MOODY'S INVESTORS SERVICE

CREDIT ANALYSIS

Rate this Research

Iceland, Government of

Overview and Outlook

Among Iceland's key credit strengths are its high levels of wealth, which acted as a cushion during the severe adjustment of the past several years, and the return to robust economic growth. We also believe that the economic recovery is on a more sustainable footing than in the past. The country's public finances have improved significantly and the public debt burden – while still high – has started to decline from 2012 onwards. If the government's large cash buffers are taken into account, the public debt is at a moderate level. In contrast to many peer countries, Iceland has a fully funded private pension system, which together with favorable demographics bodes well for long-term fiscal sustainability.

The Icelandic authorities have used the shelter of the capital controls well and corrected many of the weaknesses that contributed to the crisis, including in the area of banking supervision and regulation. Iceland's key credit challenge is how to maintain macroeconomic and financial-sector stability during capital control liberalization, which will commence in earnest toward the end of this year, and continue over the next several years (see Special Topic).

Iceland's rating could be upgraded if the economic recovery were sustained and significant fiscal consolidation were achieved. A smooth resolution of the failed bank estates and successful relaxation of capital controls affecting residents, with the exchange rate remaining broadly stable during the lifting of capital controls, would also imply upward pressure on the rating. Conversely, the rating could be downgraded if the government's commitment to fiscal consolidation were to show signs of waning, thereby halting the declining trend in the public debt ratio. The rating could also be downgraded if the capital control liberalization were to prove disorderly for any reason, 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.

This Credit Analysis elaborates on Iceland's credit profile in terms of Economic Strength, Institutional Strength, Fiscal Strength and Susceptibility to Event Risk, which are the four main analytic factors in Moody's Sovereign Bond Rating Methodology. The report also provides an analysis on the current status of the capital controls in place and the prospects for their removal.

RATINGS

Iceland

	Foreign Currency	Local Currency
Gov. Bond Rating	Baa2	Baa2
Country Ceiling	Baa2	Baa2
Bank Deposit Ceiling	Baa1	Baa1

Table of Contents:

OVERVIEW AND OUTLOOK 1
Special Topic: Iceland's New Strategy for Capital Account Liberalization 2
RATING RATIONALE 5
Economic Strength: Moderate (+) 5
Institutional Strength: Very High 7
Fiscal Strength: Moderate (-) 10
Susceptibility to Event Risk: Moderate 13
Rating Range 16
Comparatives 17
APPENDICES 18
MOODY'S RELATED RESEARCH 23

Analyst Contacts:

NEW YORK +1.212.553.1653

Kristin Lindow +1.212.553.3896
Senior Vice President
kristin.lindow@moodys.com

Anna Snyder +1.212.553.4037
Associate Analyst 2
anna.snyder@moodys.com

FRANKFURT +49.69.70730.700

Dietmar Hornung +49.69.70730.790
Associate Managing Director
dietmar.hornung@moodys.com

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

Special Topic: Iceland's New Strategy for Capital Account Liberalization

After seven years of capital controls…

On June 8, 2015, the Icelandic authorities announced a long-awaited update to their strategy for lifting capital controls, first put in place in November 2008 when Iceland's three large commercial banks collapsed[1]. At that time, more than half of the assets of these banks were held abroad, mainly concentrated in the banks' subsidiaries and branches in the UK, Luxembourg and other Nordic countries. Concomitantly, the banks' funding – 75% of which had been obtained from the international wholesale market – was unable to be refinanced, leading to the government's drastic decision to shut down those banks and "bail in" private creditors with the exception of domestic depositors[2], giving the government no choice but to initiate capital controls to maintain a semblance of financial stability.

The restrictions on capital account transactions have been modified several times since they were inaugurated. Most importantly, the prohibition on two-way capital flows related to trade in goods and services were released immediately following the adoption of the Foreign Exchange Act in November 2008. Further, in mid-2011, controls on short-term króna assets were partially lifted when the central bank began to hold foreign-currency auctions, allowing non-residents holding short-term króna assets to sell them to long-term investors (for long-term investment in Icelandic treasury bonds, Icelandic enterprises or real estate) in exchange for foreign currency.

Following the last auction in February 2015, short-term króna assets have been reduced to 15% of GDP, compared to 30% of GDP in 2011. By reducing the size of these short-term, króna-denominated claims, the auctions have reduced the potential draw on Iceland's foreign currency assets emanating from potential conversions of this stock of króna assets when capital account controls are removed.

Today, however, króna- and foreign-currency denominated funds equivalent to roughly ISK1.2 trillion remain trapped in the Icelandic financial system. Although substantially reduced compared to when capital controls were first imposed, they are equivalent to 65%-70% of Iceland's current GDP and a sudden withdrawal of such funds would therefore be extremely destabilizing to the domestic economy, financial markets and exchange rate.

As a consequence, the Icelandic authorities have engaged in consultations with the creditors of Iceland's failed banks (which today include hedge funds that began purchasing the banks' distressed assets as early as 2010). The goal was to have the failed bank estates acknowledge the need to restructure those portfolios in such a way that would mitigate the potential balance of payments (BOP) pressures, and at the same time award those creditors that own claims against the failed banks an acceptable level of recovery on their overseas investments. In this way, the capital account liberalization (CAL) process could proceed with relatively low likelihood that the economy or FX market would be disrupted.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

…the authorities have designed a clear roadmap for capital account liberalization

The newly updated strategy takes a three-stage approach to lifting capital account restrictions, with the success of each step in avoiding disruption to the Icelandic economy and financial markets key to the success of the next. The first stage targets a reduction in and maturity extension of the ISK900 billion in non-resident net claims on domestic assets held by the failed banks' estates (the estates). The second stage deals with the principal and interest associated with non-resident-owned, króna-denominated bonds (the

[1] For a detailed account of Iceland's capital controls and the mechanics of the new capital controls liberalizations strategy please see: FAQ: Capital Controls and the NewLiberalization Strategy, July 2015.

[2] Non-resident depositors from the old Landsbanki (the "Icesave" scheme) and the Dutch and UK governments are being paid back from the proceeds of the sale of the bank's assets. The Central Bank expects that all of these claims will be repaid by yearend 2015.

so-called trapped ISK) that matured after the capital controls were imposed, the proceeds of which were not able to be repatriated. The third stage addresses the gradual release of capital controls on Icelandic residents, the timing and sequencing of which has yet to be fully elaborated.

Phase 1: Neutralizing disruptions from freeing the trapped assets of the failed bank estates

The first step in the CAL process is the requirement that the creditors of the estates of the three large Icelandic banks that failed in 2008, which at ISK900 billion are the largest component of these claims, adopt "stability conditions". These conditions are essentially threefold: (1) a release of domestic assets (the so-called "stability contribution"); (2) an extension of maturities on foreign currency-denominated domestic deposits; and (3) the refinancing of government foreign-currency funding from the time when the new banks were launched. The failed bank estates have all voluntarily submitted proposals on the basis of these conditions rather than incur a 32%-39% "stability tax" on the total assets of the failed banks.

In return for their adoption of these conditions, and with an exemption from the Foreign Exchange Act from the Central Bank, the creditors of the old banks will be able to achieve composition, that is, they can dissolve the failed banks without having to undergo bankruptcy. The rest of their assets are held abroad, and therefore do not pose risks to disruption of the Icelandic foreign-exchange market. Although these obligations had not been serviced since the banks collapsed, they represented notional external liabilities in excess of 400% of GDP. After the write-off, Iceland's net international investment position (net IIP) is expected to be reduced to around -20% to -25% of GDP.

In the composition process, the failed banks' creditors will transfer their ISK assets to the Icelandic authorities. Another new piece of legislation, the Stability Tax Bill, earmarks these proceeds for the reduction of government debt as the assets mature, a process that is expected to be front-loaded over the next three years. Moreover, the estates' creditors will write off the substantial external liabilities owed to them by the estates.

Phase 2: Addressing remaining offshore liquid króna (OLK) holders, using an auction format

The second phase of the liberalization strategy involves dealing with the large stock of so-called offshore liquid króna, mostly owned by non-residents, that are trapped by the capital controls. Holders of these assets will be offered a choice between three options: long-term treasury bonds denominated in either krónur or euros, a currency auction, or locked non-interest-bearing accounts. The main aim of the Icelandic authorities will be to extend the maturity profile of these liabilities, and investors who choose the foreign-currency auction to exit will pay a premium to do so.

Phase 3: Gradual removal of capital controls for residents

The third stage of the capital account liberalization process will take longer to complete, and will involve the gradual lifting of restrictions on foreign capital transactions of Icelandic residents. The capital controls constrain portfolio diversification, and key asset managers such as Iceland's large pension funds, as well as households and corporations, have a smaller proportion of their portfolios invested abroad than they did before the old banks collapsed. The timetable for this stage of the process is not yet defined, and will likely be dictated by the success of the earlier stages of liberalization in avoiding disruptive capital flows. However, the authorities are beginning to elaborate certain "phase 3" liberalization measures. For example, on July 15, the Central Bank announced its intention to authorize pension funds to invest abroad this year, subject to certain parameters[3].

[3] Please see the Central Bank's announcement of authorization for pension funds to invest abroad this year.

