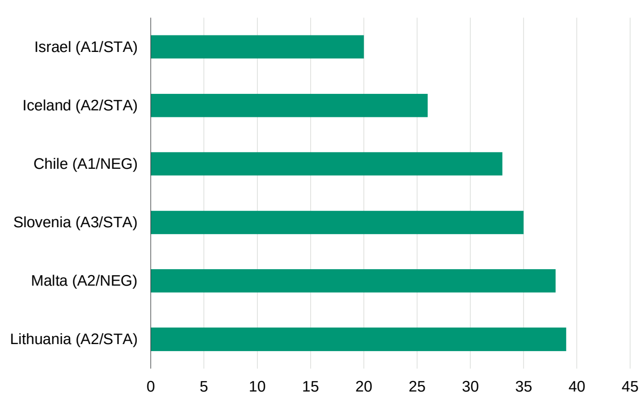

*Source: Moody's Investors Service*

Exhibit 52
**Population**



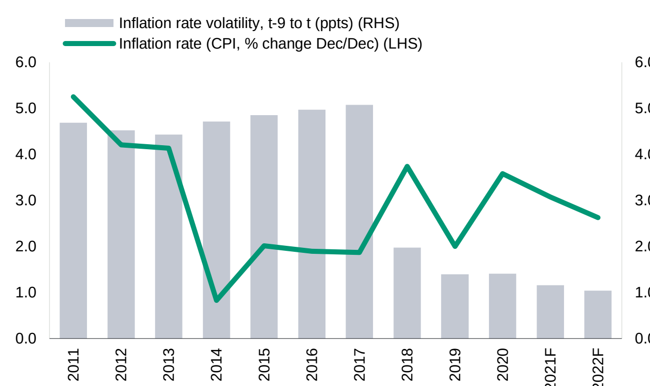

*Source: Moody's Investors Service*

Exhibit 53
**Global Competitiveness Index**
**Rank 26 out of 141 countries**



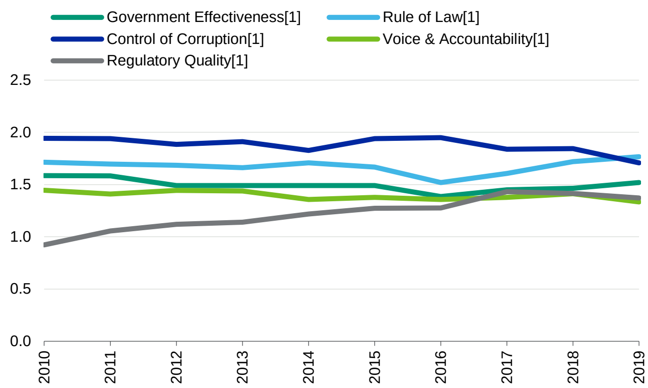

*Source: World Economic Forum*

Exhibit 54
**Inflation and inflation volatility**



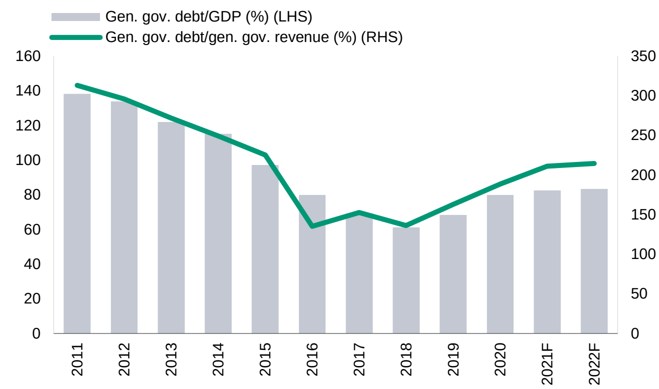

*Source: Moody's Investors Service*

Exhibit 55
### Institutional framework and effectiveness



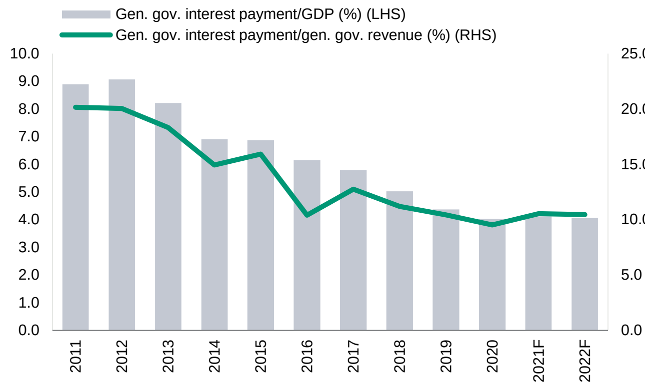

Notes: [1] Composite index with values from about -2.50 to 2.50: higher values suggest greater maturity and responsiveness of government institutions.
*Source: Worldwide Governance Indicators*

