

## CREDIT ANALYSIS

## Iceland, Government of

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

## Iceland

	Foreign Currency	Local Currency
Government Bond Rating	Baa3/Stable	Baa3/Stable
Country Ceiling	Baa3	Baa2
Bank Deposit Ceiling	Baa3	Baa2

[Moody's sovereign rating lists](#)

## Summary Rating Rationale

Iceland's Baa3 government bond rating reflects our assessment of the country's 'moderate' economic strength, which balances the high levels of wealth with the small size and undiversified structure of the economy. The post-crisis recovery is under way and Iceland's short-term growth outlook is relatively favourable, although growth has moderated in the last year. Over the medium term, Iceland's growth prospects depend crucially on the outlook for investment, which is in turn largely dependent on the speed with which the extensive capital controls will be removed.

Iceland exhibits 'high' institutional strength, reflecting the authorities' 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 another crisis.

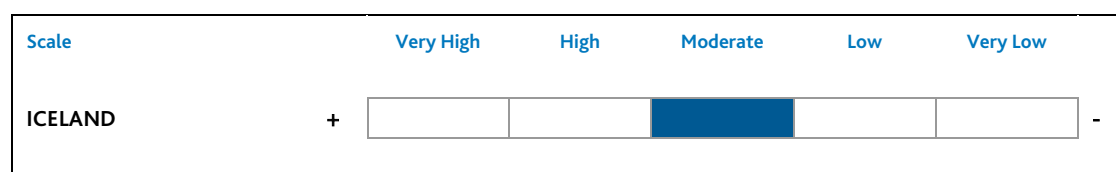
We consider Iceland's government financial strength to be 'low', mainly on account of its still elevated debt burden. At the same time, the government has managed to reduce the budget deficit significantly from its 2008 peak and in 2012 the public debt ratio started to decline for the first time since the crisis began. A material reduction 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 liabilities.

We assess susceptibility to event risk as 'moderate', mainly reflecting the risks emanating from the process of capital control liberalisation. As the size of potential capital outflows is substantial, the risk of too rapid a loosening in capital controls remains the key event risk for Iceland in our view. At the same time, we acknowledge that the authorities are well aware of these risks. In addition, 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. Moreover, the Icesave dispute is no longer a relevant risk following the EFTA Court decision in favour of Iceland earlier this year. These developments prompted us to change the outlook on Iceland's Baa3 rating to stable from negative in February 2013.

The rating could be upgraded if the economic recovery is sustained, significant fiscal consolidation continues and the exchange rate remains broadly stable during the process of gradual capital control relaxation. 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.

## Economic Recovery Under Way

### Factor 1 – Economic Strength: Moderate



We consider a variety of indicators to determine a country's economic strength, including the level of wealth, size of the economy, volatility of GDP growth, the presence (or not) of macroeconomic imbalances and the medium-term growth momentum. The wealth of a country is an important determinant of sovereign creditworthiness as it reflects the amount of resources that a government can potentially raise from the economy. Also, large and more diversified economies tend to produce a more predictable government revenue stream, thereby reducing risk.

Our assessment of Iceland's economic strength as 'moderate' balances the high levels of wealth with the small size and undiversified structure of the economy. Iceland's GDP per capita is among the highest in Moody's universe of rated sovereigns, despite the significant loss in wealth due to the banking and currency crisis, with the five year average at \$37,250 on a PPP basis as of 2011. This positions Iceland in the same category as Aa-rated sovereigns (median per-capita GDP of \$35,139) and as a clear outlier in the Baa rating range<sup>1</sup> (\$13,260). In terms of the size of the economy, Iceland is closest to peers like Namibia (Baa3), Mauritius (Baa1) and Botswana (A2). Similar to other small countries, the economy is comparatively undiversified, with approximately 80% of Iceland's goods exports composed of aluminium and marine products.

### Economic recovery continues but at a more moderate pace than expected

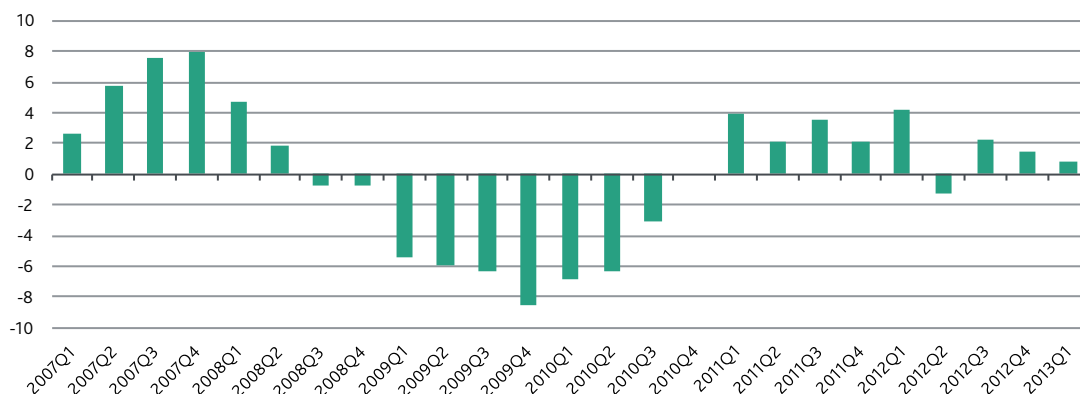
Iceland's economy has been recovering from the deep crisis since 2011, although the pace of economic growth has slowed in the last few quarters. Last year's GDP growth was more moderate than expected at 1.6%<sup>2</sup> and growth in the first quarter of 2013 (+0.8% year-on-year in non-seasonally adjusted terms) points to a continuation of the moderate pace of expansion (see Exhibit 1). At the same time, GDP

<sup>1</sup> Other outliers include Bahamas, Italy and Spain.

<sup>2</sup> An important driver for the weaker-than-expected growth in 2012 was significantly stronger import growth than initially forecast.

numbers in Iceland tend to be revised, sometimes significantly.<sup>3</sup> Given the evident slowdown we now expect real GDP to expand by only 1.8% this year and to accelerate again to 2.5%-2.8% in 2014. These forecasts are broadly in line with those of the central bank, Statistics Iceland as well as the IMF and OECD.

FIGURE 1  
Real GDP Growth, % yoy



Source: Haver - Statistics Iceland. Data is not seasonally adjusted.

Private consumption will remain an important contributor to economic growth. Unemployment continues to fall, with the unemployment rate at 5.8% as of April (seasonally adjusted) compared to a peak of above 9% in September 2010. In addition, inflation has been on a declining trend since mid-2012. This is important in an economy such as Iceland's where a large share of household debt is still indexed to inflation. At the same time, wage growth has slowed following the very substantial increases in 2011 and 2012. The next wage negotiations are due in November and it remains to be seen whether the current wage moderation will continue.

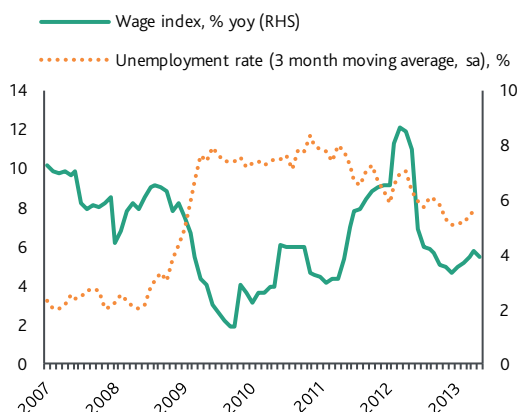
Household debt has declined to 110% of GDP as of Q1 2013 from a peak of 134% of GDP in Q1 2009, mainly due to extensive debt restructuring and write-downs.<sup>4</sup> The debt level of Icelandic households is now broadly in line with that of households in the UK and lower than in Denmark and the Netherlands, while still higher than in most other EU countries, even if the high home ownership rate in Iceland is taken into account.<sup>5</sup> The two parties that form the new coalition government both campaigned on a platform of further mortgage debt relief to households. If implemented this could provide a boost to household finances and consequently consumption. On the other hand, if the mortgage debt write-down was to be financed by creditors of the old banks (as proposed by one of the coalition partners), this could discourage foreign investment and make it more difficult for Icelandic entities to roll-over maturing foreign-currency debt. It is unclear at this point how and when such further relief would be implemented.