If faithfully implemented, the new CAL strategy will both neutralize the ISK 1.2 trillion BOP overhang and reduce government debt

The capital account liberalization strategy serves the dual purpose of both neutralizing the balance of payments overhang and helping to maintain financial sector stability as well as shoring up government finances. The boon to government finances is concentrated in Phase 1, in which a significant portion of the ISK900 billion in trapped bank assets are used to repay the government for the debt it accumulated in shoring up the new banks. Phase 1 also involves converting the new banks' capital from short-term into into longer-term deposits. Phase 2 is intended to extend the maturity of offshore liquid króna via auctions slated for this coming October, as described above.

Implementation risks remain and include (1) a disorderly unwinding of trapped assets; (2) emergence of larger than-expected asset quality problems in the new banking system; and (3) a slower-than-envisaged path toward liberalization. Any of these risks could bring negative consequences for the domestic economy and/or renewed financial market or exchange rate volatility, as well as undermining investor confidence. In view of these risks, we nevertheless foresee the dismantling of capital controls as unambiguously credit positive. Now that the economy has recovered to its pre-crisis levels, with stronger macro- and micro-prudential regulation of the financial sector, we assess the opportunity cost of maintaining capital controls as much higher than the costs associated with temporary but controlled instability wrought by winding them down.

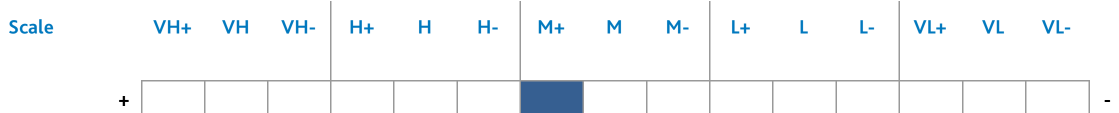
Rating Rationale

Our determination of a sovereign's government bond rating is based on the consideration of four rating factors: Economic Strength, Institutional Strength, Fiscal Strength and Susceptibility to Event Risk. When a direct and imminent threat becomes a constraint, that can only lower the preliminary rating range. For more information please see our Sovereign Bond Rating Methodology.

Economic Strength: Moderate (+)

Macro-economic context: recovery from deep financial and economic crisis is in full swing

Factor 1



Economic strength evaluates the economic structure, primarily reflected in economic growth, the scale of the economy and wealth, as well as in structural factors that point to a country's long-term economic robustness and shock-absorption capacity. Economic strength is adjusted in case excessive credit growth is present and the risks of a boom-bust cycle are building. This 'Credit Boom' adjustment factor can only lower the overall score of economic strength.

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 $41,172 on a PPP basis as of 2014. This positions Iceland in the same territory as Aa-rated sovereigns (median per-capita GDP of $35,492) and as a clear outlier in the Baa rating range ($17,302). Iceland is relatively wealthy compared to its rating peers with the exception of Italy (Baa2 stable) and Ireland (Baa1 stable).

Another key fact when it comes to comparing Iceland's socio-economic situation to that of other European crisis-hit nations is that despite the crisis, its social indicators have actually improved in the past 6 years. Already low as in the other Nordic nations, the poverty rate has fallen further to 11.3% in 2014 from 13.7% in 2010 and the GINI coefficient narrowed by 5% in 2012 (latest data) from 29% in 2009.

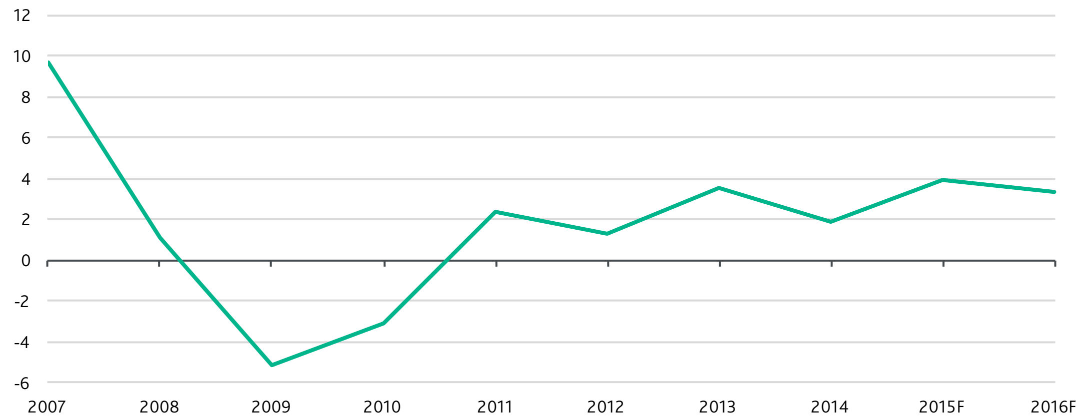
In addition to high income levels, Icelandic households possess substantial pension assets amounting to 145% of GDP (May 2014). This is not only positive for the long-term underlying fiscal position of the country, but has also allowed a smoothening of the adjustment process as households could temporarily withdraw money from their pension savings for debt repayment and consumption purposes during the crisis years. Offsetting the high level of wealth is the small size and limited diversification of the economy, which increase its vulnerability to shocks.

A score of 'moderate (+)' is in line with Latvia (A3/Stable), Mauritius (Baa1/Stable) and the Baa3 Median, while slightly lower than Ireland ('high', Baa1/Stable) and Uruguay (Baa2/Stable). Iceland's average PPP per capita income ($43,637 in 2014) remains significantly higher than the Baa3 and Europe/Central Asia medians ($19,610 and $27,051), and more than two-fold the per-capita GDP of above mentioned peers except for Ireland ($49,195).

The Icelandic economy registered an 11% cumulative decline in real GDP from late 2008 to the first quarter of 2010 after the banks collapsed, and has recovered fully from that loss as of 2014. This is a stronger position than most other European countries are in vis-a-vis their pre-crisis peaks, ironically, with the

exceptions of Ireland and the Baltics, which also had severe recessions. The economy is expected to grow quite fast at around 4% this year after an unremarkable 1.9% growth rate in 2014, followed by a slowdown below 3% next year because we expect a tighter monetary policy stance in response to recent large real wage increases given to unions to avoid a general strike in the spring.

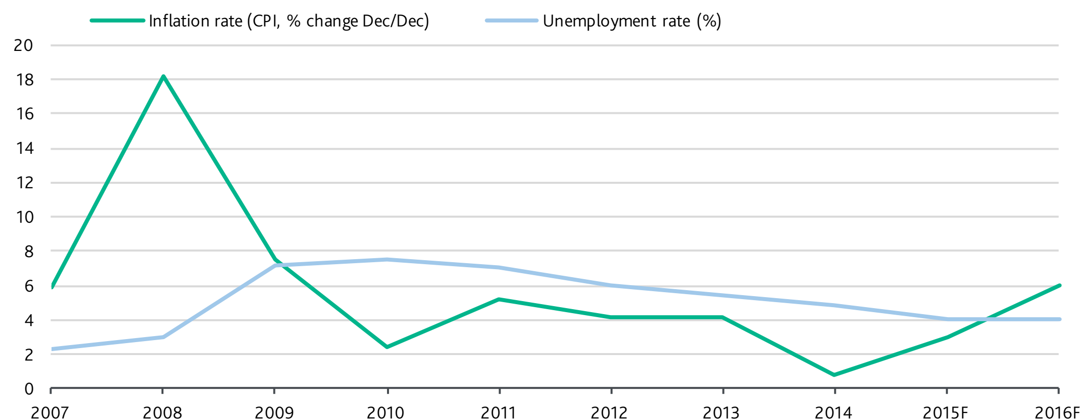
EXHIBIT 1
Real GDP growth (%) rebounds sharply



Source: Haver and Moody's forecasts

Still to be settled (in a court of arbitration rather than via ongoing negotiations, following the passage of a new law that bans public sector worker strikes) are the disputes with unions representing nurses and academics in response to the one-time increases given to doctors last year. Unemployment is down at around 4%, which is considered full employment in a NAIRU sense, part of the reason for the unions' obstinacy. At present, inflation is at 1.5%, up from much lower earlier this year when the impact of lower oil prices was still feeding through, but inflationary expectations are rising now.

EXHIBIT 2
Inflation and unemployment have stabilized



Source: Directorate of Labor, Moody's estimates

Among the factors that have restrained growth while capital controls have been in place is the relative lack of significant investment projects that have broken ground because of the uncertainty surrounding the timing and circumstances of the controls' removal. Iceland had attracted and is still the focus of interest of a number of large foreign investment projects that are energy-intensive, which are ideal to locate in Iceland

with its massive reserves of renewable geothermal and hydroelectric energy, proximity to major markets, highly educated workforce and cool climate.

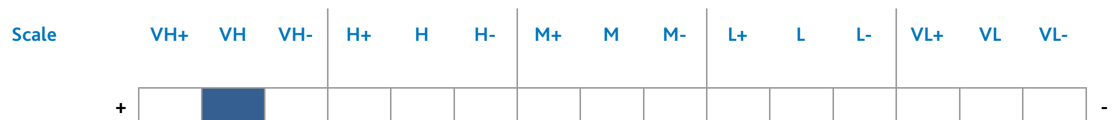
Four projects worth an estimated $1 billion are now in the pipeline that will have significant positive socio-economic impacts, with one located far away from Reykjavik where 2/3 of the country's population resides, which will keep jobs and activity there that might otherwise migrate to the capital. Such projects also tend to have little additional inflationary impact despite the already-tight jobs situation since the construction workers are generally brought into the country from Eastern Europe by the companies and return when the projects are completed. These forthcoming projects also represent an expansion into a new area of industry for Iceland – silica – which will help to diversify the economy and exports.

