MOODY'S INVESTORS SERVICE

ISSUER IN-DEPTH
29 July 2019

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RATINGS

Iceland

	Foreign Currency	Local Currency
Gov. Bond Rating	A3/POS	A3/POS
Country Ceiling	A3	A1
Bank Deposit Ceiling	A3	A1

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Government of Iceland – A3 positive

Annual credit analysis

OVERVIEW AND OUTLOOK

Iceland's (A3 positive) credit strengths include the economy's flexibility, wealth, competitiveness and favourable demographics, all of which support its long-term growth prospects and help it absorb shocks from its small size and sector concentration. The country's track record of effective macroeconomic management to restore financial stability and strengthen regulations after its banking crisis underpins its very high institutional strength. Furthermore, careful capital account liberalization – remaining capital controls were relaxed in 2019 – has been achieved with minimal disruption. Fiscal strength has been bolstered by the decline in its government debt burden which is also now significantly less exposed to exchange-rate risks. Debt should continue to decline to around 34% in 2020. Moreover, its move to a net external creditor position helps buffer against external risks.

Iceland's main credit weakness is the economy's small size and relatively limited diversification together with its high openness and small currency area, which increase its vulnerability to boom-bust cycles. The potential for a shock in one of its three main sectors to disrupt growth prospects is material, as the collapse of Wow Air in early 2019 demonstrates – a temporary recession is forecast in 2019. That said, very high household incomes serve as an important shock absorber, while the fundamentals of Iceland's economic model remain sound, such that we expect growth to recover to around 2.5% in 2020. In addition, large contingent liabilities derived from state-owned companies would pose risks to public finances if they were to crystallize on the government's balance sheet. Iceland also faces risks in the short term from a disorderly no-deal Brexit given that the UK (Aa2 stable) is Iceland's second-largest trading partner and an important source of tourism.

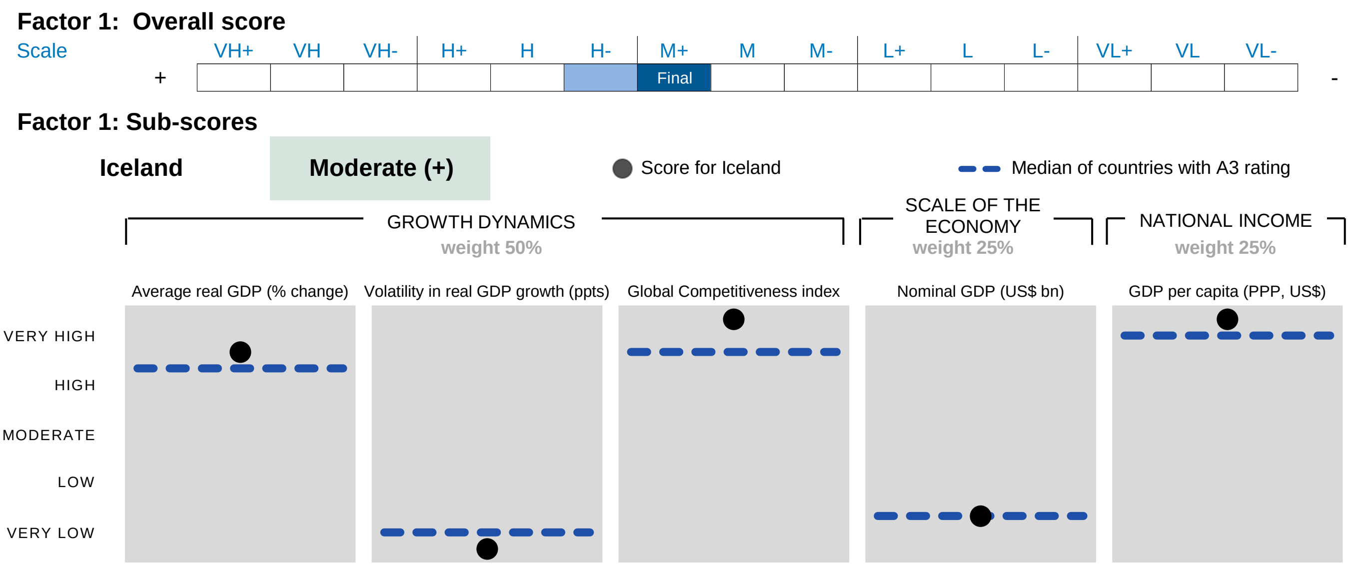
The positive outlook reflects the economy's improving resilience afforded by a net external creditor position, more balanced growth and ongoing strengthening of the country's banking system. We would consider upgrading the country's ratings if the government achieved further improvements in its debt metrics and successfully managed a soft landing of the economy amid slowing growth in the tourism sector and expected wage increases without a material weakening of its external position. A downgrade or a return to a stable outlook would be considered in the event of a disruptive slowdown or prolonged contraction in tourism revenue. A downgrade would also be considered if other economic shocks were to weaken the sustainability of public or external debt or threaten Iceland's financial stability, particularly if it had to resort to broad capital controls again.

This credit analysis elaborates on Iceland's credit profile in terms of economic strength, institutional strength, fiscal strength and susceptibility to event risk, which are the four main analytic factors in Moody's Sovereign Bond Rating Methodology.

CREDIT PROFILE

Our determination of a sovereign's government bond rating is based on the consideration of four rating factors: Economic strength, institutional strength, fiscal strength and susceptibility to event risk. When a direct and imminent threat becomes a constraint, that can only lower the preliminary rating range. For more information please see our Sovereign Bond Rating methodology.

Economic strength: Moderate (+)



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. Economic strength is adjusted in case excessive credit growth is present and the risks of a boom-bust cycle are building. This 'credit boom' adjustment factor can only lower the overall score of economic strength.

Note: The Scorecard-indicated outcome is shown in light blue in the scale above. In case the Scorecard-Indicated outcome and Final scores are the same, only the Final score will appear in the table above.

We assess Iceland's economic strength as "Moderate (+)", which balances the country's small size and associated history of economic boom and bust episodes with its very high wealth levels. As evidenced by its 28th ranking globally in the World Economic Forum's Global Competitiveness Index for 2017-2018, Iceland's economy is also highly competitive – standing out compared with close peers, particularly given the economy's small size. Other sovereigns with the same assessment of economic strength include Latvia (A3 stable), Lithuania (A3 stable) and Slovakia (A2 positive).

Exhibit 1

Peer comparison table factor 1: Economic strength

	Iceland A3/POS	M+ Median	Latvia A3/STA	Lithuania A3/STA	Slovakia A2/POS	Costa Rica B1/NEG	Bahrain B2/STA	Cyprus Ba2/STA
Final score	M+		M+	M+	M+	M+	H-	M
Scorecard-indicated outcome	H-		M	M+	H-	M+	H	M+
Nominal GDP (US$ bn)	25.9	88.3	34.8	53.3	106.5	60.2	37.7	24.5
GDP per capita (PPP, US$)	55,917.3	27,856.8	29,901.3	34,825.8	35,129.8	17,918.4	50,056.5	39,973.2
Average real GDP (% change)	3.6	3.3	3.1	2.8	3.5	3.3	2.8	2.6
Volatility in real GDP growth (ppts)	4.1	2.9	6.1	5.9	2.9	1.7	1.1	3.5
Global Competitiveness Index	5.0	4.3	4.4	4.6	4.3	4.5	4.5	4.3

Sources: National sources, IMF, World Economic Forum, Moody's Investors Service

The final score of "Moderate (+)" is one notch lower than the scorecard-indicated outcome of "High (-)" given the high degree of concentration in the Icelandic economy. While more diversified than in the past, Iceland's very open economy still relies on three main export sectors, which points to a smaller degree of diversification than that implied by the standard assessment of size in the scorecard.

The potential for a shock in one of these sectors to disrupt aggregate growth prospects is material, as seen with the collapse of Wow Air in early 2019.

Iceland's small size and concentration are offset by its wealth and flexibility

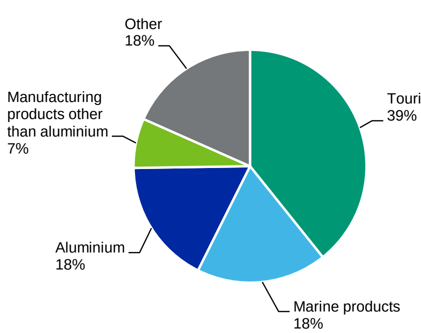
With nominal GDP of $25.9 billion in 2018, Iceland's economy is one of the smallest of the sovereigns we rate. Although its size mainly reflects the country's small population (around 350,000 in 2018), its wealth stands as a strength relative to rating peers, with GDP per capita on purchasing power parity basis at $55,917, higher than 90% of the sovereigns we rate. Compared to other A-rated sovereigns, Iceland's robust growth performance, aided both by its flexible currency and labour markets and its very high per capita income, also stands out favourably.

That said, very high levels of economic concentration have led to periods of boom bust cycles and lead to much more volatile real GDP growth figures compared to peers. Given its size and geographic location, Iceland's main export industries take advantage of its unique characteristics such as its natural beauty, abundant fishing grounds and hydroelectric and geothermal energy resources. More than 70% of the country's export revenues come from three sectors that leverage these resources: tourism (39% of total export revenues), marine products (18% of total export revenues) and aluminum (18% of total export revenues) given Iceland's relative cost advantage for energy-intensive smelting (see Exhibit 2). Most notably, the tourism industry has served as a positive external shock to both the economy and the country's balance of payments in recent years, helped initially by the competitiveness gains from the weak krona and international press coverage of Eyjafjallajökull volcano eruption.

Given the small size of the domestic economy, Iceland is also highly dependent on international trade, with exports and imports accounting for 44% and 47% of GDP, respectively, in 2018. A high degree of economic openness combined with limited diversification of its export products makes the economy vulnerable to external events that could disrupt trade flows, such as changes in the economic prospects of its main trading partners, fluctuation in the exchange rate or price of aluminium, or the imposition of trade tariffs. At the same time, the economy is susceptible to environmental risks, such as the potential for natural disasters to interrupt tourism or ocean warming to disrupt fishing stocks.

Exhibit 2

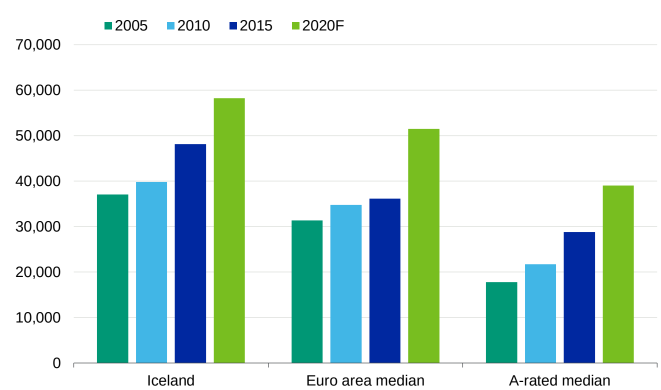
Three sectors dominate more than 70% of Iceland's exports
% of total goods and services exports, 2018



Sources: Statistics Iceland, Moody's Investors Service

Exhibit 3

Iceland's high income levels act as an important shock absorber
GDP per capita based on power purchasing basis, international $



Sources: IMF, Moody's Investors Service

The recent collapse of one of Iceland's main domestic airlines, Wow Air, is a clear illustration of the risks posed by a highly concentrated economy. The shock is likely to result in a sharp decline in tourists arrivals after a significant boom in the sector since 2010, with the total number of tourists reaching 2.3 million in 2018 from only 430,000 a decade earlier. The impact will be felt widely across the economy as tourism has grown to be the single most important source of export revenue, with potential knock-on effects to construction activity and employment. As a result, after growing 4.6% in 2018, we expect the economy to contract by 0.8% in 2019.

That said, the very high incomes of Icelandic households serve as an important shock absorber, as demonstrated during the banking crisis in 2008 (see Exhibit 3). Their financial situation was buffered by substantial pension assets and savings, despite declines in wealth levels after house prices collapsed. Moreover, special legislation approved in 2015 allowed households to draw upon their supplementary pension savings for debt repayment and consumption purposes, an allowance that was extended and is currently in effect through 2021.

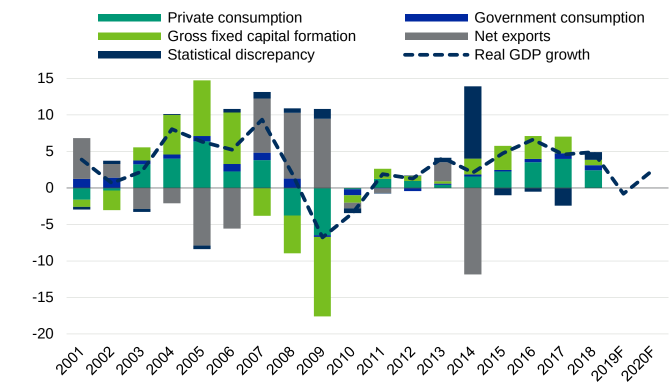
The economy grew for eight consecutive years, supported by a broadening in growth to include domestic demand...

Helped by the rapid expansion of the tourism sector, Iceland's economy has exhibited very strong growth rates since 2011 (see Exhibit 4), one of the longest periods of uninterrupted economic growth in Iceland's history. Real GDP growth averaged 3.7% over this time, supporting a 40% increase in Iceland's GDP per capita on power purchasing basis.

Importantly, the expansion has been more broad-based with domestic demand, both public and private, playing a larger and more consistent role in this expansion (see Exhibits 4 and 5).

Exhibit 4

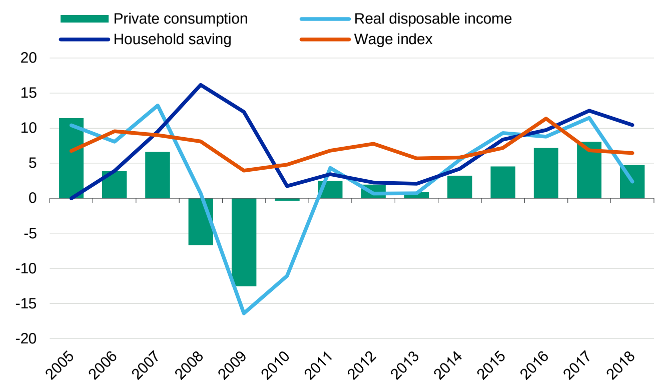
Consumption has been the main driver of economic growth...
GDP growth and its contributions



Sources: Statistics Iceland, Moody's Investors Service

Exhibit 5

...supported by rising wages, disposable incomes and savings
% change



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

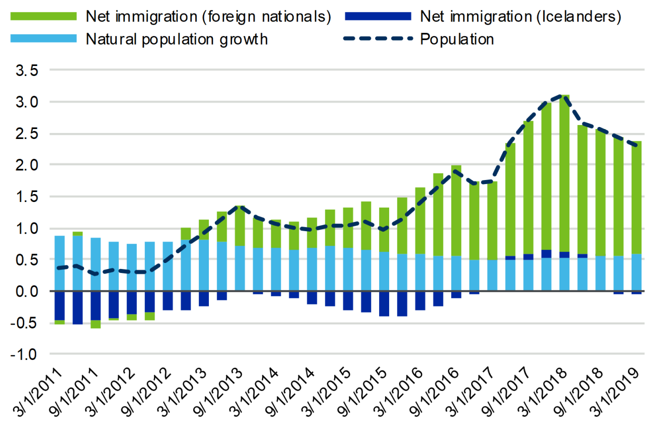
Private consumption has been supported by positive household savings rates given rising real disposable incomes, a tight labour market and lower debt burdens, with household financial positions strengthening despite the growth in spending. Households have also undergone significant deleveraging in recent years, with household debt falling from a peak of more than 121.7% of GDP in 2009 to approximately 75.6% of GDP in 2018. A favorable labour market and high wages also attracted foreign labour, which contributed to private consumption spending (Exhibit 6). At the same time, households have benefitted from strong house price inflation in recent years, given the shortages in supply, strong population growth and low interest rates, although prices have now started to increase more slowly in line with fundamentals as supply has gained pace and the slower construction of hotels and tourist-focused apartments.

Fixed investment has also shown solid momentum over the last few years, after collapsing immediately following the crisis. As a share of GDP, government, residential and private businesses' investment have all regained momentum from their recent troughs in 2009-2011 and accelerated between 2015-18, particularly residential construction supported by the increased tourist activity (Exhibits 6 and 7). On the external side, tourism also supplemented exports from traditional fishing and aluminum sectors, although it registered its first signs of a slowdown in 2017.

