

## CREDIT OPINION

21 May 2019

Update

✓ Rate this Research

### Analyst Contacts

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

Malgorzata Glowacka +49.69.70730.938  
 Associate Analyst  
 malgorzata.glowacka@moodys.com

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

Yves Lemay +44.20.7772.5512  
 MD-Sovereign Risk  
 yves.lemay@moodys.com

# Government of Iceland - A3 positive

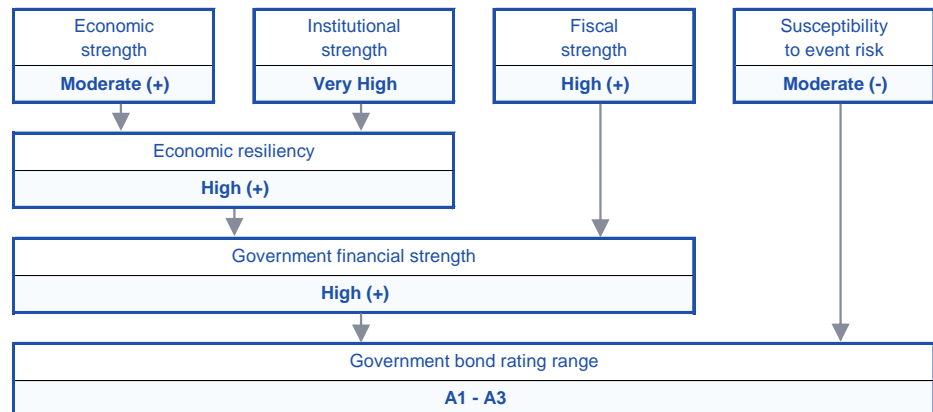
Regular update

## Summary

The credit profile of [Iceland \(A3 positive\)](#) is supported by its wealthy, flexible economy, benefiting from a natural resource base that affords robust growth potential. The credit profile is constrained by the economy's small size, relatively limited diversification, openness and small currency area, which increase its vulnerability to shocks and can cause volatility in growth.

Exhibit 1

Iceland's credit profile is determined by four factors



Source: Moody's Investors Service

## Credit strengths

- » Economic flexibility and very high wealth provide significant shock-absorption capacity
- » Strong fiscal position and low share of foreign currency debt
- » Well-funded pension system, long working lives and favorable demographics

## Credit challenges

- » Small, open economy and currency area subject to volatility
- » Substantial, albeit significantly reduced, exposure to external risks
- » Large contingent liabilities derived from state-owned companies

## Rating outlook

The positive outlook reflects the Icelandic economy's improving economic resilience afforded by a net external creditor position, more balanced growth and ongoing strengthening of the country's banking system. The positive outlook also reflects the progress made in the past two years on the major preconditions we laid out at the time of the upgrade to A3 in September 2016, including the smooth removal of capital controls and the settlement of the offshore kronur debt.

## Factors that could lead to an upgrade

We would consider upgrading Iceland's A3 ratings should the authorities achieve the expected further improvement in the government's debt metrics and be successful in managing a soft landing of the economy amidst the maturation of the tourism sector and upcoming wage round without a material degradation of the external position.

## Factors that could lead to a downgrade

We would consider removing the positive outlook or taking a negative rating action if a disruptive slowdown or outright contraction in tourism revenues or other economic shocks were to weaken public or external debt sustainability or threaten financial stability, particularly should Iceland again have to resort to capital controls.

## Key indicators

Iceland	2013	2014	2015	2016	2017E	2018E	2019F	2020F
Real GDP (% change)	4.1	2.1	4.7	6.6	4.6	4.6	0.1	2.7
Inflation (CPI, % change, Dec/Dec)	4.1	0.8	2.0	1.9	1.9	3.7	3.4	3.2
Gen. gov. financial balance/GDP (%)	-1.8	-0.1	-0.8	12.4	0.5	1.1	0.1	0.7
Gen. gov. primary balance/GDP (%)	2.6	4.5	3.6	16.4	4.4	4.2	2.9	3.3
Gen. gov. debt/GDP (%)	88.0	80.9	65.0	52.2	44.0	38.6	37.6	34.9
Gen. gov. debt/revenues (%)	216.8	184.9	160.2	91.7	100.3	90.3	89.0	81.7
Gen. gov. interest payment/revenues (%)	10.9	10.4	10.9	6.9	8.8	7.2	6.6	6.1
Current account balance/GDP (%) <sup>[1]</sup>	7.2	5.2	5.7	7.5	3.6	2.9	1.5	0.5

[1] Excludes DMBs undergoing winding up in 2008-2015

Sources: Central Bank of Iceland, Statistics Iceland, Moody's Investors Service

## Detailed credit considerations

The credit profile of Iceland reflects its "Moderate (+)" **economic strength**, "Very High" **institutional strength**, "High (+)" **fiscal strength**, and "Moderate (-)" **susceptibility to event risk**.

