MOODY'S INVESTORS SERVICE

Credit Opinion: Iceland, Government of

Global Credit Research - 29 Sep 2015

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa2
Senior Unsecured	Baa2

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Key Indicators

Iceland

	2009	2010	2011	2012	2013	2014	2015F	2016F
Real GDP (% change)	-4.7	-3.6	2.0	1.2	3.9	1.8	4.0	3.3
Inflation (CPI, % change Dec/Dec)	7.5	2.5	5.3	4.2	4.1	0.8	3.0	6.0
Gen. Gov. Financial Balance/GDP (%)	-9.7	-9.8	-5.6	-3.7	-1.2	-0.1	-0.5	-0.9
Gen. Gov. Debt/GDP (%) [1]	92.3	101.0	114.0	100.3	92.7	85.5	77.8	71.0
Gen. Gov. Debt/Gen. Gov. Revenue (%)	237.6	254.9	284.0	240.5	215.6	170.1	172.0	161.2
Gen. Gov. Int. Pymt/Gen. Gov. Revenue (%)	15.5	12.0	10.3	11.5	10.8	10.5	9.1	8.9
Current Account Balance/GDP (%) [2]	7.3	7.1	4.1	2.7	7.3	5.5	4.3	2.2
External Debt/CA Receipts (%) [3]	429.6	478.6	437.0	381.5	391.8	272.8	374.0	350.2
External Vulnerability Indicator [4][5]	1,302.7	84.6	52.9	26.3	45.5	48.7	41.5	34.0

[1] General government includes loans from the IMF and Norway that were extended directly to the central bank in 2009. The Norwegian loan and most of the IMF loan were repaid early. [2] From 2009 onwards excludes Deposit-Money Banks undergoing winding-up proceedings and Actavis [3] Current Account Receipts [4] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year) / Official Foreign Exchange Reserves [5] Excludes Total Nonresident Deposits Over One Year

Opinion

Credit Strengths

The credit strengths of Iceland include:

- A flexible and highly skilled labor force

- A natural resource base that underpins robust economic growth potential

- A tradition of consensus-based economic policy formation

- Strengthened institutions since the 2008 banking system collapse

- Nearly fully-funded pension system and favorable demographics, including long working lives

Credit Challenges

The credit challenges facing Iceland include:

- The orderly implementation of capital account liberalization, in order to reduce the country's external vulnerabilities, while protecting economic and financial stability

- Large contingent liabilities

- Further reducing the government and external debt ratios to allow public finances a larger buffer against potential shocks

Rating Rationale

Among the key credit strengths supporting Iceland's Baa2 credit rating are its high levels of wealth and moderate economic dynamism thanks to favorable demographics and improving household, corporate and government balance sheets. Accumulated wealth provided an important buffer during the severe economic adjustment of the past several years. The recent economic recovery is on a more sustainable footing than was growth in the pre-crisis era given the rebalancing of the economy and large external surpluses, which are bringing down the country's sizeable external debt. The country's public finances have improved significantly, and the public debt burden - while still high - has started to decline from 2012 onwards. If the government's large cash buffers are taken into account, the public debt is at a moderate level in the European context. In addition and in contrast to many other highly-indebted European countries, Iceland has a nearly fully funded private pension system, which together with favorable demographics bodes well for long-term fiscal sustainability.

According to our sovereign bond methodology, Iceland exhibits `moderate (+)' Economic Strength. Iceland's GDP per-capita is among the highest in the universe of Moody's-rated sovereigns, despite the significant loss in wealth due to the banking and currency crisis of 2008, with the five-year average at $41,172 on a PPP basis as of 2014. This positions Iceland in the same territory as Aa-rated sovereigns (median per-capita GDP of $35,492) and as a clear outlier in the Baa rating range ($17,302). In addition to high income levels, Icelandic households possess substantial pension assets amounting to 145% of GDP (May 2014). This is not only positive for the long-term underlying fiscal position of the country, but has also allowed a relatively smooth adjustment process following the banks' collapse as households could temporarily withdraw money from their pension savings for debt repayment and consumption purposes. Offsetting the high level of wealth is the small size and limited diversification of the economy, which increase its vulnerability to shocks. The post-crisis recovery is well under way and Iceland's short-term growth outlook is relatively favorable. Over the medium term, however, Iceland's growth prospects depend crucially on the outlook for investment, in turn reliant on the speed with which the extensive capital controls will be abolished.