Exhibit 56
### Debt burden



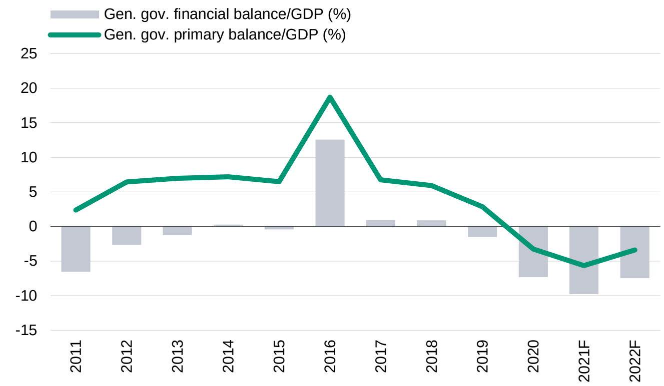

*Source: Moody's Investors Service*

Exhibit 57
### Debt affordability



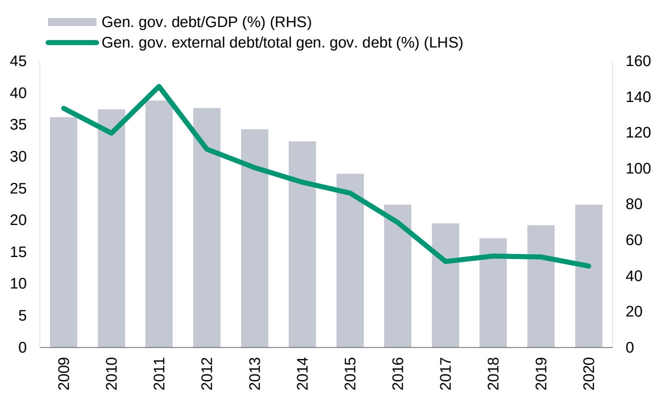

*Source: Moody's Investors Service*

Exhibit 58
### Financial balance



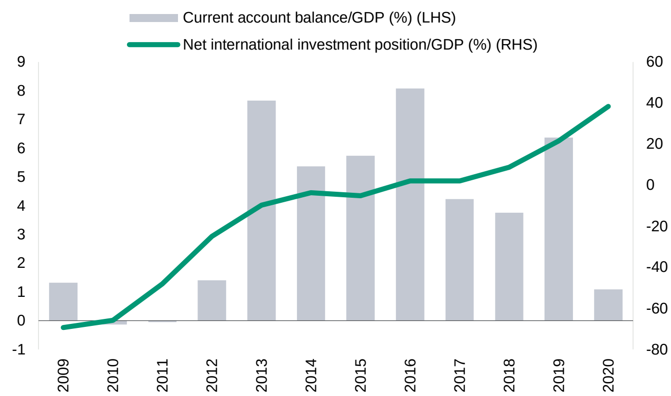

*Source: Moody's Investors Service*

Exhibit 59
### Government liquidity risk




*Source: Moody's Investors Service*

Exhibit 60
### External vulnerability risk




*Source: Moody's Investors Service*

## Rating history

Exhibit 61
**Iceland[1]**

| Long Term Ratings | | Outlook | Review Action | | Short Term Ratings | | Action Date |
|---|---|---|---|---|---|---|---|
| Foreign Currency | Local Currency | | Foreign Currency | Local Currency | Foreign Currency | Local Currency | |
| A2 | A2 | STA | - | - | - | - | Nov-19 |
| A3 | A3 | POS | - | - | - | - | Jul-18 |
| A3 | A3 | STA | - | - | - | - | Sep-16 |
| Baa2 | Baa2 | RUR | Possible Upgrade | Possible Upgrade | - | - | Jun-16 |
| Baa2 | Baa2 | STA | - | - | - | - | Jun-15 |
| Baa3 | Baa3 | STA | - | - | - | - | Feb-13 |
| Baa3 | Baa3 | NEG | - | - | - | - | Jul-10 |
| Baa3 | Baa3 | STA | - | - | - | - | Apr-10 |
| Baa3 | Baa3 | NEG | - | - | - | - | Apr-10 |
| Baa3 | Baa3 | STA | - | - | - | - | Nov-09 |
| Baa1 | Baa1 | NEG | - | - | - | - | Dec-08 |
| A1 | A1 | RUR | Possible Downgrade | Possible Downgrade | - | - | Oct-08 |
| Aa1 | Aa1 | RUR | Possible Downgrade | Possible Downgrade | - | - | Sep-08 |
| Aa1 | Aa1 | STA | - | - | - | - | May-08 |
| Aaa | Aaa | NEG | - | - | - | - | Mar-08 |
| Aaa | Aaa | STA | - | - | - | - | Nov-03 |
| Aaa | Aaa | - | - | - | - | - | Oct-02 |
| Aa3 | Aaa | - | - | - | - | - | Jul-97 |
| A1 | - | - | Possible Upgrade | - | - | - | Jun-97 |
| A1 | - | - | - | - | - | - | Jun-96 |
| A2 | - | - | Possible Upgrade | - | - | - | Apr-96 |
| A2 | - | - | - | - | - | - | May-89 |

Notes: [1] Table excludes rating affirmations and ceilings. Please visit the issuer page for Iceland for the full rating history.
*Source: Moody's Investors Service*