Exhibit 6

Tourism boom has led to an influx of foreign labour...

% change in population and its contributors

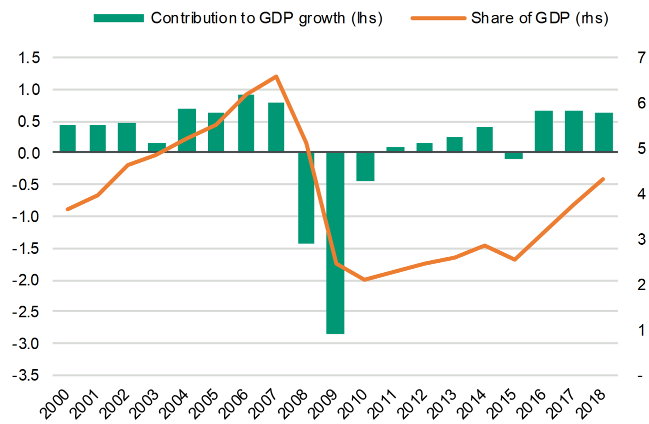


Sources: Central Bank of Iceland, Moody's Investors Service

Exhibit 7

... and increased construction activity

Residential construction: contribution to GDP (lhs) and share of GDP (rhs)



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

...although collapse of Wow Air and poor capelin season will lead to a short recession

Following robust growth of 4.6% in 2018, we expect the economy to enter a recession in 2019 following the bankruptcy of one of Iceland's main airlines, Wow Air, which will significantly impact on tourist arrivals for the forthcoming summer season,[1] while fish exports will be hit by no quotas issued for capelin fishing this season.

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 2019. The airline transported around one-quarter of total tourists to Iceland at its peak and 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 tourist arrivals to fall by around 15% in 2019, bringing it below 2017 levels (Exhibit 8).

We also expect the airline's collapse to contribute to a notable increase in unemployment, to 3.8% 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 3.6% in May from 2.7% in December 2018 (see Exhibit 9).

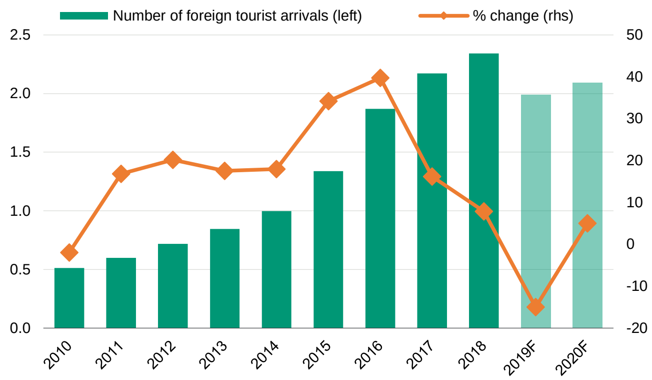
However, over the medium to long term, we expect that the remaining 27 airlines that fly to Iceland will largely fill the gap created by Wow Air's failure. Furthermore, some of the impact from declining tourist numbers has been offset by a higher spend per tourist, likely helped by the recent weakening in the krona. We have also 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.

That said, the speed by which competitors can cover the slack created by Wow Air's failure in the coming months remains an open question, especially given that the main domestic airline, Icelandair, has faced capacity constraints following the grounding of its Boeing 737 MAX aircrafts.

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.

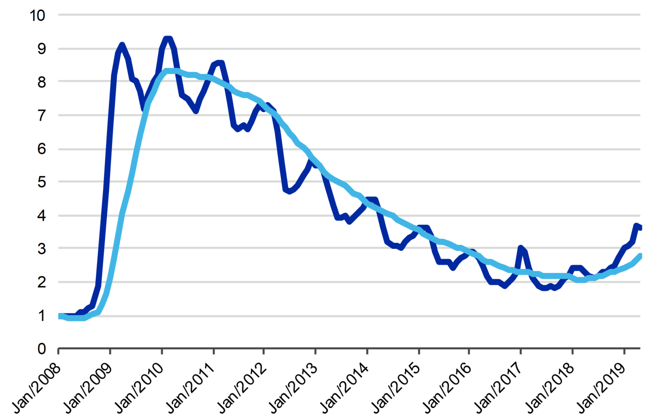
While these shocks are expected to be short term in nature, their impact on growth in 2019 will be material. As a result, we now expect real GDP to contract 0.8% in 2019 before recovering to 2.5% in 2020, supported by gradual recovery in tourism and a loosening of monetary and fiscal policy. According to the central bank's estimates, the fiscal measures related to the collective wage agreement will increase disposable income by around ISK 20 billion in 2020 and ISK 25 billion in both 2021 and 2022, which translates in around 0.2% higher growth per year.

Exhibit 8
Tourist arrivals will contract in 2019
Million of foreign tourist arrivals (rhs), % change (lhs)



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

Exhibit 9
The unemployment rate has started to rise due in part to Wow Air's bankruptcy
Registered unemployment rate (NSA) and its trend



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

The fundamentals of Iceland's economic model remain sound

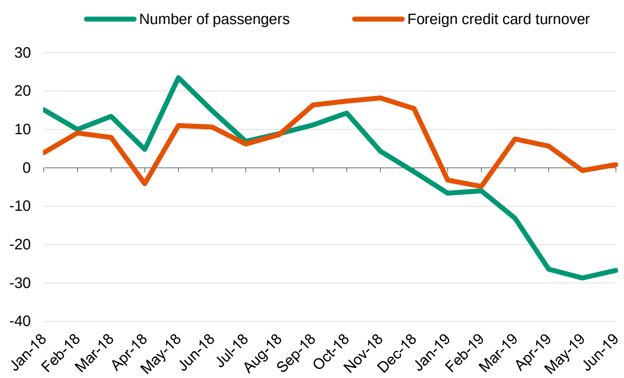
Despite the shocks impacting the economy in 2019, the longer-term fundamentals of the three pillar economic model remain sound. We forecast the economy to grow between 3.5% and 4% in 2021-24, aided by the recovery in the tourism industry to more sustainable rates of growth, with tourists arrivals expected to increase in line with the growth in global tourism of between 4-7%.

Attracting approximately 0.5% of total travel and passenger transport among advanced European economies, Iceland still captures only a fraction of the total market. The collapse of the discount airline Wow Air will also help accelerate the move into higher-value added segments in the tourism industry, a long-term strategy identified by the authorities, as there is a shift to tourists arriving on more expensive airlines which may choose to spend more per capita (a trend which has been evident in the recent past, see Exhibit 10). Efforts to decrease seasonality are already bearing fruit, helping to improve the resilience of the sector, while increased connectivity to other parts of the island will further increase capacity.

At the same time, cod stocks, which account for around 40% of marine exports, are expected to remain abundant (see Exhibit 11), with a 3% quota increase scheduled for the forthcoming fishing season. Exports from farmed-fishing are also growing significantly and may help to counterbalance the lack of capelin exports this year. This sector is also benefitting from foreign investments and a more streamlined regulatory process, but disagreements around farmed versus wild fish have held back the sector's growth in the past.

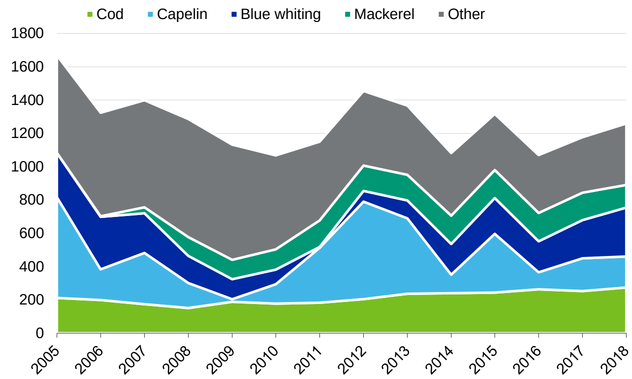
The aluminium industry's comparative advantage in terms of low energy costs has been reinforced by the recent signing of long-term contracts with the domestic energy provider, Landsvirkjun (Baa2 stable). The potential for fluctuations to impact on the smelting operations is hedged somewhat given their reliance on alumina inputs, although the risk of a prolonged downturn in aluminium prices could threaten the long-term viability of the plants operating in Iceland.

Exhibit 10
Decline in tourist arrivals is cushioned by increased spending per tourist
% change (year-on-year)



Sources: Center for Retail Studies, Isavia, Moody's Investors Service

Exhibit 11
Fishing of cod, Iceland's most valuable fish, remains strong
Catch by species, billion tonnes



Sources: Statistics Iceland, Moody's Investors Service

High underlying competitiveness and favourable demographics supports long-term economic growth prospects

An additional strength of the Icelandic economy is its high degree of competitiveness, as demonstrated by its 28th position in the World Economic Forum's Global Competitiveness Rankings. Among the aspects where Iceland stands out relative to its peers are its institutions, technological readiness, educational environment and labour market efficiency. The latter has been a key contributor to labour productivity growth over the last few years.

Iceland's demographic profile is also more positive 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's age-old dependency ratio — defined as ratio of population aged 65+ divided by the population aged 15-64 — is projected to remain below that of peers over the coming decades, according to forecasts made by the OECD in 2017.

Moreover, the average life expectancy for an Icelander is 82.5 years, above the European average of 77.5 years, while Iceland's fertility rate at 1.8 births per woman as of 2016 was above the rates of Slovenia (Baa1 positive, 1.6), Czech Republic (A1 positive, 1.6), Norway (Aaa stable, 1.7) and the Netherlands (Aaa stable, 1.7).

The flexibility of Iceland's work force is one reason why high wage awards given in 2015 did not lead to higher inflation, since at times of strong labour demand and full employment, Icelandic companies hire workers from other countries, mainly other Nordic and East European countries, who then return home when those jobs are finished.

No-deal Brexit poses the main downside risk given strong linkages with the UK

The UK is Iceland's second-largest trading partner, accounting for 10% of its goods exports in 2018, with marine products sold to the UK comprising a significant share of Iceland's total marine exports (around a third between 2010 and 2017). The recent signing of a trade continuity agreement with the UK that assures that the current trading arrangements would be preserved in a no-deal scenario will help to shelter Iceland from the worst of a discorderly Brexit. However, those fish exports to the UK which are designated for the EU would likely face a worsening in trade terms.

Furthermore, UK tourists, which comprise a sizeable proportion of visitors to Iceland (around 13% in 2018), may slow in the event of a sharper than expected downturn in the UK economy. More broadly, an economic shock hitting Iceland's main trading partners in Europe would weigh on the country's highly open economy (45% of exports are directed at the euro area).

The Central Bank of Iceland estimates that the adverse trade effects of a no-deal Brexit would lower GDP growth in Iceland by 0.1pp in 2019 and 0.4pp in 2020, and reduce the level of GDP by about 0.5pp from 2020 onwards, although we consider that the actual impact could be larger, particularly if marine products cannot be readily sold into other markets.

There are also downside risks to our forecasts if the impact from the current shocks emanating from the tourism and fishing sectors were to be a deeper recession and slower than expected recovery. Furthermore, second-round negative effects from these shocks on uncertainty and spending could extend the downturn into 2020.

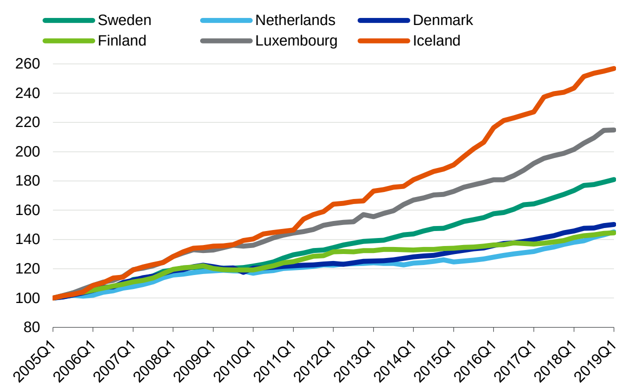
Given the openness of the economy and expected weak productivity growth, risks to competitiveness from strong wage growth remains a credit concern. That said, the immediate risks to competitiveness from the expiration of the 2015 wage agreements have abated following the multi-year agreements reached between some labour unions and the employer's federation in early April for more moderate than expected wage rises.

Nevertheless, wage negotiations in the public sector are yet to conclude and there remains the risk that wage drift, which has been significant in pushing compensation above agreed levels in prior years, could weigh on inflation and competitiveness, particularly if not accompanied by significant inflows of foreign labour. In nominal terms, wages in Iceland have already increased by an estimated cumulative 45% over the last five years, according to the wage index published by Statistics Iceland, much faster than Iceland's main trading partners (see Exhibit 12). Unit labour costs, which have been rising since 2010 despite productivity gains, are expected by the central bank to grow by 7% this year (see Exhibit 13). See F2: Institutional Strength for more details on risks to inflation.

Exhibit 12

Wages and salaries increased 45% over last five years, much more then peers

Wage and salaries index, Q1 2005 = 100

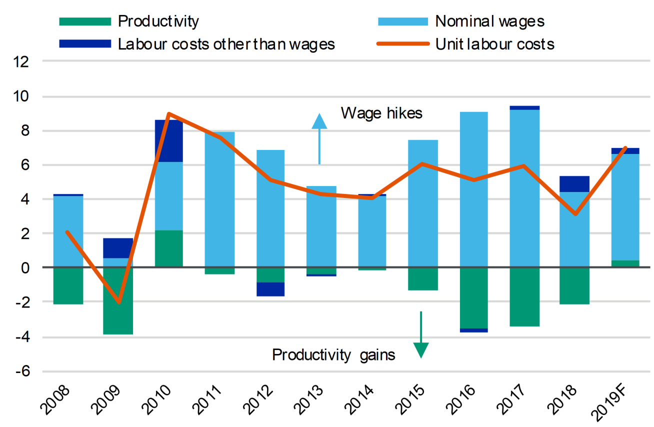


Sources: Eurostat, Statistics Iceland, Moody's Investors Service

Exhibit 13

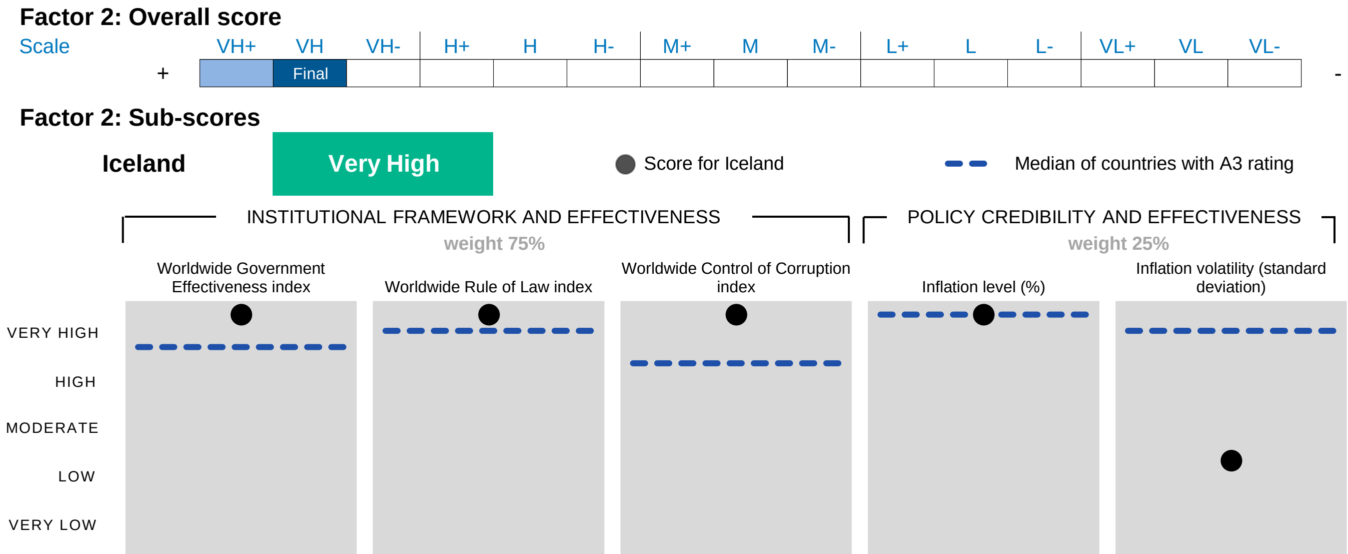
Unit labour costs are set to accelerate given weakening productivity gains

Unit labour costs and its components, % change (year-on-year)



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

Institutional strength: Very High



Institutional 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 of institutional strength is the capacity of the government to conduct sound economic policies that foster economic growth and prosperity. Institutional strength is adjusted for the track record of default. This adjustment can only lower the overall score of institutional strength.
Note: The Scorecard-indicated outcome is shown in light blue in the scale above. In case the Scorecard-Indicated outcome and Final scores are the same, only the Final score will appear in the table above.

