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Government of Iceland – A3 Stable

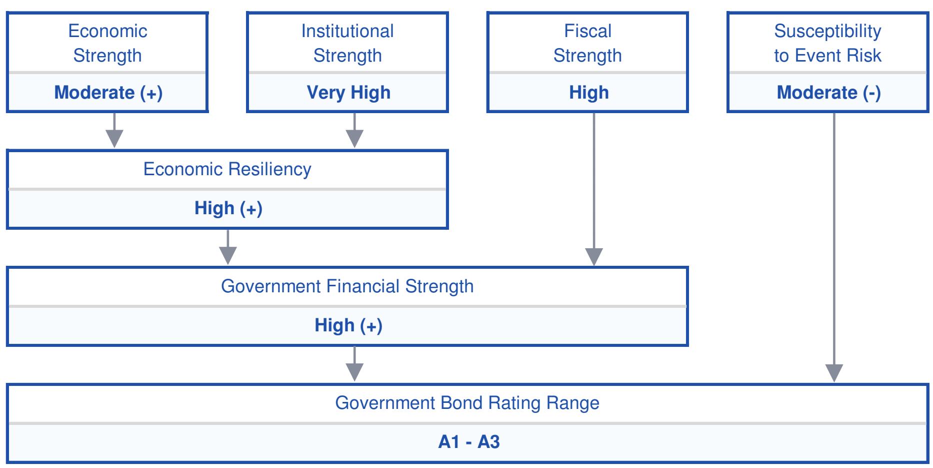
Regular Update

Summary Rating Rationale

» Iceland's **credit strengths** include (1) economic flexibility and wealth, which provide significant shock-absorption capacity; (2) a deep natural resource base that affords robust growth potential; (3) strong institutions focused on avoiding vulnerabilities that led to 2008 banking sector collapse; and (4) a well-funded pension system, long working lives and favorable demographics.

» Iceland's **credit challenges** include (1) a very small economy subject to high volatility; (2) substantial, albeit reduced, exposure to external risks, which requires careful management to protect economic and financial stability; and (3) large contingent liabilities derived from state-owned companies.

Exhibit 1
Iceland's A3 stable rating is determined by four factors



Source: Moody's Investors Service

This Credit Opinion provides a discussion of the credit rating(s) for the Government of Iceland and should be read in conjunction with Moody's most recent Credit Analysis and rating information available on Moody's website.

Key Indicators

Iceland	2011	2012	2013	2014	2015	2016E	2017F	2018F
Real GDP (% change)	2.0	1.2	4.4	1.9	4.1	7.2	5.5	3.5
Inflation (CPI, % change, Dec/Dec)	5.3	4.2	4.1	0.8	2.0	1.9	2.2	3.0
Gen. Gov. Financial Balance/GDP (%)	-5.6	-3.7	-1.8	-0.1	-0.8	17.2	1.2	1.5
Gen. Gov. Primary Balance/GDP (%)	-1.4	1.0	2.7	4.6	3.8	21.4	5.0	4.9
Gen. Gov. Debt/GDP (%)	115.1	100.2	91.2	84.6	68.1	55.0	44.5	37.8
Gen. Gov. Debt/Revenues (%)	287.1	240.5	216.8	187.1	162.0	94.2	103.9	90.7
Gen. Gov. Interest Payment/Revenues (%)	10.3	11.3	10.9	10.4	11.0	7.1	8.8	8.2
Current Account Balance/GDP (%)[1]	-0.5	0.8	7.5	5.3	6.1	8.0	6.0	5.0
External Debt/CA Receipts (%)[2][3]	409.6	364.9	408.0	356.6	308.7	227.8	205.0	189.4
External Vulnerability Indicator [4]	145.5	90.4	72.9	108.0	99.1	59.7	32.7	52.9

[1] Excludes DMBs undergoing winding up in 2008-2015
[2] Current Account Receipts
[3] The services component of current account receipts is not adjusted to account for FISIM services related to the DMBs undergoing winding up. The primary income receipts are adjusted to account for FISIM services related to the DMBs undergoing winding up
[4] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves

Summary Rating Rationale (continued)

Iceland's government bond and issuer ratings are A3, which reflect its rapidly shrinking government debt metrics and strong institutions. Iceland's rating trajectory has lagged the improvement in some of its core fundamentals since the financial crisis, because of the residual risks posed to economic and financial stability by the complex process of removing the capital controls first imposed in 2008. That said, the process of removing capital controls is now essentially complete, and the plan's cautious implementation both maintained macro-financial stability and considerably reduced the risks posed from the overhang of liabilities left by the 2008 banking sector collapse.