That said, the traditional industries of fisheries and energy-intensive exports (e.g. aluminum) are currently in good situations, with the country's skillful management of fishing stocks having led to a boom in the valuable cod catch this year. Also, although commodity prices are soft, Iceland's aluminum production plants always operate full-out because they are extremely cost- and energy-efficient by any other country's standards. The tourism sector is also booming, rapidly establishing itself as a third pillar of the Icelandic economy.

Institutional Strength: Very High

Recovery of institutional strength is cemented with the resolution of the failed banks' estates

Factor 2



Institutional strength evaluates whether the country's institutional features are conducive to supporting a country's ability and willingness to repay its debt. A related aspect of institutional strength is the capacity of the government to conduct sound economic policies that foster economic growth and prosperity. Institutional strength is adjusted for the track record of default. This adjustment can only lower the overall score of institutional strength.

We assess Iceland's Institutional Strength as 'very high' in our sovereign bond rating methodology. This assessment has improved over the past several years, reflecting the refinements made to the macroeconomic policy and regulatory framework in the aftermath of the country's 2008 banking system collapse. The massive external imbalances that led to the financial crisis materialized in large part because of the expansion of Iceland's three big banks into offshore activities unrelated to the Icelandic economy itself, exacerbated by positive interest rate differentials due to an overreliance on tight monetary policy to address an overheating economy.

The authorities have since introduced comprehensive reforms intended to prevent such distortions from ever re-emerging, pairing tight fiscal with tight monetary policy and a more flexible exchange rate, partly in conjunction with a 3-year IMF Stand-By Arrangement and subsequent post-program monitoring. Moreover, a myriad of tough banking rules have been enacted with a view to avoiding the significant currency, interest rate and maturity mismatches that were critical vulnerabilities leading up to the banks' collapse.

Increased focus on macro policy coherence, but high wage increases will undermine price stability

The most important measures undertaken since the crisis were the introduction of more stringent supervision and regulation of the banking sector, including tougher reporting requirements and strict

limitations on the new banks' scope of activity. There is also greater collaboration between the central bank and the banking regulator FME, in addition to the introduction of a Financial Stability Council to oversee the monitoring of systemic risks. These new rules are meant to assure that the new banking system is well capitalized, liquid and funded primarily by long-term deposits or wholesale funding. Asset quality at the three big banks has also improved significantly, in part thanks to widespread loan restructuring.

The monetary policy framework is based on inflation targeting, and following comprehensive rule changes in 2009 is now much more transparent. Monetary policy is also better aligned with the fiscal policy stance, which has translated into positive but not excessively positive real interest rates in the past few years. However, much higher inflation is threatened by the recent four-year wage settlements – which will range from 21% to 30% depending on where a worker falls in the income spectrum – for the member unions of the largest labor federation. These increases were substantially in excess of expected inflation plus productivity gains, reflecting the tight labor market (with a roughly 4% unemployment rate and 80% employment rate) as well as contagion from similarly large settlements for certain high-profile public employee groups last year.

Internal debates have been taking place over the effectiveness of "plain-vanilla" inflation targeting, i.e. relatively weak monetary policy transmission, given the central bank's clear desire that the exchange rate not appreciate. In addition, the removal of capital controls will undoubtedly create more financial instability for the very small, open economy (the openness ratio exceeds 100%).

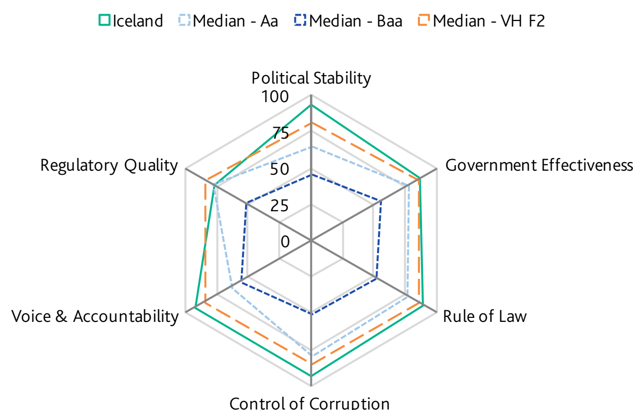
The central bank responded within days of the wage settlement, hiking interest rates by 50 bps and promising more hikes in the next several months in an attempt to curb inflationary expectations. Although we expect inflation to rise by several percentage points by the end of next year, we expect the spike will taper off subsequently, with inflation coming back down to the 2.5% target level by around the end of 2017. Moreover, the authorities have cautioned that they will act aggressively to deflect speculative capital inflows that are likely to materialize as a consequence of higher interest rates, going so far as to impose taxes and/or surcharges if necessary in order to avoid a recurrence of the pre-crisis bubble.

International surveys convey similarly strong assessments of institutional strength

In terms of quantitative indicators, Iceland scores very highly, although the country's relative position worsened for a time after the banks collapsed because of the deterioration in the macroeconomic situation. In 2013, Iceland ranked at the 86th percentile of the World Bank's indicators of "Government Effectiveness" (up from 85 in 2012) and the 89th percentile of "Rule of Law" (up from 88 in 2012), well above the Baa and A rating category medians and more consistent with Aa median levels (see Exhibit 3), similar to the peer comparisons related to economic strength. 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. Also, Iceland has a long tradition of broad cooperation and consensus on economic matters between government, employer and employee associations, although this cooperation obviously broke down in the latest wage round.

EXHIBIT 3

Governance scores in line with much higher rating range



Source: World Bank

Careful management of capital account liberalization provides further evidence of institutional strength

The normalization of the economic and financial situation in Iceland following its banking crisis and recession would not be complete without the removal of its strict capital account restrictions. The government's decision to proceed with a careful process of capital account liberalization appears to more than adequately address our concerns about the potential economic and financial destabilization that could be inherent in their unwinding. In addition, the creditors of the failed bank estates have agreed to turn over considerable financial assets to the Icelandic government and central bank that will be used to pay down government debt and bolster official foreign exchange reserves. The creditors will also extend the maturity of the new banks' capital, thereby improving their financial stability. Further, they have agreed to write off the old banks' (notional) foreign currency liabilities such that the Icelandic net international investment position (net IIP) will shrink massively: from -387% of GDP at the end of 2014 to an estimated -20%-25% by the end of this year, since it was these banks' estates that were responsible for the country's colossal external exposure.

New political party polls the largest share of popular support two years ahead of next election

In the 2013 election, voters returned the long-serving center-right Independence Party-Progressive Party coalition to office after a single term for the Social Democrats following the onset of the recession in 2009. We note that Iceland traditionally elects more centrist-leaning governments than its Nordic counterparts on the Continent. In the 2013 election, three MPs were elected from a newly formed party in Iceland, the Pirate Party, which is part of an international movement of parties of the same name with similar agendas, mainly focused on individual privacy on the internet and in other aspects of life.

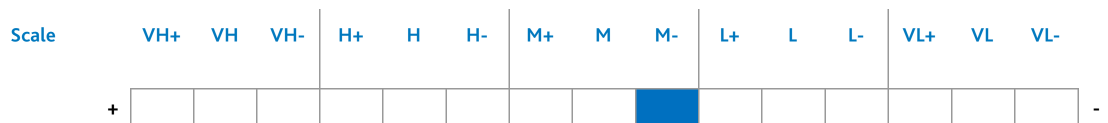
Iceland's Pirate Party has since surged in the polls, and it holds the largest share of popular support of any party in the country at present, at 32.4% (June) higher even than the two-party government coalition, who had 31.9% support in the same poll, although it is not yet clear on what policies it has garnered this strong following. The party is slightly to the left of the Social Democrats, which as mentioned has generally not been in governments in the past, but could be seen as a logical partner should the Pirate Party retain its popularity at the next election.

Based on the comments of Pirate Party MPs in the parliamentary debate over the capital account liberalization strategy, including the disposition of the amounts of money that the authorities will receive from the failed bank estates under either the stability conditions or stability tax, we do not perceive a threat to prudent management of public finances should the new party indeed be part of the next government. That said, in any such emergence of an untested group, the possibility of a political shakeup in a consensus-based society such as Iceland's needs to be followed closely.