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. The reforms introduced following the banking crisis, in conjunction with the IMF, have strengthened the macro-policy mix undertaken alongside a careful liberalisation of the capital account and the increased maturation of financial regulation and supervision processes in line with global best practices.

Other sovereigns with the same assessment of institutional strength include Belgium (Aa3 stable), France (Aa2 positive) and Austria (Aa1 stable).

Exhibit 14

Peer comparison table factor 2: Institutional strength

	Iceland A3/POS	VH Median	Belgium Aa3/STA	France Aa2/POS	Austria Aa1/STA	Hong Kong Aa2/STA	Denmark Aaa/STA	Portugal Baa3/STA
Final score	VH		VH	VH	VH	VH	VH+	VH-
Scorecard-indicated outcome	VH+		VH+	VH+	VH+	VH+	VH+	VH+
Gov. Effectiveness, percentile [1]	88.2	85.2	80.1	83.8	88.9	97.0	94.1	83.0
Rule of Law, percentile [1]	88.2	86.7	85.2	86.7	94.1	91.9	96.3	81.6
Control of Corruption, percentile [1]	91.1	86.7	86.7	83.8	88.2	89.7	97.7	78.6
Average inflation (%)	2.4	1.7	1.7	1.1	1.7	2.7	0.9	1.2
Volatility in inflation (ppts)	3.1	1.1	1.1	0.9	0.9	1.5	1.0	1.3

[1] Moody's calculations. Percentile based on our rated universe.
Sources: Statistics Iceland, Worldwide Governance Indicators, Moody's Investors Service

The final score of "Very High" is one notch lower than the scorecard-indicated outcome of "Very High (+)" as the depth of the financial crisis and the weaknesses in the country's regulatory framework and policy toolkit it exposed indicate a level of institutional strength below our highest possible assessment. Significant progress has been made by Iceland in rebuilding the policy toolkit, although the improved framework remains untested and some gaps are still being addressed, especially in the area of financial sector oversight.

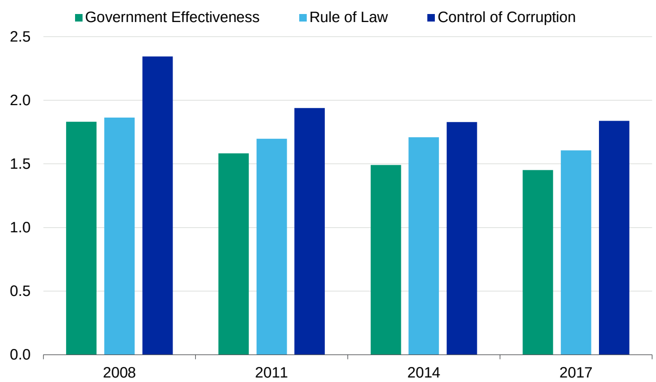
International surveys confirm the very high assessment of institutional strength

In line with other highly rated countries, Iceland scores strongly on the Worldwide Governance Indicators (WGI), which help inform our assessment of institutional strength, ranking in the 88th percentile of the WGI's measure of government effectiveness and rule of law, and 91st for control of corruption. Despite the slight decline since 2008, Iceland's WGI quantitative indicators are well above both A- and Aa-rated medians (see Exhibit 15 & 16). That said, Iceland's WGI scores are lower than some of its highly-rated North European peers such as Denmark (Aaa stable) and Sweden (Aaa stable) which have "Very High (+)" assessments of institutional strength. Iceland 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 15

Despite some deterioration...

Worldwide Governance Indicator, score (values from -2.5 to 2.5)

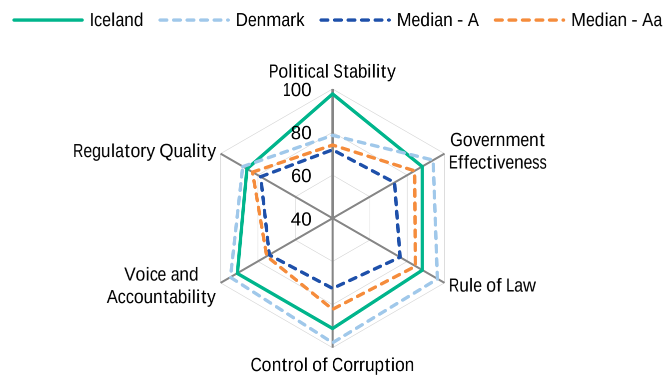


Sources: Worldwide Governance Indicators, Moody's Investors Service

Exhibit 16

...Iceland's institutional strength indicators rank above A- and Aa-rated peers

Percentile, Moody's rated universe



Sources: Worldwide Governance Indicators, Moody's Investors Service

Recovery of institutional strength is cemented with emerging track record of macro policy coherence

Iceland's government has made significant progress in bringing the economy, the financial system and the public finances back onto a sustainable path after the collapse of the country's banking system in 2008. In conjunction with a three-year IMF Stand-By Arrangement and post-monitoring program in place at the time, the authorities introduced a number of reforms, such as tighter fiscal and monetary policy, a flexible exchange range and significant improvements to banking system supervision, to prevent such distortions from recurring.

Some of the most important measures undertaken since the crisis were the introduction of more stringent supervision and regulation of the banking sector, including tougher reporting requirements, greater transparency and strict limitations on the new banks' scope of activity. These rules have been designed to guide the new banking system towards higher capital and liquidity buffers and funded primarily by more reliable sources such as long-term deposits. Asset quality at the three big banks has also improved significantly, in part as a result of widespread loan restructuring.

Iceland's reintegration into the global financial markets has increased the importance of prudent oversight of the financial sector as it migrates towards greater risk taking. Reflecting continued progress towards the increased maturation of financial regulation and supervision processes, the government announced, in October 2018, that it was merging the central bank and the Financial Stability Authority (FME).

The merger of the two institutions will help to integrate macroprudential policy and financial market supervision to reduce any gaps and create a less complex regulatory structure, in line with global best practices. These steps will help to assure the restoration of the banking system's health will be maintained. That said, tackling weaknesses in the supervisory framework will take time.

Monetary policy framework has helped gain policy credibility and improve effectiveness

In 2001, Iceland adopted an inflation-targeting framework, in line with developments internationally. With a numerical target of 2.5% annual rate in headline consumer price inflation, the chief priority of the Central Bank of Iceland has been price stability. Following the crisis and comprehensive rule changes in 2009, the framework became much more transparent.

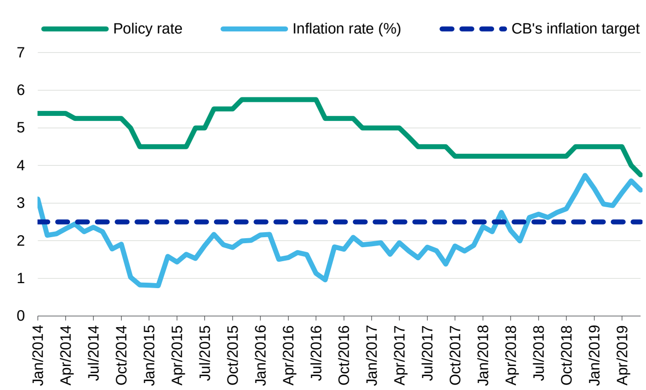
The "Inflation targeting-plus" monetary policy regime now in place includes improvements to the inflation targeting framework and macro-prudential tools, including the capital flow management tool. The framework has gradually gained market credibility. Monetary policy is also better aligned with the fiscal policy stance now than before the crisis, which has led to positive but not excessively positive real interest rates over the last few years.

After rising into double digits after the 2008-09 depreciation, inflation dropped below target through 2017, driven by the fall in oil import prices initially and then a further steep appreciation of the krona. More recently, the inflation rate has picked up, reaching 3.7% in December 2018 year-on-year, as a consequence of the krona depreciation related to the announcement of Wow Air's financial difficulties (see Exhibit 17).

Despite the recent uptick, inflation will continue slowing due to the rapid cooling off of the economy and some measures of inflation expectations have been declining (see Exhibit 18). The relative stability of the exchange rate following the successful removal of the last capital controls (see below), together with the abatement of the material inflation risks from outstanding wage negotiations, provided space for the central bank to loosen monetary policy. The bank's Monetary Policy Committee cut interest rates in two successive meetings, by a cumulative 75 basis points, reversing the previous interest rate hike by 25 basis points in November 2018 (see Exhibit 17).

Exhibit 17

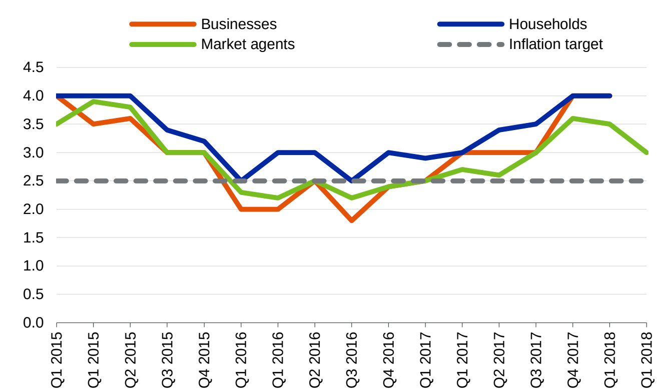
Policy rate has been lowered by 75 basis points in 2019...
% rate



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

Exhibit 18

... as inflation expectations have moderated given the recession and reduced wage risks
One-year inflation expectations



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

Importantly, the wage agreements reached were more moderate than expected, reducing an important risk to the inflation outlook. The agreements concluded in April equate to around a 4% annual (net) wage rise until November 2022, lower than in previous wage rounds, and specify a set krona increase in wages rather than a percentage, which serves to limit the inflationary impact from wage increases for higher earners. Furthermore, additional wage rises are linked to income growth. To secure the agreement, the government also provided a generous fiscal package (see F3: Fiscal Strength). While the full set of negotiations 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.

We expect inflation to slow to around 2.5% by 2020 in line with the central bank's target. That said, there remain risks to inflation, which reached 3.1% year-on-year in July 2019, still 0.6 percentage point above the central bank's target. Any required slowing or reversal in monetary easing may further weigh on the economic outlook and could result in a larger fiscal stimulus. The pass-through from the depreciation of the krona in autumn 2018 has been smaller than expected but may still emerge with a delay. Furthermore, another sharp depreciation trend on the back of the economic downturn could add pressure to inflation. Finally, higher than expected wage growth or the potential for the wage agreements already closed to be reopened present further risks.

Careful capital account liberalization achieved with minimal disruption is further evidence of elevated institutional strength

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%, a policy change also proposed by the IMF, the government has now concluded the process of lifting capital controls in early 2019. After its introduction in June 2016, the SRR required foreign investors to make deposits into a zero-interest-bearing account at Icelandic deposit-taking institutions when they want to bring in capital to the country, excluding the case of fixed capital investment.

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, 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 (see Exhibits 19 and 20).

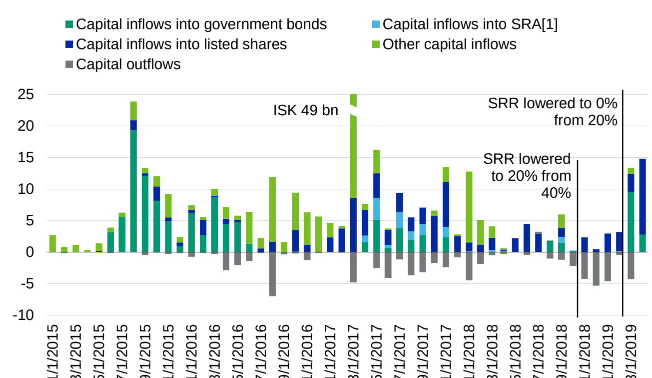
The central bank's ability to lower the SRR to zero reflects the improvement achieved in monetary policy transmission since the crisis, the economy's narrower current-account surpluses and more market-determined exchange rate. In our view, these developments further demonstrate Iceland's progress in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

Since mid-2016, the authorities have been gradually lifting the capital controls on households and businesses, which culminated in almost full liberalization of financial account in early 2017. During the final four years of the controls, the central bank heavily intervened in the domestic foreign exchange market to buy up excess foreign exchange to bolster its reserves and combat excessive exchange-rate volatility. After the removal of the capital controls and with the slowing of tourism income growth, those interventions have essentially ceased.

Exhibit 19

Capital outflows following the capital controls were much smaller then expected

ISK billion



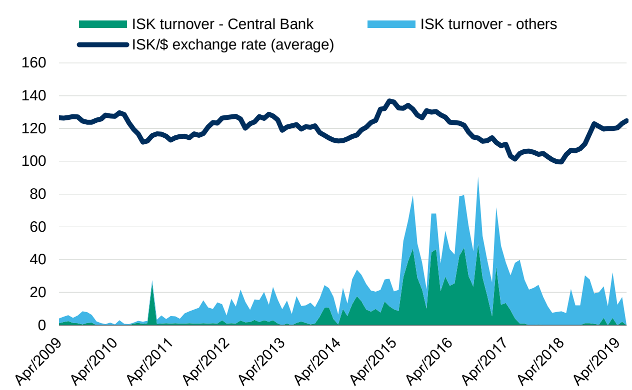
[1] SRA stands for Special Reserve Account

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

Exhibit 20

Foreign exchange interventions slowed following the removal of most capital controls in March 2017

ISK/$ exchange rate, ISK turnover



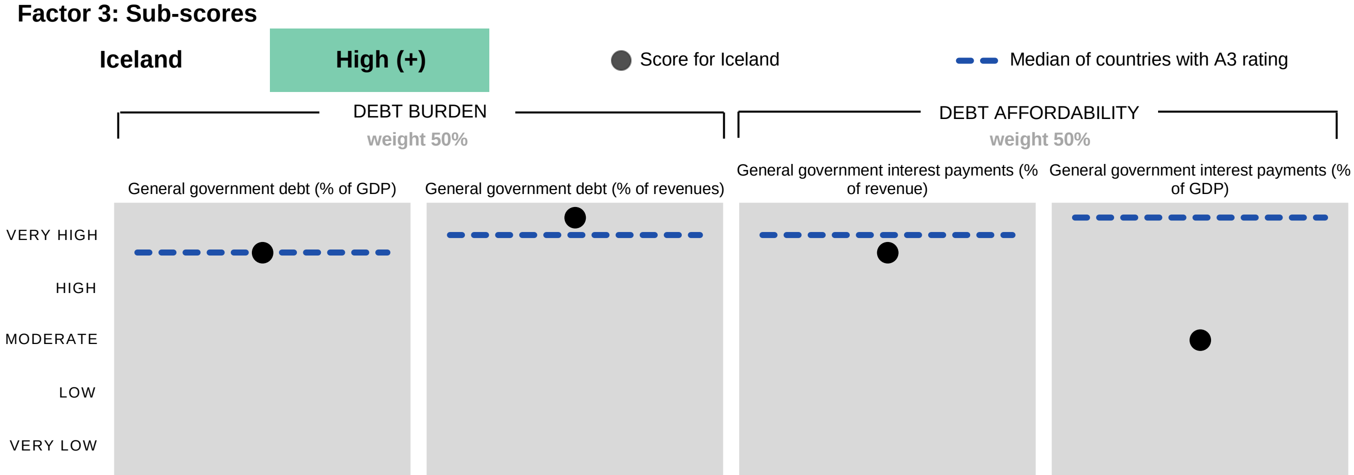
Sources: Central Bank of Iceland, Moody's Investors Service

Fiscal strength: High (+)

Factor 3: Overall score

Scale	VH+	VH	VH-	H+	H	H-	M+	M	M-	L+	L	L-	VL+	VL	VL-	
+				Final												-

Factor 3: Sub-scores



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 Scorecard-indicated outcome is shown in light blue in the scale above. In case the Scorecard-Indicated outcome and Final scores are the same, only the Final score will appear in the table above.

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 alongside persistent budget surpluses, debt buybacks and rapid economic growth to 37.2% in 2018. Concurrently, the government's debt burden is now significantly less exposed to exchange rate risk, with the foreign-currency share of gross government debt falling to 11.6% in 2018 from 41.9% in 2011, and the debt's maturity remains relatively long. Other sovereigns with a "High (+)" assessment of fiscal strength include Austria (Aa1 stable), Malta (A2 stable) and Panama (Baa1 stable).