We assess Iceland's **economic strength** as "Moderate (+)", which is below the indicative score of "High (-)" because of the country's small size and associated history of economic boom and bust episodes. That said, at \$55,917 as of 2018 on a purchasing power basis, Iceland's GDP per-capita is higher than that of around 90% of the universe of Moody's rated sovereigns, having overcome significant losses registered during the country's banking and currency crisis. As evidenced by its ranking at 28th globally by the World Economic Forum's Global Competitiveness Index for 2017-2018, Iceland's economy is highly competitive – standing out compared with close peers, particularly given the economy's small size.

We assess Iceland's **institutional strength** as "Very High", mainly reflecting the country's strong scores in the Worldwide Governance Indicators (WGI) and track record of effective macroeconomic management to restore financial stability after the banking crisis. Iceland ranks in the 88th percentile of the WGI's measure of government effectiveness and rule of law, and 91st for control of corruption, well above the A-rating category median. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative and high tech-oriented business sector, an efficient and flexible labor market and well-developed infrastructure.

The progress that the authorities have achieved in restoring macroeconomic, financial, and fiscal health also informs our assessment of Iceland's institutions. For example, the regulatory framework for the banking sector has strengthened considerably – with domestic

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banks focusing inward to mitigate risk. Our assessment also recognizes the careful and ultimately successful liberalization of capital account restrictions, with almost all such controls ultimately removed by April 2019. Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between the government, employers and employee associations, which contribute positively to policy effectiveness.

We assess Iceland's **fiscal strength** as "High (+)" reflecting Iceland's relatively low debt burden and high debt affordability, although contingent liabilities remain sizeable. After peaking at 111.5% of GDP in 2011, Iceland's gross government debt burden declined precipitously, with persistent budget surpluses, debt buybacks and rapid economic growth, to stand at 38.6% in 2018. Compositionally, the government's debt burden is now significantly less exposed to exchange rate risk, because the foreign currency share of gross government debt has declined to 11.6% in 2018 from 41.9% in 2011, and the debt's maturity remains relatively long. The final score of "High (+)" is one notch higher than the indicative score of "High" to reflect our expectation that debt is forecast to continue to decline, albeit not as fast as before, and that improvements to the composition of debt from the buybacks and refinancings in previous years will help to ensure a continued reduction in interest costs.

We assess Iceland's **susceptibility to event risk** as "Moderate (-)". The "Moderate (-)" score is driven by our banking system risk assessment, which is set below the indicative score of "Moderate (+)". Given our lack of a published baseline credit assessment for the Icelandic banking system, which leads to incomplete data for the calculation of an indicative banking sector risk score, we incorporate our aggregate analysis of the Icelandic banking system developed from publically available information into the final score. As a consequence, we believe banking sector risk is lower than the indicative score produced by the scorecard.

Furthermore, risks to financial stability from the banking sector have diminished significantly since the 2008 banking sector crisis. Strong capitalization and liquidity, lower NPLs and otherwise solid operating performance at the three main domestic money banks are however somewhat tempered by the banking sector's concentration within three institutions, all successors of the old failed banks.

We assess external vulnerability risk and political risk at "Low" and "Very Low", respectively, because both pose minimal risks to Iceland's credit profile. External vulnerability risk is set at "Low", which is below the indicative score of "Moderate (+)" to reflect a data-driven aberration of a large decline in gross FDI liabilities during 2017 owing to accounting treatment of ownership changes in the pharmaceuticals sector and the winding-up of special purpose entities established before the financial crisis, which are fully netted out elsewhere in the capital account. Government liquidity risk is assessed at "Very Low", consistent with the government's low refinancing needs, low levels of government foreign debt, and otherwise a significantly improved debt management framework.