<sup>3</sup> GDP growth in seasonally-adjusted terms -- as reported by Statistics Iceland -- was much stronger at +4.6% q-o-q in Q1 2013. However, as the statistics office points out, the seasonally-adjusted GDP estimates should be interpreted with caution as they are very volatile and unstable given the major structural changes under way and as large but irregular items have a major impact on the data.

<sup>4</sup> The central bank calculates the cumulative debt relief for households at ISK244 billion between 2010 and 2013, equivalent to around 14% of 2012 GDP. In addition, households have benefited from special payments, resulting from favourable court rulings with regards to exchange-rate linked loans, of a further ISK 21 billion. Source: Central Bank of Iceland, Monetary Bulletin, May 2013.

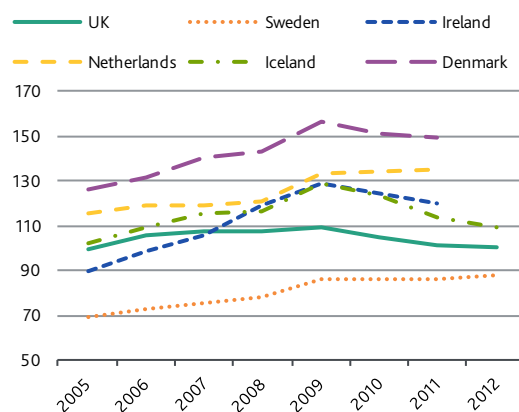
<sup>5</sup> Household debt as percentage of total assets (excluding pension but including real estate assets) stood at 52% in Iceland compared to 40% in Sweden, 25% in the US and less than 20% in the UK, France and Italy in 2011. See the OECD report on Iceland for comparisons. OECD Economic Surveys: Iceland 2013.

FIGURE 2  
Unemployment and Wage Developments



Source: Haver - Statistics Iceland

FIGURE 3  
Gross Household Debt (% of GDP)

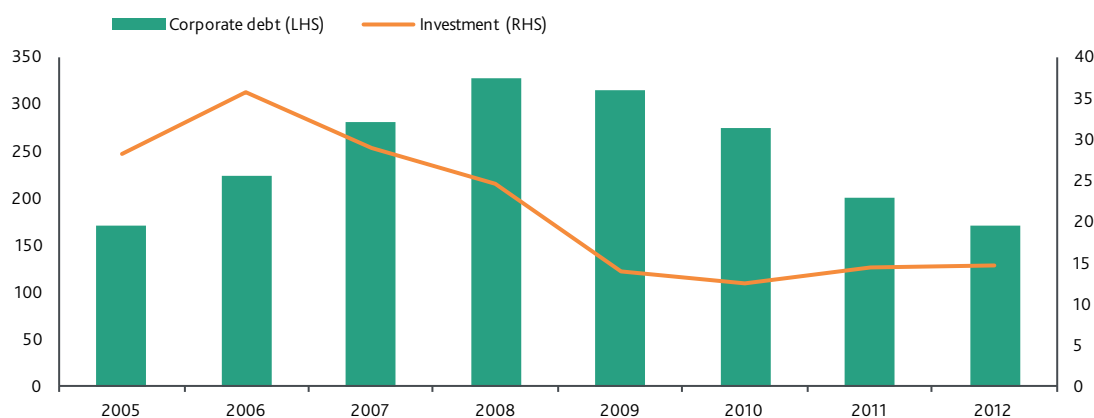


Source: Eurostat, Central Bank of Iceland

Investment grew by 8.6% in 2012, driven largely by investment in ships and aircraft, while energy-related investments were lower than expected. The central bank expects a significant contraction in gross fixed investment (-9% in real terms) in 2013, based on delays to large foreign direct investment (FDI) in energy-related industries and a sharp year-on-year contraction in investment in ships and aircraft.<sup>6</sup> Given the small size of the economy, one or two large investment projects (mainly FDI) can make a significant difference to the growth outlook. Other business investment is also expected to contract, based on the central bank's latest survey of companies' investment plans. The picture should improve in 2014 when investment is forecast to grow by 20% year-on-year if – as is currently expected – delayed foreign investments start to come on stream, particularly the expansion of the existing aluminium smelter in Helgavik.

Following extensive restructuring and debt write-offs, the corporate sector has significantly reduced its debt levels, standing at 162% of GDP in Q1 2013, compared to the peak of over 380% of GDP in Q3 2008. While still high by international comparison, this provides some confidence that investment levels can and will indeed rise again once companies' financial health has improved sufficiently.

FIGURE 4  
Corporate Debt and Investment (% of GDP)

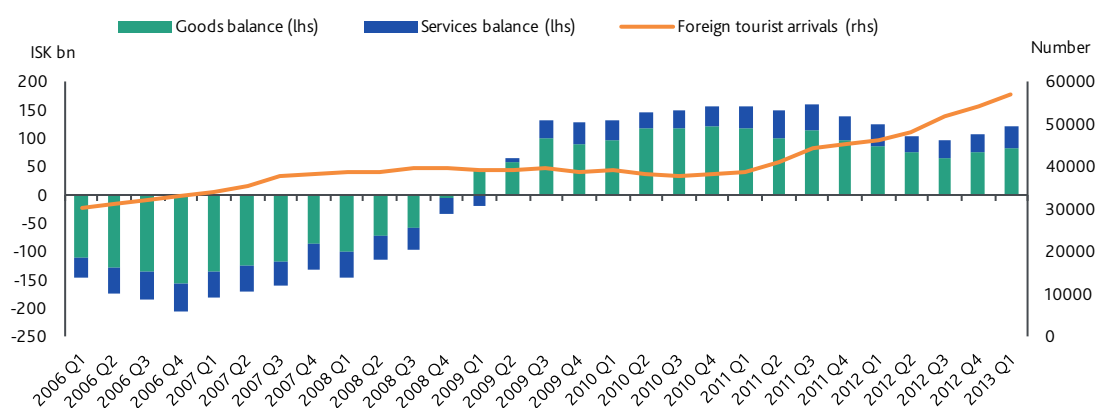


Source: Central Bank of Iceland, Moody's forecasts

<sup>6</sup> The net impact on GDP growth of investments in ships and aircraft is zero as they also appear in the national accounts as imports.

The slowdown in the EU has had an impact on Iceland's goods exports, mainly via lower prices rather than volumes. In contrast, tourism continues to expand strongly, with tourist arrivals increasing by close to 40% in Q1 2013 compared to the first quarter of 2012. This set a new record for tourist arrivals and indicates that the sector is increasingly developing into a further pillar of growth for the Icelandic economy, benefiting from the more favourable exchange rate and a significant expansion of facilities and overseas marketing. Tourism accounts for around 6% of Iceland's nominal GDP and 23.5% of exports of goods and services (2012 data), up from 19.6% in 2009. The balance of trade in goods and services has registered substantial surpluses since 2009 of around 8% of GDP on average per year. While this surplus is expected to shrink in the coming years as imports grow more strongly due to the high import content of investment projects, the trade balance will likely remain in substantial surplus, a stark contrast to the pre-crisis period.

