

MOODY'S

RATINGS

Rating Action: Moody's Ratings upgrades Iceland's ratings to A1, changes outlook to stable

20 Sep 2024

London, September 20, 2024 -- Moody's Ratings (Moody's) has today upgraded the local and foreign-currency long-term issuer ratings of the Government of Iceland to A1 from A2 and changed the outlook to stable from positive. Concurrently, the foreign-currency senior unsecured rating has been upgraded to A1 from A2, and the foreign-currency senior unsecured MTN program rating has been upgraded to (P)A1 from (P)A2.

The key driver for the upgrade is the government's improving fiscal metrics, which we expect to continue, with a sizeable reduction in the budget deficit and a clearly established downward trend in the government debt ratio since a recent peak in 2020. A consensual settlement of the HF Fund's (A2 positive) liabilities, which are included in government debt, and renewed sales of government held bank shares will likely result in additional one-off reductions in the debt ratio, in addition to an underlying declining trend. Secondly, tight monetary and fiscal policy has started to moderate elevated inflation, which supports our assessment of Iceland's strong institutions and pro-active and well-coordinated policy stance. In turn, lower inflation will improve the government's debt affordability metrics over the coming years, given that around a quarter of government debt is indexed to inflation.

The stable outlook reflects balanced risks at the A1 rating level. We expect fiscal consolidation to continue over the coming years broadly as planned in the medium-term fiscal plan. The economy is expected to return to robust growth next year, after a temporary slowdown this year as the tight monetary and fiscal policy cool the previously overheated economy. The sovereign's economic and fiscal metrics may improve faster than we currently expect. At the same time, Iceland remains a small and comparatively undiversified economy, sensitive to sector-specific shocks. Also, its debt ratio and debt affordability metrics remain weaker than close peers at the same rating level, making fiscal strength relatively sensitive to shocks.

Concurrently, both the local-currency and foreign-currency ceilings have been raised

to Aaa from Aa1 and Aa2 respectively. The four-notch gap between the local-currency ceiling and the sovereign rating reflects the very high predictability and reliability of Iceland's institutions and government actions, as well as low political risk and very limited external imbalances. Also, the footprint of government in the economy is relatively limited, while the government is actively reducing its involvement in the financial system. While Iceland is exposed to higher exchange rate volatility than many other countries, the central bank's very large foreign-currency reserves at close to 20% of GDP provide a substantial cushion against excessive volatility.

The alignment of the foreign-currency ceiling with the local-currency ceiling reflects low transfer and convertibility risk, given Iceland's high policy effectiveness and robust net external creditor position at around 37% of GDP.

RATINGS RATIONALE

RATIONALE FOR RATINGS UPGRADE TO A1

CONTINUED IMPROVEMENTS TO FISCAL AND DEBT METRICS

Iceland's fiscal and debt metrics have continued to improve last year, in line with our expectations at the time of assigning the positive outlook. We expect a further improvement in fiscal and debt metrics.

The budget deficit of the central government was reduced to 1.3% of GDP in 2023, nearly two percentage points narrower than budgeted. The strong fiscal performance was the result of strong revenue growth but also reflected the government's decision to tighten fiscal policy through spending restraint, in an effort to support the central bank's disinflation efforts. The deficit at the general government level was 2% of GDP, compared to 8.3% of GDP two years earlier.

As we expected, the fiscal costs associated with the seismic and volcanic activity in the Reykjanes peninsula have had a limited impact on the public finances.

The government targets further gradual fiscal consolidation over the coming years, with the budget to be brought back to balance by 2029 and a surplus from 2030 onwards, through constrained growth in current spending. We expect the budget deficit to decline broadly in line with the government's medium-term plans, as we consider these to be credible.