Exhibit 21

Peer comparison table factor 3: Fiscal strength

	Iceland A3/POS	H+ Median	Austria Aa1/STA	Malta A2/STA	Panama Baa1/STA	Lithuania A3/STA	Poland A2/STA	Slovenia Baa1/POS
Final score	H+		H+	VH-	H+	VH-	VH-	H
Scorecard-indicated outcome	H+		H+	VH	H+	VH-	VH-	H+
Gen. gov. debt/GDP	37.2	37.2	73.8	46.0	39.5	34.2	48.9	70.1
Gen. gov. debt/revenue	87.0	126.4	151.8	118.4	200.4	98.6	118.7	163.2
Gen. gov. interest payments/GDP	3.1	1.7	1.7	1.5	1.8	0.9	1.4	2.0
Gen. gov. int. payments/revenue	7.2	4.6	3.4	3.9	9.0	2.6	3.5	4.6

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

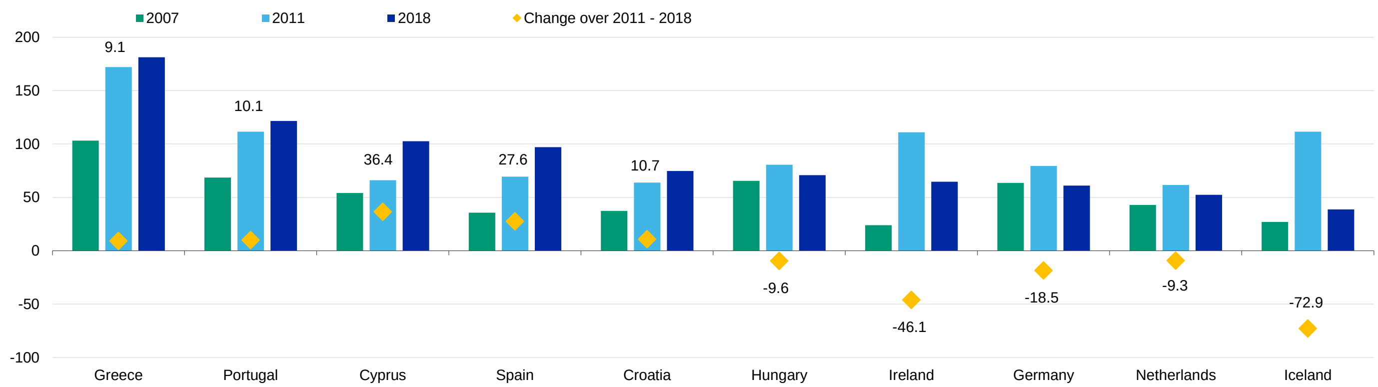
Fiscal metrics have recently outperformed expectations

After peaking at 111.7% of GDP in 2011, Iceland's gross government debt burden has declined at a markedly fast pace. A material debt reduction has been achieved through the combination of (1) significant fiscal consolidation; (2) the restored health of the Icelandic economy and substantial accumulation of foreign exchange reserves, which among other assets has helped pay down debt ahead of schedule; and (3) the stability contributions from the estates' of the failed Icelandic banks.

Compared with other sovereigns in our rated universe, the restoration of Iceland's fiscal health following the global financial crisis has been unparalleled. Among European sovereigns, a group that includes many other crisis-hit countries, Iceland achieved by far the largest debt reduction relative to GDP, even exceeding that of Ireland (A2 stable), which has experienced more rapid nominal GDP growth (see Exhibit 22).

Exhibit 22

Iceland's remarkable debt reduction stands out compared to peers
General government debt, % of GDP



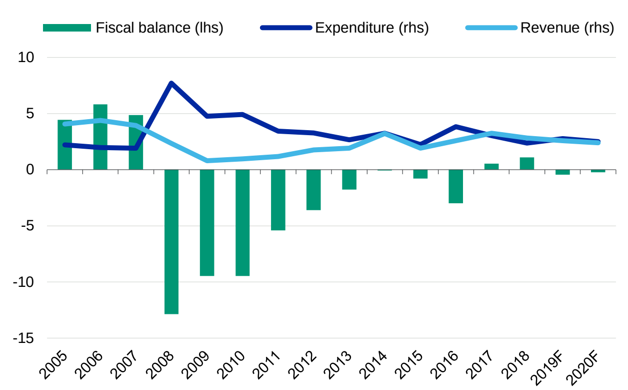
Sources: National authorities, IMF, Moody's Investors Service

Consolidation through prudent fiscal rules, revenue enhancements and declining interest payments

Since the Organic Budget Law (OBL) took effect in early 2016, successive governments have approved fiscal policy statements and strategies that adhere to the newly prudent framework. Under the OBL, the government is required to publish a five-year Fiscal Policy Statement at the beginning of each electoral term, as well as a five-year Fiscal Strategy Plan on an annual basis. There are two overarching fiscal rules: (1) the deficit cannot exceed 2.5% of GDP in any one year, and (2) over a five-year period, net lending must be positive. Followed a period of robust economic growth, these refinements will help to ensure that the fiscal improvements are broadly preserved, particularly given the forecast for a short recession in 2019.

Exhibit 23

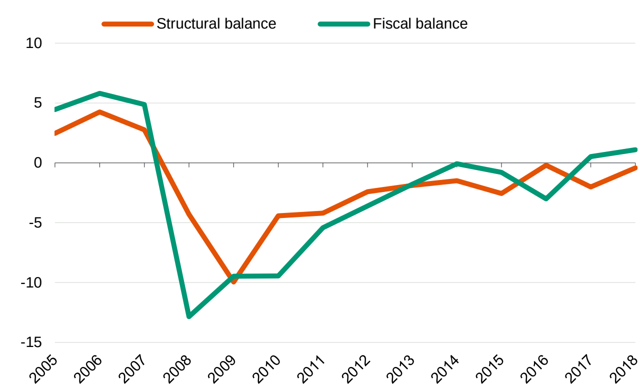
Expenditure control and buoyant tax receipts have supported fiscal outturns in recent years
% of GDP



Sources: Ministry of Finance, Moody's Investors Service

Exhibit 24

Structural deficit (IMF estimate) reached balance in 2018
% of GDP



Sources: Ministry of Finance, IMF, Moody's Investors Service

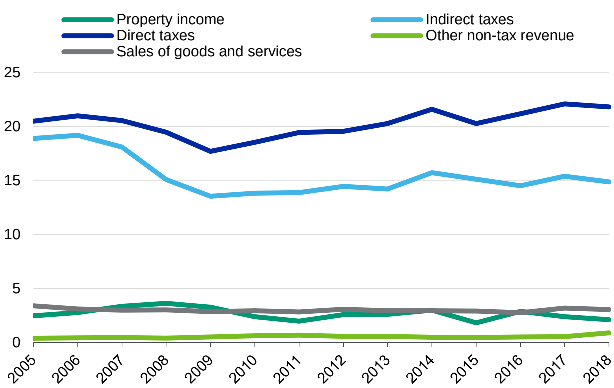
Beyond the OBL, there have been a number of refinements to the fiscal strategy that have improved fiscal outcomes.

On the revenue side, most of the growth was attributable to increased direct tax receipts, helping to raise the revenue base by 4.1pp of GDP between 2018 and 2009 (see Exhibit 25). This reflects both policy changes, as tax rates on capital gains (to 22% in 2018 from

15% in 2011) and corporate income (to 20% in 2011 from 15% in 2009) have been raised sharply, but also very strong wage growth by a cumulative 45% growth over the last five years, according to the wage index published by Statistics Iceland. There have also been steps to capture more of the gains from the tourism industry, which pushed the VAT intake to 8.3% of GDP in 2018, although plans for a tourism levy may now be delayed given the economic slowdown.

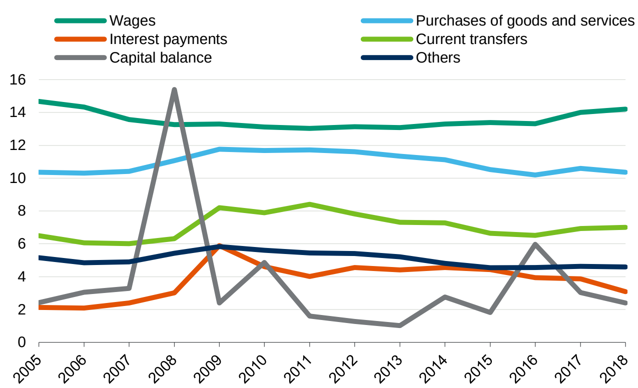
On the expenditure side, the government significantly cut investment spending and curtailed the growth of current expenditure, such as purchases of goods and services (which declined to 10.4% of GDP from 11.7% in 2011) and current transfers (to 7% of GDP from 8.4% in 2011, see Exhibit 26). A continued fall in interest payments, in part due to repayment of its expensive FX debt, helped free up an additional 2.8% of GDP between 2011 and 2018. While part of this fiscal space was used to increase public sector wages by 0.9% between 2016-17, the IMF estimates that the structural balance (adjusted for cyclical effects) has still improved, reaching balance in 2018 (see Exhibit 24).

Exhibit 25
Growing direct tax receipts have strengthened the revenue base
Revenues, % of GDP



Sources: Statistics Iceland, Moody's Investors Service

Exhibit 26
Falling interest payments, among others, helped increase budget space
Expenditures, % of GDP



Sources: Statistics Iceland, Moody's Investors Service

According to preliminary figures, the government's fiscal balance recorded a surplus of 1.1% of GDP in 2018, an improvement from 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 and a substantial decline in interest payments (by 0.8% of GDP). 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.

Five-year fiscal strategy outlines an easing in policy compared to previous years

Following the marked fiscal consolidation in recent years, the government's fiscal strategy for 2020-24 outlines an increase in spending on priority areas such as infrastructure as well as reducing taxation for households and businesses. Exhibit 27 summarizes some of the new spending measures and their expected fiscal impact.

On the expenditure side, the fiscal plan envisages increased spending on infrastructure, including the new National University Hospital at a cost of ISK 74 billion (around 2.5% of GDP) until the completion of the project in 2025. More funding will be also allocated to the extension of parental leave and increased subsidies for social housing, as part of the collective wage agreement. The government also plans to increase spending on education, research and technological development.

Exhibit 27

Fiscal Plan for 2020-24 is focused on infrastructure expansion, lowering taxes and housing support

Selected measures from the government's fiscal plan published in March 2019

ISK billion	% of GDP	Measure
15.0	0.4	Extention of parental leave (in connection with the collective wage agreement)
6.3	0.2	Contributions to subsidised housing (in connection with the collective wage agreement)
20.0	0.6	Increased transportation infrastructure spending
5.5	0.2	Spending for education, research & technological development
8.0	0.2	Grants for innovation
74.0	2.2	Investment in hospital services inclusing construction of the new National University Hospital
6.0	0.2	Investment in new nursing home facilities
11.4	0.3	Increased grants for purchase of construction of subsidised housing
146.2	4.3	Total (years 2019 - 2024)

Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

At the same time, the strategy allocates a substantial multi-year package of 45 measures to support the collective bargaining negotiations underway in 2019, mainly through improvements to household's disposal and helping to facilitate certain groups to enter the housing market. This package is estimated at ISK 80 billion or 2.7% of GDP according to the Central Bank of Iceland, although some measures such as the extension of parental leave and housing subsidies were already included in the government's fiscal strategy.

On the revenue side, the authorities are pursuing significant changes to the tax system including a comprehensive overhaul of personal income tax to improve progressiveness, predictability and incentives to work. These changes include the introduction of a new lowest level tax rate and changes to cut-off points for higher brackets, with the intension to increase the disposable income of the lowest income groups. Other revenue measures include plans to reduce the social security contribution for employers and the reduction of the bank levy. Discussions around a potential “tourism tax” are still ongoing although now seem less likely until there is greater clarity on the pace by which the sector recovers from the sharp reduction in tourism arrivals expected this year.

Fiscal targets for 2019/20 revised down following collapse of Wow Air

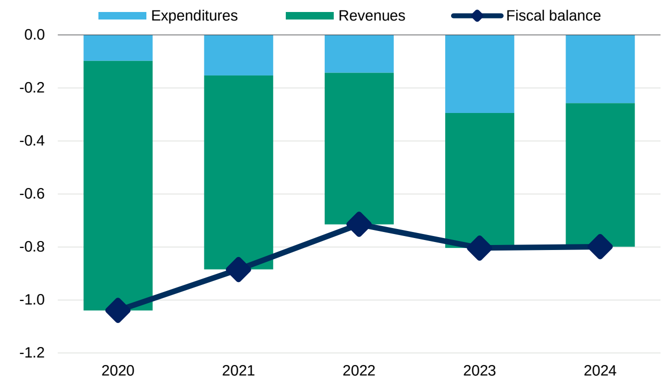
The worsened economic outlook and the expectation of a recession in 2019 have led the government to revise its fiscal policy statement and plan to reflect the markedly lower than expected revenue forecasts.

We do not expect the fiscal commitments set out by the current government, including numerous spending and tax reduction measures in line with the governing coalition's policy objectives, will materially change, such that the shock to government revenues will likely use up some of the recently gained budget space. Many of the measures are planned to support the collective wage agreement reached by the social partners in April 2019 and there is limited flexibility for the government to roll back on these commitments.

As such, compared to an expected overall fiscal surplus of 1% over the next four years, the amended Fiscal Policy Statement outlines a deficit of -0.8% in each year until 2021 and a deficit of -0.5% in 2022. This includes an “uncertainty scope” of 0.8% of GDP in each year of the forecast to accommodate a worsening in the economic projections underlying the budget. That said, the government plans for a better fiscal outcome, as indicated in its revised fiscal strategy plan which includes additional measures to ensure a broadly balanced budget in 2019/2020, to maintain compliance with the fiscal rules.[2]

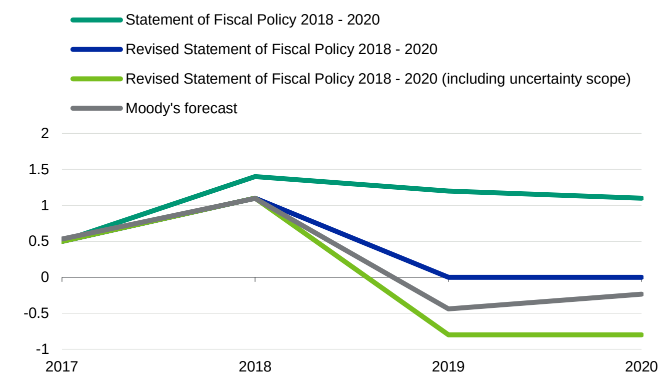
Our forecast of a fiscal deficit of -0.4% of GDP in 2019 and -0.2% of GDP in 2020 is broadly in line with the authorities and assumes some of this “uncertainty scope” will need to be used in the coming years given that the economic projections underlying the budget seem overly optimistic, particularly in 2019, being below most other forecasts (for example, the central bank estimates GDP growth to decline by -0.4% in 2019 compared to -0.2% in the budget).

Exhibit 28
Wow Air will cause a marked deterioration in Iceland's fiscal accounts
Changes between March 2019 and June 2019 Fiscal Strategy Plan, % of GDP



Sources: Ministry of Treasury and Economic Affairs, Moody's Investors Service

Exhibit 29
Reduction in fiscal targets outlined in the revised Statement of Fiscal Policy
Fiscal balance, % of GDP



Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

Importantly, we expect Iceland's accumulated fiscal space will help to cushion the negative effect of these dual economic shocks, with the fiscal improvements and move to budget surpluses in recent years allowing the government accounts to broadly absorb these shocks. That said, there remain risks to the fiscal forecasts if the economic downturn were to be materially larger than expected or if the economy were to face further unforeseen shocks. Furthermore, some of the material commitments to support the wage agreements are yet to be defined, such as support to first time buyers which can have multi-year fiscal impacts.