FIGURE 5  
External Balance and Tourist Arrivals



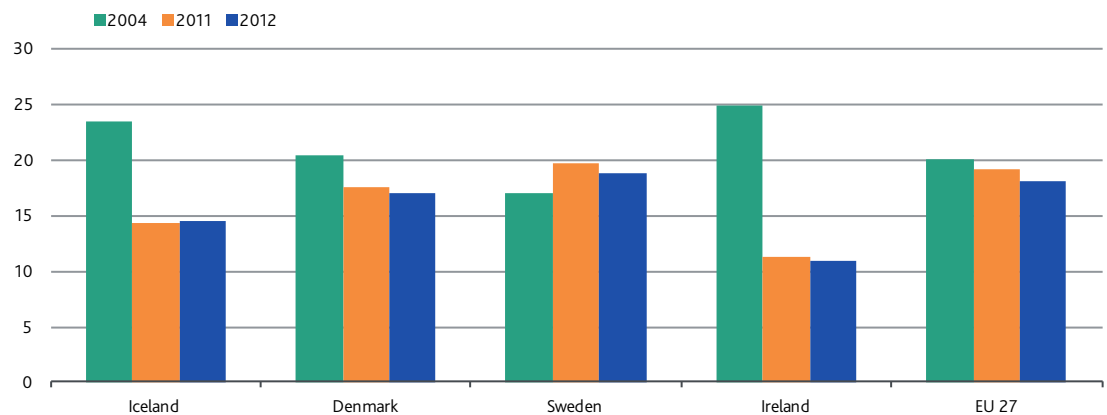
Source: Central bank of Iceland, Icelandic Tourist Board. Goods and services balances are 4 quarters moving sums, tourist arrivals are 12 months moving averages

### Higher investment levels will be crucial to bolster the medium-term growth outlook

Iceland's medium-term growth prospects depend crucially on the outlook for investment. As stated above one or two large investment projects can make a significant difference to the growth outlook. In principle, the prospects are good given that Iceland is highly competitive in its key industries and benefits from some of the lowest energy costs globally as well as a well-educated workforce and a still very favourable exchange rate. Moreover, there is significant potential to further develop Iceland's vast hydro and geothermal energy sources. Due to the low energy costs and the renewable nature of its energy sources, Iceland will probably continue to be a favoured destination for energy-intensive industries like aluminium smelting.

The capital controls do not affect FDI directly as these inflows are exempt, but external funding constraints for Icelandic utilities appear to have been partially responsible for the delay in energy-related FDI. Even assuming stronger investment in 2014, overall investment levels will remain lower than in other countries and relative to Iceland's own historic investment rates.

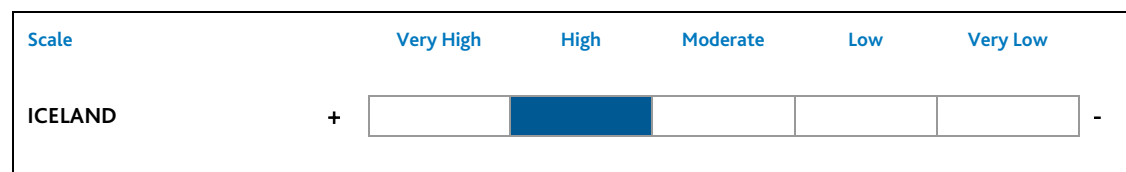
FIGURE 6  
Investment Rate (% of GDP)



Source: Haver, Moody's

## Institutional Strength In Line With Higher-Rated EU Peers

### Factor 2 - Institutional Strength: High

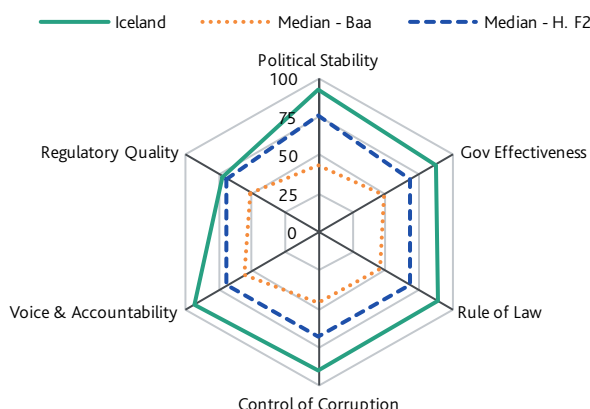


In Moody's methodology, institutional strength reflects an assessment of the efficiency and predictability of government action as well as the transparency and degree of consensus on key policy goals. A key question is whether existing institutions are conducive to respecting the terms of contracts, in particular those that concern debt payments. We use both quantitative and qualitative indicators to assess a sovereign's institutional strength.

In terms of quantitative indicators, Iceland scores very highly, although the country's relative position has worsened since the crisis on account of the deterioration in the macroeconomic situation. In 2011, Iceland ranked at the 88<sup>th</sup> percentile of the World Bank's indicators of "Government Effectiveness" and 89<sup>th</sup> percentile of "Rule of Law", well above the Baa and A rating category medians and more consistent with Aa median levels, 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, a flexible labour market and well-developed infrastructure.<sup>7</sup> Also, Iceland has a long tradition of broad cooperation and consensus on economic matters between government, employer and employee associations, which is a credit strength.

<sup>7</sup> See World Economic forum: Global Competitiveness Report 2012-13.

FIGURE 7  
World Bank Governance Indicators



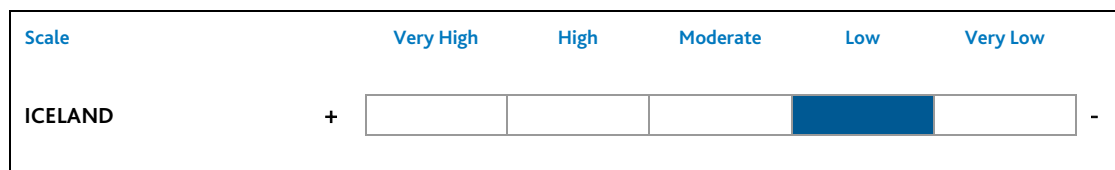
Source: World Bank

Moreover, Moody's notes that the Icelandic authorities have made significant progress in returning the economy, the banking sector and the public finances to a sounder footing and have made wide-ranging changes to the institutional and regulatory frameworks so as to avoid another crisis. Supervision and regulation of the banking sector have been significantly strengthened and collaboration between the central bank and the banking regulator FME has been improved markedly.<sup>8</sup> While the authorities still deal with the aftermath of the collapse of its oversized banking system in October 2008 (see Factor 4 - Susceptibility to Event Risk), its much smaller size, high capitalisation and purely domestic focus limit the risks emanating from the sector.