## Annual statistics

Exhibit 62

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021F | 2022F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Economic structure and performance** | | | | | | | | | | | | |
| Nominal GDP (US$ bil.) | 15.2 | 14.8 | 16.1 | 17.9 | 17.5 | 20.8 | 24.7 | 26.2 | 24.8 | 21.7 | 26.0 | 27.8 |
| Population (Mil.) | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 |
| GDP per capita (US$) | 47,867 | 46,098 | 50,078 | 54,809 | 53,244 | 62,442 | 73,161 | 75,357 | 69,571 | 59,656 | 70,335 | 73,968 |
| GDP per capita (PPP basis, US$) | 41,009 | 42,154 | 44,673 | 46,239 | 49,471 | 53,943 | 56,945 | 59,291 | 60,419 | 55,966 | -- | -- |
| Nominal GDP (% change, local currency) | 5.0 | 4.5 | 6.8 | 5.9 | 10.8 | 8.7 | 5.2 | 7.5 | 7.2 | -3.4 | 9.7 | 8.7 |
| Real GDP (% change) | 1.8 | 1.1 | 4.6 | 1.7 | 4.4 | 6.3 | 4.2 | 4.7 | 2.6 | -6.6 | 3.4 | 5.0 |
| Inflation (CPI, % change Dec/Dec) | 5.3 | 4.2 | 4.1 | 0.8 | 2.0 | 1.9 | 1.9 | 3.7 | 2.0 | 3.6 | 3.1 | 2.6 |
| Unemployment rate (%) | 7.7 | 6.6 | 5.8 | 5.4 | 4.5 | 3.3 | 3.3 | 3.1 | 3.9 | 6.4 | 6.0 | 5.0 |
| Gross investment/GDP | 15.4 | 16.0 | 15.6 | 17.2 | 19.3 | 20.9 | 21.8 | 21.6 | 20.6 | 21.1 | 21.3 | 21.8 |
| Gross domestic saving/GDP | 23.3 | 21.8 | 23.2 | 23.6 | 26.9 | 27.7 | 26.2 | 25.5 | 25.7 | 21.1 | 21.2 | 23.3 |
| Nominal exports of G & S (% change, US$ basis) | 16.7 | -2.4 | 6.0 | 7.2 | -1.7 | 9.1 | 14.5 | 8.3 | -10.1 | -32.8 | 24.5 | 11.2 |
| Nominal imports of G & S (% change, US$ basis) | 23.8 | 1.7 | 1.3 | 9.8 | -4.1 | 9.8 | 20.1 | 11.1 | -13.9 | -22.8 | 21.3 | 7.2 |
| Real exports of G & S (% change) | 3.4 | 3.6 | 6.8 | 3.9 | 8.9 | 11.0 | 5.1 | 1.7 | -4.6 | -30.5 | 9.8 | 10.0 |
| Real imports of G & S (% change) | 6.8 | 4.6 | 0.1 | 10.0 | 13.5 | 14.6 | 11.8 | 0.5 | -9.3 | -22.0 | 6.9 | 6.0 |
| Net exports of goods & services/GDP | 7.7 | 5.8 | 7.7 | 6.4 | 7.5 | 6.6 | 4.5 | 3.5 | 5.1 | -0.6 | 0.3 | 1.6 |
| Openness of the economy[1] | 101.4 | 104.1 | 98.8 | 96.7 | 95.8 | 88.3 | 87.0 | 89.9 | 83.7 | 68.8 | 70.5 | 72.1 |
