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CREDIT OPINION
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Update

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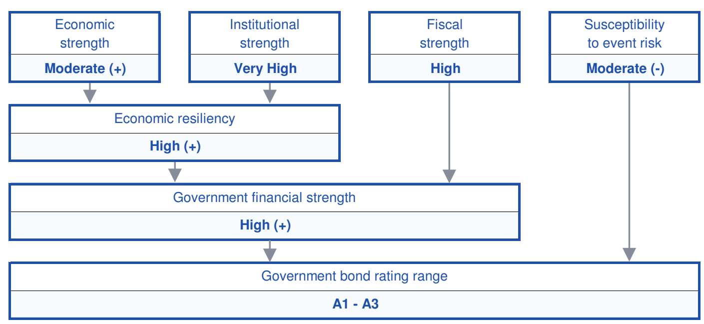
Government of Iceland – A3 Stable

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 the 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

THIS REPORT WAS REPUBLISHED ON 18 DECEMBER 2017 WITH A REVISED DESCRIPTION OF THE NEWLY FORMED GOVERNMENT COALITION ON PAGE 3.

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 now that the vivid, tourism-driven pace of growth has slowed and large external surpluses have narrowed. Government debt metrics will continue to improve through fiscal surpluses and asset sales to pay down debt. 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	2016E	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	1.4
Gen. gov. primary balance/GDP (%)	-1.4	1.0	2.7	4.6	3.7	16.5	4.3	4.0
Gen. gov. debt/GDP (%)	114.7	99.7	90.8	84.0	67.6	53.8	42.7	39.0
Gen. gov. debt/revenues (%)	287.1	240.5	216.8	187.1	162.2	93.2	100.0	93.9
Gen. gov. interest payment/revenues (%)	10.3	11.3	10.9	10.4	10.9	6.8	7.4	6.1
Current account balance/GDP (%)[1]	-0.5	0.8	7.4	5.2	5.9	7.8	5.3	4.6

[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, after overcoming 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 the 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 score is adjusted down from the indicative "High (-)" score to better align with peers such as 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 has dropped steeply 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 riskis 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

New three-party coalition expected to support policy continuity

After nearly a month of negotiations following the late October election, a three-party, left-to-right coalition, led by the Left-Green Movement, emerged and is anticipated to advocate for modestly higher taxes on capital gains and energy grid reforms in lieu of further power plant construction. The coalition's program will include an emphasis on road building and other infrastructure spending.

Also high on the agenda for the new government will be negotiating the details of a free trade agreement with Britain as that country prepares to leave the European Economic Area (EEA), of which Iceland is a member. Despite the more tumultuous political environment that has led to two early elections in as many years, we believe that the prudent macroeconomic policy framework established in recent administrations will continue.

Domestic demand remains very strong in 2017 while net exports contract

Economic growth slowed after the vivid 7.4% pace registered in 2016 to 4.3% in the first three quarters of 2017. Household consumption remained very strong because of rising real incomes and virtually full employment. Investment continued to expand at a double-digit rate. Still, import demand soared in line with the rise in domestic spending, which amid slower tourism growth brought headline GDP growth lower.

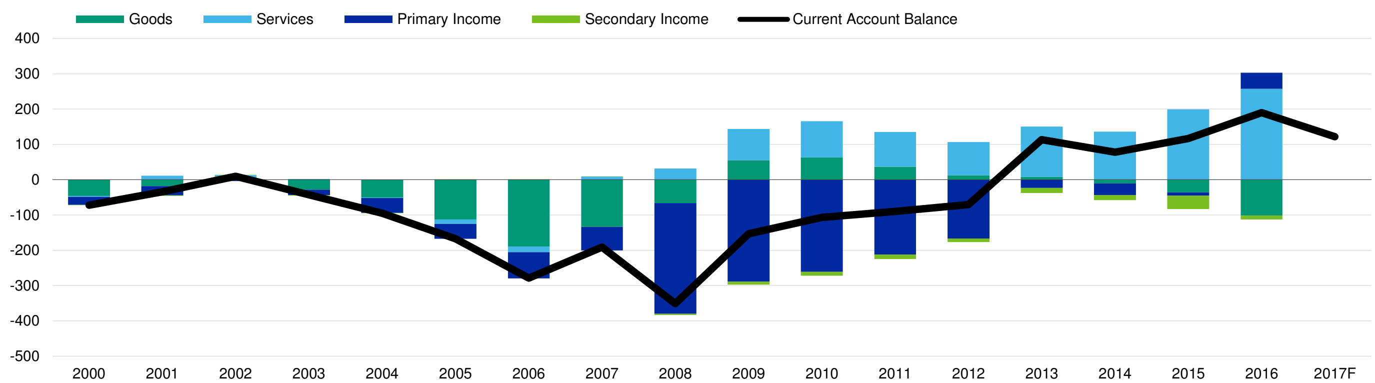
The slowdown in tourism growth, which was the main driver behind 2016's fast expansion, likely relates to the strength of the krona as well as to some capacity constraints despite immense growth in construction of hotel, AirBNB rental flats and other types of accommodation. Year-to-date 2017 passenger arrivals on international flights are up 11% from last year, while hotel utilization is down modestly to 82.8% from 83.8% in 2016 on the higher base.