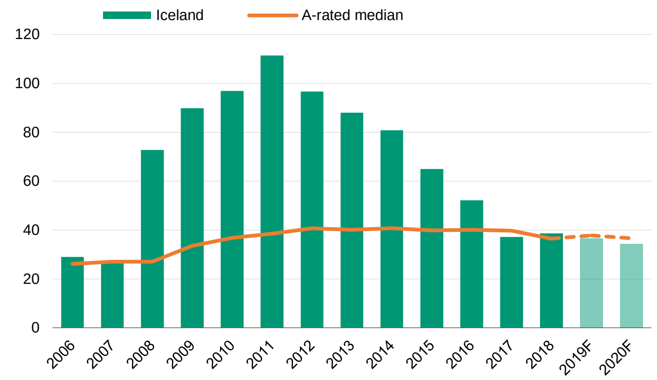
Fiscal consolidation and robust economic growth allowed for rapid debt reduction

Driven by robust economic growth, an improving fiscal position, increasing debt affordability and divestment in assets acquired during the financial crisis, Iceland's debt burden has been declining at a fast pace since 2011 when it reached 111.5%. At the end of 2018, the general government debt stood at 37.2% of GDP, down from 44% of GDP at the end of 2017, far lower than our previous expectations, and in line with the median for A-rated sovereigns (see Exhibit 30).

The government's plans for negative net issuance of ISK 30-40 billion annually between 2019 and 2024 will support continued declines in government debt. In addition, the substantial deposits accrued to date can be used to help accommodate the effects of the economic shock on revenues. Our forecast is for debt to decline to 36.5% in 2019 and 34.4% in 2020, as modest fiscal deficits, the slowdown in economic growth and the limits on further large prepayments will slow the pace of debt reduction compared to previous years. Furthermore, the authorities expect that further material reductions in government debt burden may negatively impact the domestic debt markets given the government's role as a benchmark issuer (see F4: Government Liquidity Risk for more details).

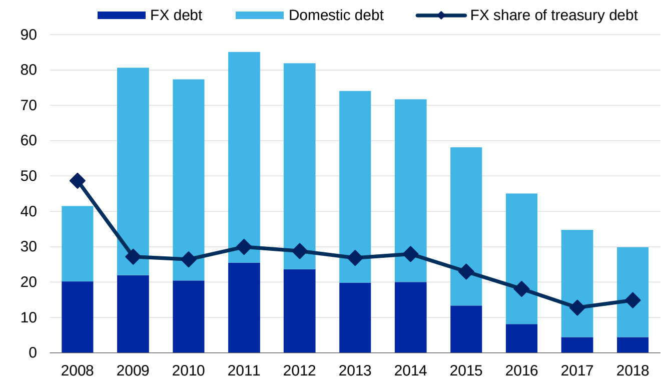
Apart from the precipitous decline in general government debt over recent years, the level of government foreign debt has also decreased substantially. As a share of total general government debt, it currently stands at 11.6%, down from 41.9% in 2011 (see Exhibit 31), removing a significant source of FX risk.

Exhibit 30
Iceland's debt burden has declined to the median for A-rated peers
General government debt, % of GDP



Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

Exhibit 31
Debt is now significantly less exposed to exchange rate risk
Treasury debt, % of GDP



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

Debt affordability improves significantly, reducing exchange rate and interest rate risk

Following the crisis, the government's revenue base took an immediate hit – declining to 38.6% of GDP in 2009 from 42.2% of GDP in 2008. Borrowing costs also spiked, with interest payments as a share of revenue more than doubling to 15.5% in 2009 from 7.2% in 2008. However, over the course of the last nine years, there has been a marked improvement in the government's debt affordability because of the retirement of higher-cost debt and the rebuilding of the government's revenue base. However, debt affordability, as measured by interest payments to revenue, remains higher than in many similarly rated peers, such as Sharijah (A3 negative) and Poland (A2 stable), although is expected to decline further towards the A-rated median in 2020 (see Exhibit 32).

Future stability contributions or privatisations to be used to reduce debt or build up buffers

At the central government level, surpluses have also been driven by the receipt of the failed banks' stability contributions. During 2016, government revenue was boosted by an accrual of ISK 384.2 billion (15.7% of GDP or 27.1% of 2016 general government revenue) from the stability contributions. Of this, the government received ISK 63 billion in cash during 2018/2019. Total dividends from the government's equity stakes in banks is estimated at ISK 170 billion over the period 2020-24 (around 4.9% of GDP) according to a scenario provided by the government.

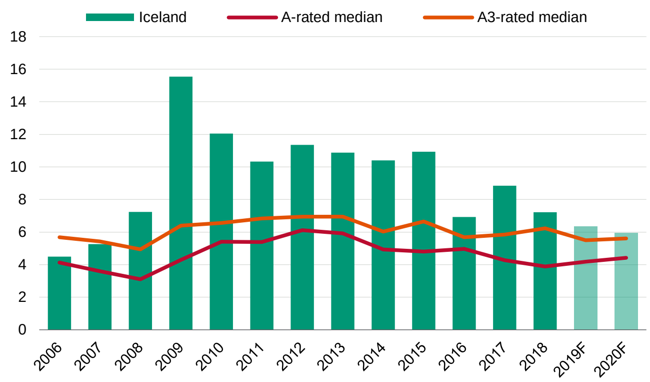
While future inflows arising from stability contributions are expected to be minimal going forward, there is scope for privatisation proceeds in the future.

In a report published a week after confirmation of the February 2018 sale of the Treasury's 14% stake in Arion Bank, the government estimated that the state's average annual nominal return on the capital contribution to Arion Bank since 2008 was about 10.8%, with the state's estimated total gain on financial interest in Arion and transactions with the Kaupthing estate at just over ISK 150 billion. The government is considering selling part or all of its stake in Islandsbanki (valued at ISK 143 billion or 4.9% of GDP) to further pay down debt or reduce pension liabilities. The government also owns a 98.2% share of Landsbankinn, valued at around ISK196 billion or 6.7% of GDP.

Given that the scope for further material reductions in government debt may be narrowing, the authorities announced in November 2018 its intention to establish a sovereign wealth fund (SWF), under discussion for some time, which could house the receipts of dividends or future privatisation proceeds.

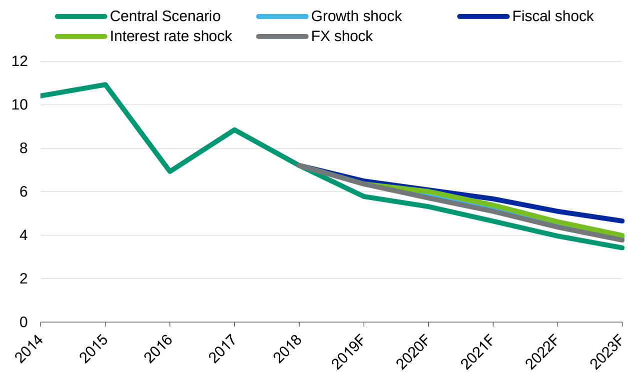
Some estimates suggest that the fund could reach around ISK300 billion (8.6% of GDP), with the dividends from public power companies identified as the most likely source of inflows, such as Landsvirkjun (LV, Baa2 stable) where dividends are expected to reach around ISK10-20 billion per annum in the coming years. The exact details around the setting up and management of the SWF are still to be determined and draft legislation was presented to the parliament in December 2018. Steps towards increasing Iceland's savings would be credit positive, with the fund helping to a buffer against unforeseen events, such as a major natural catastrophe, impacting the small island economy.

Exhibit 32
Iceland's debt affordability converged to the A3-rated median
Interest payments, % revenue



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

Exhibit 33
Debt affordability set to improve even in stress scenarios
Interest payments, % revenue



Note: a standard shock of 0.25 standard deviation was applied
Sources: Statistics Iceland, Moody's Investors Service

Large, yet declining, government contingent liabilities

The government's contingent liabilities are very large, although they have been roughly halved in both nominal and relative terms since the peak of the crisis. They mainly derive from government guarantees which, as of 2018, the total stock of outstanding guarantees stood at ISK 957 billion or 34% of GDP (see Exhibit 34). Most of the guarantees are for the Housing Financing Fund (HFF, Baa1 positive) and LV, which account for around 81% and 10% of all outstanding guarantees, respectively (see Exhibit 35). Both companies are of strategic importance for the Icelandic economy, for example the dividends from the national power company have been identified as a potential revenue source for a future SWF (see above).

That said, the operating results of HFF and LV have improved over the last few years.

HFF's capitalisation has been improving, with tangible common equity at 9.1% of risk weighted assets as of the end June 2018, while default ratios are down. Significantly, no new debt has been issued since 2012 and the Ministry of Finance and Economic Affairs expects no further capital injections. However, HFF continues to face significant prepayment risk on its loan portfolio as interest rates on mortgage loans have decreased significantly in recent years, which acts as a drag on profitability.

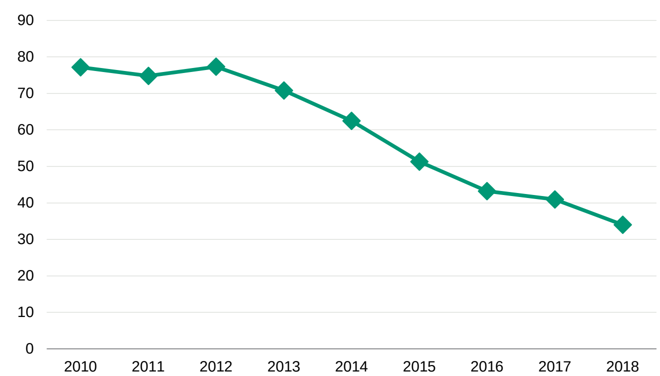
Reflecting its changing role from a mortgage lender to implementing housing policies, the authorities recently announced plans to split HFF into two entities, with the creation of a new agency responsible for housing policies in Iceland. Most of the legacy loans together with the government guaranteed debt will remain in an HFF Fund overseen by the Ministry of Finance and Economic Affairs. The Ministry will also appoint an investment council to advise on the management of the fund as it is run down over time. The new housing agency will assume the HFF's social loans portfolio and, as a government agency, will be funded directly by the Ministry of Finance. The separation is pending a vote in parliament on the proposal which is expected in Autumn 2019.

LV's operations have also improved over the last couple of years. The equity ratio stood at 48.6% in 2018, an all-time high, and net profit increased in 2018. Importantly, LV has been able to raise debt without government guarantees. However, LV faces a large and concentrated exposure to a small number of counterparties, mainly in the aluminium industry. Over 40% of Landsvirkjun's energy generation is sold under contracts linked to aluminium prices, although the proportion will decline closer to 30% later in 2019. That said, Landsvirkjun has long-term relationships with its counterparties, which have demonstrated a good track record of timely payments even during periods of economic stress.

While the financial performance of these main recipients of state guarantees has improved, and the issuance of further guarantees is not foreseen, the sheer size and importance of these entities, together with the fact that both have received direct government support in the past, suggest that contingent liabilities will remain an ongoing fiscal risk for the government's accounts.

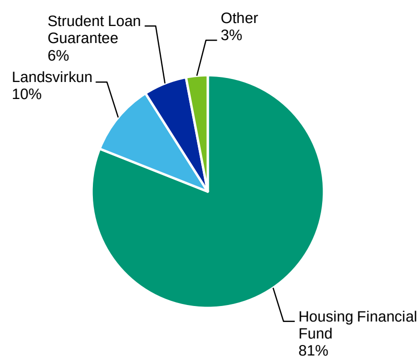
Beyond direct guarantees, total non-financial sector public debt within the general government sphere remains large at an estimated 21% of GDP in 2018, most of which are energy companies including the public utility for Reykjavik (Orkuveita Reykjavikur, Ba1 stable), although this is expected to gradually decline in the coming years.

Exhibit 34
Although still large in size, government guarantees have declined
Stock of outstanding guarantees, % of GDP



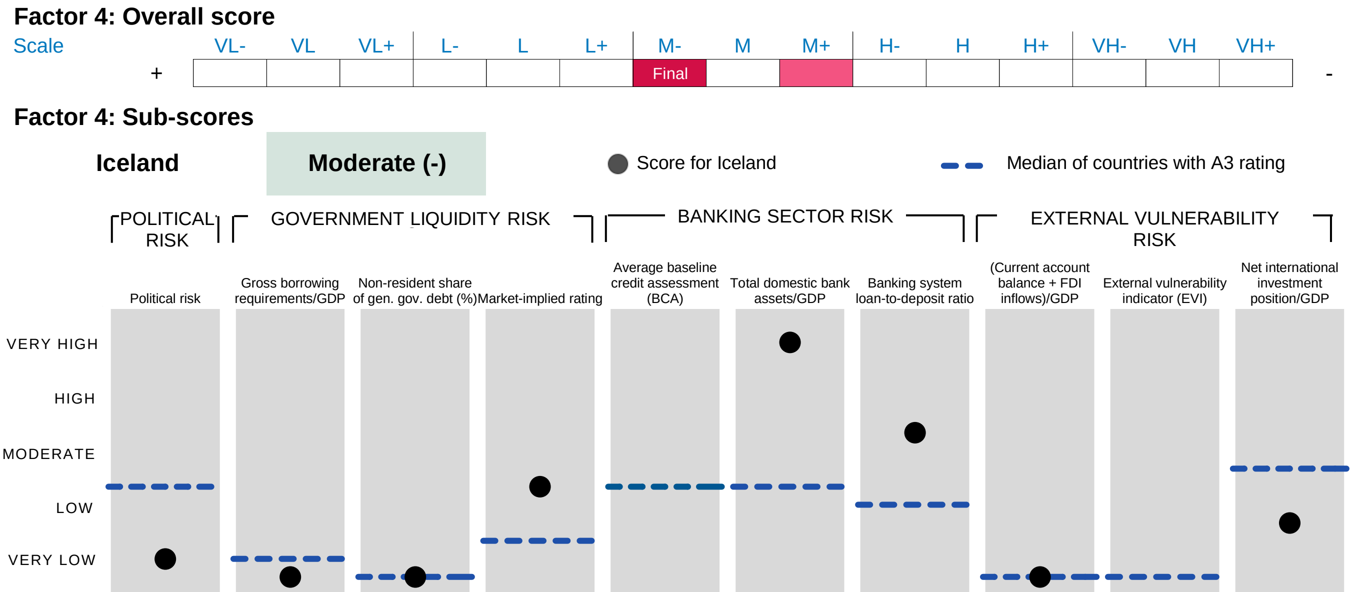
Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

Exhibit 35
Housing Financing Fund makes up over 80% of total government guarantees
% of total guarantees, as of 2018



Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

Susceptibility to event risk: Moderate (-)



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 preliminary rating range as given by combining the first three factors.

Note: In case the Scorecard-Indicated outcome and Final scores are the same, only the Final score will appear in the table above.

Our assessment for susceptibility to event risk is "Moderate (-)", driven by banking system risk. While Icelandic banks have successfully emerged as healthy financial institutions since the economic crisis, their reliance on wholesale funding remains very high and the banking system remains concentrated and highly interconnected with the three main economic sectors. We assess external vulnerability risk at "Low" and government liquidity and political risks at "Very Low". Other sovereigns with "Moderate (-)" banking sector risk driving the overall F4 score are Ireland (A2 stable), Slovenia (Baa1 positive), Croatia (Ba2 positive) and Hungary (Baa3 stable).

Frequent elections have had limited effect on policy continuity

Political risk is "Very Low" for both domestic and geopolitical risks, because there has been relatively consistent policy in key areas important to safeguarding the government's credit profile despite several changes in government since 2008. Peers sharing this assessment include Sweden (Aaa stable), Denmark (Aaa stable), Germany (Aaa stable) and Ireland (A2 stable).

Exhibit 36

Peer comparison table factor 4a: Political risk

	Iceland A3/POS		Sweden Aaa/STA	Denmark Aaa/STA	Germany Aaa/STA	Ireland A2/STA	New Zealand Aaa/STA	United States of America Aaa/STA
Final score	VL		VL	VL	VL	VL	VL-	VL+
Geopolitical risk	VL	--	VL	VL	VL	VL	VL-	VL
Domestic political risk	VL	--	VL	VL	VL	VL	VL-	VL+

Source: Moody's Investors Service

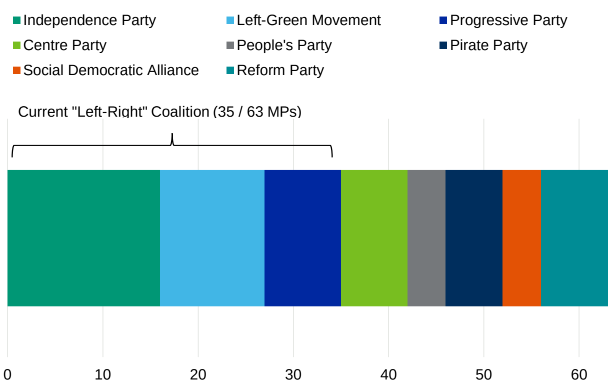
Of the four Icelandic governing coalitions since 2007, only one has served the full four-year term, that being the centre-left coalition that lasted from 2009-2013 immediately after the crisis erupted. Although the current government has just a narrow majority (see Exhibit 37), it represents a broader coalition from left-to-right as compared to the outgoing centre-right government. The current coalition seeks to rebuild Icelandic citizens' trust in government and restore stability to the political environment following two snap elections in 2016 and 2017, both of which were triggered by political scandals involving high-ranking politicians.