Fiscal Strength: Moderate (-)

Government debt load is lightening, but considerable challenges need to be addressed

Factor 3



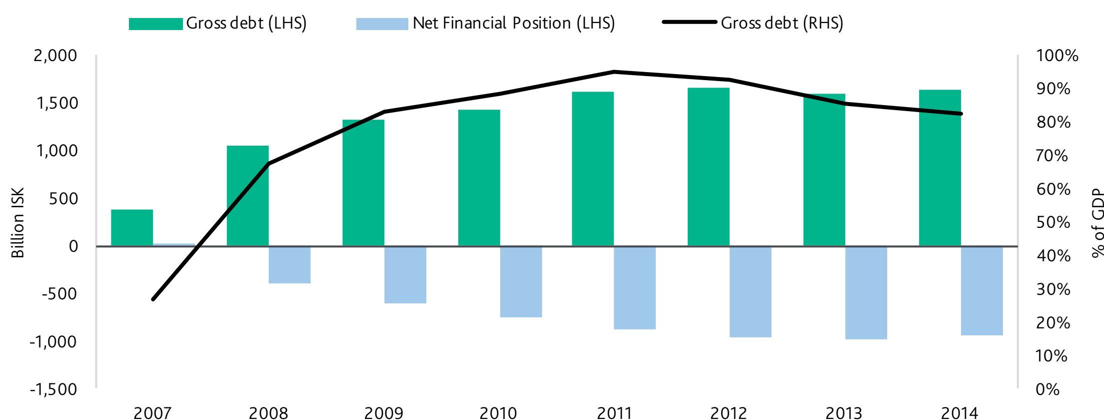
Fiscal strength captures the overall health of government finances, incorporating the assessment of relative debt burdens and debt affordability as well as the structure of government debt. Some governments have a greater ability to carry a higher debt burden at affordable rates than others. Fiscal strength is adjusted for the debt trend, the share of foreign currency debt in government debt, other public sector debt and for cases in which public sector financial assets or sovereign wealth funds are present. Depending on the adjustment factor the overall score of fiscal strength can be lowered or increased.

We consider Iceland's Fiscal Strength to be `moderate (-)', which reflects the substantial reduction in the debt burden over the last three years. A continuation of the downward trend in the debt burden in the coming years will depend on the ability of government to further strengthen the country's fiscal position and run consistent and substantial primary surpluses. In addition, the government's contingent liabilities are very large and mainly arise from its guarantee for Housing Financing Fund (HFF) liabilities. A mitigating factor is the significant financial assets that the government has acquired as part of the recapitalization of the "new" banking system.

The overall debt of the Icelandic economy declined to under 300% of GDP in 2014, its lowest level since 2005, and well below the crisis peak of more than 475% of GDP in 2009. In particular, household debt has come down to about the lowest level in Europe at about 87% of GDP and is expected to be the lowest in Western Europe next year thanks to deleveraging and the mortgage debt relief program introduced by the current government after it came into office in 2013. The business sector has also both restructured and scaled back its debt, which is now down to 111% of GDP after dropping 25% a year in 2012-13 and 17% last year.

The government's own debt has dropped by almost 37 percentage points as a share of GDP since its 2011 peak as a consequence of favorable debt dynamics and the prepayment of nearly all of the multilateral and bilateral financial support the country received in 2009 (see Exhibit 4 below). Moreover, Iceland's fiscal framework is being strengthened with the introduction of new restrictions being placed on budget balances and debt. The authorities' overriding objective has been to register a surplus in the primary balance sufficient to more than offset the deficit in the interest balance. This goal was accomplished last year for the first time since the crisis began, and the finances are on track to achieve this again in 2015.

EXHIBIT 4
Government's gross and net financial position continues to improve



Source: Statistics Iceland

Budget revisions fail to dissuade unions to settle for low real wage increases

The original 2015 budget proposal tabled in September last year envisioned that the overall financial balance would register a small 0.2% of GDP overall surplus and a 3.5% of GDP primary surplus based on a relatively rosy economic assumptions, which have largely materialized. In the context of preparing the 2016-19 medium term fiscal outlook in April this year, however, the authorities decided on a series of measures to lighten the tax burden for individuals and raise disposable incomes across the board. The measures are likely to return the overall budget balance to a small deficit both this year and next.

The tax package was adopted in May this year[4] and the government explicitly stated their hope that it would convince labor unions to moderate their demands in this year's wage round. While the new wage deal was reached at much lower levels than initially demanded, the increases agreed were still outsized, especially on top of the real increases that were obtained last year. The IMF sounded a very strong warning about the risks of the agreement in its statement following its sixth post-program monitoring review last month. Indeed, the central bank is determined to hike rates to restrain price hikes as much as possible, but some industries operate on tight profit margins and will have to raise prices.

The wage agreement will have both direct and indirect impacts on government finances. Public sector wage negotiations are still not settled, with some influential segments asking for wage increases similar to the 30% given to doctors last year. Although highly uncertain at this time, authorities estimate the outcome could add an additional ISK 10 billion (~ $77 million) to government expenditure in the coming years (compared to a positive financial balance for 2015 of ISK 26.8 billion forecast in the government's April 1, 2015 medium-term outlook). Further indirect costs to the government budget will also derive from government support for the housing costs tied to agreements negotiated in the private sector.

The government's ownership of the often-loss-making Housing Financing Fund (HFF) also poses risks to sovereign creditworthiness given its scale (ISK 824 billion in assets at end-2014). While a May 2015 report of a working group on restructuring the housing market (including the role of the HFF) found the HFF should no longer operate and that lending should cease – a view shared by the IMF and by the Financial Stability Council – the future of the HFF (including when and how it will be wound down) has not been finally decided; if contingent liabilities related to the HFF are even partially realized, this will lead to higher debt and interest costs for the government.

[4] See Ministry of Finance website.

Creditors' proposals to settle failed banks' estates are expected to reduce debt substantially further

The capital account liberalization strategy serves the dual purpose of both neutralizing the balance of payments overhang and shoring up the government finances. The boon to government finances derives from payments made from the failed bank estates (the principal creditors of the new banks) to the government to repay the government for its cumulative costs of supporting the new banks. The payments to the government range from ISK400-470 billion if the composition agreements are finalized as was envisioned in the three estates' proposals to the government. With these payments and upon completion of the other steps in the process of dissolving the failed banks (as described in the Special Topic section on page 3), the estates could then be exempted from the capital controls and be free to manage their foreign assets, which are currently also frozen by the capital controls. We consider this to be the likeliest scenario, given that it is less expensive for the old banks as well as being more favorable for Iceland's economic and financial stability.

The ISK400-470 billion range relates to uncertainty over the sale price of the old banks' króna assets and whether or not certain króna assets are sold to a domestic or foreign investor. With these proceeds, the government estimates that government debt, currently equal to 77% of GDP, would be reduced by up to a third over four to five years and as a consequence, its annual debt service requirements will be cut sharply as well.

Introduction of consensus-based fiscal rules further solidifies the government's debt dynamics

A new bill on an Organic Budget Law (OBL) was submitted to Parliament in 2014, with approval anticipated at the opening of the next parliamentary session in September. The objective of the law is "to ensure meticulous preparation of strategies in fiscal policy, to create a clearer vision of the long-term objectives of fiscal policy, to clarify the accountability of executive powers, to tighten discipline and firmness in public financial management and to improve supervision and budget execution." The bill is extremely comprehensive, including contingencies and provisions for all imaginable scenarios. Consultation and cooperation among all levels of government prior to preparation of the medium-term budget are stipulated, an element in the process that is clearly intended to ensure that such fiscal problems as emanated from the municipal sector during and after the crisis will be avoided.

The OBL envisions a number of fiscal rules that should strengthen financial discipline, once implemented:

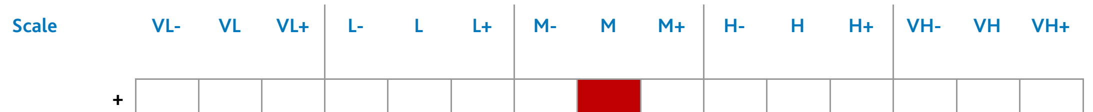
- A cumulative general government surplus is mandated over any five-year period
- Overall general government financial deficit in any single year is never to exceed 2.5% of GDP
- The general government debt to GDP ratio is to be reduced to below 30% and never exceed that level again
- BUT if the debt ratio rises above 30% (presumably for an exogenous reason such as global recession), it should be reduced by 1/20 of the difference between actual levels and the target annually thereafter

With the strictures imposed by the OBL, the medium-term strategy under the Spring Fiscal Plan 2016-19 is to reduce the government's debt from about 75% of GDP (central government definition; general government debt is just over 77% of GDP) at present to under 50% of GDP by the end of 2019. Given the scale of the planned decline, this would involve reducing the nominal level of debt as well as the ratio to GDP. The consensus on this strategy is broad-based among politicians and the population, by all accounts, but the costly recent wage agreement is likely to require making spending cuts elsewhere in order to keep the budget comfortably in surplus.

Susceptibility to Event Risk: Moderate

Financial sector risks have moderated, but the banking sector still has room to improve

Factor 4



Susceptibility to Event Risk evaluates a country's vulnerability to the risk that sudden events may severely strain public finances, thus increasing the country's probability of default. Such risks include political, government liquidity, banking sector and external vulnerability risks. Susceptibility of Event Risk is a constraint which can only lower the preliminary rating range as given by combining the first three factors.

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 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. Political risk and government liquidity risk, at 'very low' and 'low (-), respectively, pose very minimal risks to the sovereign.

