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CREDIT OPINION
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Update

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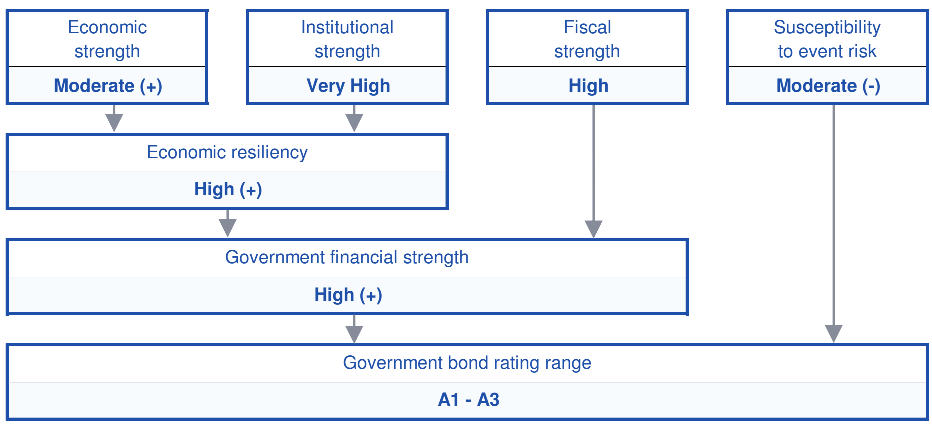
Government of Iceland – A3 Stable

Regular update

Summary

The credit profile of Iceland is supported by its wealthy, flexible economy, benefiting from a deep natural resource base that affords robust growth potential. The credit profile is constrained by its economy's small size, relatively limited diversification, openness and small currency area, which increase its vulnerability to shocks and cause volatility in annual growth rates.

Exhibit 1
Iceland's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» Economic flexibility and wealth, which provide significant shock-absorption capacity

» Strong institutions focused on avoiding vulnerabilities that led to 2008 banking crisis

» Well-funded pension system, long working lives and favorable demographics

Credit challenges

» Very small economy subject to high volatility

» Substantial, albeit reduced, exposure to external risks

» Large contingent liabilities derived from state-owned companies

Rating 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, as the torrid, tourism-driven pace of growth slows and large external surpluses narrow. Enhanced regulation is expected to maintain the strong capitalization and stability of the banking system, including by preventing its overseas expansion along the lines seen prior to the crisis.

Factors that could lead to an upgrade

We could upgrade Iceland's ratings should the decline in debt and debt service ratios exceed our expectations, assuming that the government's management of the economy and banking system is sufficiently cautious to ensure that the boom-bust cycles and macro imbalances of the past will be avoided.

Factors that could lead to a downgrade

Downward pressure on Iceland's ratings could develop if economic or financial volatility re-emerges and threatens public or external debt sustainability, particularly should Iceland again have to resort to capital controls.

Key indicators

Exhibit 2

Iceland	2011	2012	2013	2014	2015	2016	2017F	2018F
Real GDP (% change)	2.0	1.3	4.3	2.1	4.3	7.4	5.0	3.5
Inflation (CPI, % change, Dec/Dec)	5.3	4.2	4.1	0.8	2.0	1.9	2.0	2.5
Gen. gov. financial balance/GDP (%)	-5.6	-3.7	-1.8	-0.1	-0.8	12.6	1.2	1.5
Gen. gov. primary balance/GDP (%)	-1.4	1.0	2.7	4.6	3.7	16.5	4.4	4.1
Gen. gov. debt/GDP (%)	114.7	99.7	90.8	84.0	67.5	52.8	42.7	39.0
Gen. gov. debt/revenues (%)	287.1	240.5	216.8	187.1	162.0	91.5	98.0	91.4
Gen. gov. interest payment/revenues (%)	10.3	11.3	10.9	10.4	11.0	6.8	7.3	6.0
Current account balance/GDP (%)[1]	-0.5	0.8	7.4	5.2	5.9	7.8	5.4	4.8

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

Source: Moody's Investors Service

Detailed credit considerations

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

According to our sovereign bond methodology, Iceland exhibits "Moderate (+)" **economic strength**. Iceland's GDP-per-capita is among the highest of the sovereigns that we rate, despite the significant loss in wealth owing to the banking and currency crisis. Iceland also benefits from strong, albeit very volatile, real GDP growth. It is also highly competitive as suggested by the global competitiveness index, in which it stands out compared with its close peers.

Factors that constrain Iceland's economic strength relate to its economy's small size and relatively limited diversification, along with its openness and small currency area, which increase its vulnerability to shocks and cause volatility in annual growth rates. Iceland's F1 assessment is in line with similarly rated Latvia (A3 stable) and Lithuania (A3 stable).