We expect that the flattening trend in the tourist sector – at least relative to recent years' growth – portends a soft landing for the economy generally. As a consequence, we forecast a further slowdown in real GDP growth to 3.5% in 2018 and 2.8% in 2019. The momentum will nonetheless be enough to push the average annual unemployment rate to 2.5% of the labor force in 2018 – an all-time low.

Net IIP in rough balance as current account remains in surplus, albeit narrowing

On the external side, through three quarters of 2017, Iceland's current account surplus shrunk considerably, as stronger domestic consumption has driven import growth and net revenues from international travel are beginning to subside. Nonetheless, Iceland's net international investment position improved to ISK 208 billion, or 4.4% of GDP at the end of Q3 2017 – the highest level in at least half a century.

Exhibit 3
Stronger domestic consumption and dampening tourism will curb the current account surplus
Bil. ISK



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

Macro policy stance expected to remain relatively tight

Although overall demand pressures have eased, we expect that the stance of both monetary and fiscal policy will remain relatively tight. The monetary policy authorities are trying to strike a balance to assure that strong domestic demand and the high wage awards likely to be given in upcoming wage negotiation rounds for certain key unions do not raise inflation and inflation expectations above the central bank's 2.5% target.

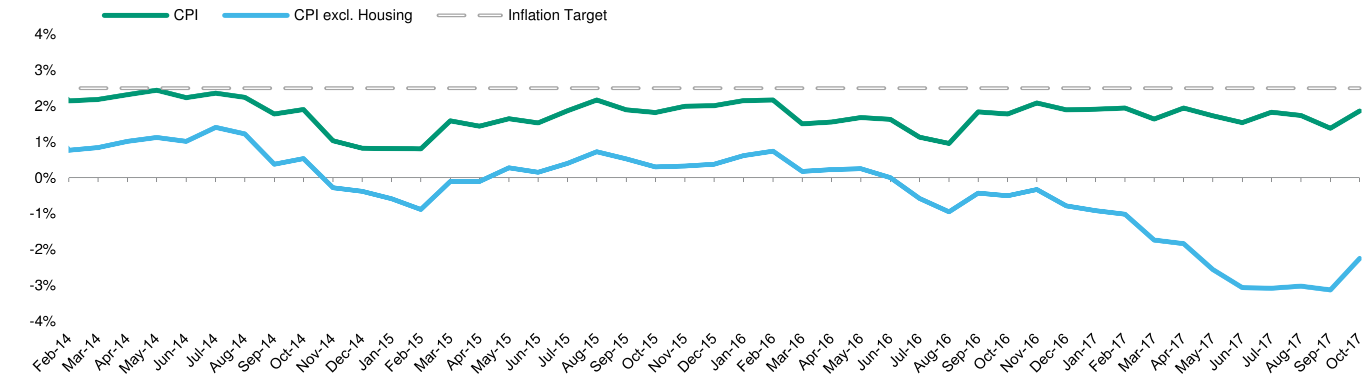
In recent years, inflation remained stubbornly below the target. Downward pressure has come mostly through increased competition in the retail market and imported deflation from krona appreciation. Meanwhile, wage inflation and surging house prices, growing in the high double digits in the Reykjavík area, have been supporting headline inflation's sideways movement (see Exhibit 2). The Q3 wage index rose 7.4% year-over-year, and only in the event of a review of private sector wage settlements in 2018 do we anticipate wage inflation to be strong enough to push inflation beyond its targeted level, particularly amidst continued currency strength and low commodity prices.

With respect to fiscal policy, some increases in spending are likely in store in light of the new government coalition's emphasis on infrastructure investment. We expect the government will be tabling a revised 2018 budget in the very near term. Still, the strictures imposed by the organic budget law and the commitment to fiscal surpluses and debt reduction by successive parliaments will keep these increases marginal.

Exhibit 4

During 2017, rapidly rising house prices have been the largest push factor for inflation

Annual percent change (%)



Source: Moody's Investors Service; Haver Analytics/Statistics Iceland

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			H-	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 (2017)		5.0		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2016)		20.3		
National income	**25%**			
GDP per capita (PPP, US$, 2016)		49,123		
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)		53.8		
General government debt/revenue (2016)		93.2		
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 (%)		29.7		
Market-Implied Ratings		A2		
Banking sector risk			*M*	*M-*
Average baseline credit assessment (BCA)		--		
Total domestic bank assets/GDP		202		
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: r**ating 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, 29 November 2017
- **Rating Methodology**: Sovereign Bond Ratings, 22 December 2016

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