The next general election is scheduled for 2021, however there is a risk that the current government will not serve its full term. Since the last vote in 2017, some opinion polls show a decline in support for members of the governing coalition, including the Left-Green Movement. In addition, the risk of a further fragmentation of the political landscape may make the formation of a future government more challenging. That said, political consensus on the economic and fiscal direction for Iceland has remained strong following the crisis such that we don't expect a notable change in policy direction.

Exhibit 37

A broad coalition but with a narrow majority

Current government (as of October 2017)

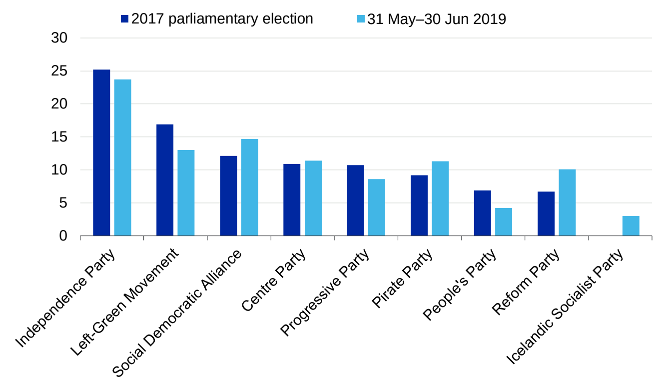


Sources: Alpinigi, Moody's Investors Service

Exhibit 38

Voter support for coalition members has declined since last election

Share of respondents favourable to a particular party



Sources: Alpinigi, Moody's Investors Service

Government liquidity risk declined amid fiscal consolidation and substantial debt reduction

We assess government liquidity risk as "Very Low." The government's funding situation remains very comfortable with low borrowing requirements given fiscal surpluses in recent years and much reduced government debt. While borrowing needs may need to increase if the economy and fiscal outturns are significantly impacted by the recent shock to the tourism and fishing sectors, they start from one of the lowest among peers. Other sovereigns sharing this assessment are Estonia (A1 Stable), Panama (Baa1 stable), Saudi Arabia (A1 stable) and Botswana (A2 stable).

Exhibit 39

Peer comparison table factor 4b: Government liquidity risk

	Iceland A3/POS	VL Median	Estonia A1/STA	Panama Baa1/STA	Saudi Arabia A1/STA	Botswana A2/STA	Romania Baa3/STA	Denmark Aaa/STA
Final score	VL		VL	VL	VL	VL	VL+	VL-
Scorecard-indicated outcome	VL+		VL-	VL	VL+	VL	VL+	VL-
Gross borrowing req./GDP	1.4	3.1	0.5	4.3	5.5	5.5	7.6	4.2
Gen. gov. ext. debt/gen. gov. debt	23.1	73.1	73.1	80.1	45.9	61.2	45.8	26.1
Market funding stress indicator	Baa3	Baa1	--	Baa1	Baa1	--	A3	Aaa

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

While sizable in the past, Iceland's gross borrowing requirements have declined substantially, in line with the rapid reduction in its debt burden achieved since 2011. The government has recorded financial surpluses over the last three years that averaged 4.7% of GDP, although this figure is inflated by a one-off stability contribution of around 15.7% of GDP in 2016 from the estates of the fallen banks that was ultimately used to pay down outstanding debt.

Going forward, we expect Iceland's gross borrowing requirements in the range of 3-4% of GDP, a significant reduction from 18.8% of GDP in 2011. When compared to similarly rated peers, Iceland's borrowing needs are one of the lowest (see Exhibit 40). The economic shock arising from the collapse of Wow Air and zero capelin season will likely lead to small fiscal deficits projected for 2019/2020. However, we do not expect this will lead to a material rise in borrowing requirements as the government has cash buffers which it can draw on to cushion the temporary shock.

According to the country's medium-term debt strategy, Iceland will continue to issue 1-2 benchmark issues each year to ensure sustainable market access although the intention is that the proceeds would be saved, as with the recent €500 million Eurobond issued in June 2019, such that debt net of deposits at the central bank will continue to decline at a rapid rate (net debt is expected to drop below 30% at the end of 2020 according to the latest Fiscal Policy Statement).

Moreover, the government's relatively long average maturity of debt, at approximately 6.5 years for all outstanding debt, limits refinancing needs.

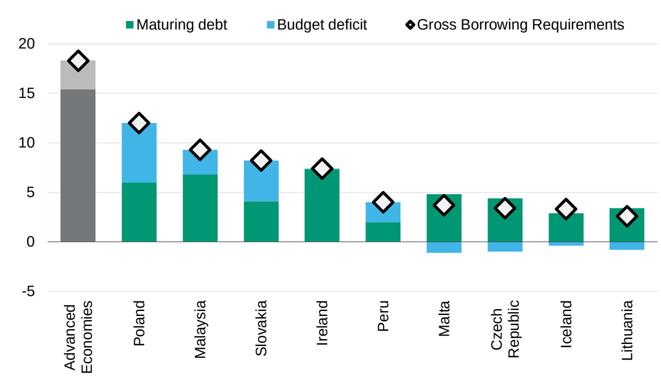
Apart from the reduction in financing needs, there has been a substantial improvement in the structure of government debt. Owners of marketable treasury bonds are now relatively diverse and primarily consist of pension funds, which have maintained a stable holding of government debt over the last few years. As of 2018, only 16% of the total treasury debt was held by the foreign investors, down from over 40% in 2009, limiting the currency and refinancing risks (see Exhibit 41). Foreign investors they are traditionally less "sticky" than domestic long-term investors and consequently more prone to capital flight during external shocks, particularly those stemming from a slowdown in global liquidity or unexpected domestic events.

To further reduce liquidity risks and treasury's expenditure, the government issued guidance in 2017 for the treasury to maintain around ISK 40 billion (around 1.4% of GDP) in deposits at the central bank at any given time. According to this guidance, the treasury is authorized to borrow money anytime the deposits are below this guidance, and to offer short-term loans to other market agents if the deposits exceed it.

Exhibit 40

Iceland benefits from one of the lowest gross borrowing requirements among peers

Gross borrowing requirements, % of GDP, 2019

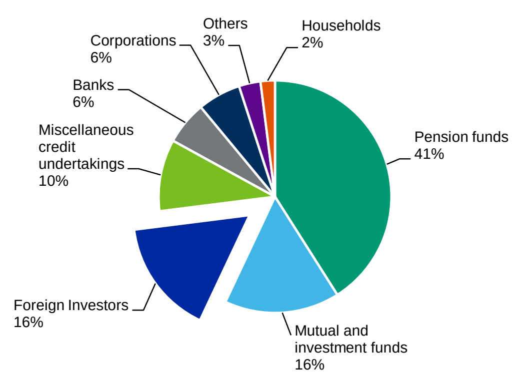


Sources: IMF, Moody's Investors Service

Exhibit 41

Foreign holdings of government debt are very small

% of total treasury debt, 2018



Sources: Ministry of Finance and Economic Affairs

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

We assess Iceland's banking sector risk as "Moderate (-)", better than the indicative score of "Moderate (+)". Because we do not rate any of the Icelandic banks, the indicative banking sector risk score is incomplete. That said, we incorporate our aggregate analysis of the Icelandic banking system derived from publicly available information into the final score, which leads to the two notch uplift from the indicative score.

Exhibit 42

Peer comparison table factor 4c: Banking sector risk

	Iceland A3/POS	M- Median	Croatia Ba2/POS	Ireland A2/STA	Hungary Baa3/STA	Slovenia Baa1/POS	Bulgaria Baa2/STA	Germany Aaa/STA
Final score	M-		M-	M-	M-	M-	M	L+
Scorecard-indicated outcome	M+		L	L+	M-	M-	M+	H-
Baseline credit assessment	--	ba2	--	baa3	ba2	ba1	b1	b1
Total dom. bank assets/GDP	179.3	82.6	105.9	104.7	82.7	88.4	97.8	155.6
Loan-to-deposit ratio	151.1	90.6	83.8	92.4	82.0	88.1	99.2	122.2

Sources: IMF, Moody's Investors Service

Icelandic banks have successfully emerged as healthy financial institutions since the economic crisis, underpinned by the rapid economic recovery in recent years and under the regulatory supervision of the Financial Supervisory Authority and the Central Bank of Iceland. The structure of the financial system has also changed in recent years: Pension funds have increased their share of assets, the share of deposit institutions has shrunk and the shadow banking system has grown.

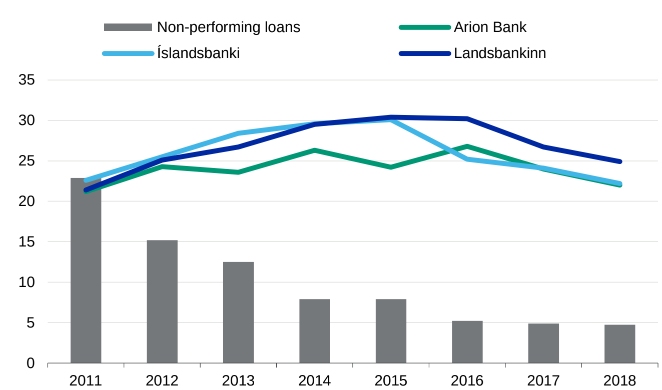
The system benefits from strong solvency indicators, with high capital ratios (ranging from 22% – 25%) and low single digit nonperforming loans (NPL) ratios (see Exhibit 43). The banking system also appears to be coping well with the relaxation of capital controls, as the central bank and the banking regulator require the banks to maintain very high levels of liquidity and capital and their lending activities are restricted to the domestic economy.

That said, wholesale funding remains very high with a loan-to-deposit ratio of 151% in 2018, and the banking system is very concentrated. Also, according to the IMF, more work needs to be done on strengthening the power of the supervisors and regulators and reducing the gaps in financial safety nets and the deposit insurance and bank resolution frameworks.

Exhibit 43

D-SIBs' capital adequacy and loan quality are far improved

Capital adequacy ratios (capital base % of risk-weighted assets), NPL ratio

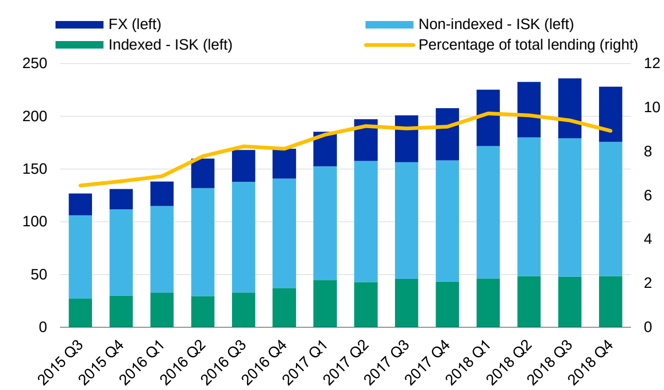


Sources: Central Bank of Iceland, Moody's Investors Service

Exhibit 44

Bank's exposure to tourism industry is significant

ISK billion (lhs), % of total lending (rhs)



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

Given the small scale of the economy and population size, we see a substantial level of interconnectedness within the country and contagion risk among the three main economic sectors. This makes banks highly susceptible to boom-bust cycles, creating significant tail risk since banks cannot diversify in such a system.

In this context, banks' direct exposure to the tourism sector is not insignificant, at around 9% of banks' total loan portfolio (see Exhibit 44), and larger still if we consider the wider services sector. As a result, asset quality could suffer if the economic contraction related to Wow Air were to be more pronounced than expected, in the event that overconfidence in past rapid growth led to credit-financed overinvestment in that sector.

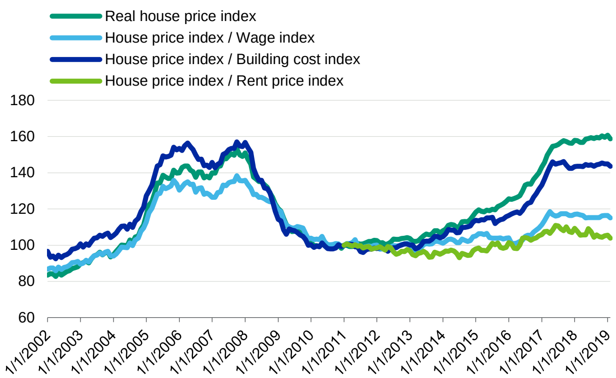
However, most of these loans are over collateralized – around one-third of the loans are backed by commercial real estate – which limits the downside risks to financial stability in the event that slower tourism activity leads to increased risk for banks' loans.

With regards to the real estate market, while house prices have increased sharply, various measures of house prices compared to key determinants (see Exhibit 45) and systemwide household debt metrics compared to household wealth (see Exhibit 46) suggest that the risks are manageable.

Exhibit 45

House prices have risen beyond fundamentals...

Index, January 2011 = 100

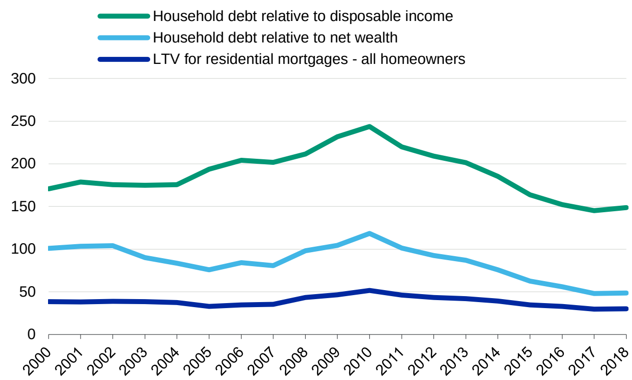


Source: Central Bank of Iceland, Moody's Investors Service

Exhibit 46

....yet metrics systemwide have indeed improved

Household debt and LTV ratio for residential mortgages



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

External vulnerability risk is low, with current account surpluses contributing to net external creditor position

External vulnerability risk is set at "Low", which is set above the indicative score of "Very Low" as the data on FDI inflows has been quite volatile in the past and can present a misleading signal. Peers sharing a "Low" assessment of external vulnerability risk include Cyprus (Ba2 stable), Ireland (A2 stable), Poland (A2 stable) and Lithuania (A3 stable).

Exhibit 47

Peer comparison table factor 4d: External vulnerability risk

	Iceland A3/POS	L Median	Cyprus Ba2/STA	Ireland A2/STA	Poland A2/STA	Lithuania A3/STA	Hungary Baa3/STA	Latvia A3/STA
Final score	L		L	L	L	L	L+	L-
Scorecard-indicated outcome	VL		H-	H-	L	VL+	L	VL+
(Curr. acc. bal. + FDI inflows)/GDP	1.3	-0.7	-8.4	-8.5	1.2	3.2	5.1	1.3
Net international inv. position/GDP	10.9	-53.1	-114.6	-142.5	-53.4	-29.5	-45.0	-49.1

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

Iceland's return to economic normalcy over the past few years has been bolstered by a turnaround in its external position achieved over the last decade, even after the economy returned to strong growth and capital controls were eased.

Driven by a rapidly expanding services balance related to a boom in tourism, the current account has been in surplus since 2013 and peaked in 2016 at 7.3% of GDP, before narrowing to 3.7% of GDP in 2017 due to strong growth in merchandise imports (see Exhibit 48). While the goods balance improved in 2018, the services balance was impacted by a decline in tourist arrivals as Wow Air reduced its fleet size, resulting in a current account surplus of 2.9% of GDP. Positive balance of payments dynamics have allowed the Central Bank of Iceland to purchase substantial foreign exchange in the foreign exchange market, bolstering its free foreign exchange reserves to $5.8 billion (roughly 25% of GDP and 24% of M2) as of May 2019.