Among the key credit strengths supporting Iceland's A3 credit rating are its high levels of wealth and strengthening 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 after the banking crisis. The 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 once-sizeable public and external debt.

The government's finances have improved significantly and its gross debt burden has been cut by more than half from its 115% of GDP peak in 2012 to 55% at the end of 2016 and an estimated 45% at present. If the government's financial and real assets are taken into account, net public debt is still lower. In addition, and in contrast to many other European countries, Iceland has a nearly fully funded private pension system, which 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 owing to the banking and currency crisis of 2008, at $45,740 on a PPP basis as of 2015. This positions Iceland in the same territory as Aa-rated sovereigns (median per-capita GDP in 2015 of $46,833) and as a clear outlier in the A-rating range ($29,277).

As already mentioned, in addition to high income levels, Icelandic households possess substantial pension assets, which amount to more than 160% of GDP. This is not only positive for the long-term underlying fiscal position of the country, but also allowed a relatively smooth adjustment process following the banking system's 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 of the economy, which increases its vulnerability to shocks and sometime results in volatile growth rates, such as was exhibited in 2016 when growth soared to double-digit levels in the second half of the year.

We assess Iceland's Institutional Strength as `very high', reflecting the country's strong scores on the Worldwide Governance Indicators (WGI). Iceland ranks at the 85th percentile of the WGI's measure of “Government Effectiveness” and the 88th percentile of “Rule of Law”, well above the A-rating category median. 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.

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 operations – so as to avoid a repeat of the factors that led the crisis. Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between government, employer and employee associations, which is an important aspect of the economy's resiliency and credit strength.

We consider Iceland's Fiscal Strength to be `high'. We have adjusted upward this score by three notches to reflect the pending transition to 2016 data in our scorecard, at which time the score will be 'high' with no adjustments (we previously had two upward adjustments). 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 (and has fallen still further in 2017 after the government bought back nearly all of a 2022 eurobond). Similarly, the value of the government's direct guarantees continues to decline, although its guarantees for Housing Financing Fund (HFF) liabilities remain very large. A mitigating factor related to these contingencies is the significant financial assets that the government acquired as part of the resolution of the failed bank estates in 2015-16, which are already being deployed to prepay government debt.

We assess Iceland's Susceptibility to Event Risk as `moderate (-)', mainly reflecting the risks to financial stability from the banking sector, which have moderated significantly since the 2008 banking sector crisis. In our view, the banking system should be able to withstand potential renewed external pressure, as the central bank and the banking regulator require the banks to maintain very high levels of liquidity and capital.

Other aspects of event risk are lower, including government liquidity risk and political risk at 'very low (-)'. External vulnerability risk is 'low' – above its indicative score of 'very low (-)'. The economy’s small size and openness expose the external finances to a potentially quick reversal in fortune if the factors driving the external surpluses and the foreign exchange strength change considerably. Furthermore, the concentration of current account receipts in a single sector, tourism, suggests more vulnerability than does the indicative score. The rapid growth in the sector has generated immediate benefits for the economy and external position, but given the steep trajectory of its climb, the long-term sustainable level of visitors is difficult to assess and may lead to overinvestment in the sector.

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, 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. Iceland has been attracting substantial capital inflows, which are likely to continue given higher interest rates, low inflation and the economy’s favorable prospects. In response, the central bank put in place a Capital Flow Mechanism (CFM) in June last year to discourage short-term speculative capital inflows.

The authorities are alive to the potential pressures implied by high employment levels and the high pay awards granted last year.

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 at the time of the September 2016 upgrade to A3, 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.

Recent Developments

The economy continues to expand rapidly, having grown by 7.2% in 2016, the fastest annual rate in a decade, driven largely by increased investment, household spending and exports, notably in the fast-growing tourism sector. We expect growth will subside to about 5% this year, again led by buoyant domestic demand and tourism, and then to 4% in 2018, but risks to growth are to the upside. Iceland's economic dynamism has benefitted from favorable terms of trade because low oil prices and a strong dollar boosted revenues from the mostly dollar-denominated export base.

Inflation continues to remain low at 1.6% year-on-year in March 2017, below the CBI's 2.5% inflation target, driven in part by the exchange rate's appreciation. The CBI accordingly cut the key policy interest rate twice in 2016 to 5% by the end of December.

An anticipated further reduction in government debt-to-GDP derives in large part from the deployment of the assets received in the resolution of the failed bank estates to pay down debt. Last month, the government bought back nearly $900 million of a $1 billion Eurobond that would fall due only in 2022. At this stage, the government's share It also reflects ongoing fiscal consolidation, enacted under a medium-term fiscal strategy consistent with the Organic Budget Law passed in December 2015 and its accompanying fiscal rules.