Iceland's medium-term fiscal policy framework has been a credit strength, ensuring fiscal sustainability and the creation of fiscal space over time since its introduction in 2015. The fact that the authorities are now considering to replace the current balanced budget rule with an expenditure rule is credit positive, as such a change would strengthen the framework further by contributing more strongly to macroeconomic stability. Under the proposal, spending (potentially excluding public investment) would have to grow below the growth rate of potential GDP unless it was

matched by an increase in revenues. The proposal will likely be discussed in parliament this autumn and we expect it to be adopted.

Against the strong GDP growth of the past few years and consistent fiscal consolidation, the government debt ratio has declined rapidly – from a peak of 77.5% of GDP in 2020 to 64.2% in 2023. We expect continued fiscal consolidation in conjunction with positive economic growth to reduce the debt ratio further over the coming years, to below 50% of GDP by the end of the decade.

The downward debt trend could be faster than under our baseline scenario if the currently ongoing negotiations of the government with 18 pension funds who are the main holders of the remaining HF-Fund bonds lead to an early consensual settlement of the Fund's liabilities. Such an agreement would allow the government to wind-down the Fund and exit its guarantee of collection on the bonds, resulting in a potentially substantial one-off reduction in the government debt ratio. The book value of the guarantee for HF-Fund currently amounts to 15.5% of GDP. Moreover, the government has restarted the process of selling its remaining stake in Islandsbanki (A2/A3 stable, baa2) this year and next, with the proceeds likely to also be used for debt-reduction purposes, beyond what is currently included in our projections.

COORDINATED POLICY TIGHTENING CONFIRMS STRONG INSTITUTIONAL FRAMEWORK

The second driver for the upgrade is the progress achieved in reducing Iceland's high inflation, which confirms our assessment of Iceland's strong institutions. The Central Bank of Iceland's (CBI) tight monetary policy stance and the government's decision to tighten fiscal policy in the course of last year have succeeded in materially slowing down the previously overheating economy. While somewhat more persistent than expected earlier, consumer price inflation has declined to 6% in August 2024, from a peak of 10.2% in February 2023. Excluding the housing component – which has been the main contributor to inflation over the past few months, also due to the additional demand for housing from the evacuated population of Grindavík – inflation is significantly lower at 3.6%. In line with the CBI, we expect inflation to continue to moderate over the coming months and drop below 4% by the middle of next year, the upper limit of the CBI's notification band.

The recently concluded wage agreement for the private sector further supports our expectation of declining inflation going forward. Wages will increase by 4% per year on average over the next four years, broadly in line with target inflation plus expected productivity growth. Wage growth was substantially higher in recent years, averaging 8.8% over the 2021-2023 period and 7% in the first six months of this year. The agreement is longer than in recent years and as such provides some degree of certainty and stability. The new agreement includes a redesigned bonus anchored to the level of labour productivity at the start of the agreement (rather than annual increases as before), which should help prevent real wage increases during periods when labour productivity is declining.

Lower inflation in turn will improve the government's debt affordability metrics over the coming years, given that around a quarter of government debt is indexed to inflation. In our baseline scenario, we forecast the ratio of interest payments to revenues to decline to 6.1% in 2024 from a recent peak of 8.7% in 2022, and approach 5% over the coming years, compared to the median of around 3% for A1-rated peers in 2023.

RATIONALE FOR STABLE OUTLOOK

We expect fiscal consolidation to continue over the coming years broadly as planned in the medium-term fiscal plan. The economy is expected to return to robust growth next year, after a temporary slowdown this year as the tight monetary and fiscal policy cool the previously overheated economy.

The sovereign's economic and fiscal metrics may improve faster than we currently expect, helped by the ongoing economic diversification efforts. At the same time, Iceland remains a small and comparatively undiversified economy, sensitive to sector-specific shocks. Against our expectations, the government and the pension funds may not be able to find a consensual agreement over the HF Fund's liabilities, and the ongoing seismic activity on the Reykjanes peninsula could have more profound implications for the economy, in particular on the important tourism sector.

ESG CONSIDERATIONS

Iceland's CIS-2 score indicates that ESG considerations have limited impact on the rating. This reflects the country's low exposure to environmental and social risks, as well as its very strong governance. Ensuring sufficiently large buffers to be able to respond to external or sector-specific shocks has been the consistent policy of successive Icelandic governments since the country emerged from its deep banking crisis.