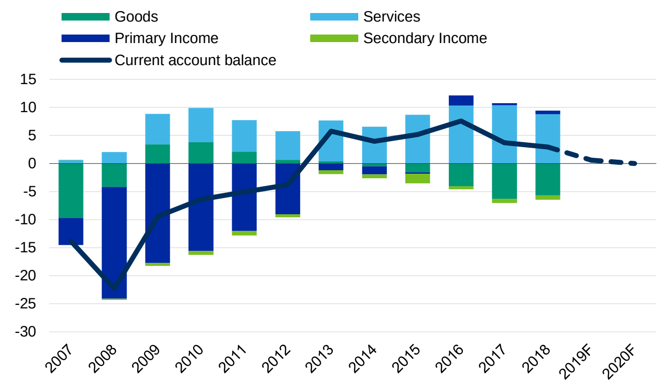
That said, the current account surplus has been narrowing in recent years and the collapse of Wow Air together with the resulting impact on tourist arrivals will lead to a notable decline in the current account surplus. We forecasts it to reach 0.6% of GDP in 2019, down from 2.9% of GDP a year before, and to be roughly in balance in 2020. In the medium term, we expect tourism to reach a steady state growth in line with global tourism growth which, together with a stronger role for domestic demand pushing up imports, will result in smaller current account surpluses than seen in recent years.

Additionally, Iceland's net international investment position (NIIP) has improved significantly in the years since the crisis because current account surpluses facilitated the paying down of external debt, while rising prices increased the value of Iceland's foreign assets and the owners of the failed banks wrote down their external debt in the context of winding-up proceedings. After the resolution of the failed bank estates in 2016, Iceland's NIIP improved sharply, moving into a positive territory of 2.6% of GDP at the end of 2016 from -4.8% of GDP at the end of 2015 (see Exhibit 49). This improvement continued in 2018, with NIIP reaching 10.9% of GDP.

Exhibit 48

Current account surplus will continue to decline given the shock to tourist arrivals

Current account balance and its components, % of GDP

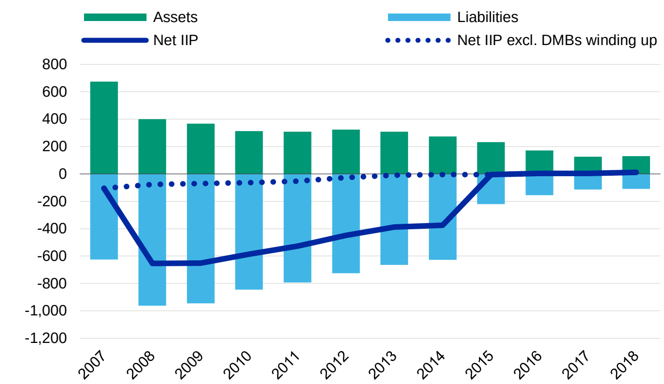


Sources: Central Bank of Iceland, Statistics Iceland, Moody's Investors Service

Exhibit 49

Resolution of the bank estates has helped turn the net IIP positive

Net international investment position, % of GDP



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

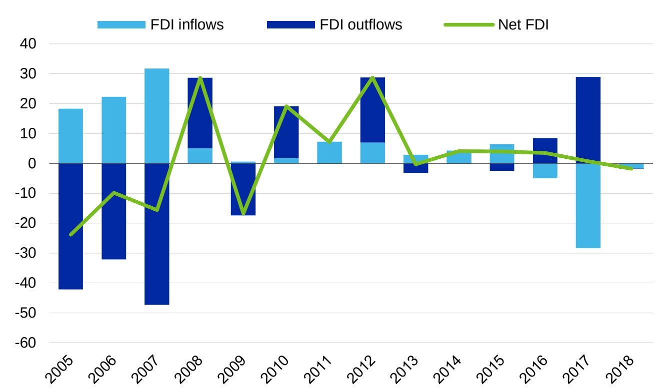
In terms of financing, Iceland benefited from foreign direct investment (FDI) inflows in the post-crisis era, mostly attracting investment in energy-intensive industries, such as aluminium smelters (see Exhibit 50). However, inflows of foreign investment into Iceland turned negative from 2016 (although the large decline in 2017 was offset by matching inflows). According to the OECD, the average return to foreign investors in Iceland was only 0.1% in 2015, the lowest among OECD countries, compared to around 5% in Norway and the Netherlands. On the other hand, the average income from Iceland's outward investment was around 3%, explaining the negative net foreign investment inflows.

Going forward, we expect the FDI inflows to move into positive territory as investors gain confidence following the removal of capital controls and new investment opportunities, e.g. in aquaculture, arise. That said, the low productivity of investment (apart from aquaculture and energy-intensive sectors) will keep them subdued.

Exhibit 50

FDI inflows turned negative in 2016

% of GDP

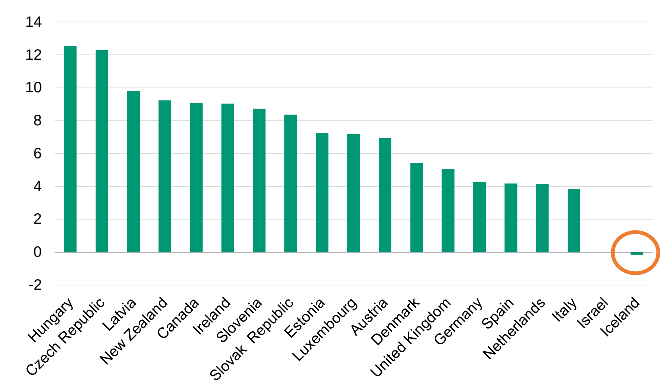


Sources: Central Bank of Iceland, Moody's Investors Service

Exhibit 51

Average income on FDI in Iceland declined further in 2018

% average income on inward FDI, 2018



Sources: OEDC, Moody's Investors Service

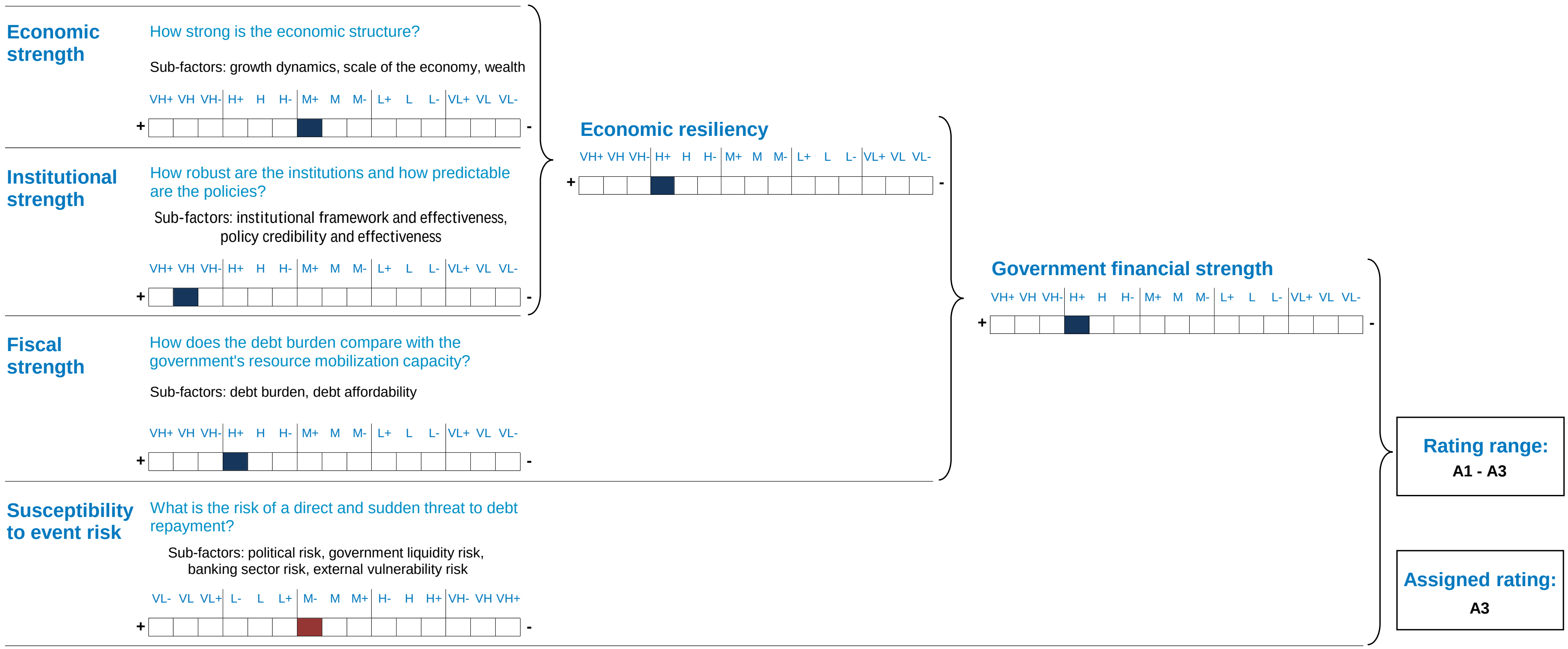
Deteriorating competitiveness represents the most significant threat to the sustainability of Iceland's external position, which would be endangered if, despite recent wage agreements, wage drift in the coming years lead to outsized pay increases relative to inflation and productivity.

Rating range

Combining the scores for individual factors provides an indicative rating range. 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 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.

Exhibit 52

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 rating range and shows the relevant credit metrics and factor scores.

Iceland compares well against near-peers on the rating scale with its dynamic growth, very high wealth, strong institutions, fast falling debt and declining susceptibility to event risk as the banking system continues to mature. By comparison, Slovakia (A2 positive) and Ireland (A2 stable) have significantly higher debt although their membership of the single currency area reduces their cost of funding. All of the A3 and some of the A2 peers have weaker institutional strength by 1-2 notches.

Exhibit 53
Iceland's key peers

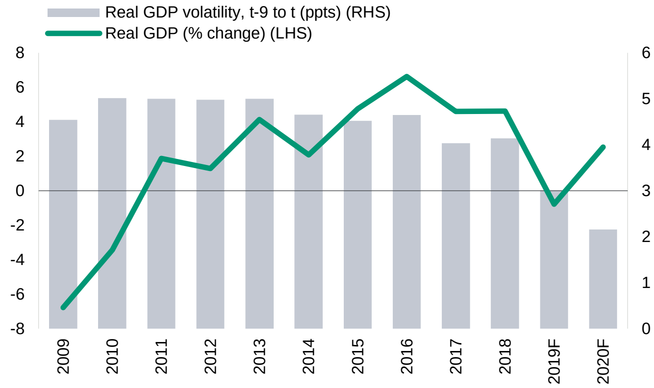
	Year	Iceland	Latvia	Lithuania	Sharjah	Slovakia	Ireland	A3 Median	Western Europe Median
Rating/Outlook		A3/POS	A3/STA	A3/STA	A3/NEG	A2/POS	A2/STA	A3	Aa2
Rating Range		A1 - A3	A1 - A3	A1 - A3	A3 - Baa2	Aa3 - A2	A1 - A3	A1 - A3	Aa2 - A1
Factor 1		**M+**	**M+**	**M+**	**M-**	**M+**	**H**	**M+**	**H+**
Nominal GDP (US$ bn)	2018	25.9	34.8	53.3	26.5	106.5	375.9	44.1	445.2
GDP per capita (PPP, US$)	2018	55917.3	29901.3	34825.8	32310.6	35129.8	78784.8	31585.2	52120.5
Avg. real GDP (% change)	2014-2023	3.6	3.1	2.8	2.2	3.5	6.9	3.3	1.8
Volatility in real GDP growth (ppts)	2009-2018	4.1	6.1	5.9	4.0	2.9	8.0	3.9	2.4
Global Competitiveness index	2017	5.0	4.4	4.6	--	4.3	5.2	4.6	5.2
Factor 2		**VH**	**H+**	**VH-**	**H+**	**H+**	**VH**	**H+**	**VH**
Government Effectiveness, percentile [1]	2017	88.3	73.7	75.1	--	70.0	82.4	73.7	88.3
Rule of Law, percentile [1]	2017	88.3	76.6	77.3	--	69.3	86.1	76.6	89.0
Control of Corruption, percentile [1]	2017	91.2	68.6	69.3	--	60.5	89.0	68.6	91.2
Average inflation (% change)	2014-2023	2.4	1.8	1.8	2.5	2.5	1.0	2.3	1.3
Volatility in inflation (ppts)	2009-2018	3.1	1.8	1.7	1.5	1.6	1.1	1.3	1.1
Factor 3		**H+**	**VH**	**VH-**	**M+**	**VH**	**M+**	**VH-**	**VH-**
Gen. gov. debt/GDP	2018	37.2	35.9	34.2	25.4	48.9	64.8	35.6	60.1
Gen. gov. debt/revenue	2018	87.0	95.9	98.6	246.4	122.6	251.4	125.3	126.9
Gen. gov. interest payments/revenue	2018	7.2	1.9	2.6	8.5	3.3	6.4	7.1	3.3
Gen. gov. interest payments/GDP	2018	3.1	0.7	0.9	0.9	1.3	1.6	1.4	1.6
Gen. gov. financial balance/GDP	2018	1.1	-1.0	0.7	-4.0	-0.7	0.0	-1.4	0.3
Factor 4		**M-**	**M-**	**M-**	**M-**	**L+**	**M-**	**M-**	**L**
Current account balance/GDP	2018	3.0	-1.0	1.5	--	-2.5	9.1	1.5	2.5
Gen. gov. external debt/gen. gov. debt	2018	23.9	81.1	73.3	--	57.5	72.1	27.5	45.9
Net international investment position/GDP	2018	10.9	-49.1	-29.5	--	-66.9	-142.5	-32.6	6.9

[1] Moody's calculations. Percentiles based on our rated universe.
Sources: National authorities, IMF, World Economic Forum, Worldwide Governance Indicators, Moody's Investors Service

DATA, CHARTS AND REFERENCES

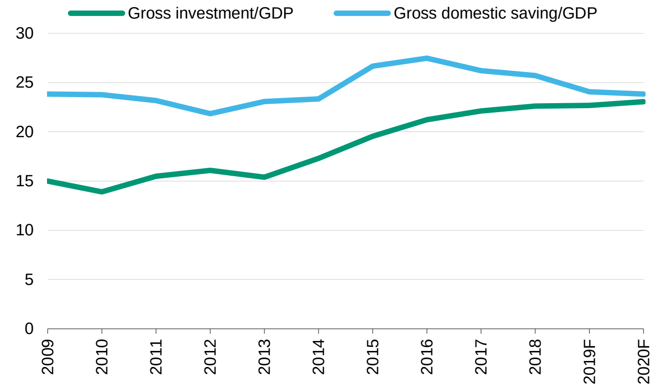
Chart pack: Iceland

Exhibit 54
Economic growth



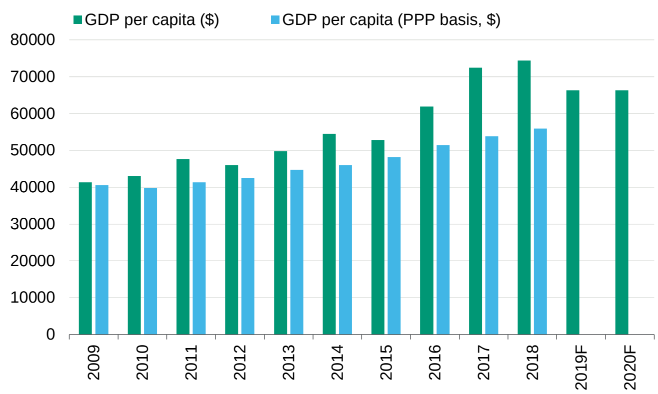
Sources: Statistics Iceland, Moody's Investors Service