The crisis also exposed the weak fiscal framework of local governments, some of which had to restructure their liabilities with domestic and international lenders. A new Local Government Act was passed in September 2011, which restricts the local authorities' ability to run large budget deficits and raise new debt, and aligns their fiscal policy stance more closely with that of the central government. In 2012, the local government sector ran a deficit of 0.3% of GDP, compared to around 1% of GDP over the period 2008-2010. On the other hand, the implementation of the new Organic Budget Law has been delayed and is now only expected to reach parliament in the autumn. As pointed out by the IMF, the introduction of a medium-term fiscal framework would be a positive development for the country's public finances, especially considering Iceland's history of a pro-cyclical fiscal policy stance.<sup>9</sup>

### High Public Debt Continues To Constrain Iceland's Credit Standing

#### Factor 3 – Government Financial Strength: Low

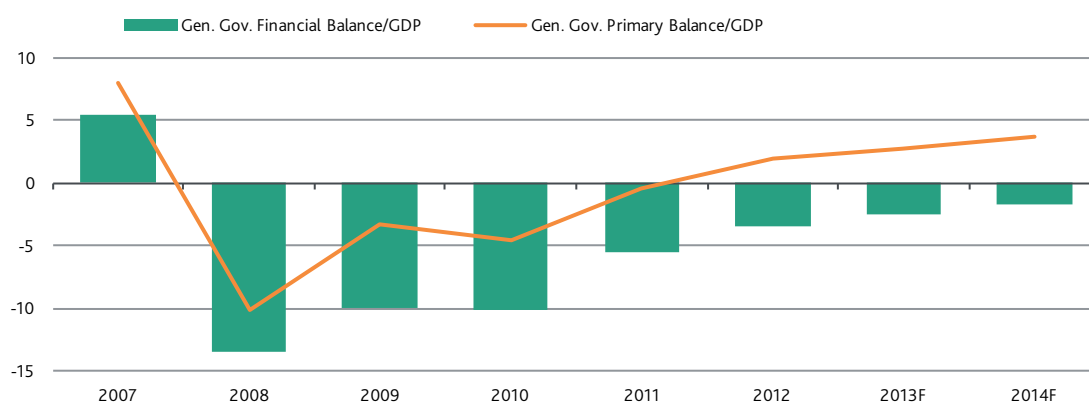


<sup>8</sup> The establishment of a Financial Stability Council is in preparation. The key function of the Council is to ensure a clear distribution of responsibilities for financial stability and better coordination in the event of a crisis. The Special Investigative Committee on the collapse of the Icelandic banks in October 2008 found that the lack of communication and of a coordinated response by the relevant institutions contributed to the severity of the crisis. See [Report of the Special Investigation Commission \(SIC\)](#)

<sup>9</sup> See IMF: Iceland: Technical Assistance Report on a new Organic Budget Law, January 2012. See also OECD Economic Surveys: Iceland 2013.

Iceland has made significant progress in bringing its public finances closer to a sustainable path, reducing the general government budget deficit from a high of 13.5% of GDP in 2008 to 3.4% of GDP in 2012 (including write-offs and cost of bank recapitalisation). Excluding these one-off factors the deficit was in line with earlier expectations at 2.4% of GDP. While higher than originally budgeted, the fiscal effort was nevertheless strong enough to achieve the first primary surplus (1.9% of GDP) since 2007.

FIGURE 8  
General Government Budget Balance (% of GDP)



Source: Haver, Moody's

A material reduction 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. The current medium-term fiscal plan targets an increasing primary surplus and an overall surplus of the budget in 2014. This should be feasible: Iceland has a strong track record of running primary surpluses for an extended period of time, with the average primary surplus in the period 2000-05 (prior to the boom years) at 3% of GDP. According to IMF calculations, the average cyclically-adjusted primary surplus needed to engineer a meaningful reduction in the public debt ratio in the coming years is around 2% of GDP.<sup>10</sup>

However, this will require an ongoing strong political commitment on the part of the new government and a continuation of the economic recovery, as the debt trend is very sensitive to the growth outlook. In addition, the government currently benefits from an artificially low interest rate level in Iceland – due to the limited availability of investment alternatives as a result of capital controls – and this will almost certainly change once the controls are gradually lifted. Non-resident investors currently hold close to 45% of all Treasury Bills and 22% of all government bonds (data as at end-June 2013).

The 2013 budget targets a broadly balanced budget for the central government and a significant primary surplus of 3.2% of GDP. Our forecasts assume a larger deficit (2.6% of GDP for the general government sector), given that the economy has lost momentum and hence tax revenues are likely to fall short of the budget targets.<sup>11</sup> In addition, parliament passed a bill that modified the fisheries levy, which will reduce the revenues from this source by an estimated 0.2% of GDP compared to budget this year. However, the debt ratio would continue its declining trend even under our more pessimistic public-finance forecasts. The new government will present its first budget in October 2013 for the

<sup>10</sup> See IMF: Fiscal Monitor, April 2013.

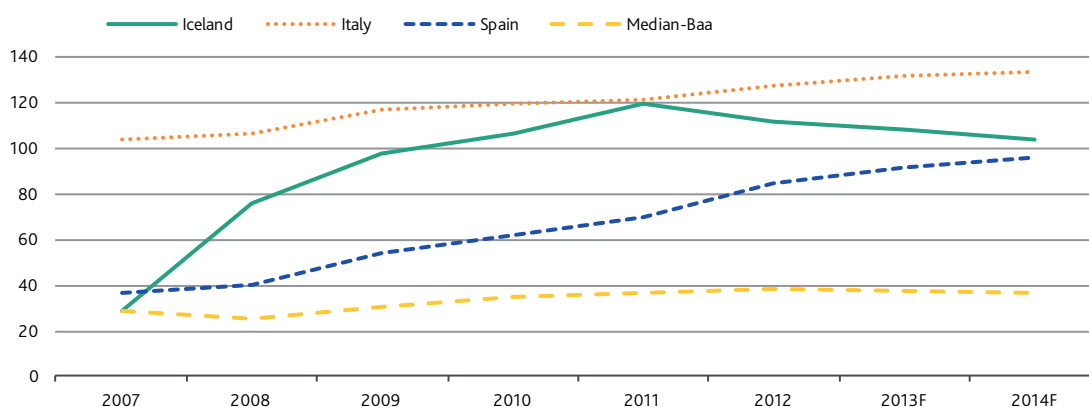
<sup>11</sup> The 2013 budget was based on a real GDP growth rate of 2.7%. Central government budget execution data for January– May 2013 (cash basis) show an increase in revenues of 3.5% year-over-year while the budget assumes an increase of 6.1% for the whole year (compared to 2012 outcome). Source: Ministry of Finance, Statistics Iceland.



coming year, which should give clear indications of its fiscal plans and the speed of fiscal consolidation going forward.

Further reductions in the general government debt ratio are key to an improvement in Iceland's rating. The debt ratio – even though it is now on a declining path – remains significantly higher than the median of the Baa rating category. Several other high-income countries in Europe, rated in the Baa rating category like Iceland, have similarly high debt ratios and are further away from achieving a stabilisation or decline (see exhibit below). However, their economies tend to be far larger, more diversified and less volatile than Iceland's.

FIGURE 9  
General Government Debt (% of GDP)



Source: Haver, Moody's

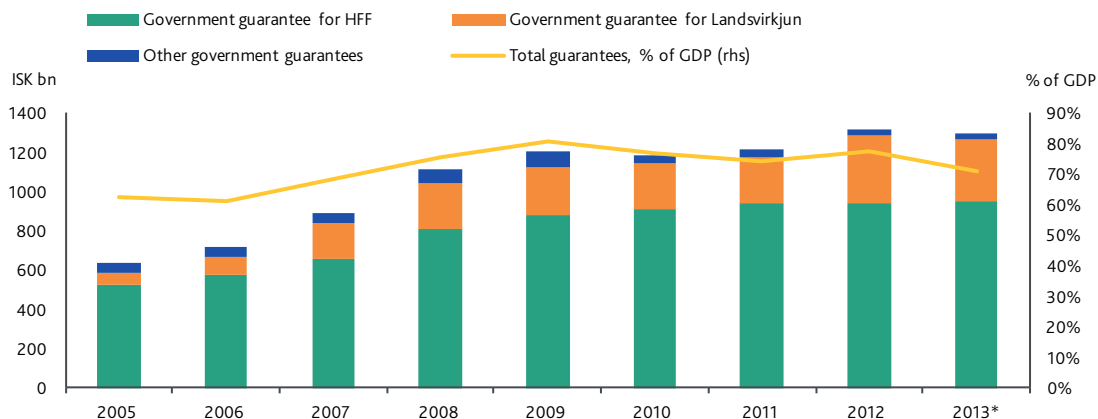
In addition, Iceland's government has assumed very large contingent liabilities in the form of guarantees, the most significant of which were extended to the Housing Financing Fund (HFF) (rated caa1 on standalone basis, final rating Ba1, stable). The HFF has twice required government financial support in the past two years and in our opinion the company is quite likely to require further capital injections. Government guarantees to HFF amount to 52% of GDP.<sup>12</sup> In a positive step, the government implemented measures to improve the supervision of HFF's activities and to limit its ability to extend high-value loans last year.

