MOODY'S
INVESTORS SERVICE

ISSUER IN-DEPTH
12 September 2016

Rate this Research

RATINGS

Government of Iceland

FC Government Bond Rating	A3/STA
LC Government Bond Rating	A3/STA
FC Country Ceiling	A3
LC Country Ceiling	A1

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Government of Iceland

Key Drivers for Two-Notch Upgrade to A3 Stable, Concluding Ratings Review

On 1 September 2016, we upgraded Iceland's government bond ratings to A3 from Baa2 and changed the outlook to stable, following a review for upgrade that was initiated in June 2016. The two-notch upgrade of Iceland's government rating reflects two key drivers:

» **Significant government debt reduction which is likely to continue**. The speed and extent of Iceland's recent progress in recovering from its 2008 banking crisis were the result of sustained growth as well as fiscal restraint, which allowed a very sizeable reduction in government debt over the past year. We expect this debt reduction to continue and to be sustained with the deployment of the proceeds of the failed banks' estates over the coming years.

» **Reduced event risk due to the cautious liberalization of capital controls**. Careful and steady progress in addressing the problems in the banking sector and in relaxing capital controls has considerably reduced the risks to economic and financial stability from the final stages of capital account liberalization.

The stable outlook reflects the balance of risks that we foresee for Iceland's rating over the next two years. It balances the positive impact of moderate but sustained growth and continued fiscal consolidation against, for example, the residual risks from capital account liberalization, overheating pressures associated with potential capital inflows and tight labor markets and finally the evolving political dynamics.

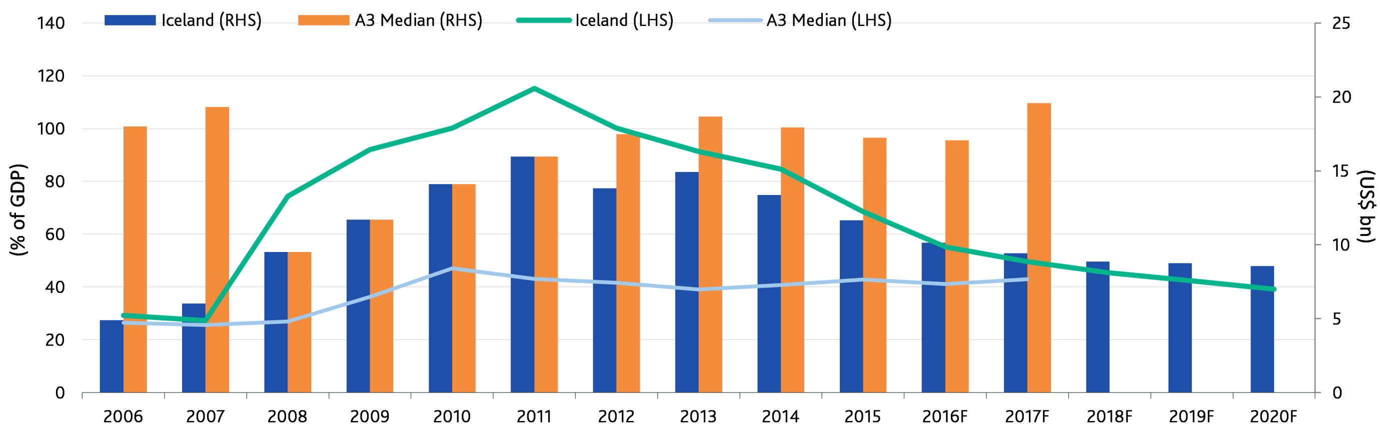
In a related move, we have also raised the ceilings on Iceland's local-currency debt and deposits from Baa1 to A1 and the ceilings on long-term foreign-currency debt and deposits to A3 from Baa2. The ceilings on short-term foreign-currency debt and deposits are unchanged at P-2.

RATIONALE FOR THE UPGRADE

FIRST DRIVER: FURTHER SIGNIFICANT IMPROVEMENT IN GOVERNMENT DEBT METRICS EXPECTED

The sharp drop in Iceland's indebtedness has continued apace over the past year, and we expect the trend to continue in the years ahead. As shown in Exhibit 1, we expect Iceland's general government debt-to-GDP ratio to decline to under 50% by the end of 2017 and to around 40% by 2020 from 68.5% at the end of 2015 – a fall of roughly 75 percentage points from the 2011 peak. Such ratios will be consistent with or better than A3 peers.