We assess Iceland's **institutional strength** as "Very High", mainly reflecting the country's strong scores in the Worldwide Governance Indicators (WGI). Iceland ranks in the 86th percentile of the WGI's measure of government effectiveness, the 87th percentile for rule of law and the 94th for control of corruption, well above the A-rating category median. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative and high-tech-oriented business sector, an efficient labor market and well-developed infrastructure. Iceland's peers with the same "Very High" score are all higher rated, including Austria (Aa1 stable), Belgium (Aa3 stable), and Ireland (A2 stable).

Moreover, 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 – with the latter focusing exclusively on domestic lending – so as to avoid a repeat of the factors that led to the crisis. Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between the government, employers and employee associations, which is an important aspect of the economy's resilience and credit strength.

Fiscal strength is set at “High” instead of the indicative “High (+)” to account for large contingent liabilities, including the explicit guarantees provided to the Housing Finance Fund (HFF) and the National Power Company. Iceland has made a substantial progress in reducing its debt in recent years. The score is a function of Iceland's rapidly declining gross general government debt-to-GDP ratio, achieved through persistent budget surpluses and debt buybacks.

The foreign currency portion of the government's debt is also shrinking quickly, having fallen to 17.3% in 2016 from 41.9% in 2011, exposing the sovereign balance sheet to less exchange rate risk. It has fallen still further in 2017 after the government bought back nearly all of a 2022 eurobond. Additionally, the government’s new budget laws require that it run consistent and substantial primary surpluses, which further supports the improvement in fiscal strength. Peers with a similar assessment include higher rated Austria (Aa1 stable), France (Aa2 stable), the United Kingdom (Aa2 stable) and Poland (A2 stable), and similarly rated Malta (A3 stable).

We assess Iceland's **susceptibility to event risk** as “moderate (-)”. The “moderate (-)” score is driven by our banking system risk assessment, which is below the indicative score of “Moderate” because risks to financial stability from the banking sector have diminished significantly since the 2008 banking sector crisis. External vulnerability risk, political risk and government liquidity risk, at “Low” or “Very Low”, pose minimal risks to the sovereign. External vulnerability risk is set at “low”, which is above the indicative score of “very low” to reflect potential volatility resulting from Iceland’s very small currency area. Peers sharing the “Low” assessment include Ireland (A2 stable), Lithuania (A3 stable), and Poland (A2 stable). Government liquidity risk is set at “very low”, which is above the indicative score of “very low (-)” to reflect the need to maintain relatively high interest rates to restrain inflation. Peers with the same assessment include France (Aa2 stable) and Romania (Baa3 stable).

Recent developments

Unexpectedly soft landing with regard to growth so far this year

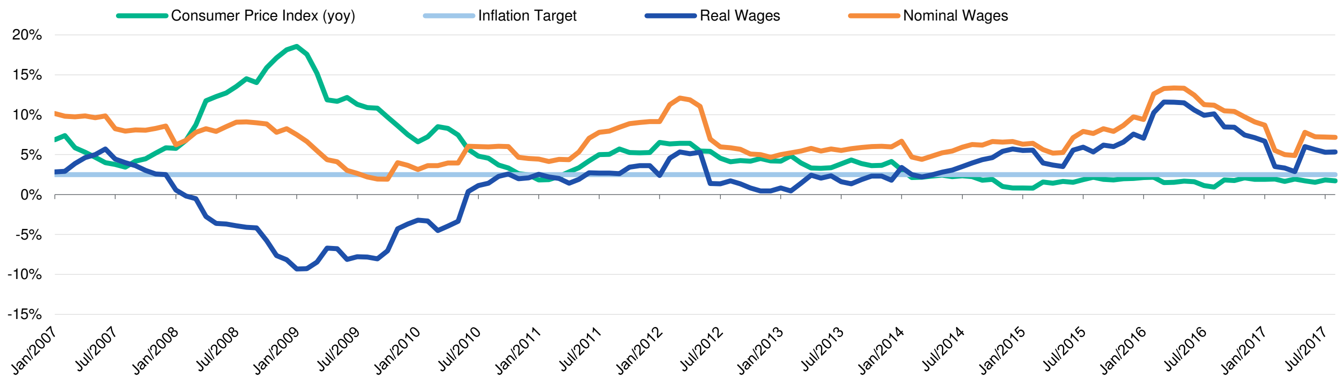
The economy has continued to expand this year but at a slower pace of about 5%, again led by buoyant domestic demand and tourism exports. Tight monetary and fiscal policy are part of the explanation, as is the appreciation of the krona. In line with these developments, the unemployment rate has fallen further from a 3% average in 2016. The rate is volatile because of high seasonality during the year, but we expect the annual average rate to drop to 2.7% this year and 2.5% next year, the lowest rates since before the banking sector collapse in the second quarter of 2008.

As far as the major sectors of the economy outside of tourism, the fisheries sector is still trying to make up for lost activity during a lengthy strike at the beginning of the year, one factor that explains the drop in real GDP in the first quarter relative to the fourth quarter of 2016. Barring labor strife, Iceland’s aluminum production plants normally operate at full capacity because they are extremely cost- and energy-efficient by other producers’ standards.