## Recent developments

### **Collapse of Wow Air and poor capelin season will strain Icelandic economy in short term**

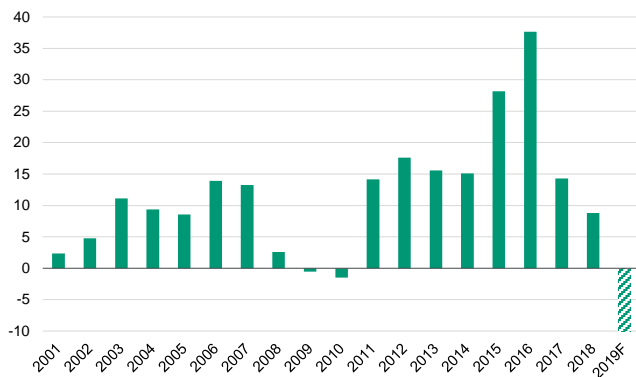
Following robust growth of 4.6% in 2018, we expect the economy to slow markedly in 2019 given the bankruptcy of Iceland's low-cost airline Wow Air, which will impact on tourist arrivals for the forthcoming summer season, and that there will be no capelin quotas this season. While these shocks are expected to be short term in nature, their impact on growth in 2019 will be material. As a result, we have revised our real GDP growth forecasts to 0.1% and 2.7% for 2019 and 2020, from 2.5% and 2.0%, respectively.

Financial pressures at Wow Air escalated at the end of 2018 and, after a number of failed rescue attempts, the company declared bankruptcy in March this year. The airline transported around one-quarter of total tourists to Iceland such that we expect the disruption caused by Wow Air's collapse to result in a significant decline in tourism receipts and hence exports. As such, following years of torrid growth, we expect tourism arrivals to decrease by around 10%, bringing it in line with 2017 levels (see Exhibit 3). We also expect the airline's collapse to contribute to a notable increase in unemployment, to 3.5% in 2019 from 2.7% in 2018, after around 1,000 former Wow Air employees lost their jobs earlier this year, which will weigh on private consumption. The non-seasonally adjusted unemployment rate recorded a steep increase already this year, reaching 3.7% in April from 2.7% in December 2018.

However, over the medium to long term we expect that the remaining 27 airlines that fly to Iceland will largely fill the gap created by Wow Air's failure. Furthermore, the airline's importance had already declined since its financial troubles became public last year. We have seen evidence of flexibility on the part of other airlines to increase seat capacity or redirect routes, helping to alleviate some of the near term impact, but the speed by which competitors can cover the slack created by Wow Air's failure in the coming months remains an open question.

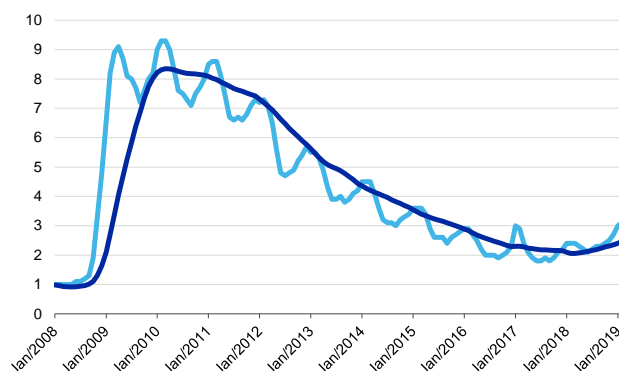
While we expect the impact on growth to be transitory, the shock does demonstrate the significant concentration of activity in a limited number of sectors within the Icelandic economy. According to the World Travel and Tourism Council, the total (including indirect) contribution from tourism to GDP stood at around 33%, more than double than in 2009.

Exhibit 3  
**Tourism arrivals will decline for the first time in almost 10 years**  
% change in tourist arrivals



Sources: Statistics Iceland, Moody's Investors Service

Exhibit 4  
**Unemployment rate has bottomed out as Wow Air bankruptcy leads to job losses**  
Registered unemployment rate (NSA) and its trend



Sources: Iceland's Directorate of Labour and Moody's Investors Service

The impact of no quotas issued for capelin fishing this season will further weaken economic momentum this year. Following unsuccessful expeditions of Icelandic research vessels to locate capelin shoals, Iceland's Marine and Freshwater Research Institute issued zero quotas for the capelin catch, the first time since Icelanders started fishing for capelin in 1963. In 2018, the capelin export amounted to ISK 17.8 billion (\$164 million), equal to 0.6% of GDP. That said, we expect the impact to be offset somewhat by strong stocks of cod and the continued growth in aquaculture.

### Wage negotiations have resulted in more moderate than expected increases to date

The recent agreements reached between some labour unions and the employer's federation in early April have resulted in more moderate wage agreements than expected, and, importantly, mitigated the risk of an escalation of strike action.

The agreement reached with Efling and its associated unions would lead to a ISK90,000 increase to the gross monthly minimum wage until the end of 2022 (below the initial demand by the unions of ISK125,000). The new agreement is set in krona rather than a percentage such that it benefits lower earnings most, and the increase of ISK68,000 on a net basis equates to around a 4% annual increase. The agreement also included favourable changes to annual bonus payments and working conditions, as well as further wage hikes linked to economic growth.