Iceland's E-2 environmental issuer profile score is in line with that of other advanced economies, marked by low exposure to environmental risks across all categories. Nearly all of Iceland's energy generation and consumption are covered by renewable sources, in particular hydroelectric power and geothermal energy. Iceland's unique geological features imply some exposure to physical climate risks but also offer opportunities for the country's key sectors. The impact of warming seas on fish stocks in Icelandic waters is not yet clear; while some varieties may migrate out of Iceland's waters as illustrated by the decline in capelin fish stocks in 2019, other species have migrated into Icelandic waters. Also, the sector has considerable flexibility to adapt to changing stocks, which it has proved multiple times. Warmer temperatures are favourable for plant productivity and agriculture. Around 11% of Iceland's land mass consists of glaciers; while the melting of glaciers raises the risk of landslides, it also increases availability of hydropower, at least for several decades.

Iceland's S-2 social issuer profile reflects a more favourable demographic profile than in many other countries because of long working lives, high participation rates of

women and the flexibility of the labour force. Strong inward migration further supports the economy, as immigrants' participation rate exceeds that of the domestic population. In contrast to some of the Nordic countries, immigrants and refugees are widely perceived to benefit the Icelandic economy and society. Iceland also benefits from high-quality education, access to basic services and housing availability, similar to other Scandinavian countries. Indicators for access to healthcare are very strong, as demonstrated by the fast response to the coronavirus pandemic. Households have very large pension assets, which have shown to be effective shock absorbers in the past. While wage negotiations between employers and trade unions can affect Iceland's competitiveness, the highly coordinated collective bargaining has generally been a stabilising factor, ensuring relatively contained wage differentials and contributing to limited income disparities and social peace.

Iceland's G-1 governance issuer profile is underpinned by very high policy credibility and effectiveness. The fiscal framework and budget management are predictable and transparent with a focus on medium-term sustainability. There is broad political and social consensus over key fiscal policy goals, stability-oriented economic policies and the need for large buffers to deal with unavoidable shocks. Iceland has demonstrated its high shock-absorption capacity and ability to reverse debt trends in the past, most visibly in the aftermath of its banking crisis but also more recently during the coronavirus pandemic. As a result of solid budgetary out-turns and the use of one-off revenue for debt reduction, Iceland's public debt declined by 75 percentage points of GDP between the peak in 2011 and 2018, one of the strongest episodes of debt reduction globally. The score also reflects the professional public administration and the country's strong rankings in global surveys assessing rule of law, voice and accountability, and the control of corruption.

GDP per capita (PPP basis, US\$): 71,969 (2023) (also known as Per Capita Income)

Real GDP growth (% change): 5% (2023) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 7.7% (2023)

Gen. Gov. Financial Balance/GDP: -2% (2023) (also known as Fiscal Balance)

Current Account Balance/GDP: 1.1% (2023) (also known as External Balance)

External debt/GDP: 73.8% (2023)

Economic resiliency: a1

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 17 September 2024, a rating committee was called to discuss the rating of the Iceland, Government of. The main points raised during the discussion were: The issuer's fiscal or financial strength, including its debt profile, has materially increased.

Other views raised included: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutions and governance strength, have not materially changed.

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

The rating could be upgraded further if the government debt ratio continued to decline much faster than under our baseline assumptions and debt affordability metrics aligned with higher-rated peers. The rating could also be upgraded if the ongoing economic diversification efforts yielded stronger results in terms of reducing volatility of economic growth.

Conversely, the rating would come under downward pressure if the government deviated significantly from its medium-term fiscal plans, resulting in a material increase in the public debt ratio with no indication of a timely correction.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at <https://ratings.moodys.com/rmc-documents/395819>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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At least one ESG consideration was material to the credit rating action(s) announced and described above.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moodys.com/documents/PBC_1355824.

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