We assess Iceland's Institutional Strength as `very high', reflecting the country's strong scores on the World Bank's governance indicators. Iceland ranked at the 90th percentile of the World Bank's indicators of "Government Effectiveness" and the 92nd percentile of "Rule of Law", well above the Baa and A rating category medians, similar to the peer comparisons related to Economic Strength. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative business sector, an efficient labor market and well-developed infrastructure. In addition, the authorities have made significant progress in bringing the economy, the financial system and the public finances back onto a sustainable path. The government has implemented important changes to its institutions and to the banking sector's regulatory framework so as to avoid a repetition of the crisis. Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between government, employer and employee associations, which is a credit strength.

We consider Iceland's Fiscal Strength to be `moderate (-)', which takes into account the substantial reduction in the debt burden over the last three years. This is likely to continue, in part due to the expectations of persistent primary budget surpluses but also due to the repayment of debt with some of the proceeds that will accrue from the former bank estates in the process of capital account liberalization. In addition, the government's contingent liabilities are very large, mainly guarantees for Housing Financing Fund (HFF) liabilities. A mitigating factor is the significant financial assets that the government has acquired as part of the recapitalization of the "new" banking system.

We assess Iceland's Susceptibility to Event Risk as `moderate', mainly reflecting the risks to economic and financial stability emanating from the process of capital control liberalization. Risks to financial stability from the banking sector have moderated since the 2008 banking sector crisis. In our view, the banking system should be able to withstand 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.

Rating Outlook

The outlook on the rating is stable, reflecting balanced risks. Iceland's key credit challenge is how to maintain macroeconomic and financial sector stability throughout all phases of capital control liberalization, which we expect to commence in the next few months, but to take several years for controls to be fully lifted.

What Could Change the Rating - Up

Iceland's rating could be upgraded if the economic recovery were sustained and significant fiscal consolidation were achieved. A smooth resolution of the failed bank estates and successful relaxation of capital controls affecting residents, during which time the exchange rate remains broadly stable, would also exert upward pressure on the rating.

What Could Change the Rating - Down

The government's rating could be downgraded if its commitment to fiscal consolidation flagged, thereby halting the declining trend in the public debt ratio. The rating could also be downgraded if the capital account liberalization were to prove disorderly for any reason, leading to large and/or sudden capital outflows and a severe weakening of the exchange rate, with negative consequences for the domestic economy and financial stability.

Recent Developments

Real growth exceeded 5% in the first half of the year compared to the same period of 2014, driven by a 4.4% rise in private consumption and a 21.2% increase in investment spending. In many respects, such as employment levels, real incomes, inflation rates and the size of real GDP, the Icelandic economy has recovered fully from the banking sector collapse of October 2008. The government budget is now registering primary surpluses sufficiently large to permit the early repayment of bilateral and multilateral debt, which has led to significant reductions in debt to GDP ratios. Moreover, the authorities are finally resolving the external debt overhang that led to the systemic crisis, which will allow the gradual removal of the capital account controls put in place at that time.

Iceland's economic recovery has also benefitted from favorable terms of trade and steady current account surpluses, helped by a growing tourism sector, higher global fish prices, lower oil prices and a strong dollar (boosting revenues from mostly dollar-denominated export base). The appreciation of the dollar will provide a significant boost to export prices in krona terms, since sales of Iceland's two main exports - fish and aluminum - are dollar-denominated. We forecast the current account balance, which was 5% of GDP in 2014, to remain in surplus but to narrow in the coming years, mainly due to deteriorating terms of trade and a lower overall trade balance. We expect the current account surplus to fall to about 4% of GDP in 2015 and around 2% of GDP in 2016. Positive and sustained balance of payments dynamics have allowed the Central Bank (CBI) to purchase foreign exchange - a trend we expect to continue - building up sizable deposits at CBI. The steadily rising foreign exchange reserve is an important buffer to maintain during the process of capital controls liberalization.