'Moderate' Banking Sector Risk

Financial system risks have diminished since the collapse of the banks in 2008, but they are still present. The improvements thus far relate primarily to the reduction of resident entities' refinancing risk with the lengthening of the Landbankinn bonds and a persistent current account surplus, and now with the apparently well-constructed plan to remove capital controls without incurring fresh instability for the banking system or exchange rate. The banking sector is well capitalized with strong liquidity buffers and declining NPLs. Risks posed by foreign contractual debt service have declined as the debt overhang has shrunk, so that debt service profile and access to foreign capital markets is no longer considered to be one of the key risks to financial stability.

Moreover, domestic households and corporates to which the banks lend continue to deleverage significantly and now are in better shape than their mainland European counterparts. And in the next parliament cycle beginning in September, laws prohibiting companies from borrowing in FX unless it has FX-denominated revenues with which to service the debt or the borrowing is hedged will come under consideration. The restructuring of corporate debt continues to move forward, especially among small and medium-sized companies of which NPLs have now fallen in line with large companies. Bankruptcies also continue to decline (792 firms were declared bankrupt in 2014, or 2.1% of all firms), the lowest level of bankruptcies since 2007 (when 2.0% of firms declared bankruptcy, compared to a 4.6% peak in 2011).

However, while the strength of Iceland's financial regulation and the positive spillovers of Iceland's very high institutional strength bode well for financial sector stability, the banking system still has notable weaknesses which continue to pose risks to the sector and to the sovereign. First, while banking sector buffers are strong and asset quality is improving, some uncertainties surrounding the unwinding of crisis legacies and legal risks, including challenges related to CPI indexation, remain. Significant progress in improving macrofinancial and supervisory stress tests and the ongoing gaps in financial safety nets, deposit insurance, and bank resolution frameworks, as well as weaknesses related to banking sector profitability (which is high, but currently driven by irregular items, like asset sales related to the winding up of the old estates, rather than core operations).

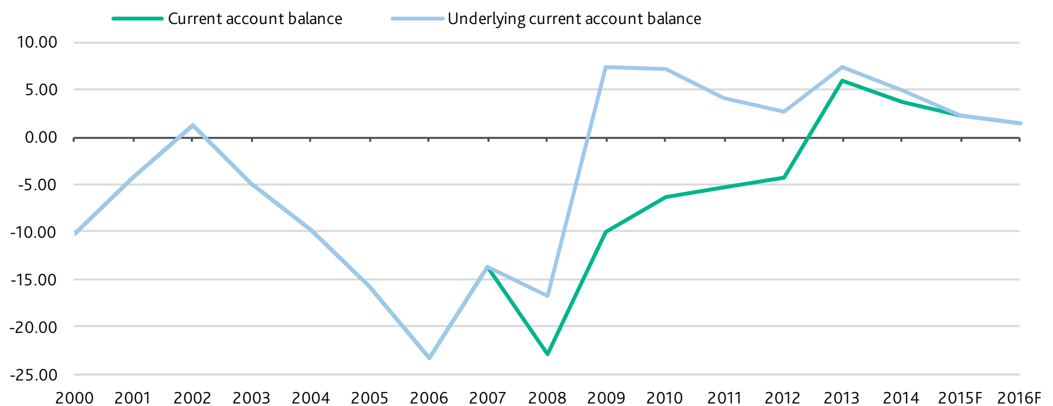
As such key risks to financial stability persist and include: 1) The successful implementation of the capital controls liberalization; 2) The fact that bank lending has been weak outside of a few sectors (primarily export-oriented), with 3) profitability and high return on assets (ROA) rates driven by one-off items rather than core operations. Iceland shares its banking sector risk score of (M) with Ireland (Baa1/Sta) and Bulgaria (Baa2/Sta).

'Very Low' External Vulnerability Risk

Iceland's economy was overheating before the crisis, an obvious symptom of which were the very large external deficits of between 10% and 22% of GDP registered between 2004 and 2008. Immediately upon the imposition of capital controls and the nonpayment of the significant external liabilities that were held by the failed banks, as well as because of the very large depreciation of the currency against other major currencies and the domestic recession, the underlying current account deficit (excluding interest and payments owed on the failed banks) moved into a significant surplus averaging between 5% and 10% of GDP.

EXHIBIT 5

Consistent underlying current account[1] surpluses, which are expected to sustain



Source: *Central Bank Monetary Bulletin 2015/2*

[1]The underlying current account reflects a services account balance adjusted for FISIM of DMBs in winding-up proceedings and a primary income account balance adjusted for the effects of DMBs in winding-up proceedings and other factors that do not reflect Iceland's financial burdens.

The underlying current account surplus is expected to be sustained thanks to a number of factors, including improved terms of trade because of lower oil prices and the fact that most of the country's exports are dollar-denominated. An important element to this turnaround is the booming tourism sector, which has more than doubled in the past 6 years to nearly a million visitors generating over ISK303 trillion in export revenue in 2014, which represented nearly 1/3 of total goods and services receipts, up from 19% in 2010 and generating 6,100 new jobs in that time. Also as mentioned, both of the traditional goods export sectors are also expanding strongly in volume terms, and marine product prices have also been rising at a double-digit pace over the past year.

Imports have also been picking up over the past year, although this was attributable to imports of ships and aircraft, which tend to overwhelm the statistics of the small country. New orders have been placed for more such purchases this year to support the tourist trade, with the international airlines servicing the country increasing their flights by one-fourth and Icelandair is planning a similar increase. Consumer durables goods imports are also likely to expand because of households' better financial position. With the resolution of the failed banks' estates, the underlying current account position will become the actual current account position. As a consequence, we show these statistics consistently over the recent history as well as in our forecasts.

Weak competitiveness represents the most significant obstacle to the sustainability of Iceland's external position, which will be further endangered by the 4-year wage agreement. Price levels in Iceland are roughly 40% higher than those of its European trading partners even after the 2008-09 depreciation. However, the composition of Iceland's specialized and niche exports should assure continued surpluses, although we expect them to shrink gradually as domestic demand recovers more strongly and capital controls are fully dismantled.

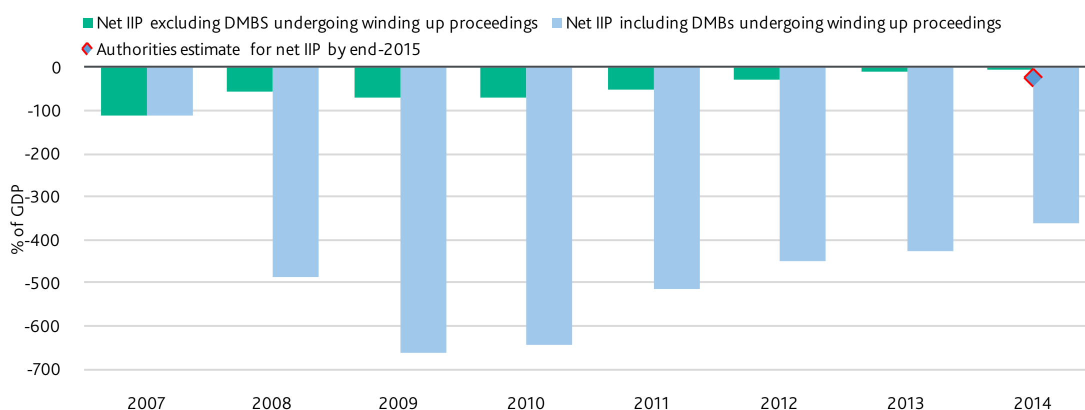
Impact of the capital control liberalization on Iceland's net international investment position

During the course of the global financial crisis, Iceland's net international investment position (net IIP) widened sharply, from 106% of GDP in 2007 to 605% of GDP in 2010. By 2010 external liabilities dwarfed the economy's size, not to mention the banks' equity (which was denominated mostly in krónur) and the government's foreign exchange reserves. However, Iceland's net IIP has improved significantly in the years since the crisis due to significant current account surpluses facilitating paying down external debt, rising prices in foreign asset markets increasing the value of Iceland's foreign assets, and the ongoing write-downs of debt owned by the failed banks in winding-up proceedings *inter alia*.

Today, Iceland's net International Investment Position (IIP), including DMBs in winding up proceedings) is estimated at -387% of GDP. This, of course, overstates Iceland's actual net IIP since it includes the book value of the debt that will not be paid, except in part, once the estates are resolved. Net IIIP excluding DMBs in winding up proceedings was -6% of GDP at end 2014; this, of course, understates Iceland's actual net IIP since a portion of the banks external debts will be paid (See Exhibit 6).

EXHIBIT 6

Net IIP shrank significantly as failed banks were gradually wound down



Source: CBI, Moody's estimates

As per the envisioned liberalization strategy, Iceland's net IIP at the end of this year – assuming winding-up of the estates is handled by year end (our base case) – is estimated to fall between -20 to -25% of GDP, a substantial reduction from both today's "overstated NIIP" (i.e. including the debt will be written off) and from Iceland's net IIP in the years leading up to the financial crisis, which averaged -83% of GDP from 2003-2007. To the extent that capital controls liberalization unfolds without meaningful incident, the external adjustment which followed the 2008 banking crisis will have reduced Iceland's external vulnerability risks posed by foreign liabilities to the lowest level in decades.

