MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes Iceland's outlook to positive from stable and affirms A3 ratings

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New York, July 20, 2018 -- Moody's Investors Service ("Moody's") has today changed the Government of Iceland's sovereign rating outlook to positive from stable and affirmed Iceland's A3 long-term issuer rating. The government's long-term senior unsecured debt rating of A3 and the (P)A3 and (P)Prime-2 ratings assigned to its medium-term note (MTN) programme have also been affirmed.

The key drivers for the change in the rating outlook to positive from stable are:

1. Improving economic resilience afforded by a net external creditor position, more balanced growth and ongoing strengthening of the country's banking system

2. Anticipated further improvement in the government's debt metrics beyond what was previously expected

The positive outlook also reflects the progress made in the past two years on the major preconditions we laid out at the time of the upgrade to A3 in September 2016, including the smooth removal of capital controls and the settlement of most offshore krónur obligations.

The A3 rating affirmation balances the above positive trends against ongoing challenges related to the country's small size and its relative lack of economic diversification, uncertainties regarding the tourism sector's ability to successfully adjust to a lower and more sustainable pace of expansion, competitiveness challenges arising from the upcoming rounds of wage negotiations and its inherent vulnerability to excessive capital flows.

Iceland's A3/P-2 long- and short-term ceilings for foreign currency bonds and deposits and its A1 country ceilings for long-term local currency bonds and deposits remain unchanged.

RATINGS RATIONALE

RATIONALE FOR CHANGING THE OUTLOOK TO POSITIVE FROM STABLE

FIRST DRIVER: IMPROVING ECONOMIC RESILIENCE AFFORDED BY NET EXTERNAL CREDITOR POSITION AND MORE BALANCED GROWTH

The first driver for the positive outlook is that Iceland's resilience to global or domestic shocks has been improving in recent years thanks to the effective extrication of the economy from the 2008 banking crisis. Although the economy is still not very diversified, particularly from the standpoint of export composition, there are now three rather than two main pillars contributing to exports with the development of the tourism sector.

Another element of the economy's improving resilience is the shift in the country's external position, which has moved to a net creditor from a large debtor position in recent years, despite the removal of capital controls and the settlement of most of the offshore krónur. The external position on both a stock (net IIP surplus of 9% of GDP) and flow (current account surplus of 3+% of GDP) basis is much healthier than was the case previously whenever growth was robust, which bodes well for a continued reduction in economic volatility.

Iceland's banking system is also better regulated, posing significantly less risk to financial stability. In our assessment of banking sector risk, we incorporate our aggregate analysis of the Icelandic banking system developed from publicly available information. Strong capitalization, healthy liquidity buffers and lower NPLs at the three main domestic money banks (DMBs) are somewhat tempered, however, by the banking sector's concentration within these three institutions and high reliance on wholesale funding.

SECOND DRIVER: ANTICIPATED FURTHER IMPROVEMENT IN THE GOVERNMENT'S DEBT METRICS BEYOND WHAT WAS PREVIOUSLY EXPECTED

The second driver for changing the rating outlook to positive from stable is the expectation of a more rapid improvement in Iceland's fiscal flexibility than Moody's had anticipated at the time of the last upgrade two years ago. Given the small size of the economy and its currency area, Iceland is vulnerable to shifts in the global economy that would leave larger countries unaffected, making it all the more important for the government debt to be low and the external position to be roughly balanced or in surplus.

Moody's expects Iceland's government debt will continue to decline in the next 1-5 years based on the official fiscal strategy that stipulates nominal government surpluses of 1%-1.5% of GDP over the entire term of the current government. This is approximately the same strategy pursued by each of the two previous administrations. The government finance outcomes are benefiting from healthy growth and some one-offs, which make the government's strategy highly realistic in Moody's view. Should the economy and budgetary outcomes perform as expected, general government debt to GDP should decline to about 36% by the end of next year, positioning the country favorably related to A3-rated peers. If realized, asset sales could potentially lead to further strengthening of the country's fiscal strength in the coming years.

RATIONALE FOR AFFIRMING THE A3 RATING

The A3 rating affirmation reflects a balance of the above positive trends against ongoing challenges related to the country's very small size, and therefore its vulnerability to destabilizing capital flows, and its relative lack of economic diversification, which will be tested as the tourism sector matures and adjusts to more sustainable growth trends.

The rationale for affirming the rating is that despite the improving credit trends, certain risks exist that require ongoing evaluation over the next 12-18 months. The first risk is the possibility of destabilizing capital inflows should the authorities eliminate the current mechanism that discourages speculative capital inflows attracted by the country's relatively high interest rates. Also, in the event that high real wage increases are awarded in the upcoming rounds of wage negotiations, labor cost rises could add to the competitiveness challenges already facing the economy from the arguably overvalued exchange rate.

Developments in the tourism sector over the next year will give better visibility on how the economy can effectively adjust to the recent slowdown in the sector's growth, what the domestic economic and financial repercussions might be and whether new airline routes and expansion into new regions of the world will allow for continued growth of the sector at a more economically sustainable pace. A risk to the Icelandic credit profile would be an outright contraction rather than just a slowdown in tourist arrivals. This is particularly important to the country's economic strength given that the sector accounted for more than 40% of exports of goods and services last year and an increasingly larger share of economic activity.

WHAT WOULD CHANGE THE RATING UP/DOWN

We would consider upgrading Iceland's A3 ratings should the authorities achieve the expected further improvement in the government's debt metrics and be successful in managing a soft landing of the economy amidst the maturation of the tourism sector and the coming wage round without a material degradation of the external position.

We would consider removing the positive outlook or downgrading Iceland's A3 ratings should a disruptive slowdown or outright contraction in tourist revenues or other economic shocks were to weaken public or external debt sustainability or threaten financial stability, particularly should Iceland again have to resort to broad capital controls.

SUMMARY OF MINUTES FROM RATING COMMITTEE

GDP per capita (PPP basis, US$): 51,842 (2017 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.6% (2017 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.9% (2017 Actual)

Gen. Gov. Financial Balance/GDP: 1.5% (2017 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 3.4% (2017 Actual) (also known as External Balance)

External debt/GDP: n/a

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 17 July 2018, a rating committee was called to discuss the rating of the Iceland, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutional strength/ framework, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has increased. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the credit rating action on the support provider and in relation to each particular credit rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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