Exhibit 1
Iceland's General Government Debt Is on a Downward Trajectory



Source: Moody's Investors Service

The anticipated further reduction in the debt-to-GDP ratio will derive in large part from the deployment of the assets received in last year's resolution of the failed bank estates to pay down debt. It also reflects our expectation of ongoing fiscal consolidation, enacted under a medium-term fiscal strategy devised in line with the Organic Budget Law of December 2015 and its accompanying fiscal rules. Budget restraint, driven by a deficit ceiling of 2.5% of GDP in any one year and a requirement that net lending remain positive over any five-year period, will facilitate the net repayment of government debt at least for the next five years, as maturing debt is only partially rolled over. The cut in debt will also result in lower interest costs, which we anticipate will fall to 6.5% of revenues in 2017 from 10.5% in 2015.

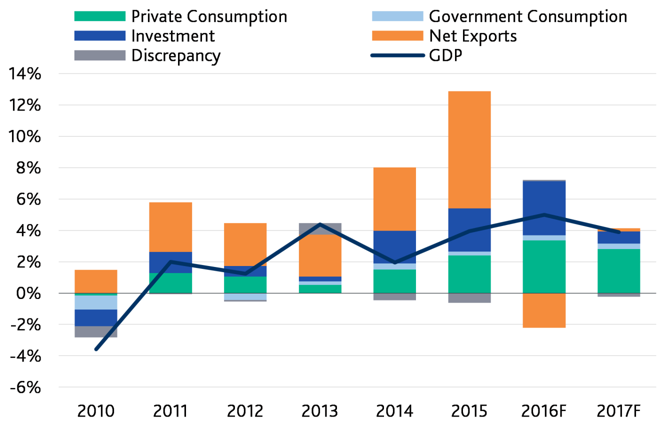
The favorable debt-to-GDP dynamics are also expected to continue to benefit from strong economic growth, which we forecast at 5% in 2016 and 3.9% next year, led by domestic demand (see Exhibit 2). The growth in real disposable incomes, following last year's generous four-year wage agreements and the decline in unemployment, have boosted both consumption and imports. Concurrently, household savings continue to grow and private sector debt remains low. Investment is also expected to expand, particularly in tourism infrastructure, business investment and residential housing, after having been subdued for a number of years.

Exports are still profiting from the competitive edge gained with the depreciation of the currency at the time that the crisis erupted, and the trade and current account surpluses remain large. Some of that advantage has been eroded by the króna's appreciation since the start of 2015, and net exports are now a drag on growth, in part owing to buoyant imports for expensive items such as ships and airplanes. Nonetheless, key export sectors continue to perform well, especially tourism, which has surpassed fishing as the largest sector of the economy.

The recent appreciation of the exchange rate plus falling energy costs have helped keep inflation low even after generous multi-year wage increases granted in 2015 and amid a widening positive output gap (see Exhibit 3). Indeed, a flexible labor force that relies on foreign workers, such as in the rapidly expanding tourism sector, has mitigated wage-push inflation. That said, above-potential growth for several successive years signals potential overheating risks, exacerbated by sizeable capital inflows in recent years. The government aims to address these risks in part by moving forward with the final stages of capital control liberalization.

Exhibit 2

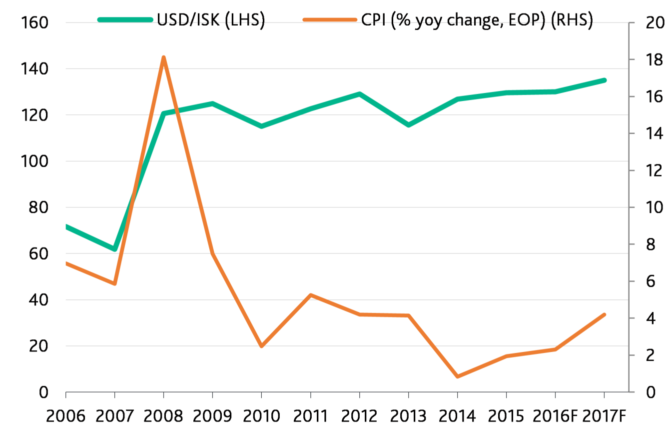
Domestic Demand Will Drive Iceland's Real GDP Growth
(% change)