We are somewhat less concerned about the state-owned utility Landsvirkjun, whose operating performance has improved substantially and which has obtained funding from abroad since 2011 (government guarantees to Landsvirkjun amount to 17% of GDP).

<sup>12</sup> We rate HFF one notch lower than the government despite the evidence of strong support as the stand-alone credit profile of the entity is extremely weak. See Moody's press release: [Moody's downgrades Iceland's Housing Financing Fund to Ba1; outlook stable](#).

FIGURE 10

## General Government Guarantees



\* As of May 2013

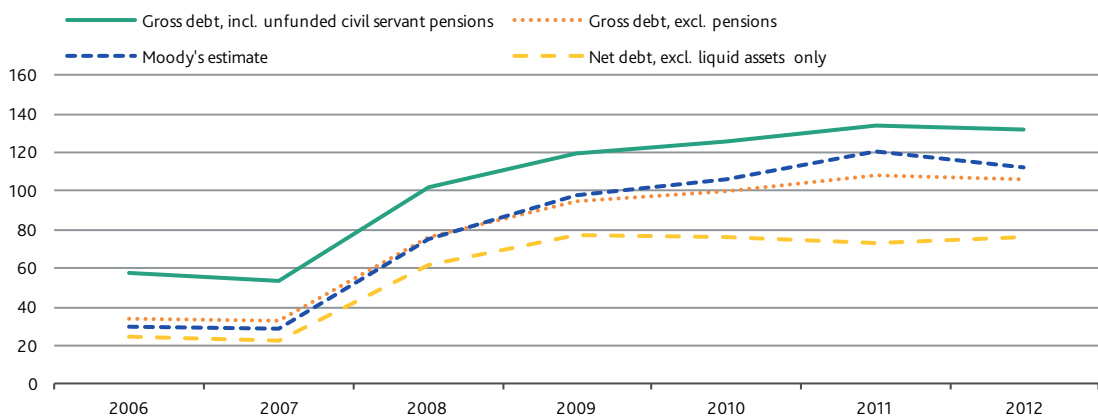
Source: Iceland Debt Management Agency, Moody's

At the same time, we acknowledge several features that positively differentiate Iceland from many other countries with large debt burdens. Firstly, Iceland has a fully funded private pension system, with assets amounting to around 138% of GDP (as of May 2013), which significantly bolsters the government's long-term fiscal sustainability. The civil servants pension scheme is the only unfunded pension obligation of the state, amounting to approximately 25% of GDP. In contrast to European countries, Iceland's Statistics Institute has started to include these into the public debt numbers.

Secondly, the government holds substantial liquid assets (currency and deposits) to the tune of 30% of GDP. In net terms, Iceland's general government debt therefore stands at around 76% of GDP (2012), broadly in line with many EU countries. Our debt ratios are higher than those of the government as we include the loans extended by the IMF and Norway to the central bank (to bolster the foreign-exchange reserves) in our public debt calculations. The trend is similar irrespective of the exact definition.

FIGURE 11

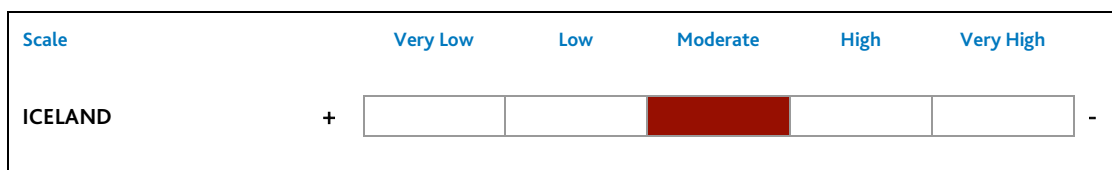
## General Government Debt (% of GDP)



Source: Statistics Iceland, Moody's. Moody's estimates include loans from IMF and Norway

## Too Rapid Loosening of Capital Controls Is Key Event Risk

### Factor 4 – Susceptibility to Event Risk: Moderate



An excessively rapid relaxation of capital controls continues to constitute the largest event risk for Iceland going forward, as the potential capital outflows are substantial and could easily destabilise the currency. An important mitigating factor is the Icelandic authorities' awareness of such risks and the likely continuation of their gradual approach, as detailed in the capital account liberalisation strategy of March 2011.<sup>13</sup> The parliament has also removed any explicit expiration date of the controls earlier this year, allowing the authorities greater flexibility. In addition, with time progressing, the Icelandic authorities have obtained more clarity and information about the size and timing of potential capital outflows, which is a prerequisite to being able to manage the relaxation of the capital controls smoothly. Icesave is no longer an issue following the EFTA Court decision in Iceland's favour in February 2013.<sup>14</sup>

At the same time, it is clear that maintaining the capital controls for too long has a clear cost to the economy, in terms of investment that is not taking place as the needed external funding is not forthcoming and investor confidence is low. In the latest Global Competitiveness Report (2012-13) by the World Economic Forum, foreign-currency regulations were cited by Icelandic business owners as the most problematic factor by a large margin. There is also a risk of asset-price distortions given the limited investment options for both households and the Icelandic pension funds.

Thus far, the central bank has managed to release the most "impatient" foreign holdings of Icelandic kronur assets through a series of foreign-currency auctions.<sup>15</sup> According to latest information from the central bank, these holdings stand at ISK363 billion (20% of GDP as of April 2013), compared to ISK657 billion or 37% of GDP in late 2008 when the capital controls were imposed. However, it has become clear that two other sources of potentially large and destabilising capital outflows need to be resolved, before the next (and more substantive) steps to relax the capital controls can be taken. Negotiations over both issues are currently under way and the Icelandic authorities expect a conclusion of these in the coming months, paving the way for the next steps in relaxing the capital controls. However, full abolition of the controls – including those for residents – is unlikely for some time.

- 1) **Renegotiation of the asset values in the estates of the failed banks.** Two of the three failed banks are in the process of negotiating agreements with their creditors with effect on the distribution of the assets in the estates. The central bank estimates that foreign creditors will receive 95% of the assets in the estates, while 33% of the assets are domestic. The net result is that domestic assets amounting to ISK770 billion will be acquired by foreign creditors (around 45% of 2012 GDP). Of these and excluding the equity stake in the new banks, assets worth an estimated ISK210 billion (12% of GDP) are denominated in Icelandic kronur.<sup>16</sup> Their transfer to foreign creditors would therefore result in significant pressure on the exchange rate, particularly if distributed over a

<sup>13</sup> According to the strategy document, controls on unstable foreign ISK holdings are to be removed first, before controls on residents are lifted in full.

<sup>14</sup> See [Iceland: EFTA Court Decision Frees Iceland from Failed Landsbanki Liabilities, a Credit Positive](#)

<sup>15</sup> In total the auctions attracted new investment in Iceland of around 8% of GDP. See Central Bank of Iceland: Financial Stability Report, April 2013.