EXHIBIT 7

Positive impact of stability contribution on net IIP (% of GDP) is massive

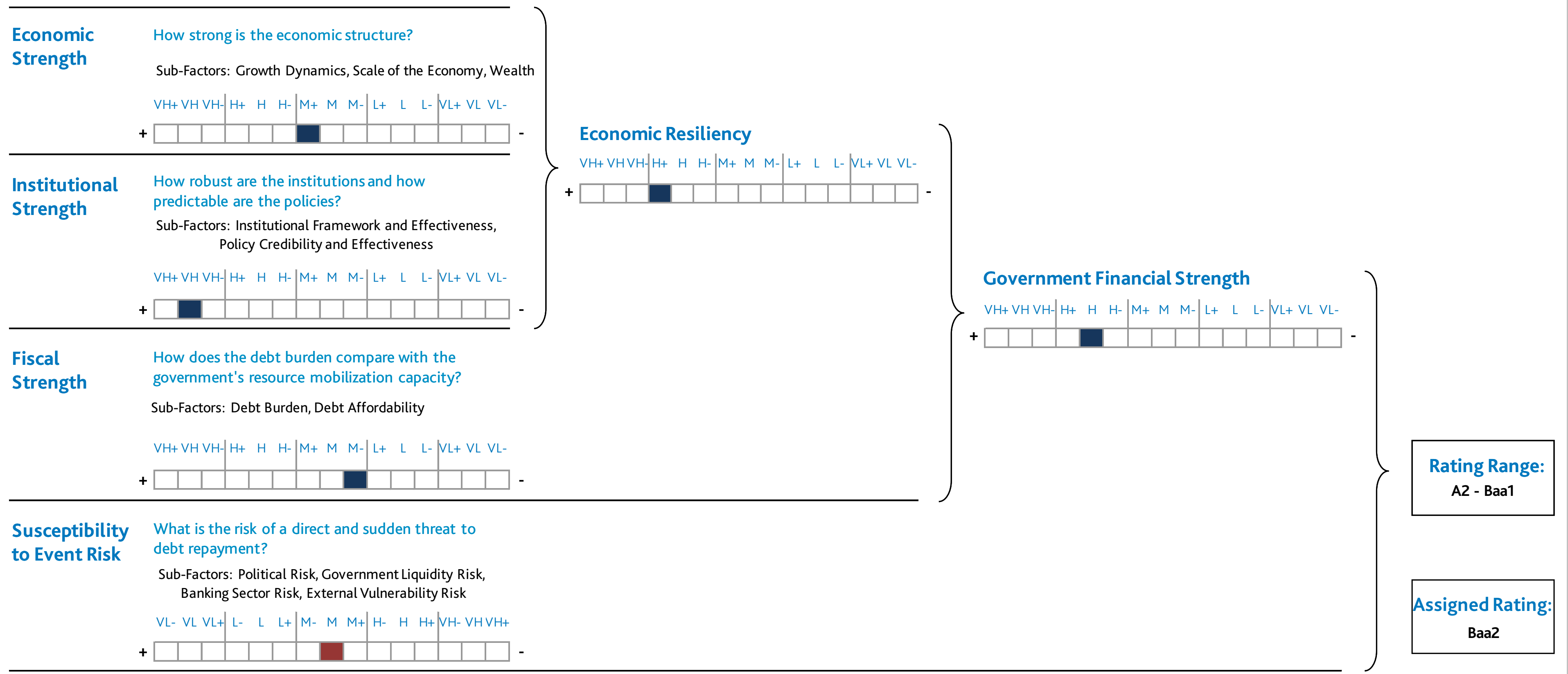
	Foreign assets	Foreign Liabilities	Net International Investment Position
Current position end-2014 (including DMBs in winding up proceedings)	275	-662	-387
Following failed bank resolutions, ca end-2015	201	-221 to -226	-20 to -25

Source: Central Bank of Iceland

Rating Range

Combining the scores for individual factors provides an indicative rating range. 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.

Sovereign Rating Metrics: Iceland



Comparatives

This section compares credit relevant information regarding Iceland with other sovereigns rated by Moody's Investors Service. It focuses on a comparison with sovereigns within the same rating range and shows the relevant credit metrics and factor scores.

Iceland compares favorably to other Baa3 rated sovereigns as far as its wealth levels and institutional strength are concerned. Iceland's key credit weaknesses relate mainly to its elevated public debt level which leads to a comparatively low score on fiscal strength.

EXHIBIT 8

Iceland Key Peers

	Year	Iceland	Ireland	Bulgaria	Latvia	Uruguay	Mauritius	Baa2 Median	Europe & Central Asia Median
Rating/Outlook		Baa2/STA	Baa1/STA	Baa2/STA	A3/STA	Baa2/STA	Baa1/STA	Baa2	Baa2
Rating Range		A2 - Baa1	A1 - A3	Baa3 - Ba2	A1 - A3	Baa1 - Baa3	A2 - Baa1	Baa1 - Baa3	A2 - Baa1
Factor 1		**M+**	**H**	**M-**	**M+**	**H-**	**M+**	**H-**	**H-**
Nominal GDP (US$ Bn)	2014	17.1	246.4	55.7	32.0	57.5	12.7	246.6	137.1
GDP per Capita (PPP, US$)	2014	43,637	49,195	17,860	23,707	20,556	18,553	20,006	27,025
Avg. Real GDP (% change)	2010-2019	2.3	2.2	1.5	2.9	4.1	3.5	2.4	1.9
Volatility in Real GDP growth (ppts)	2005-2014	4.2	4.0	3.7	7.8	1.7	1.2	2.4	3.6
Global Competitiveness Index, percentile [1]	2014	72.8	77.1	52.6	63.1	31.5	65.7	52.6	63.1
Factor 2		**VH**	**VH**	**M+**	**VH-**	**M+**	**H+**	**M+**	**H+**
Government Effectiveness, percentile [1]	2013	86.7	84.3	48.4	67.9	56.2	67.1	54.3	65.6
Rule of Law, percentile [1]	2013	89.0	90.6	44.5	68.7	61.7	72.6	45.3	69.9
Control of Corruption, percentile [1]	2013	92.9	85.9	40.6	58.5	82.0	60.9	44.1	62.1
Avg. Inflation (% change)	2010-2019	3.1	1.0	1.2	1.6	7.6	4.4	3.4	1.8
Volatility in Inflation (ppts)	2005-2014	3.5	2.8	3.9	5.1	1.3	2.8	1.6	1.7
Factor 3		**M-**	**M-**	**M+**	**VH**	**M**	**M**	**M**	**H-**
Gen. Gov. Debt/GDP	2014	77.2	109.7	27.6	40.0	39.2	54.1	40.9	51.9
Gen. Gov. Debt/Revenues	2014	168.0	314.3	74.2	112.9	197.1	265.2	197.7	130.7
Gen. Gov. Interest Payments/Revenue	2014	10.2	11.6	2.0	3.9	11.4	12.7	9.2	4.7
Gen. Gov. Interest Payments/GDP	2014	4.7	4.0	0.7	1.4	2.3	2.6	2.4	1.8
Gen. Gov. Financial Balance/GDP	2014	0.5	-4.1	-2.8	-1.4	-2.3	-3.2	-2.9	-2.1
Factor 4		**M**	**M**	**M**	**M-**	**L**	**L+**	**M-**	**M-**
Current Account Balance/GDP	2014	4.4	6.2	0.9	-3.1	-4.6	-7.2	-1.8	0.7
Gen. Gov. External Debt/Gen. Gov. Debt	2014	37.7	64.2	45.3	85.2	36.0	24.4	31.3	60.6
External Vulnerability Indicator	2016F	34.0	--	57.8	--	61.6	12.3		104.7

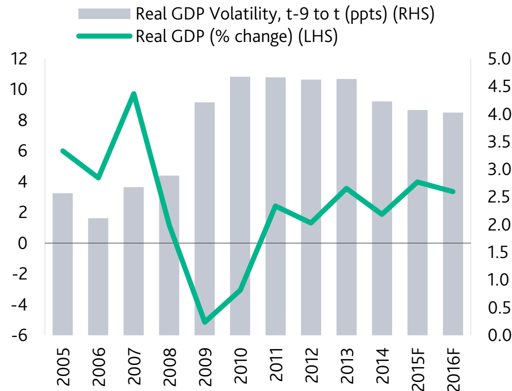
Notes:
[1] Moody's calculations. Percentiles based on our rated universe.
Source: Moody's

Appendices

Chart Pack:

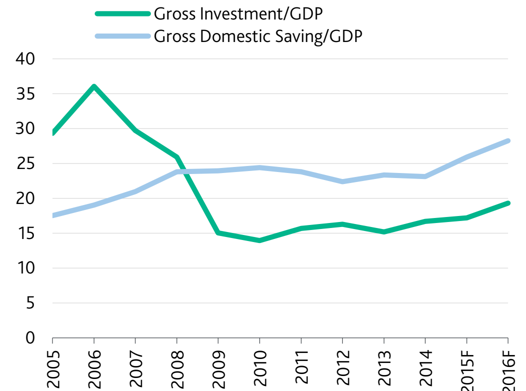
Iceland

EXHIBIT 9
Economic Growth



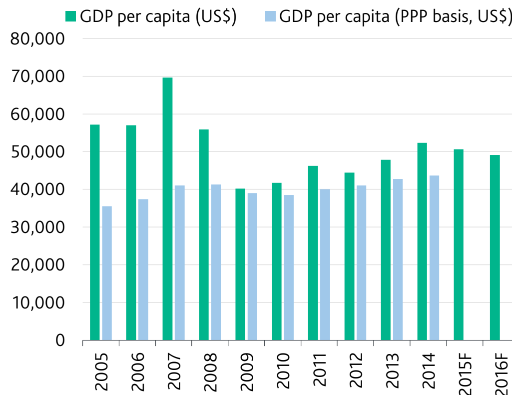
Source: Moody's,

EXHIBIT 10
Investment and Saving



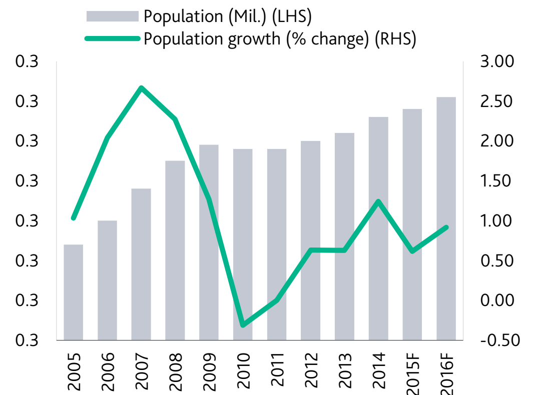
Source: Moody's,

EXHIBIT 11
National Income



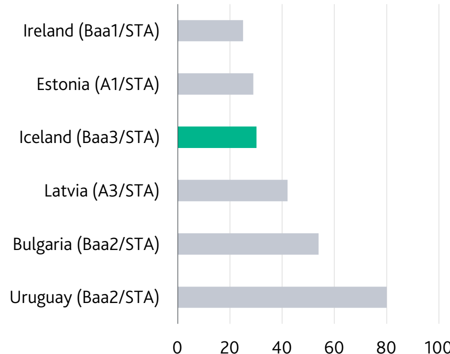
Source: Moody's,

EXHIBIT 12
Population



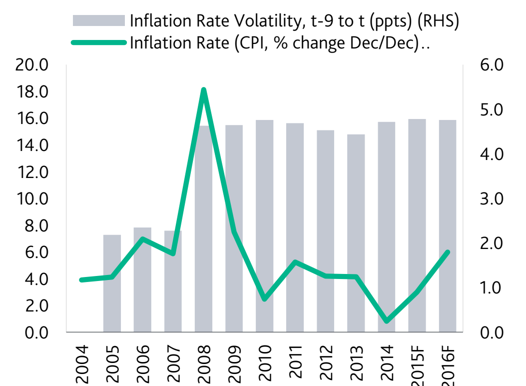
Source: Moody's,

EXHIBIT 13
Global Competitiveness Index
Rank 30 out of 144 countries



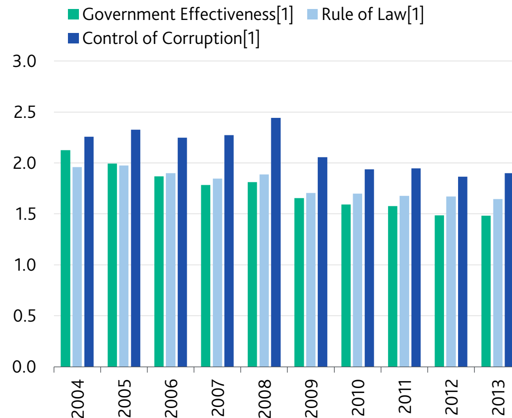
Source: World Economic Forum

EXHIBIT 14
Inflation and Inflation Volatility



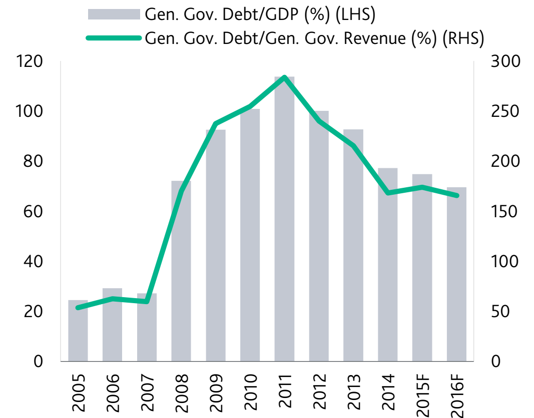
Source: Moody's,

EXHIBIT 15
Institutional Framework and Effectiveness



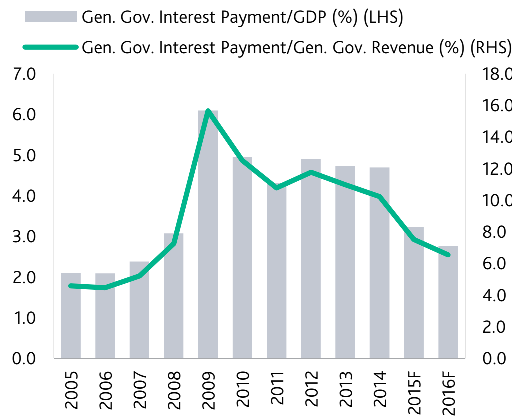
Notes: [1] Composite index with values from about -2.50 to 2.50: higher values correspond to better governance.
Source: World Bank Governance Indicators

EXHIBIT 16
Debt Burden



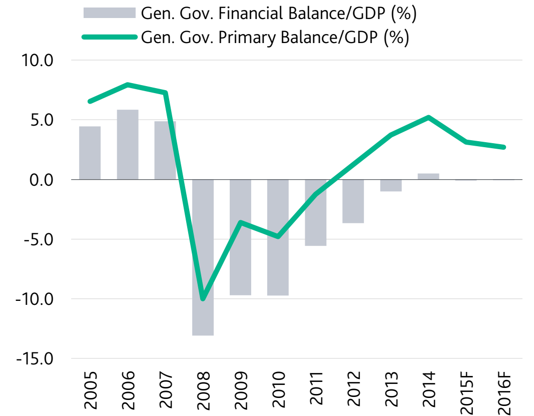
Source: Moody's,

EXHIBIT 17
Debt Affordability



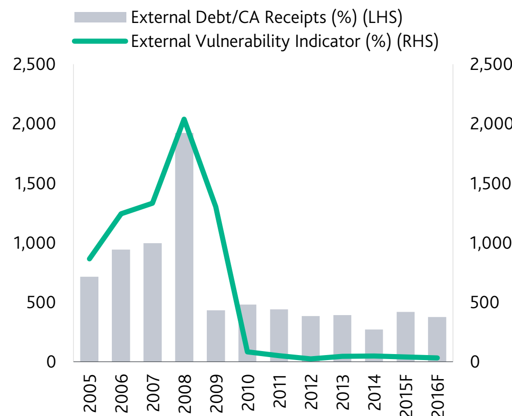
Source: Moody's,

EXHIBIT 18
Financial Balance



Source: Moody's,

EXHIBIT 19
External Vulnerability Risk



Source: Moody's,

Rating History

Iceland

	Government Bonds			Foreign Currency Ceilings				
	Foreign Currency	Local Currency	Outlook	Bonds & Notes		Bank Deposit		Date
				Long-term	Short-term	Long-term	Short-term	
Rating Raised	Baa2	Baa2	Stable	Baa2	P-2	Baa2	P-2	June-15
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	February-13
Rating Lowered	--	--	--	Baa3	--	--	--	November-12
Outlook changed	Baa3	Baa3	Negative	--	--	--	--	July-10
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	April-10
Outlook changed	Baa3	Baa3	Negative	--	--	--	--	April-10
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	November-09
Rating Lowered	Baa3	Baa3	--	Baa2	P-3	Baa3	P-3	November-09
Rating Lowered	Baa1	Baa1	Negative	A2	P-2	Baa1	P-2	December-08
Rating Lowered & Review for Downgrade	A1	A1	RUR-	Aa1	--	A1	--	October-08
Review for Downgrade	Aa1	Aa1	RUR-	--	--	--	--	September-08
Rating Lowered	Aa1	Aa1	Stable	--	--	Aa1	--	May-08
Outlook Changed	Aaa	Aaa	Negative	--	--	--	--	March-08
Rating Raised	Aaa	--	Stable	Aaa	--	Aaa	--	October-02
Rating Assigned	--	Aaa	--	--	--	--	--	July-97
Rating Raised	Aa3	--	Stable	Aa3	--	Aa3	--	July-97
Review for Upgrade	A1	--	RUR+	--	--	--	--	June-97
Outlook Assigned	--	--	Positive	--	--	--	--	March-97
Rating Raised	A1	--	--	A1	--	A1	--	June-96
Review for Upgrade	A2	--	RUR+	--	--	--	--	April-96
Rating Assigned	--	--	--	--	--	A2	P-1	October-95
Rating Assigned	--	--	--	--	P-1	--	--	October-90
Rating Assigned	A2	--	--	A2	--	--	--	May-89