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

Exhibit 3

Improved Exchange Rate Has Helped Keep Inflation Low



Source: Moody's Investors Service

SECOND DRIVER: REDUCED EVENT RISK DUE TO THE CAUTIOUS LIBERALIZATION OF CAPITAL CONTROLS

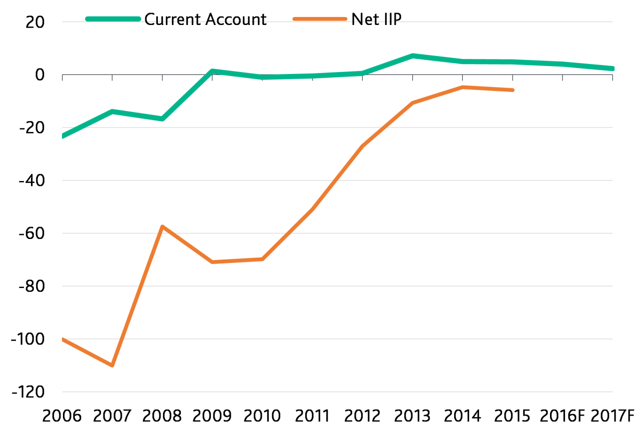
The second driver for the upgrade of Iceland's government rating to A3 reflects Moody's anticipation that the phasing out of capital controls first imposed in 2008 will continue to proceed smoothly and therefore not be disruptive to economic and financial stability. Iceland's rating trajectory has lagged the improvement in some of its core fundamentals since the financial crisis because of the residual risks posed by the complex process of removing the capital controls.

The first two stages of the liberalization process are now complete. The resolution of the failed bank estates was completed in late 2015, providing the government with stability contributions that will be used to reduce the debt burden. In June 2016, the central bank auctioned part of its foreign-exchange reserves for 'offshore krónur' (mainly non-resident-owned ISK assets trapped when capital controls were imposed in late 2008 at the time the old banks collapsed), thereby further reducing the overhang of such assets. Our view is that while the few remaining holdings of offshore krónur are sizeable at 8% of GDP, the event risk they pose for Iceland's external position is limited.

The third stage of the process, the liberalization of capital controls on residents, will begin immediately following parliamentary approval of the relevant legislation. While pension funds have already been able to incrementally reallocate their portfolios abroad in recent years, owing to successive exemptions from capital controls, a further easing of controls on residents is scheduled to take place on 1 January 2017. Pension funds will surely be a steady buyer of foreign investments over time (the central bank estimates ISK 60-80 billion per year); however, they are unlikely to shift meaningful amounts of additional funds in the closing months of this year

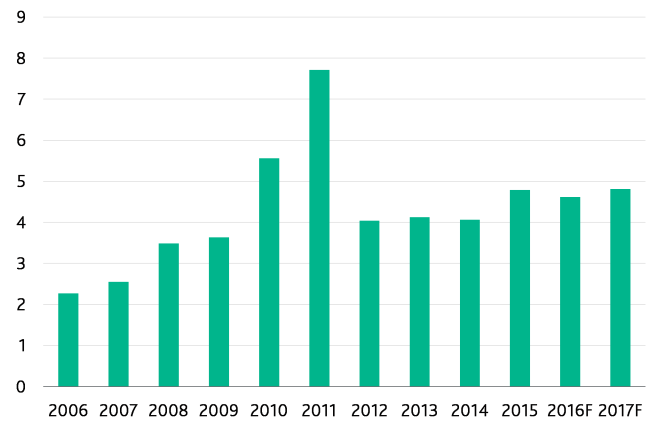
We still believe, however, that some downward pressure is likely to emerge on the onshore exchange rate in the next few months, under the assumption that outflows from resident accounts will be front-loaded into the closing months of 2016. Given the appreciation of the exchange rate over the past 18 months, this would be helpful to competitiveness and would potentially narrow the gap between the onshore and offshore exchange rates. The inflationary impact is likely to be rather contained, as evidenced by the Central Bank's decision to cut its key policy rate[1] by 50 bps to 5.25% on September 7.