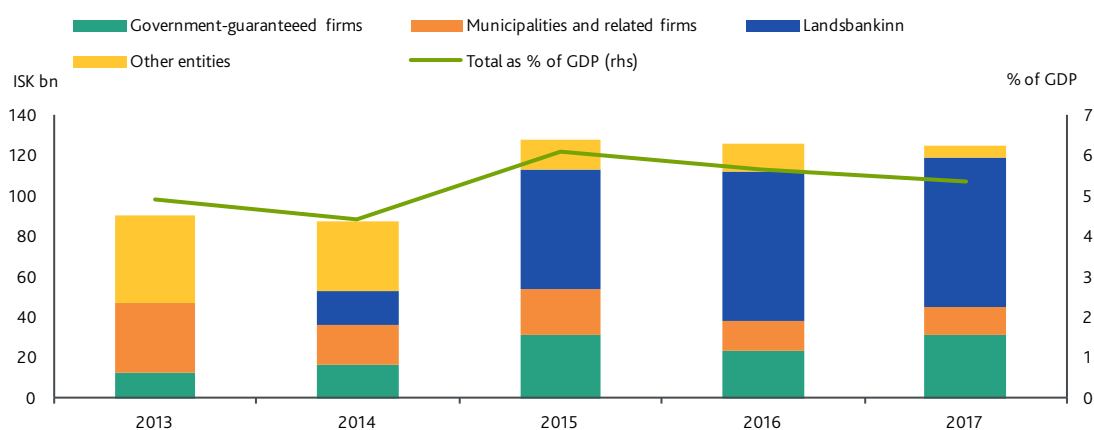
<sup>16</sup> See Central Bank of Iceland: Financial Stability Report, April 2013.

short period of time. However, the resolution process of the estates of the failed banks may result in a write-down of the value of these domestic assets.

- 2) **Refinancing or maturity extension of Landsbankinn bonds.** The foreign-currency bonds were issued by the new Landsbankinn to the failed Landsbanki (LBI) to compensate for the difference in the value of assets and domestic deposits transferred to the new bank. The outstanding amount is approximately ISK300 billion (16.5% of GDP) with the first significant payments due in 2015 and 2016.<sup>17</sup>

In addition, the repayment schedule of private Icelandic borrowers for the coming years is heavy (see Exhibit 12). Several of the entities do not have foreign-currency earnings and their repayment needs will therefore exert pressure on the exchange rate, unless they manage to refinance their upcoming maturities with foreign creditors.<sup>18</sup> The central bank estimates that over the period 2014-17 domestic entities other than the government and the central bank need to refinance on average around ISK116 billion or 5.4% of GDP per annum. Against these payments due, the underlying current account surplus stands at only around 4% of GDP. The country's foreign-currency reserves amount to ISK490 billion (27% of GDP) as of May 2013.

FIGURE 12  
External Payments Due



Source: Central Bank of Iceland, Moody's

The banking sector would clearly be heavily affected by a relaxation of capital controls given that a substantial share of the assets of both the “trapped” investors and the estates of the failed banks are currently deposited at the new banks. At the same time, banks have very limited funding alternatives to deposits.<sup>19</sup> However, we do not consider this a risk to the sovereign's creditworthiness given the banks' high levels of liquidity and capital (with the exception of HFF, as discussed earlier). Liquidity rules have been tightened in October 2012, requiring full coverage of the estates' deposits with liquid assets. The central bank intends to further strengthen the liquidity rules in the autumn, essentially following the Basel III liquidity framework.

<sup>17</sup> Landsbankinn made an advance payment in early 2012, amounting to ISK 73 billion. See also Central Bank of Iceland, Financial Stability Report, April 2013.

<sup>18</sup> In contrast, the government has substantially reduced its own repayment schedule by pre-paying around half of the obligations to the IMF and the Nordic countries. See Issuer Comments entitled “Iceland: Early part-repayment of IMF and Nordic loans is positive”, March 2012 and “Iceland's Prepayments on IMF and Nordic Government Loans are Credit Positive”, June 2012.

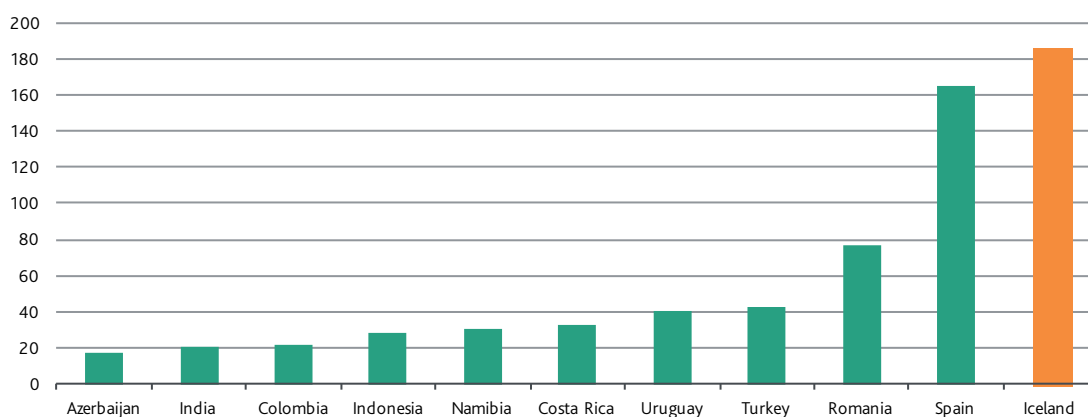
<sup>19</sup> According to the central bank around 17% of total deposits fall under these categories.

### External vulnerability is lower than headline numbers suggest

Iceland's external position is heavily influenced by the settlement of the estates of the failed banks and other Icelandic entities in winding-down proceedings. It is highly likely that a large share of their external liabilities will have to be written off upon settlement of the estates. As most estates are in advanced stages of reaching a settlement with their creditors, there is now more clarity over the share of liabilities that will realistically be repaid. The central bank has started to calculate the underlying external position of Iceland (also excluding the accrued interest payments on the large intra-company debt of Actavis).<sup>20</sup> According to these calculations, Iceland's underlying net external debt amounts to around 186% of GDP as at year-end 2012, compared to the headline external debt of 782% of GDP. Going forward, Iceland's external vulnerability will therefore be considerably smaller than the current headline numbers suggest. Still, Iceland's external debt levels continue to be significantly higher than those of most other sovereigns.

FIGURE 13

#### External Debt of Baa3 Rated Sovereigns (2012, % of GDP)



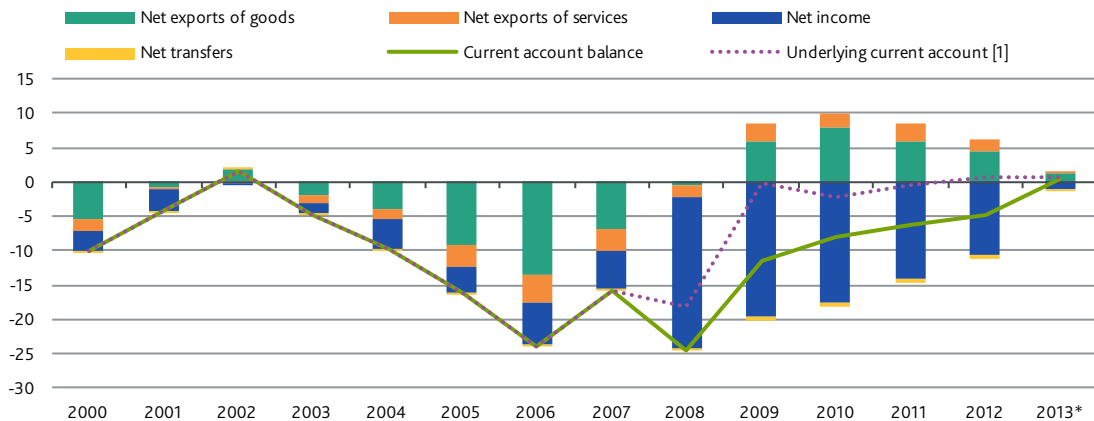
Source: Various central banks, IMF

The current account balance presents a similar picture. While the headline balance posted a deficit of close to 5% of GDP in 2012, the underlying balance was in surplus to the tune of 3% of GDP. For 2013, we expect a surplus of 4.7% of GDP. Iceland's trade balance has shifted into a sustained surplus since 2009, amounting to 6.3% of GDP in 2012, compared to a peak deficit of 17.5% of GDP in 2006.