Tourism numbers are being restrained by capacity issues, including availability of flights and hotel rooms despite rapid expansion. The type and length of stay as well as the composition of tourist spending are also being affected by the stronger krona. Partly for these reasons, we expect growth to taper off to 3.5% next year.

Despite the torrid pace of growth, inflation has remained low and below the central bank's 2.5% inflation target. However, an upcoming wage round for most public sector unions poses risks to inflation, particularly if the increases exceed budget and lead other unions to reopen their agreements early next year. The 2015 wage round led to large wage increases, ranging between 21% and 30% over three years, as various unions piggy-backed on other unions' increases. The anticipated burst of inflation never materialized then because of terms of trade gains as the currency strengthened and oil and other commodity prices fell, in addition to the flexibility of the labor force. Now, with virtually full employment and the elimination of capital controls, overly high wage increases could push up inflation past target levels, although that is not our base case.

Exhibit 3
Inflation has remained below target thanks to favorable terms of trade



Sources: Haver Analytics, Central Bank of Iceland, MIS

Frequent elections have had limited effect on policy continuity

Iceland faces early elections at the end of October, the second early election in as many years, after the junior coalition party withdrew from the nine-month-old center-right government. This time, however, the reasons probably had more to do with the nature of the fragile coalition – which commanded only a one-vote majority in parliament. It is unclear at this stage what the next government will look like, or how long it will take a new coalition to be formed, but we believe that continuity of macroeconomic policy is nearly assured.

Rating methodology and scorecard factors

Rating factors grid - Iceland

Rating factors	Sub-factor weighting	Indicator	Indicative factor score	Final factor score
Factor 1: Economic strength			M+	M+
Growth Dynamics	**50%**			
Average real GDP growth (2012-2021F)		3.6		
Volatility in real GDP growth (standard deviation, 2007-2016)		4.7		
WEF Global Competitiveness index (2016)		5.0		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2016)		20.3		
National income	**25%**			
GDP per capita (PPP, US$, 2016)		49,136		
Automatic adjustments	**[-3; 0]**	Scores applied		
Credit boom		0		
Factor 2: Institutional strength			VH	VH
Institutional framework and effectiveness	**75%**			
Worldwide Government Effectiveness index (2016)		1.4		
Worldwide Rule of Law index (2016)		1.5		
Worldwide Control of Corruption index (2016)		2.0		
Policy credibility and effectiveness	**25%**			
Inflation level (%, 2012-2021F)		2.6		
Inflation volatility (standard deviation, 2007-2016)		3.9		
Automatic adjustments	**[-3; 0]**	Scores applied		
Track record of default		0		
Economic Resiliency (F1xF2)			**H+**	**H+**
Factor 3: Fiscal strength			H+	H
Debt burden	**50%**			
General government debt/GDP (2016)		52.8		
General government debt/revenue (2016)		91.5		
Debt affordability	**50%**			
General government interest payments/revenue (2016)		6.8		
General government interest payments/GDP (2016)		3.9		
Automatic adjustments	**[-6; +4]**	Scores applied		
Debt trend (2013-2018F)		0		
Foreign currency debt/general government debt (2016)		0		
Other non-financial public sector debt/GDP (2016)		0		
Public sector assets/general government debt (2016)		0		
Government financial strength (F1xF2xF3)			**H+**	**H+**
Factor 4: Susceptibility to event risk	**Max. function**		M	M-
Political risk			*VL*	*VL*
Worldwide voice & accountability index (2016)		1.3		
Government liquidity risk			*VL-*	*VL*
Gross borrowing requirements/GDP		1.7		
Non-resident share of general government debt (%)		30.3		
Market-Implied Ratings		A3		
Banking sector risk			*M*	*M-*
Average baseline credit assessment (BCA)		--		
Total domestic bank assets/GDP		201		
Banking system loan-to-deposit ratio		136		
External vulnerability risk			*VL*	*L*
(Current account balance + FDI Inflows)/GDP		2.1		
External vulnerability indicator (EVI)		--		
Net international investment position/GDP		2.8		
Government bond rating range (F1xF2xF3xF4)			**A1 - A3**	**A1 - A3**
Assigned foreign currency government bond rating		**A3**		

Note: While information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range. For more information please see our Sovereign Bond Rating Methodology.

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

Moody's related publications

» **Issuer in Depth:** Government of Iceland - A3 stable: annual credit analysis, 29 September 2017

» **Issuer Comment**: Government of Iceland: Elimination of Capital Controls is Credit Positive for the Sovereign and the Financial Sector, 17 March 2017

» **Issuer Comment**: Iceland's Improving External Position Is Credit Positive, 13 March 2017

» **Country Statistics**: Iceland, Government of, 13 June 2017

» **Rating Methodology**: Sovereign Bond Ratings, 22 December 2016

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