MOODY'S INVESTORS SERVICE

Credit Opinion: Iceland, Government of

Global Credit Research - 03 Feb 2015

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa3
Senior Unsecured	Baa3
Parent: Iceland	
Country Ceiling: Fgn Currency Debt	Baa3/P-3
Country Ceiling: Fgn Currency Bank Deposits	Baa3/P-3

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Key Indicators

Iceland

	2008	2009	2010	2011	2012	2013	2014F	2015F
Real GDP (% change)	1.1	-5.1	-2.9	2.1	1.1	3.5	2.3	3.0
Inflation (CPI, % change Dec/Dec)	18.1	7.5	2.5	5.3	4.2	4.1	0.8	1.5
Gen. Gov. Financial Balance/GDP (%)	-13.1	-9.7	-9.7	-5.6	-3.7	-1.0	1.4	0.7
Gen. Gov. Debt/GDP (%) [1]	72.1	92.5	100.8	114.0	100.4	93.1	89.0	88.4
Gen. Gov. Debt/Gen. Gov. Revenue (%)	170.1	237.6	254.8	284.0	240.4	215.6	187.5	190.4
Gen. Gov. Int. Pymt/Gen. Gov. Revenue (%)	7.3	15.7	12.5	11.4	12.1	11.2	7.0	7.2
Current Account Balance/GDP (%) [2]	-22.8	7.4	7.2	4.6	3.1	7.3	4.0	2.5
External Debt/CA Receipts (%) [3]	1,922.3	432.2	480.7	441.6	384.3	395.0	368.2	356.5
External Vulnerability Indicator [4][5]	2,039.5	1,327.6	109.1	145.5	46.3	78.8	123.6	68.1

[1] General government includes loans from the IMF and Norway that were extended directly to the central bank in 2009. The Norwegian loan and most of the IMF loan were repaid early. [2] From 2009 onwards excludes Deposit-Money Banks undergoing winding-up proceedings and Actavis [3] Current Account Receipts [4] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year) / Official Foreign Exchange Reserves [5] Excludes Total Nonresident Deposits Over One Year

Opinion

Credit Strengths

The credit strengths of Iceland include:

- Flexible and highly skilled labor force

- Natural resource base that underpins economic growth potential

- Tradition of consensus-based economic policy formation

- Strengthened institutions since the 2008 banking system collapse

- Fully-funded private pension system and favorable demographics, including long working lives

Credit Challenges

The credit challenges facing Iceland include:

- Achieving an appropriate sequencing of capital control liberalization to secure a sustainable economic growth pattern

- Further reducing the government and external debt ratios to allow public finances a larger buffer against potential shocks

Rating Rationale

Among Iceland's key credit strengths are its high levels of wealth and moderate 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 sizeable external debt. 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 the European context. In addition and in contrast to many other highly-indebted European countries, Iceland has a 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, with the five-year average at $38,716 on a PPP basis as of 2013. 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 ($13,813). 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. The post-crisis recovery is under way and Iceland's short-term growth outlook is relatively favorable. Over the medium term, Iceland's growth prospects depend crucially on the outlook for investment, on which the speed with which the extensive capital controls will be abolished will have an important bearing.

We assess Iceland's Institutional Strength as `very high', reflecting the country's strong scores on the World Bank's governance indicators. Iceland ranked at the 90th percentile of the World Bank's indicators of "Government Effectiveness" and the 92nd percentile of "Rule of Law", well above the Baa and A rating category medians, 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. 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 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 '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. Moreover, unlike most other European countries, Iceland has very large and fully funded pension funds, bolstering the government's long-term fiscal sustainability and allowing the government to finance itself in the local capital markets at low interest rates and relatively long maturities.

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. The timing of the lifting of the capital controls is on the horizon within the next year or so following the agreement on the Landsbanki bond restructuring and incremental progress on the settlement of the failed banks' estates. 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 as and when the stringent capital controls in place since the crisis are lifted.

What Could Change the Rating - Up

Iceland's rating could be upgraded if the economic recovery were sustained, significant fiscal consolidation continued, and the exchange rate remained broadly stable during the process of capital control relaxation. While we expect the capital account liberalization process to be gradual, probably taking several years, the next steps have the potential to affect Iceland's sovereign rating. Hence, the rating would come under upward pressure if the key obstacles identified by the authorities can be resolved in an orderly fashion.

What Could Change the Rating - Down

Conversely, the rating could be downgraded if the government's commitment to fiscal consolidation showed signs of waning, thereby halting the declining trend in the public debt ratio. The rating could also be downgraded if our expectation of an orderly capital control liberalization fails to materialize, 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, or if other serious problems emerged in the banking sector.