<sup>20</sup> Actavis is a pharmaceutical company which sells all its products abroad but has intra-company liabilities amounting to around 50% of Iceland's GDP. According to international accounting standards, accrued interest has to be recorded in Iceland's balance of payments. The company was acquired by a US company last year. See Central Bank of Iceland: Iceland's underlying external position and balance of payments, March 2013.

FIGURE 14

**Current Account and Components (% of GDP)**

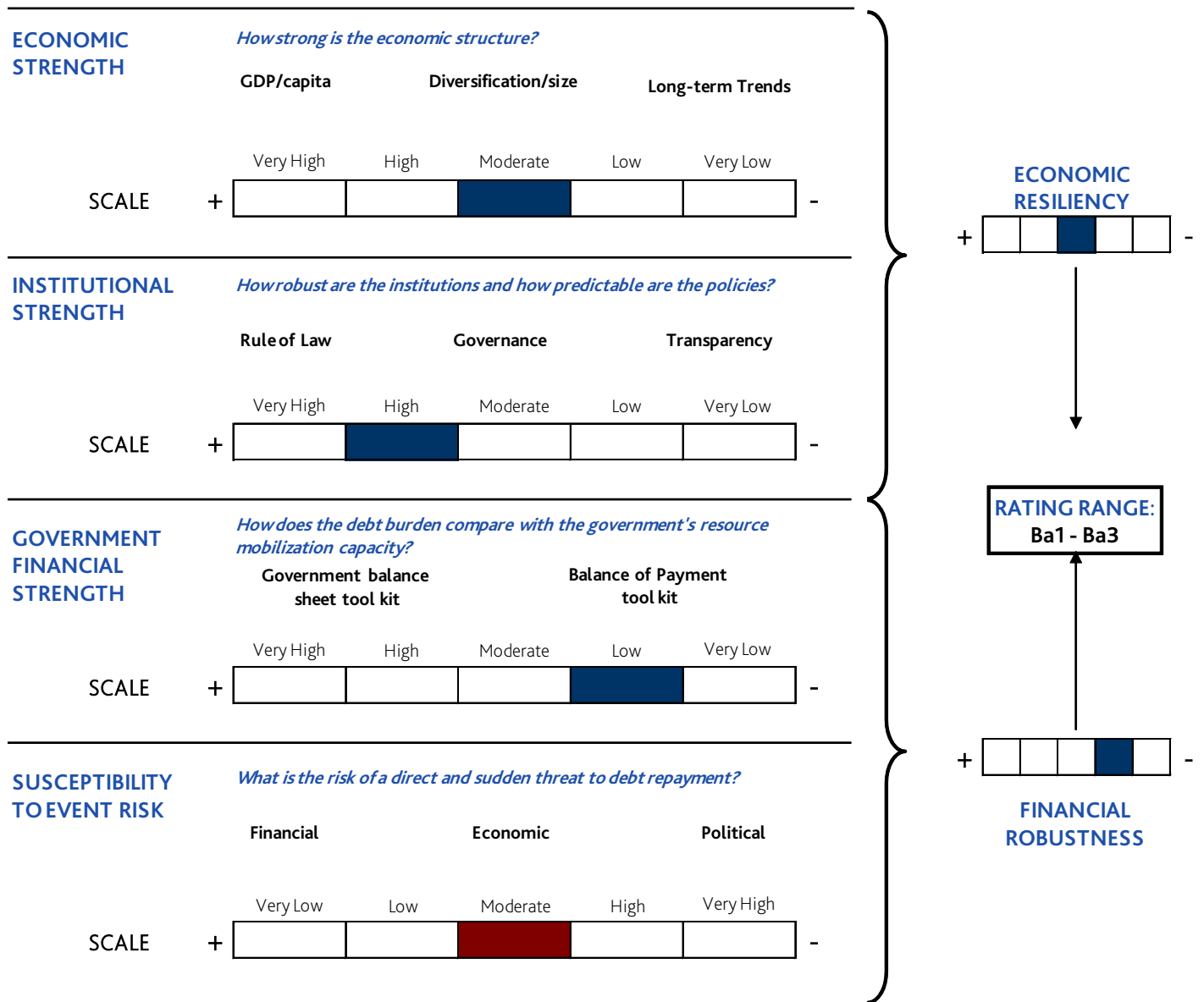


\* as of Q1 2013.

[1] Excludes DMBs undergoing winding-up proceedings and accrued interest payments on intra-company debt of Actavis.

Source: Central Bank of Iceland, Moody's

### Sovereign Rating Mechanics<sup>21</sup>: Iceland



<sup>21</sup> [Link to our Sovereign Bond Rating Methodology](#)

## Rating History

## Iceland

	Foreign Currency Ceilings				Government Bonds		Outlook	Date
	Bonds & Notes		Bank Deposit		Foreign Currency	Local Currency		
	Long-term	Short-term	Long-term	Short-term				
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	Baa2	P-3	Baa3	P-3	Baa3	Baa3	--	November-09
Rating Lowered	A2	P-2	Baa1	P-2	Baa1	Baa1	Negative	December-08
Rating Lowered & Review for Downgrade	Aa1	--	A1	--	A1	A1	RUR-	October-08
Review for Downgrade	--	--	--	--	Aa1	Aa1	RUR-	September-08
Rating Lowered	--	--	Aa1	--	Aa1	Aa1	Stable	May-08
Outlook Changed	--	--	--	--	Aaa	Aaa	Negative	March-08
Rating Raised	Aaa	--	Aaa	--	Aaa	--	Stable	October-02
Rating Assigned	--	--	--	--	--	Aaa	--	July-97
Rating Raised	Aa3	--	Aa3	--	Aa3	--	Stable	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