At the same time, the government has provided a generous package of measures to support the agreement. These measures, some of which were already announced but conditional on an agreement, included additional support for housing, child benefits, more generous parental leave as well as tax relief for those in the lowest tax bracket. These measures are expected to total around ISK80 billion (or 2.7% of 2019 nominal GDP) over 2019-2022.

Overall, the wage agreements reached, which cover around an estimated half of the labour market, are more moderate than expected, particularly given the outcome of previous wage negotiations, helping to contain risks to inflation and overall competitiveness in a weakening growth environment. For example, wages in Iceland have increased by an estimated cumulative 45% over the last 5 years, according to the wage index published by Statistics Iceland, although part of this increase is due to catching up with pre-crisis levels. While the full set of agreements have not yet concluded, our baseline expectation is that the agreements reached so far are likely to set the framework for the remaining negotiations, which include public sector employees.

As a result, we've lowered our forecast for inflation to 3.4% at the end of this year and to 3.2% at the end of 2020, which also reflects the weaker economic activity following the shock to the tourism sector.

### **Strong budget outcome in 2018 provides further fiscal space to cushion the economic shock**

According to preliminary figures, the government fiscal balance stood at a surplus of 1.1% of GDP in 2018, an improvement on the 0.5% of GDP surplus recorded in 2017. The strong fiscal outcome was partly driven by the one-off capital transfer of ISK32 billion (1.1% of GDP) from local governments to the public pension fund. However, revenues also increased materially, by 4.6%, supported by the better than expected cyclical economic momentum last year, which exceeded the 3.1% growth in expenditure.

Iceland's favourable fiscal outcome - with a primary surplus of 4.2% in 2018 after 4.4% in 2017 - has also helped to continue the reduction in the government's debt burden, which reached 38.6% of GDP in 2018 down from 44% of GDP a year earlier and its peak at 111.5% in 2011.

While we don't expect the government's balance sheet to be directly affected by the airline's bankruptcy, indirect factors such as lower tax receipts, higher social security spending and slower GDP growth will translate into a worse than initially expected government fiscal outcome relative to GDP in 2019. As a result, we forecast the government's overall fiscal balance to fall to a small surplus of 0.1% in 2019, before recovering to 0.7% in 2020.

That said, we expect Iceland's accumulated fiscal space will help to cushion the negative effect of these temporary economic shocks. We expect a slower pace of debt reduction going forward compared to recent years, with the general government debt reaching just below 35% of GDP by 2020. Apart from the precipitous decline in general government debt over recent years, the level of government foreign debt and the government financing needs have decreased substantially. Iceland's improving economic resilience is also afforded by a net external creditor position that increased to around 10% of GDP in 2018, a substantial change from -105% in 2007.

We expect the healthy state of Iceland's public finances, which support the country's improved resilience to withstand shocks, will continue. Under the government's announced Fiscal Strategy Plan for 2020-2024, the authorities envisage a treasury budget surplus of 0.8%-1.0% in each year. In addition to higher public investment and measures to support the wage negotiations, the Plan anticipates an ambitious reform of the personal income tax system between 2019 and 2022 which will lower the effective tax rate of minimum wage earners. The authorities also plan to build up financial buffers to cushion unforeseen shocks.

### **The authorities have lifted almost all remaining capital controls**

Following the steps taken in November 2018 by the central bank to reduce the special reserve requirement (SRR) ratio for new foreign currency inflows to 20% from 40%, in line with guidance from the IMF, the government has now largely concluded the process of lifting capital controls in early 2019, an important milestone for Iceland's economic and financial stability.

In March 2019, the authorities lifted restrictions on offshore-krona assets and reduced the SRR ratio, which had been used to discourage speculative capital inflows and protect the exchange rate, to zero. The restrictions on capital inflows which had the sole purpose of supporting the SRR were removed in April 2019. While it is difficult to disentangle any impact from the wage negotiations and collapse of Wow Air, the lifting of the controls has not resulted in any material or destabilizing outflows or abrupt exchange rate movements to date.

The central bank's ability to lower the SRR to zero reflects the improvement achieved in monetary policy transmission since the crisis, the economy's narrower current-account surpluses and more market-determined exchange rate. In our view, these developments further demonstrate Iceland's progress in restoring macroeconomic and external normalcy following the crisis.