Recent Developments

Iceland's January-September 2014 national accounts figures suggest much lower growth in 2014 than we originally expected: 0.5% on a year over year basis compared to the roughly 2.3% we are projecting for the full year. However, we believe growth was in fact not as weak as the data imply because of various anomalies in Iceland's statistical accounts. High frequency indicators reveal a more robust picture for 2014. In particular, various domestic demand indicators - such as imports of consumer and investment goods, auto sales, credit card turnover - suggest a more robust performance. As a consequence, we expect a relatively sizeable upward revision in yearly average growth when the fourth quarter data are released in early March.

As a net oil importer, Iceland's economy also benefits from positive terms of trade effects due to the collapse in oil prices, which will produce more noticeable effects in 2015-16. In addition, the appreciation of the dollar will provide a significant boost to export prices in kronur terms, since sales of Iceland's two main exports - fish and aluminum - are dollar-denominated. The current account is therefore likely to remain in surplus for at least the next two years. After coming in somewhat lower than was previously forecast in 2014, therefore, we expect growth to accelerate slightly to 3.0% by 2015.

Reforms to recover the health of the banking sector are ongoing. A recent landmark step in this process was the recent agreement to extend the maturity structure of the bond issued by Landsbanki (LBI hf) to cover the losses of Icesave, its failed venture into online deposit-taking in Europe. Announced in December, 2014, the bond restructure agreement allows the estate of LBI hf to remit payments (worth Kronur 400 billion or US$ 3.2 billion) to priority creditors overseas, the payout of which goes a long way toward resolving the long-standing Icesave dispute. Moreover, as per the restructure, the repayment schedule end-date was extended from 2018 to 2026; the longer repayment schedule reduces 2015-2018 balance of payments pressures stemming from the shorter repayment timeline, which necessitated larger payments. Moreover, the combination of a smaller bank balance sheet (stemming from the repayment) and the bond extension reduces economic vulnerabilities in both the banking sector and overall, an important development in light of the eventual lifting of capital controls.

With respect to the liberalization of capital controls, we anticipate a decision on timing and sequencing will be made in the next several months.

Rating Factors

Iceland, Government of

Rating Factors	Sub-Factor Weighting	Indicator	Factor Score
Factor 1: Economic Strength			**M**
Growth Dynamics	**50%**		
Average Real GDP Growth (2009-18F)		1.1	
Volatility in Real GDP Growth (Standard Deviation, 2004-13)		4.7	
WEF Global Competitiveness Index (2013)		4.7	
Scale of the Economy	**25%**		
Nominal GDP (US$ billion, 2013)		14.6	
National Income	**25%**		
GDP per Capita (PPP, US$, 2013)		40,999.6	
Factor 2: Institutional Strength			**VH**
Institutional Framework and Effectiveness	**75%**		
World Bank Government Effectiveness Index (2012)		1.5	
World Bank Rule of Law Index (2012)		1.7	
World Bank Control of Corruption Index (2012)		1.9	
Policy Credibility and Effectiveness	**25%**		
Inflation Level (%, 2009-18F)		4.4	
Inflation Volatility (Standard Deviation, 2004-13)		3.4	
Economic Resiliency (F1xF2)			**H**
Factor 3: Fiscal Strength			**M-**
Debt Burden	**50%**		
General Government Debt/GDP (2013)		97.7	
General Government Debt/Revenues (2013)		217.7	
Debt Affordability	**50%**		
General Government Interest Payments/Revenue (2013)		11.8	
General Government Interest Payments/GDP (2013)		5.3	
Government Financial Strength (F1xF2xF3)			**H-**
Factor 4: Susceptibility to Event Risk	**Max. Function**		**M**
Political Risk			
World Bank Voice & Accountability Index (2012)		1.5	
Government Liquidity Risk			
Gross Borrowing Requirements/GDP		2.1	
Non-Resident Share of General Government Debt (%)		31.9	
Market-Implied Ratings		Ba2	
Banking Sector Risk			
Average Baseline Credit Assessment (BCA)		--	
Total Domestic Bank Assets/GDP		231.5	
Banking System Loan-to-Deposit Ratio		123.5	
External Vulnerability Risk			
(Current Account Balance + FDI Inflows)/GDP		8.6	
External Vulnerability Indicator (EVI)		77.7	
Net International Investment Position/GDP		-12.5	
Government Bond Rating Range (F1xF2xF3xF4)			**A3 - Baa2**
Assigned Foreign Currency Government Bond Rating		**Baa3**	

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.

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 http://www.moodys.com for the most updated credit rating action information and rating history.

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