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
<b>Economic Structure and Performance</b>												
GDP Nominal (US\$ Bil.)	10.97	13.25	16.29	16.65	20.43	16.83	12.12	12.56	14.07	13.66	15.07	15.28
Population (Mil.)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.322	0.324
GDP per capita (US\$)	37,890	45,370	54,885	54,814	65,566	53,029	38,038	39,505	44,118	42,678	46,816	47,159
GDP per capita (PPP basis, US\$)	30,762	33,790	34,889	35,849	37,131	39,718	37,410	35,506	36,483	--	--	--
Nominal GDP (% change, local currency)	3.1	10.5	10.3	13.9	12.0	13.1	1.2	2.5	6.3	4.7	6.4	7.1
Real GDP (% change)	2.4	7.8	7.2	4.7	6.0	1.2	-6.6	-4.1	2.9	1.6	1.8	2.5
Inflation Rate (CPI, % change, Dec/Dec)	2.8	3.9	4.1	7.0	5.9	18.1	7.5	2.5	5.3	4.2	4.1	3.9
Gross Investment/GDP	19.8	23.5	28.2	35.6	29.0	24.6	13.9	12.5	14.3	14.6	12.8	13.8
Gross Domestic Savings/GDP	16.7	17.9	15.9	17.4	18.3	21.8	22.5	22.6	22.9	20.9	21.0	21.3
Nominal Exports of G & S (% change, US\$ basis)	12.8	20.0	14.5	3.9	31.8	5.6	-14.4	10.6	17.5	-2.8	11.9	2.3
Nominal Imports of G & S (% change, US\$ basis)	28.2	28.4	36.2	17.2	10.2	-14.2	-32.5	8.5	22.5	1.4	8.3	3.7
Openness of the Economy <sup>[1]</sup>	71.6	73.8	75.7	82.7	80.0	91.6	97.1	102.6	109.7	112.1	111.9	113.7
Government Effectiveness <sup>[2]</sup>	2.12	2.12	1.99	1.86	1.79	1.82	1.65	1.58	1.57	--	--	--
<b>Government Finance</b>												
Gen. Gov. Revenue/GDP	42.8	44.0	47.1	48.0	47.7	44.1	41.0	41.5	41.7	43.1	43.1	42.7
Gen. Gov. Expenditure/GDP	45.6	44.0	42.2	41.6	42.3	57.7	51.0	51.6	47.3	46.5	45.7	44.3
Gen. Gov. Financial Balance/GDP	-2.8	0.0	4.9	6.3	5.4	-13.5	-9.9	-10.1	-5.6	-3.4	-2.6	-1.7
Gen. Gov. Primary Balance/GDP	-0.1	2.5	7.1	8.5	8.0	-10.2	-3.4	-4.5	-0.4	1.9	2.8	3.6
Gen. Gov. Debt (US\$ Bil.) <sup>[3]</sup>	4.84	5.24	4.14	4.91	6.03	9.25	11.74	14.20	16.01	14.89	15.82	15.54
Gen. Gov. Debt/GDP <sup>[3]</sup>	40.8	34.4	25.4	30.1	28.5	75.4	97.9	106.4	120.4	112.4	109.1	104.7
Gen. Gov. Debt/Gen. Gov. Revenue <sup>[3]</sup>	95.4	78.2	53.9	62.8	59.8	170.7	238.7	256.4	288.6	261.2	253.1	245.4
Gen. Gov. Int. Pymt/Gen. Gov. Revenue	6.4	5.5	4.7	4.5	5.4	7.6	16.0	13.3	12.4	12.4	12.3	12.5
Gen. Gov. FC & FC-Indexed Debt/GG Debt <sup>[3]</sup>	56.1	51.9	40.9	55.8	46.8	39.3	37.8	35.9	40.7	30.6	29.5	27.1
<b>External Payments and Debt</b>												
Nominal Exchange Rate (local currency per US\$, Dec)	71.0	61.0	63.0	71.7	61.9	120.6	124.9	115.1	122.7	129.0	125.3	131.1
Real Eff. Exchange Rate (% change)	6.3	3.0	12.4	-7.0	5.5	-21.4	-19.2	5.0	1.4	-0.3	--	--
Current Account Balance (US\$ Bil.) <sup>[4]</sup>	-0.5	-1.3	-2.6	-4.0	-3.2	-4.1	1.0	0.9	0.5	0.4	0.8	0.5
Current Account Balance/GDP <sup>[4]</sup>	-4.8	-9.8	-16.2	-23.8	-15.7	-24.6	8.0	7.2	3.3	3.1	5.1	3.2
External Debt (US\$ Bil.) <sup>[5]</sup>	16.5	27.2	46.6	72.5	120.1	122.7	28.9	28.7	29.3	25.4	24.9	23.8
Public Sector External Debt/Total External Debt <sup>[5]</sup>	18.8	12.8	5.3	4.7	3.3	5.6	23.4	25.5	29.5	25.3	23.9	29.3
Short-term External Debt/Total External Debt <sup>[5]</sup>	22.1	18.7	15.9	16.9	34.3	37.7	10.6	10.2	7.0	7.2	8.2	7.5
External Debt/GDP <sup>[5]</sup>	150.9	205.6	285.9	435.2	588.1	728.8	238.8	228.2	208.1	185.7	165.2	155.9
External Debt/CA Receipts <sup>[4][5][6]</sup>	400.5	547.7	708.3	914.5	1045.8	1384.2	425.7	404.0	331.1	289.8	268.1	253.8
Interest Paid on External Debt (US\$ Bil.) <sup>[5]</sup>	0.3	0.4	0.8	1.9	3.1	3.3	0.3	0.5	0.5	0.3	0.6	0.6
Amortization Paid on External Debt (US\$ Bil.) <sup>[5]</sup>	2.1	2.6	3.7	5.1	18.1	10.8	1.9	1.3	4.4	0.8	0.9	1.8
Net Foreign Direct Investment/GDP	-0.4	-13.9	-24.6	-10.2	-16.5	30.5	-18.2	20.7	7.7	28.7	2.0	5.0
Net International Investment Position/ GDP <sup>[5]</sup>	-67.6	-76.2	-84.5	-100.7	-115.6	-504.7	-72.9	-74.7	-53.1	-59.1	--	--
Official Foreign Exchange Reserves (US\$ Bil.)	0.8	1.0	1.0	2.3	2.5	3.5	3.6	5.6	7.7	4.0	4.8	5.3
Net Foreign Assets of Domestic Banks (US\$ Bil.)	-1.5	-0.8	3.2	9.1	-24.3	-0.8	-0.1	0.7	1.7	2.0	--	--

## Iceland

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012F	2013F	2014F
<b>Monetary, Vulnerability and Liquidity Indicators</b>												
M2 (% change Dec/Dec)	17.5	14.9	23.2	19.4	56.8	32.1	-1.1	-9.9	8.7	-2.7	--	--
Monetary Policy Interest rate (% per annum, Dec 31)	5.3	8.3	10.5	14.3	13.8	18.0	10.0	4.5	4.8	6.0	--	--
Domestic Credit (% change Dec/Dec)	28.2	39.3	62.8	43.1	15.4	-33.0	-0.5	-6.5	-5.9	1.5	--	--
Domestic Credit/GDP	130.3	164.2	242.4	304.6	314.0	185.9	182.8	166.7	147.7	143.2	--	--
M2/Official Forex Reserves (X)	8.6	8.6	10.3	4.8	7.8	3.9	3.5	2.3	1.7	2.9	--	--
Total External Debt/Official Forex Reserves	2,164.4	2,678.6	4,614.8	3,187.7	4,713.4	3,518.9	795.2	515.9	379.9	627.4	517.9	450.0
Debt Service Ratio <sup>[7]</sup>	56.8	59.6	68.3	88.0	184.2	159.5	32.4	25.5	54.8	12.5	16.8	24.8
External Vulnerability Indicator <sup>[8]</sup>	1,099.3	815.1	865.3	1,242.7	1,333.2	2,039.5	1,379.1	121.6	131.7	36.9	68.1	78.9
Liquidity Ratio <sup>[9]</sup>	163.8	95.1	110.8	74.9	162.4	233.8	309.7	151.1	147.9	49.0	--	--
Total Liab. due BIS Banks/Total Assets Held in BIS Banks	466.2	359.4	312.6	205.9	305.2	400.6	525.0	231.5	246.5	125.9	--	--

## 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] From 2009 excludes DMBs undergoing winding-up proceedings and Actavis

[5] From 2009 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] Liabilities to BIS Banks Falling Due Within One Year/Total Assets Held in BIS Banks

## Moody's Related Research

### Issuer Comments:

- » [Iceland: EFTA Court Decision Frees Iceland from Failed Landsbanki Liabilities, a Credit Positive, January 2013 \(149659\)](#)
- » [Iceland's Prepayments on IMF and Nordic Government Loans Are Credit Positive, June 2012 \(143316\)](#)
- » [Iceland: Early part-repayment of part of IMF and Nordic loans is positive, March 2012 \(140810\)](#)

### Special Comment:

- » [Cyprus: Lessons on Capital Controls from Iceland, May 2013 \(153572\)](#)

### Rating Action:

- » [Moody's changes outlook on Iceland's Baa3 rating to stable from negative, February 2013](#)

### Credit Opinion:

- » [Iceland, Government of](#)

### Rating Methodology:

- » [Sovereign Bond Ratings, September 2008 \(109490\)](#)

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