## Rating methodology and scorecard factors

### Rating factors grid - Iceland

Rating factors	Sub-factor weighting	Indicator	Indicative factor score	Final factor score
<b>Factor 1: Economic strength</b>			H-	M+
<b>Growth Dynamics</b>	50%			
Average real GDP growth (2013-2022F)		3.7		
Volatility in real GDP growth (standard deviation, 2008-2017)		4.0		
WEF Global Competitiveness index (2017)		5.0		
<b>Scale of the economy</b>	25%			
Nominal GDP (US\$ billion, 2017)		24.5		
<b>National income</b>	25%			
GDP per capita (PPP, US\$, 2017)		53,834		
<b>Automatic adjustments</b>	[-3; 0]	Scores applied		
Credit boom		0		
<b>Factor 2: Institutional strength</b>			VH	VH
<b>Institutional framework and effectiveness</b>	75%			
Worldwide Government Effectiveness index (2017)		1.5		
Worldwide Rule of Law index (2017)		1.6		
Worldwide Control of Corruption index (2017)		1.8		
<b>Policy credibility and effectiveness</b>	25%			
Inflation level (% , 2013-2022F)		2.6		
Inflation volatility (standard deviation, 2008-2017)		4.1		
<b>Automatic adjustments</b>	[-3; 0]	Scores applied		
Track record of default		0		
<b>Economic Resiliency (F1xF2)</b>			H+	H+
<b>Factor 3: Fiscal strength</b>			H	H+
<b>Debt burden</b>	50%			
General government debt/GDP (2017)		44.0		
General government debt/revenue (2017)		100.3		
<b>Debt affordability</b>	50%			
General government interest payments/revenue (2017)		8.8		
General government interest payments/GDP (2017)		3.9		
<b>Automatic adjustments</b>	[-6; +4]	Scores applied		
Debt trend (2014-2019F)		0		
Foreign currency debt/general government debt (2017)		0		
Other non-financial public sector debt/GDP (2017)		-1		
Public sector assets/general government debt (2017)		0		
<b>Government financial strength (F1xF2xF3)</b>			H+	H+
<b>Factor 4: Susceptibility to event risk</b>	Max. function		M+	M-
<b>Political risk</b>			VL	VL
Worldwide voice & accountability index (2017)		1.4		
<b>Government liquidity risk</b>			VL	VL
Gross borrowing requirements/GDP		1.0		
Non-resident share of general government debt (%)		21.5		
Market-Implied Ratings		Baa2		
<b>Banking sector risk</b>			M+	M-
Average baseline credit assessment (BCA)		--		
Total domestic bank assets/GDP		184		
Banking system loan-to-deposit ratio		143		
<b>External vulnerability risk</b>			M+	L
(Current account balance + FDI Inflows)/GDP		-24.7		
External vulnerability indicator (EVI)		--		
Net international investment position/GDP		3.6		
<b>Government bond rating range (F1xF2xF3xF4)</b>			A2 - Baa1	A1 - A3
<b>Assigned foreign currency government bond rating</b>		A3		
<b>Note:</b> While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. 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 indicative rating range. For more information please see our Sovereign Bond Rating Methodology.				

**Footnotes:** (1) **Indicative factor score:** rating sub-factors combine with the automatic adjustments to produce an Indicative factor score for every rating factor, as detailed in Moody's Sovereign Bond Methodology. (2) **Final factor score:** where additional analytical considerations exist, Indicative factor scores are augmented to produce a Final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Bond Methodology; details on country-specific considerations are provided in Moody's research. (3) **Rating range:** Factors 1: Economic strength, and Factor 2: Institutional strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3: Fiscal strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's susceptibility to event risk, is a constraint which can only lower the preliminary government financial strength rating range as given by combining the first three factors. (4) **15 Ranking categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- (5) **Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

## Moody's related publications

- » **Issuer Comment:** [Government of Iceland: Wow Air's collapse poses downside risks for Iceland's 2019 economic growth, a credit negative](#), 3 April 2019
- » **Issuer Comment:** [Government of Iceland: Stronger-than-expected growth will support decline in Iceland's debt/GDP ratio, a credit positive](#), 6 March 2019
- » **Issuer In-Depth:** [Government of Iceland – A3 positive: Annual credit analysis](#), 3 August 2018
- » **Rating Action:** [Moody's changes Iceland's outlook to positive from stable and affirms A3 ratings](#), 20 July 2018
- » **Issuer Comment:** [Government of Iceland: Central bank's reduced reserve requirements on capital inflows are credit positive](#), 7 November 2018
- » **Methodology:** [Sovereign Bond Ratings](#), 27 November 2018

*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.*



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