In early 2017, the capital controls liberalization process was essentially finalized, after parliament approved the relevant legislation in late 2016. The unwinding of restrictions reduced or removed restrictions on various type of capital outflows, such as for external debt payments, FDI and real estate investments, among others.

The relaxation of capital controls coincided with the conclusion of an agreement between the CBI and holders of offshore krónur assets (mainly non-resident-owned ISK assets trapped when capital controls were imposed in late 2008 at the time the old banks collapsed). Although an auction last summer cleared approximately one-third of the offshore overhang, with 98.4% of the offers accepted in the auction and subsequent tender, the largest holders of offshore krónur demurred from participating, leaving approximately ISK 237 billion outstanding. The latest agreement resulted in the central bank buying back a substantial portion of the remaining offshore krónur at a more favorable rate to the investors of 137.5 krónur per euro.

Iceland's return to normalcy has also been bolstered by a turnaround in its external position. Last year, the current account surplus rose to a record ISK 193.5 billion (8% of GDP) while the net international investment position (IIP) was positive (1.1% of GDP) for only the third time since 1995. The current account surplus is likely to narrow in the coming years as aggregate demand strengthens, pulling in imports, and as the benefits of lower oil prices tail off. Positive and sustained balance of payments dynamics have allowed the CBI to purchase substantial foreign exchange in the FX market, bolstering its free FX reserves to ISK 786 billion as of March 2017.

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 (2011-2020F)		3.5		
Volatility in Real GDP Growth (Standard Deviation, 2006-2015)		4.5		
WEF Global Competitiveness Index (2016)		5.0		
Scale of the Economy	**25%**			
Nominal GDP (US$ billion, 2015)		16.8		
National Income	**25%**			
GDP per Capita (PPP, US$, 2015)		45,740		
Automatic Adjustments	**[-3; 0]**	Scores Applied		
Credit Boom		0		
Factor 2: Institutional Strength			VH	VH
Institutional Framework and Effectiveness	**75%**			
Worldwide Government Effectiveness Index (2015)		1.5		
Worldwide Rule of Law Index (2015)		1.7		
Worldwide Control of Corruption Index (2015)		2.0		
Policy Credibility and Effectiveness	**25%**			
Inflation Level (%, 2011-2020F)		2.9		
Inflation Volatility (Standard Deviation, 2006-2015)		3.7		
Automatic Adjustments	**[-3; 0]**	Scores Applied		
Track Record of Default		0		
Economic Resiliency (F1xF2)			**H+**	**H+**
Factor 3: Fiscal Strength			M-	H
Debt Burden	**50%**			
General Government Debt/GDP (2015)		68.1		
General Government Debt/Revenue (2015)		162.0		
Debt Affordability	**50%**			
General Government Interest Payments/Revenue (2015)		11.0		
General Government Interest Payments/GDP (2015)		4.6		
Automatic Adjustments	**[-6; +4]**	Scores Applied		
Debt Trend (2012-2017F)		0		
Foreign Currency Debt/General Government Debt (2015)		-1		
Other Nonfinancial Public Sector Debt/GDP (2015)		0		
Public Sector Assets/General Government Debt (2015)		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 (2015)		1.4		
Government Liquidity Risk			*VL-*	*VL*
Gross Borrowing Requirements/GDP		10.1		
Non-Resident Share of General Government Debt (%)		36.2		
Market-Implied Ratings		Aa2		
Banking Sector Risk			*M*	*M-*
Average Baseline Credit Assessment (BCA)		--		
Total Domestic Bank Assets/GDP		264		
Banking System Loan-to-Deposit Ratio		123		
External Vulnerability Risk			*VL-*	*L*
(Current Account Balance + FDI Inflows)/GDP		12.8		
External Vulnerability Indicator (EVI)		32.7		
Net International Investment Position/GDP		-5.2		
Government Bond Rating Range (F1xF2xF3xF4)			**A2 - Baa1**	**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:** Where 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 Research

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

» **Issuer Comment:** Iceland's Formation of a Governing Coalition Is Credit Positive, 16 January 2017

» **Credit Analysis**: Government of Iceland - A3 Stable: Annual Credit Analysis, 12 September 2016

» **Rating Action**: Moody's upgrades Iceland's government ratings to A3; outlook stable, 1 September 2016

» **Country Statistics**: Iceland, Government of, 28 November 2016

» **Outlook**: Sovereigns – Global: 2017 Outlook – Negative Outlook As Low Growth, High Debt Limit Policy Options, 14 November 2016

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

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