| Government Effectiveness[2] | 1.6 | 1.5 | 1.5 | 1.5 | 1.5 | 1.4 | 1.5 | 1.5 | 1.5 | -- | -- | -- |
| **Government finance** | | | | | | | | | | | | |
| Gen. gov. revenue/GDP[3] | 44.1 | 45.2 | 44.8 | 46.2 | 43.2 | 59.1 | 45.4 | 44.9 | 41.9 | 42.4 | 39.1 | 38.9 |
| Gen. gov. expenditures/GDP[3] | 50.7 | 47.9 | 46.1 | 45.9 | 43.6 | 46.5 | 44.5 | 44.0 | 43.4 | 49.7 | 48.9 | 46.3 |
| Gen. gov. financial balance/GDP[3] | -6.5 | -2.6 | -1.2 | 0.3 | -0.4 | 12.5 | 1.0 | 0.9 | -1.5 | -7.3 | -9.8 | -7.5 |
| Gen. gov. primary balance/GDP[3] | 2.4 | 6.4 | 7.0 | 7.2 | 6.5 | 18.7 | 6.7 | 5.9 | 2.8 | -3.3 | -5.7 | -3.4 |
| Gen. gov. debt (US$ bil.)[3] | 19.9 | 19.2 | 20.8 | 18.9 | 17.3 | 17.8 | 17.5 | 14.9 | 17.2 | 18.5 | 20.5 | 23.4 |
| Gen. gov. debt/GDP[3] | 138.2 | 133.9 | 122.0 | 115.2 | 97.2 | 79.9 | 69.4 | 61.1 | 68.3 | 79.9 | 82.6 | 83.4 |
| Gen. gov. debt/gen. gov. revenue[3] | 313.2 | 296.1 | 272.1 | 249.2 | 225.2 | 135.2 | 152.6 | 136.2 | 163.0 | 188.5 | 211.1 | 214.6 |
| Gen. gov. interest payments/gen. gov. revenue[3] | 20.2 | 20.0 | 18.3 | 14.9 | 15.9 | 10.4 | 12.7 | 11.2 | 10.4 | 9.5 | 10.5 | 10.5 |
| **External payments and debt** | | | | | | | | | | | | |
| Nominal exchange rate (local currency per US$, Dec) | 122.7 | 129.0 | 115.6 | 126.9 | 129.6 | 112.8 | 104.4 | 116.3 | 121.1 | 127.2 | 129.7 | 125.1 |
| Real eff. exchange rate (% change) | 0.9 | -1.1 | 4.2 | 6.9 | 2.6 | 12.5 | 12.0 | -2.6 | -6.7 | -7.6 | -- | -- |
| Relative unit labor cost | 96.6 | 98.4 | 99.5 | 100.0 | 100.0 | 102.6 | 106.9 | 108.9 | 105.1 | 107.3 | -- | -- |
| Current account balance (US$ bil.)[4] | 0.0 | 0.2 | 1.2 | 1.0 | 1.0 | 1.7 | 1.0 | 1.0 | 1.6 | 0.2 | 0.4 | 0.4 |
| Current account balance/GDP[4] | -0.1 | 1.4 | 7.7 | 5.4 | 5.7 | 8.1 | 4.2 | 3.8 | 6.4 | 1.1 | 1.6 | 1.4 |
| Net foreign direct investment/GDP | 7.2 | 28.7 | -0.3 | 4.1 | 4.0 | 3.5 | 0.7 | -1.7 | -3.1 | -3.0 | -2.4 | -2.5 |
| Net international investment position/GDP[4] | -48.1 | -24.9 | -9.7 | -3.7 | -5.2 | 2.0 | 2.0 | 8.8 | 21.6 | 38.4 | -- | -- |
| Official forex reserves (US$ bil.) | 7.7 | 4.0 | 4.1 | 4.1 | 4.8 | 6.9 | 6.2 | 6.0 | 6.4 | 6.0 | 6.6 | 6.7 |