Exhibit 55
Investment and saving



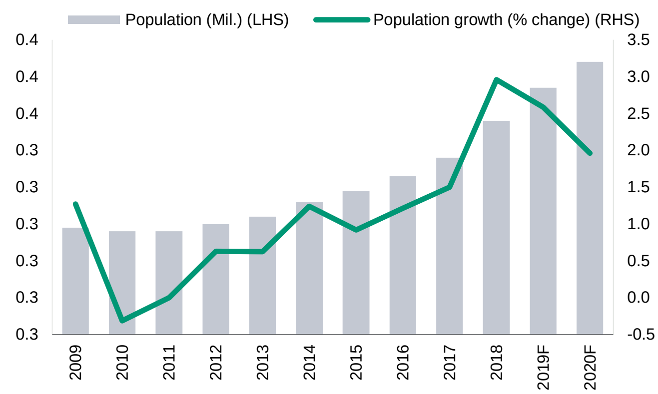
Sources: IMF, Moody's Investors Service

Exhibit 56
National income



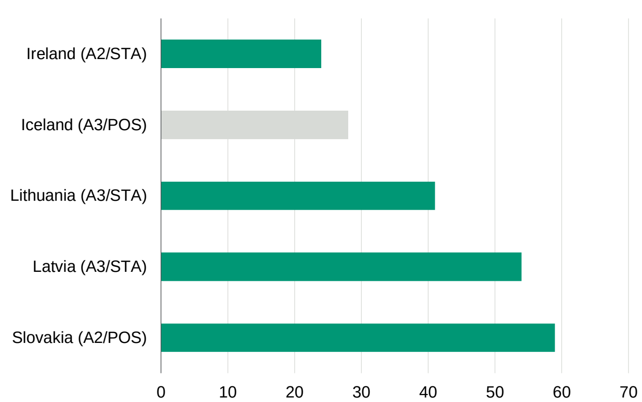
Sources: IMF, Moody's Investors Service

Exhibit 57
Population



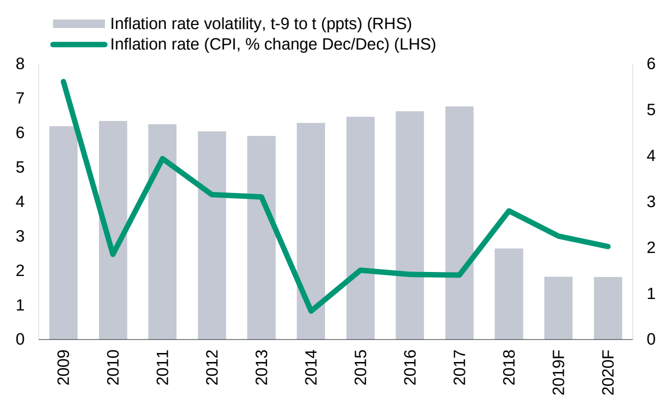
Sources: IMF, Moody's Investors Service

Exhibit 58
Global Competitiveness Index
Rank 28th out of 137 countries



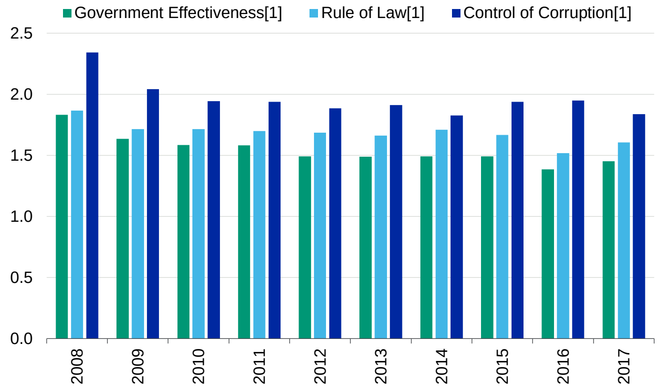
Sources: World Economic Forum, Moody's Investors Service

Exhibit 59
Inflation and inflation volatility



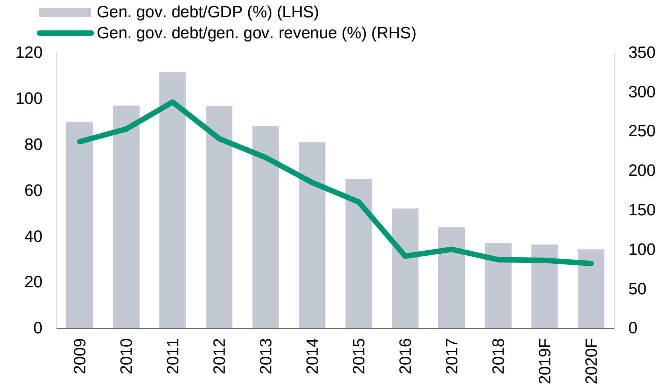
Sources: Statistics Iceland, Moody's Investors Service

Exhibit 60
Institutional framework and effectiveness



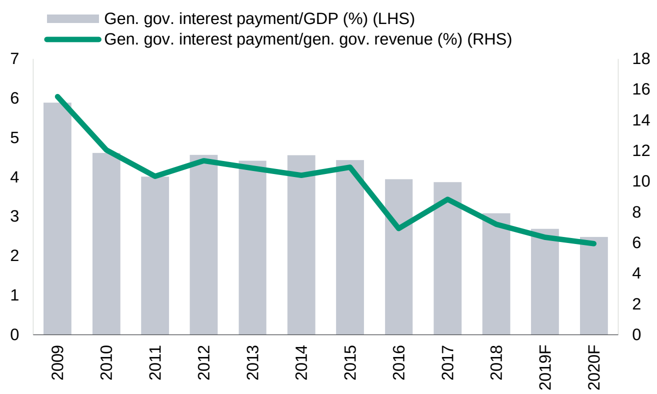
Note: [1] Composite index with values from about -2.50 to 2.50: higher values suggest greater maturity and responsiveness of government institutions.
Sources: Worldwide Governance Indicators, Moody's Investors Service

Exhibit 61
Debt burden



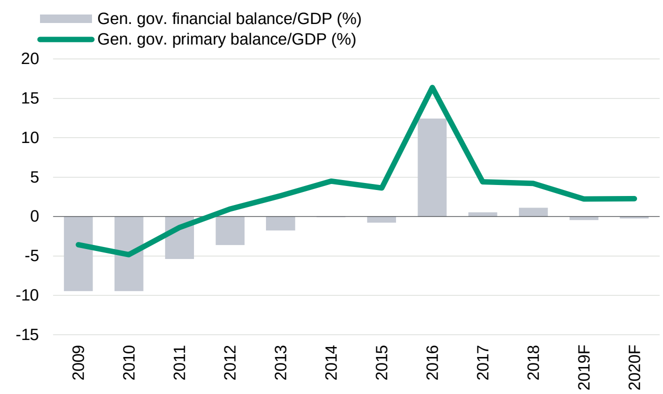
Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

Exhibit 62
Debt affordability



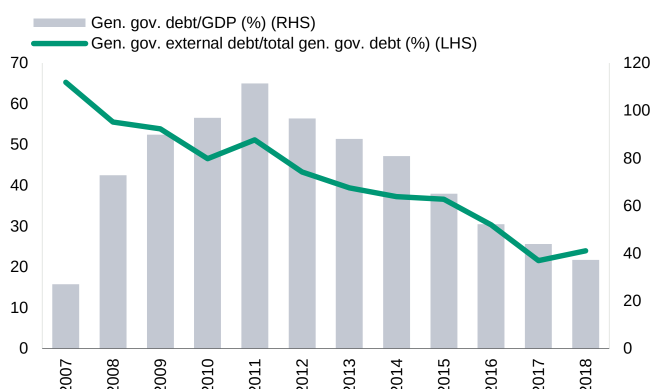
Sources: Statistics Iceland, Moody's Investors Service

Exhibit 63
Financial balance



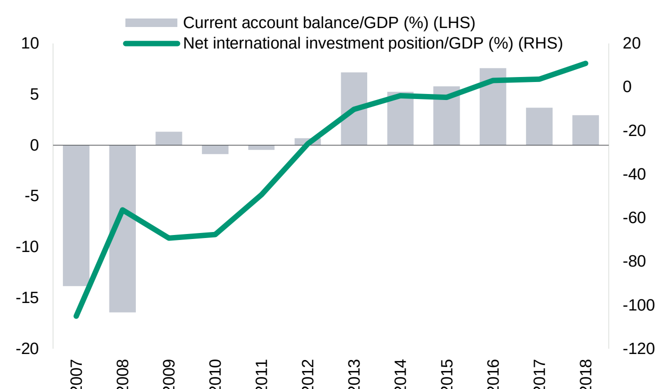
Sources: Statistics Iceland, Moody's Investors Service

Exhibit 64
Government liquidity risk



Sources: Ministry of Finance and Economic Affairs, Moody's Investors Service

Exhibit 65
External vulnerability risk



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

Rating history

Exhibit 66

Iceland[1]

	Government Bonds			Foreign Currency Ceilings				
				Bonds & Notes		Bank Deposit		
	Foreign Currency	Local Currency	Outlook	Long-term	Short-term	Long-term	Short-term	Date
Outlook Changed	--	--	Positive	--	--	--	--	Jul-18
Rating Raised	A3	A3	Stable	A3	--	A3	--	Sep-16
Outlook Changed	Baa2	Baa2	RUR-	Baa2	P-2	Baa2	P-2	Jun-16
Rating Raised	Baa2	Baa2	--	Baa2	--	Baa2	--	Jun-15
Outlook Changed	--	--	Stable	--	--	--	--	Feb-13
Rating Lowered	--	--	--	Baa3	--	--	--	Nov-12
Outlook Changed	--	--	Negative	--	--	--	--	Jul-10
Outlook Changed	--	--	Stable	--	--	--	--	Apr-10
Outlook Changed	--	--	Negative	--	--	--	--	Apr-10
Outlook Changed	--	--	Stable	--	--	--	--	Nov-09
Rating Lowered	Baa3	Baa3	--	Baa2	P-3	Baa3	P-3	Nov-09
Rating Lowered	Baa1	Baa1	Negative	A2	P-2	Baa1	P-2	Dec-08
Rating Lowered & Review for Downgrade	A1	A1	RUR-	Aa1	--	A1	--	Oct-08
Review for Downgrade	Aa1	Aa1	RUR-	--	--	--	--	Sep-08
Rating Lowered	Aa1	Aa1	Stable	--	--	Aa1	--	May-08
Outlook Changed	--	--	Negative	--	--	--	--	Mar-08
Rating Raised	Aaa	--	Stable	Aaa	--	Aaa	--	Oct-02
Rating Assigned	--	Aaa	--	--	--	--	--	Jul-97
Rating Raised	Aa3	--	Stable	Aa3	--	Aa3	--	Jul-97
Review for Upgrade	A1	--	RUR+	--	--	--	--	Jun-97
Outlook Assigned	--	--	Positive	--	--	--	--	Mar-97
Rating Raised	A1	--	--	A1	--	A1	--	Jun-96
Review for Upgrade	A2	--	RUR+	--	--	--	--	Apr-96
Rating Assigned	--	--	--	--	--	A2	P-1	Oct-95
Rating Assigned	--	--	--	--	P-1	--	--	Oct-90
Rating Assigned	A2	--	--	A2	--	--	--	May-89

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

Annual statistics

Exhibit 67

Iceland

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F
Economic structure and performance												
Nominal GDP (US$ bil.)	13.2	13.7	15.2	14.7	16.0	17.8	17.4	20.6	24.5	25.9	23.7	24.1
Population (Mil.)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4
GDP per capita (US$)	41,269	43,030	47,668	46,013	49,794	54,473	52,854	61,917	72,465	74,374	66,301	66,322
GDP per capita (PPP basis, US$)	40,555	39,835	41,325	42,514	44,728	45,979	48,170	51,389	53,834	55,917	--	--
Nominal GDP (% change, local currency)	3.4	2.8	5.1	4.8	6.4	5.8	10.6	8.6	5.1	7.1	4.0	5.6
Real GDP (% change)	-6.8	-3.4	1.9	1.3	4.1	2.1	4.7	6.6	4.6	4.6	-0.8	2.5
Inflation (CPI, % change Dec/Dec)	7.5	2.5	5.3	4.2	4.1	0.8	2.0	1.9	1.9	3.7	3.0	2.7
Unemployment rate (%)	7.2	7.6	7.1	6.0	5.4	5.0	4.0	3.0	2.8	2.7	3.9	3.8
Gross investment/GDP	15.0	13.9	15.5	16.1	15.4	17.3	19.6	21.2	22.1	22.6	22.7	23.1
Gross domestic saving/GDP	23.8	23.8	23.2	21.8	23.1	23.3	26.7	27.5	26.2	25.7	24.1	23.8
Nominal exports of G & S (% change, US$ basis)	-12.0	11.1	16.7	-2.4	5.9	6.7	-1.5	9.0	15.0	8.2	-14.1	0.1
Nominal imports of G & S (% change, US$ basis)	-31.6	9.9	23.8	1.7	1.3	9.9	-3.8	9.9	20.6	11.0	-10.9	1.4
Real exports of G & S (% change)	8.3	1.0	3.4	3.6	6.7	3.2	9.1	10.9	5.4	1.6	-4.7	0.3
Real imports of G & S (% change)	-22.4	4.4	6.8	4.6	0.1	9.8	13.8	14.5	12.5	0.1	-1.1	1.7
Net exports of goods & services/GDP	8.8	9.9	7.7	5.8	7.7	6.0	7.1	6.2	4.1	3.1	1.4	0.8
Openness of the economy[1]	88.5	94.1	101.8	104.3	99.3	97.0	96.5	89.0	88.1	91.3	87.3	86.3
Government Effectiveness[2]	1.6	1.6	1.6	1.5	1.5	1.5	1.5	1.4	1.5	--	--	--
Government finance												
Gen. gov. revenue/GDP	37.9	38.3	38.8	40.2	40.6	43.7	40.6	56.9	43.8	42.8	42.2	41.8
Gen. gov. expenditures/GDP	47.4	47.8	44.2	43.8	42.4	43.8	41.4	44.5	43.3	41.7	42.7	42.0
Gen. gov. financial balance/GDP	-9.5	-9.5	-5.4	-3.6	-1.8	-0.1	-0.8	12.4	0.5	1.1	-0.4	-0.2
Gen. gov. primary balance/GDP	-3.6	-4.8	-1.4	1.0	2.6	4.5	3.6	16.4	4.4	4.2	2.2	2.3
Gen. gov. debt (US$ bil.)	11.7	14.1	16.0	13.8	14.9	13.2	11.5	11.5	11.0	9.0	8.2	8.5
Gen. gov. debt/GDP	89.8	96.9	111.5	96.7	88.0	80.9	65.0	52.2	44.0	37.2	36.5	34.4
Gen. gov. debt/gen. gov. revenue	237.0	252.9	287.1	240.5	216.8	184.9	160.2	91.7	100.3	87.0	86.4	82.3
Gen. gov. interest payments/gen. gov. revenue	15.5	12.0	10.3	11.3	10.9	10.4	10.9	6.9	8.8	7.2	6.4	5.9
External payments and debt												
Nominal exchange rate (local currency per US$, Dec)	124.9	115.1	122.7	129.0	115.6	126.9	129.6	112.8	104.4	116.3	130.0	125.0
Real eff. exchange rate (% change)	-19.6	3.4	0.9	-1.1	4.2	6.9	2.5	12.5	12.0	-2.6	--	--
Relative unit labor cost	68.2	75.5	79.5	79.7	83.0	90.9	100.0	115.7	133.9	129.8	--	--
Current account balance (US$ bil.)[3]	0.2	-0.1	-0.1	0.1	1.1	0.9	1.0	1.6	0.9	0.8	0.1	0.1
Current account balance/GDP[3]	1.3	-0.9	-0.5	0.7	7.2	5.2	5.8	7.6	3.7	2.9	0.6	0.3
Net foreign direct investment/GDP	-16.8	19.1	7.2	28.7	-0.3	4.1	4.0	3.5	0.7	-1.8	0.3	0.6
Net international investment position/GDP[3]	-69.3	-67.6	-49.3	-26.0	-10.2	-3.9	-4.7	3.1	3.6	10.9	--	--
Official forex reserves (US$ bil.)	3.6	5.6	7.7	4.0	4.1	4.1	4.8	6.9	6.2	6.0	5.9	5.9

[1] Sum of Exports and Imports of Goods and Services/GDP
[2] Composite index with values from about -2.50 to 2.50: higher values suggest greater maturity and responsiveness of government institutions
[3] Excludes DMBs undergoing winding up in 2008-2015
Source: IStatistics Iceland, Central Bank of Island, Worldwide Governance Indicators, IMF, Moody's Investors Service

Moody's related publications

- **Credit Opinion:** Government of Iceland - A3 positive: Regular update, 21 May 2019
- **Issuer Comment:** Wow Air's collapse poses downside risks for Iceland's 2019 economic growth, a credit negative, 3 April 2019
- **Issuer Comment:**Stronger-than-expected growth will support decline in Iceland's debt/GDP ratio, a credit positive, 6 March 2019
- **Issuer Comment:** Central bank's reduced reserve requirements on capital inflows are credit positive, 7 November 2018
- **Rating Action**: Moody's changes Iceland's outlook to positive from stable and affirms A3 ratings, 20 July 2018
- **Rating 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.

Related websites and information sources

- Sovereign Risk Group Web Page
- Sovereign Ratings List
- Statistics Iceland
- Central Bank of Iceland

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Endnotes

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

2 The fiscal revisions include some offsetting measures, including new "green" taxes, tobacco excise duties and postponing the reduction in the bank levy, with the total impact of new revenue measures over 2020-2024 estimated to be ISK34.7 billion or 1% of GDP.

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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