A key risk to these positive developments, however, is the threat from this year's private sector wage settlement on inflation, with high pay increases threatening competitiveness and overall growth prospects as well as the government finances should a similar increase be granted to public sector workers. Thus far, inflation has been kept in check by the renewed downturn in oil prices but this effect is likely to be overcome by early 2016, sparking the need for tighter monetary policy that could depress investment and overall domestic demand.

Iceland's capital control liberalization strategy underpins an improved outlook for Iceland's economy and government finances. The focus of the plan is to treat the ISK 1.2 trillion (ca. $10 billion) in domestic claims held by non-residents, composed of the ISK denominated assets of failed banks (ISK 500 billion), the estates' foreign currency-denominated claims against Icelandic residents (ISK 400 billion) and offshore krona funds held by non-residents (ISK 300 billion). With progress on individual bank resolutions underway, the authorities expect Iceland's net external position, which was -387% of GDP including the failed bank estates at the end of Q12015, to be brought down to between -25 to -20% of GDP over the next year as a result of this process, which also involves the write-off of the external claims on the old banks.

Rating Factors

Iceland, Government of

Rating Factors Grid **Org ID: 392575**

Rating Factors	Sub-Factor Weighting	Indicator	Factor Score
Factor 1: Economic Strength			**M+**
Growth Dynamics	**50%**		
Average Real GDP Growth (2010-19F)		2.3	
Volatility in Real GDP Growth (Standard Deviation, 2005-14)		4.2	
WEF Global Competitiveness Index (2014)		4.7	
Scale of the Economy	**25%**		
Nominal GDP (US$ billion, 2014)		17.1	
National Income	**25%**		
GDP per Capita (PPP, US$, 2014)		43,637.3	
Factor 2: Institutional Strength			**VH**
Institutional Framework and Effectiveness	**75%**		
World Bank Government Effectiveness Index (2013)		1.5	
World Bank Rule of Law Index (2013)		1.6	
World Bank Control of Corruption Index (2013)		1.9	
Policy Credibility and Effectiveness	**25%**		
Inflation Level (%, 2010-19F)		3.1	
Inflation Volatility (Standard Deviation, 2005-14)		3.5	
Economic Resiliency (F1xF2)			**H+**
Factor 3: Fiscal Strength			**M-**
Debt Burden	**50%**		
General Government Debt/GDP (2014)		85.5	
General Government Debt/Revenues (2014)		170.1	
Debt Affordability	**50%**		
General Government Interest Payments/Revenue (2014)		10.5	
General Government Interest Payments/GDP (2014)		4.7	
Government Financial Strength (F1xF2xF3)			**H**
Factor 4: Susceptibility to Event Risk	**Max. Function**		**M**
Political Risk			
World Bank Voice & Accountability Index (2013)		1.5	
Government Liquidity Risk			
Gross Borrowing Requirements/GDP		5.2	
Non-Resident Share of General Government Debt (%)		37.7	
Market-Implied Ratings		Baa3	
Banking Sector Risk			
Average Baseline Credit Assessment (BCA)		--	
Total Domestic Bank Assets/GDP		203.0	
Banking System Loan-to-Deposit Ratio		123.4	
External Vulnerability Risk			
(Current Account Balance + FDI Inflows)/GDP		8.8	
External Vulnerability Indicator (EVI)		34.0	
Net International Investment Position/GDP		-26.1	
Government Bond Rating Range (F1xF2xF3xF4)			**A2 - Baa1**
Assigned Foreign Currency Government Bond Rating		**Baa2**	

Note: 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

Footnotes:(1) Rating Range: Factors 1, Economic Strength, and Factor 2, Institutional Strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3, Fiscal Strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the preliminary Government Financial Strength rating range as given by combining the first three factors.(2) 15 Ranking Categories: VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL-(3) Indicator Value: If not explicitly stated otherwise, the indicator value corresponds to the latest data available.

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 http://www.moodys.com for the most updated credit rating action information and rating history.

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