CREDIT OPINION
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Update

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Government of Iceland - Baa2 Stable

Quarterly Update

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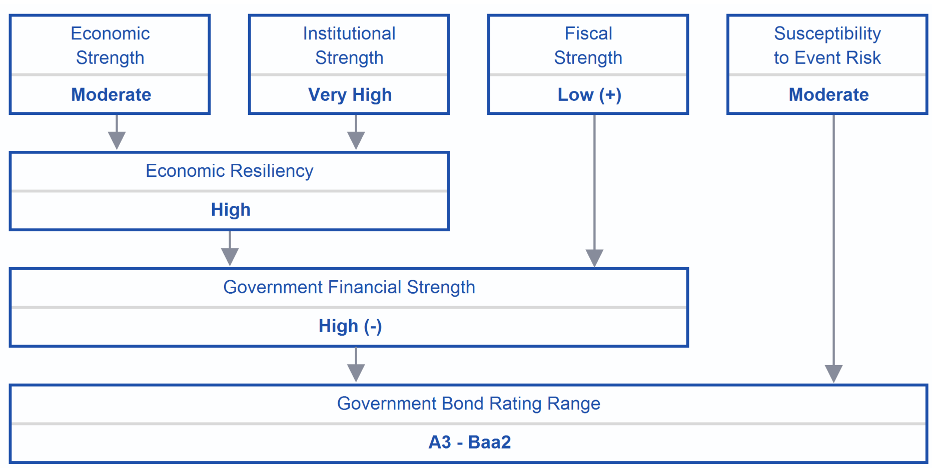
Summary Rating Rationale

» Iceland's **credit strengths** include (1) a flexible and highly skilled labor force; (2) a natural resource base that underpins robust economic growth potential; (3) consensus-based economic policy formation; (4) strengthened institutions since the 2008 banking system collapse; and (5) a nearly fully-funded pension system and favorable demographics

» Iceland's **credit challenges** include (1) the orderly implementation of the final phases of capital account liberalization while protecting economic and financial stability; (2) large contingent liabilities; and (3) further reducing government debt to protect public finances against potential shocks

Exhibit 1
Iceland's Baa2 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

	2010	2011	2012	2013	2014	2015	2016F	2017F
Real GDP (% change)	-3.6	2.0	1.2	4.4	2.0	4.0	4.0	3.5
Inflation (CPI, % change, Dec/Dec)	2.5	5.3	4.2	4.1	0.8	1.9	3.3	4.2
Gen. Gov. Financial Balance/GDP (%)	-9.8	-5.6	-3.7	-1.8	-0.1	-0.5	-0.6	-0.8
Gen. Gov. Primary Balance/GDP (%)	-5.0	-1.4	1.0	2.7	4.7	3.9	2.9	2.1
Gen. Gov. Debt/GDP (%)	100.2	115.2	100.2	91.3	84.7	70.0	58.0	55.0
Gen. Gov. Debt/Revenues (%)	252.9	287.1	240.5	216.8	187.1	165.8	141.8	139.7
Gen. Gov. Interest Payment/Revenues (%)	12.0	10.3	11.3	10.9	10.4	10.5	8.7	7.4
Current Account Balance/GDP (%)	6.8	3.0	2.6	7.2	4.7	4.9	3.7	2.6
External Debt/CA Receipts (%)[1]	504.9	409.6	366.2	410.4	358.5	322.0	291.3	281.8
External Vulnerability Indicator [2]	104.7	142.0	43.1	67.5	108.1	52.3	72.0	50.6

[1] Current Account Receipts

[2] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/ Official Foreign Exchange Reserves

Summary Rating Rationale (continued)

Among the key credit strengths supporting Iceland's Baa2 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 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 once-sizeable external debt.

The country's public finances have improved significantly, and the government's gross debt burden - while still high - has declined rapidly 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 $41,322 on a PPP basis as of 2014. This positions Iceland in the same territory as Aa-rated sovereigns (median per-capita PPP GDP of $49,173) and as an outlier in the Baa rating range (under $20,000).

In addition to high income levels, Icelandic households possess substantial pension assets amounting to more than 100% of GDP. 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 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 and limited diversification of the economy, which increase its vulnerability to shocks.

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 87th percentile of the WGI's measure of “Government Effectiveness” and the 88th percentile of “Rule of Law”, well above the Baa and A rating category medians. 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 – with the latter focusing on exclusively on domestic operations – 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 `low (+)', a function of Iceland's relatively high, albeit declining, gross debt-to-GDP ratio, 37.4% of which was foreign-currency denominated in 2014, exposing the sovereign balance sheet to exchange rate risk. 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 resolution of the failed bank estates.