Exhibit 4
Iceland's External Position is in Surplus
(% of GDP)



Source: Moody's Investors Service

Exhibit 5
Iceland's Official Foreign Exchange Reserves Are Above IMF RAM Levels
(US$ billions)



Source: Moody's Investors Service

In Moody's view, the planned relaxation of capital controls on residents poses only a limited risk to the Icelandic economy and financial system. As shown in Exhibit 4, national savings are high and the external position is strong, both on a flow (current account) and a stock (net international investment position) basis. Icelandic banks are highly liquid and have access to both foreign and domestic capital markets, and would thus be resilient to a potential deposit outflow. The central bank's FX reserves are above the IMF's Reserve Adequacy Metric, the level recommended by the IMF for the start of the liberalization of capital controls (see Exhibit 5).

There are also reasons to expect that net capital outflows will be lower than the central bank's estimates once the taps are opened. Iceland has been attracting substantial capital inflows, which are likely to continue given higher interest rates, low inflation and the economy's favorable prospects. Such inflows in the past three years allowed the central bank to accumulate its sizeable foreign exchange reserves – currently worth about 40% of GDP. In January-July this year, capital inflows have amounted to ISK 250 billion (ISK 270 billion in all of 2015), just slightly lower than the ISK 285 billion that the central bank estimates will leave the country in 2016 and 2017 combined in its "significant stress" scenario.

In fact, the central bank has put in place a capital flow mechanism (CFM) to dissuade speculative capital inflows and their potential for destabilizing markets and the exchange rate. The CFM imposes a 40% reserve requirement for a period of 12 months on inward investments into Icelandic bonds, and can be tightened further should it become necessary. The CFM should also help the central bank maintain an independent monetary policy; unlike many advanced countries, the Icelandic central bank has been in a tightening stance until just recently and large capital inflows for such a small currency make such a policy difficult to sustain.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook speaks to the balance of risks that we foresee for the rating at the A3 level. We expect growth in the coming years to be moderate but balanced, supported by the further liberalization of capital controls. Enhanced regulation is expected to maintain the capitalization and stability of the banking system, including by preventing its overseas expansion along the lines seen prior to the crisis.

Countervailing risks are being addressed. The aforementioned CFM has been implemented to address the risks from substantial speculative capital inflows. The authorities are also aware of the potential pressures implied by high employment levels and the high pay awards granted last year. And while the emergence of the relatively new Pirate Party creates a level of uncertainty over the direction of future policy following the upcoming election on 29 October, we do not believe that the fiscal or macro policy framework will change materially given the country's consensus-based politics.

WHAT COULD CHANGE THE RATING UP OR DOWN

We would upgrade Iceland's ratings (1) once the relaxation of controls on capital outflows, including the liberalization of offshore krónur, is completed, (2) if accompanied by an improvement in government debt and debt service metrics by the end of 2018 that is materially beyond current expectations, and (3) assuming that we continue to expect that the government's management of the economy and banking system will ensure that the boom-bust cycles and macro imbalances of the past will be avoided.

Conversely, downward pressure on Iceland's ratings could develop if economic or financial volatility were to re-emerge and threaten debt sustainability, particularly if Iceland needed to resort to capital controls again.

Moody's Related Research

Rating Action:

- Moody's upgrades Iceland's government ratings to A3; outlook stable, 1 September 2016
- Moody's places Iceland's Baa2 sovereign rating on review for upgrade, 10 June 2016

Credit Opinion:

- Government of Iceland – A3 Stable: Update Following Recent Upgrade, Concluding Rating Review, 1 September 2016
- Government of Iceland – Baa2 RUR+: Update Following Initiation of Review for Upgrade, 10 June 2016

Issuer Comment:

- Iceland Schedules Auction to Buy Offshore Krónur, a Credit Positive, 30 May 2016
- Iceland's Payment from Hold-Out Creditors Is Credit Positive for Sovereign, 5 October 2015

Country Statistics:

- Country Statistics: Iceland, Government of, 1 June 2016

Credit Focus:

- Iceland, Government of: FAQ: Capital Controls and the New Liberalization Strategy, 15 July 2015

Outlook:

- Sovereigns – Global: Stable Outlook Despite Low Growth, Jittery Markets and Uneven Reforms, 4 November 2015

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Endnotes

1 Key policy rate is the 7-day deposit rate; also lowered were the deposit rate to 5%, the 7-day collateralised lending rate to 6%, and the overnight rate to 7%

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