Annual Statistics

Iceland

	2007	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
Economic Structure and Performance										
GDP Nominal (US$ Bil.)	21.45	17.60	12.82	13.26	14.69	14.23	15.39	17.07	16.60	16.26
Population (Mil.)	0.31	0.32	0.32	0.32	0.32	0.32	0.32	0.33	0.33	0.33
GDP per capita (US$)	69,632	55,872	40,200	41,701	46,189	44,477	47,809	52,365	50,619	49,117
GDP per capita (PPP basis, US$)	41,049	41,290	38,979	38,454	39,982	41,021	42,767	43,637	--	--
Nominal GDP (% change, local currency)	14.5	12.7	2.4	2.2	5.1	4.5	5.7	6.0	8.3	5.5
Real GDP (% change)	9.7	1.2	-5.1	-3.1	2.4	1.3	3.6	1.9	4.0	3.3
Inflation Rate (CPI, % change, Dec/Dec)	5.9	18.1	7.5	2.5	5.3	4.2	4.1	0.8	3.0	6.0
Gross Investment/GDP	29.7	25.9	15.0	13.9	15.7	16.2	15.2	16.7	17.2	19.3
Gross Domestic Savings/GDP	20.9	23.8	23.9	24.4	23.8	22.4	23.3	23.1	25.9	28.2
Nominal Exports of G & S (% change, US$ basis)	34.7	1.3	-12.1	11.4	16.6	-2.5	6.0	6.6	-1.6	-2.6
Nominal Imports of G & S (% change, US$ basis)	9.8	-15.6	-31.4	9.2	24.1	1.6	1.4	10.0	0.3	1.3
Openness of the Economy[1]	75.5	84.5	90.5	96.6	104.6	107.3	103.1	100.5	102.7	104.1
Government Effectiveness[2]	1.78	1.81	1.65	1.59	1.58	1.49	1.48	--	--	--
Government Finance										
Gen. Gov. Revenue/GDP	45.6	42.4	38.9	39.6	40.1	41.7	43.1	45.9	43.0	42.1
Gen. Gov. Expenditure/GDP	40.7	55.4	48.6	49.3	45.6	45.3	44.1	45.4	43.1	42.1
Gen. Gov. Financial Balance/GDP	4.9	-13.1	-9.7	-9.7	-5.6	-3.7	-1.0	0.5	-0.1	-0.1
Gen. Gov. Primary Balance/GDP	7.3	-10.0	-3.6	-4.8	-1.2	1.2	3.7	5.2	3.1	2.7
Gen. Gov. Debt (US$ Bil.) [3]	6.03	9.3	11.7	14.2	15.8	13.8	15.1	12.1	11.13	10.92
Gen. Gov. Debt/GDP [3]	27.1	72.1	92.5	100.8	113.8	100.1	92.7	77.2	74.8	69.6
Gen. Gov. Debt/Gen. Gov. Revenue [3]	59.5	170.1	237.5	254.7	283.9	240.1	215.3	168.0	173.8	165.5
Gen. Gov. Int. Pymt/Gen. Gov. Revenue	5.2	7.3	15.7	12.5	10.8	11.8	11.0	10.2	7.5	6.5
Gen. Gov. FC & FC-Indexed Debt/GG Debt [3]	46.8	39.3	37.8	35.9	41.2	33.2	31.5	29.8	27.7	24.4
External Payments and Debt										
Nominal Exchange Rate (local currency per US$, Dec)	61.9	120.6	124.9	115.1	122.7	129.0	115.6	126.9	140.0	140.0
Real Eff. Exchange Rate (% change)	5.5	-21.4	-19.2	5.1	1.4	-0.3	4.6	6.7	--	--
Current Account Balance (US$ Bil.) [4]	-2.93	-4.01	0.94	0.94	0.65	0.41	1.13	1.0	0.70	0.34
Current Account Balance/GDP [4]	-13.7	-22.8	7.4	7.2	4.6	3.1	7.3	5.0	2.3	1.4
External Debt (US$ Bil.) [5]	120.6	123.4	29.3	36.8	37.0	32.9	39.0	35.8	37.5	35.1
Public Sector External Debt/Total External Debt [5]	3.3	5.9	23.2	19.9	23.3	19.5	16.2	14.7	14.9	14.9
Short-term External Debt/Total External Debt [5]	34.1	36.8	10.5	8.0	5.5	5.6	5.1	4.7	4.1	4.4
External Debt/GDP [5]	543.1	961.2	230.5	261.5	266.8	238.2	212.5	202.1	226.0	216.0
External Debt/CA Receipts [4] [5] [6]	996.9	1,922.3	432.2	480.7	439.2	382.6	392.6	273.1	419.6	375.5
Interest Paid on External Debt (US$ Bil.) [5]	3.08	3.34	1.2	1.4	5.6	1.8	2.0	2.7	0.8	1.9
Amortization Paid on External Debt (US$ Bil.) [5]	18.1	10.8	0.9	0.9	5.2	1.5	1.3	2.5	0.6	1.7
Net Foreign Direct Investment/GDP	-15.7	29.1	-17.2	19.7	7.4	29.7	-0.4	4.1	1.8	2.5
Net International Investment Position/ GDP [5]	-109.4	-485.0	-69.1	-69.8	-50.9	-27.0	-10.8	-5.1	--	--
Official Foreign Exchange Reserves (US$ Bil.)	2.5	3.5	3.6	5.6	7.7	4.0	4.1	4.1	4.5	4.2

Iceland

	2007	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
Net Foreign Assets of Domestic Banks (US$ Bil.)	-24.3	-0.8	-0.1	0.7	1.7	2.0	2.7	2.0	--	--
Monetary, Vulnerability and Liquidity Indicators										
M2 (% change Dec/Dec)	56.6	32.1	-1.1	-9.9	8.7	-2.7	4.2	3.9	--	--
Monetary Policy Interest rate (% per annum, Dec 31)	13.8	18.0	10.0	4.5	4.8	6.0	6.0	5.3	--	--
Domestic Credit (% change Dec/Dec)	15.4	-33.0	-0.5	-6.5	-5.9	1.4	0.3	-5.4	--	--
Domestic Credit/GDP	299.0	177.8	172.7	158.0	141.5	137.3	130.3	116.3	--	--
M2/Official Forex Reserves (X)	7.8	3.9	3.5	2.3	1.7	2.9	3.3	3.2	--	--
Total External Debt/Official Forex Reserves	4,732.7	3,539.2	804.2	663.0	480.2	813.1	946.1	880.1	833.8	836.1
Debt Service Ratio [7]	181.2	160.6	17.5	18.5	62.4	20.7	21.0	27.6	8.1	20.7
External Vulnerability Indicator [8]	1,333.2	2,039.5	1,302.7	84.6	52.9	26.3	45.5	48.7	41.5	34.0
Liquidity Ratio [9]	162.4	233.9	309.7	151.1	147.9	54.1	28.5	22.3	--	--
Total Liab. due BIS Banks/Total Assets Held in BIS Banks	305.2	401.0	525.0	231.5	246.7	127.2	87.6	84.8	--	--

Notes:

[1] Sum of Exports and Imports of Goods and Services/GDP

[2] Composite index with values from -2.50 to 2.50: higher values suggest greater maturity and responsiveness of government institutions

[3] Includes loans from the IMF and Norway

[4] 2009-2013 excludes DMBs undergoing winding-up proceedings

[5] 2009-2013 excludes DMBs undergoing winding-up proceedings

[6] Current Account Receipts

[7] (Interest + Current-year Repayment of Principle)/Current Account Receipts

[8] (Short-term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves. Excludes total nonresident deposits over one year

[9] Liabilites to BIS Banks Falling Due Within One Year/Total Assets Held in BIS Banks

Moody's Related Research

Credit Opinion:

» Credit Opinion, June 2015

Credit Focus:

» Iceland, Government of: FAQ: Capital Controls and the New Liberalization Strategy, July 2015 (1006366)

» Iceland: Mortgage Debt-Relief Plan Is Credit Positive for Housing Financing Fund, Without Detriment to Sovereign Creditworthiness, December 2013 (161775)

Issuer Comments:

» Arion Bank Bond Sale Reflects Continued Recovery from Banking Crisis, March 2015 (1003667)

» Iceland's Creditworthiness Is Not Affected by British and Dutch Effort to Increase Icesave Recoveries, February 2014 (165077)

» Iceland: EFTA Court Decision Frees Iceland from Failed Landsbanki Liabilities, a Credit Positive, January 2013 (149659)

Statistical Handbook:

» Country Credit Statistical Handbook, May 2014 (170108)

Special Comment:

» Cyprus: Lessons on Capital Controls from Iceland (153572)

Rating Methodologies:

» Sovereign Bond Ratings, September 2013, (157547)

» Sovereign Default and Recovery Rates, 1983-2013 April 2014 (166650)

Moody's Website Links:

» Sovereign Risk Group Webpage

» Sovereign Ratings List

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Rate this Research

Report Number: 183209

Authors
Kristin Lindow
Anna Snyder

Production Associate
Miki Takase

© 2015 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATING AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS FOR RETAIL INVESTORS TO CONSIDER MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS IN MAKING ANY INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc., have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc., for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

For Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail clients. It would be dangerous for "retail clients" to make any investment decision based on MOODY'S credit rating. If in doubt you should contact your financial or other professional adviser.

For Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.

MOODY'S
INVESTORS SERVICE