*Source: Moody's Investors Service*

## Moody's related publications

- **Credit Opinion**: Government of Iceland – A2 stable: Update following rating affirmation; outlook unchanged, 20 August 2021
- **Issuer Comment:** Government of Iceland – A2 stable: Easing of travel restrictions could accelerate tourism recovery, 25 March 2021
- **Credit Opinion**: Government of Iceland – A2 stable: Update following assignment of ESG scores, 11 February 2021
- **Outlook**: Sovereign – Global: Negative 2021 outlook as pandemic fallout weighs on economic activity, government finances, complicates policy choices, 10 November 2020
- **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.

## Related websites and information sources

- Sovereign risk group web page
- Sovereign ratings list



# Endnotes

1 The suspension applied in 2019 and 2020, since early 2021 capelin fishing is allowed again.

2 Iceland has the lowest Gini coefficent of all OECD countries, implying the most even distribution of wealth among this group of countries.

3 According to forecasts from the 2021 Ageing Report and Statistics Iceland

4 Statistics Iceland estimates the contribution to Gross Value Added (at basic prices) to be smaller at 10.3%. Direct employment stood at 13.9% of the total in 2019.

5 Individuals could withdraw up to ISK12 million between April and December 2020.

6 Growth in the first quarter of this year was weaker than expected with the economy contracting by 5.2% compared to the previous quarter. However, Iceland's quarterly GDP data tend to be volatile and have often been materially revised as more information becomes available. The weak Q1 also follows two quarters with strong average quarterly growth of 4.3%.

7 For example, the temporary unemployment benefit has been replaced by a targeted wage subsidy for companies that rehire employees. Social-security contributions are lowered by 0.25% this year.

8 See **OECD**, 2020

9 Institutional and governance changes include the move from a three-person Board of Governors, who typically had been senior politicians, to a five-member Monetary Policy Committee (MPC) with internal and external members, the appointment of a single Governor with relevant experience among others. For more detail, see **Post-crisis monetary policy reform**, 2018

10 The IMF estimates the exchange rate pass through at 10-30%, implying that a 1% depreciation of the ISK raises inflation by 0.1-0.3ppt.

11 The government defines net general government debt as gross debt excluding pension liabilities, accounts payable and also net of currency and deposits. The definition also excludes the newly reclassified entities, which will however, be included for information purposes in future budgets and financial plans.

12 More precisely, government debt for the purpose of the fiscal rules is defined as net general government debt excluding pension liabilities, accounts payable and also net of currency and deposits. The definition also excludes the newly reclassified entities, which will however, be included for information purposes in future budgets and financial plans.

13 The largest guarantees have been extended to power company Landsvirkjun, which accounts for 62% of total outstanding guarantees. The company has a stable operating performance and has been able to raise debt without government guarantees. It has also markedly improved its equity position and has become a source of revenue for the government in recent years. The company paid ISK6.2 billion (0.2% of GDP) in dividends to the government in 2020.

14 Government debt for the purpose of the fiscal rules is defined as general government debt excluding pension liabilities and accounts payable. The definition also excludes the newly reclassified entities.

15 We do not rate any Icelandic banks, and our analysis of the Icelandic banking system is derived from publicly available information.

16 See **Financial Stability Report 2021/1** and **IMF Article IV**, 2021

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

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