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 significantly 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.

Factors that Could Lead to an Upgrade

Iceland's rating could be upgraded if the economic recovery and significant fiscal consolidation is sustained. The next phase of capital controls removal, which will encompass the settlement of the so-called trapped ISK (Icelandic krone) assets, is a key determinant of further upgrades.

Factors that Could Lead to a Downgrade

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 become disorderly, 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

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 and subsequent deep recession. The economy is now growing rapidly, led by strong investment as well as household spending. 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). We expect growth to reach 4% again this year, led by buoyant domestic demand.

We expect the current account balance, which came in at 4.9% of GDP in 2015, to remain in surplus but to narrow in the coming years as domestic 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 Central Bank (CBI) to purchase substantial foreign exchange in recent years, bolstering the country's external position.

The final resolution of the failed bank estates at the end of last year led to a significant reduction in Iceland's net external debt, which dropped to under 15% of GDP at the end of 2015 following the write-off of the external claims on the failed bank estates. The massive improvement in the external position serves as an important buffer to maintain the government's room to maneuver during the next phase of capital controls liberalization.

The impact of high public and private sector wage settlements on inflation has been kept in check by the renewed downturn in oil prices. However, inflation accelerated to 2.2% yoy in February, below the Central Bank's 2.5% inflation target, but higher than the 1.6% average inflation in 2015. We therefore expect the Central bank to continue to tighten monetary policy in 2016, which could start to depress investment and overall domestic demand.

Iceland's capital control liberalization strategy unveiled in June 2015 underpins an improved outlook for Iceland's economy and government finances as the estates of the failed banks have now paid billions to the Icelandic authorities in order to settle their local obligations and gain access to the banks' foreign assets. The next phase of the process is freeing up the `trapped' ISK funds in the country through an exchange. If executed successfully, meaning without disruptions to real economic and financial stability, the resolution should help to further normalize the economy in the years ahead.

Rating Methodology and Scorecard Factors

Rating Factors Grid - Iceland

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 (2015)		4.8	
Scale of the Economy	**25%**		
Nominal GDP (US$ billion, 2014)		17	
National Income	**25%**		
GDP per Capita (PPP, US$, 2014)		44,029	
Factor 2: Institutional Strength			VH
Institutional Framework and Effectiveness	**75%**		
Worldwide Government Effectiveness Index (2014)		1.5	
Worldwide Rule of Law Index (2014)		1.7	
Worldwide Control of Corruption Index (2014)		1.8	
Policy Credibility and Effectiveness	**25%**		
Inflation Level (%, 2010-19F)		3.6	
Inflation Volatility (Standard Deviation, 2005-14)		3.5	
Economic Resiliency (F1xF2)			H
Factor 3: Fiscal Strength			L+
Debt Burden	**50%**		
General Government Debt/GDP (2014)		84.7	
General Government Debt/Revenues (2014)		187.1	
Debt Affordability	**50%**		
General Government Interest Payments/Revenue (2014)		10.4	
General Government Interest Payments/GDP (2014)		4.7	
Government Financial Strength (F1xF2xF3)			H-
Factor 4: Susceptibility to Event Risk	**Max. Function**		M
Political Risk			
Worldwide Voice & Accountability Index (2014)		1.4	
Government Liquidity Risk			
Gross Borrowing Requirements/GDP		5.2	
Non-Resident Share of General Government Debt (%)		39	
Market-Implied Ratings		Baa1	
Banking Sector Risk			
Average Baseline Credit Assessment (BCA)		--	
Total Domestic Bank Assets/GDP		202	
Banking System Loan-to-Deposit Ratio		123	
External Vulnerability Risk			
(Current Account Balance + FDI Inflows)/GDP		9.1	
External Vulnerability Indicator (EVI)		72.0	
Net International Investment Position/GDP		-41.4	
Government Bond Rating Range (F1xF2xF3xF4)			**A3 - Baa2**
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.

Moody's Related Research

- **Rating Action**: Moody's upgrades Iceland's sovereign ratings to Baa2; outlook stable, 29 June 2015
- **Issuer Comment:** Iceland's Payment from Hold-Out Creditors Is Credit Positive for Sovereign, 5 October 2015
- **Credit Analysis**: Government of Iceland, 22 July 2015
- **Credit Focus**: Iceland, Government of: FAQ: Capital Controls and the New Liberalization Strategy, 15 July 2015
- **Country Statistics**: Iceland, Government of, 25 November 2015
- **Outlook**: Sovereigns - Global: Stable Outlook Despite Low Growth, Jittery Markets and Uneven Reforms, 4 November 2015
- **Rating Methodology**: Sovereign Bond Ratings, 18 December 2015

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