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Update

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# Government of Iceland – Baa2 RUR+

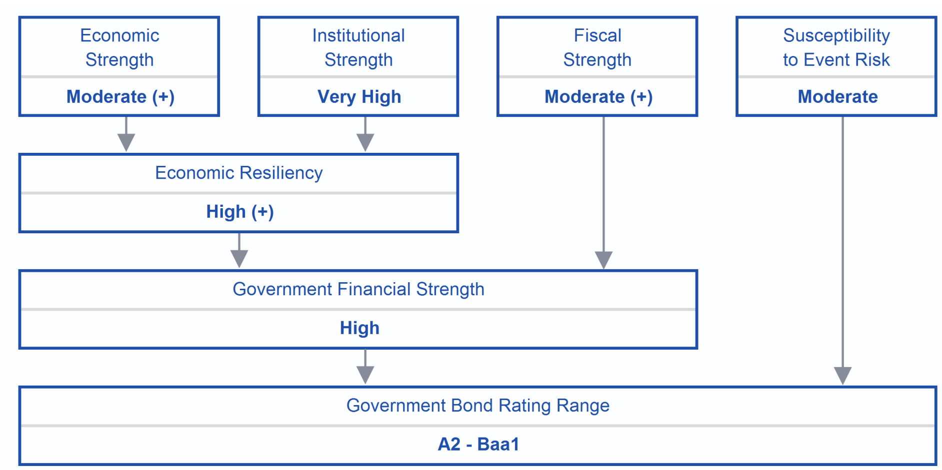
## Update Following Initiation of Review for Upgrade

## Summary Rating Rationale

» Iceland's **credit strengths** include (1) economic flexibility and wealth, which provide significant shock absorption capacity; (2) a deep natural resource base that affords robust growth potential; (3) strong institutions focused on avoiding vulnerabilities that led to 2008 banking sector collapse; and (4) a well-funded pension system, long working lives and favorable demographics

» Iceland's **credit challenges** include (1) a very small economy subject to high volatility; (2) substantial, albeit reduced, exposure to external risks, which requires careful management of capital account liberalization to protect economic and financial stability; and (3) large contingent liabilities derived from state-owned companies

Exhibit 1
**Iceland's Baa2 RUR+ rating is determined by four factors**




*Source: Moody's Investors Service*

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

## Key Indicators

**Iceland**

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015E | 2016F | 2017F |
|---|---|---|---|---|---|---|---|---|
| Real GDP (% change) | -3.6 | 2.0 | 1.2 | 4.4 | 2.0 | 4.0 | 5.0 | 3.5 |
| Inflation (CPI, % change, Dec/Dec) | 2.5 | 5.3 | 4.2 | 4.1 | 0.8 | 1.9 | 2.3 | 4.2 |
| Gen. Gov. Financial Balance/GDP (%) | -9.8 | -5.6 | -3.7 | -1.8 | -0.1 | -0.5 | -0.7 | -1.0 |
| Gen. Gov. Primary Balance/GDP (%) | -5.0 | -1.4 | 1.0 | 2.7 | 4.7 | 3.9 | 2.9 | 1.9 |
| Gen. Gov. Debt/GDP (%) | 100.2 | 115.2 | 100.2 | 91.3 | 84.7 | 68.5 | 58.0 | 50.0 |
| Gen. Gov. Debt/Revenues (%) | 252.9 | 287.1 | 240.5 | 216.8 | 187.1 | 162.2 | 136.5 | 116.3 |
| Gen. Gov. Interest Payment/Revenues (%) | 12.0 | 10.3 | 11.3 | 10.9 | 10.4 | 10.5 | 8.4 | 6.8 |
| Current Account Balance/GDP (%)[1] | -0.9 | -0.5 | 0.5 | 7.2 | 5.0 | 4.8 | 2.9 | 1.2 |
| External Debt/CA Receipts (%)[2][3] | 504.9 | 409.6 | 366.1 | 410.3 | 358.5 | 307.1 | 236.3 | 224.8 |
| External Vulnerability Indicator [4] | 104.7 | 142.0 | 43.1 | 67.5 | 108.1 | 52.3 | 48.0 | 47.7 |

[1] Excludes DMBs undergoing winding up in 2008-2015.
[2] Current Account Receipts
[3] The services component of current account receipts is not adjusted to account for FISIM services related to the DMBs undergoing winding up. The primary income receipts are adjusted to account for FISIM services related to the DMBs undergoing winding up.
[4] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/ Official Foreign Exchange Reserves

## Summary Rating Rationale (continued)

We placed Iceland's issuer and government Baa2 issuer and bond ratings on review for upgrade in June 2016.

Among the key credit strengths supporting Iceland's Baa2 credit rating are its high levels of wealth and strengthening economic dynamism thanks to favorable demographics and improving household, corporate and government balance sheets. Accumulated wealth provided an important buffer during the severe economic adjustment of the past several years. The recent economic recovery is on a more sustainable footing than was growth in the pre-crisis era given the rebalancing of the economy and large external surpluses, which are bringing down the country's once-sizeable public and external debt.

The country's public finances have improved significantly, and the government's gross debt burden – while still high – has declined rapidly from 2012 onwards. If the government's large cash buffers are taken into account, the public debt is at a moderate level in the European context. In addition and in contrast to many other highly-indebted European countries, Iceland has a nearly fully funded private pension system, which 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 owing to the banking and currency crisis of 2008, with the five-year average at $42,949 on a PPP basis as of 2015. This positions Iceland in the same territory as Aa-rated sovereigns (median per-capita GDP in 2015 of $43,585) and as a clear outlier in the Baa rating range ($20,602).

In addition to high income levels, Icelandic households possess substantial pension assets amounting to more than 100% of GDP. This is not only positive for the long-term underlying fiscal position of the country, but has also allowed a relatively smooth adjustment process following the banking system's collapse as households could temporarily withdraw money from their pension savings for debt repayment and consumption purposes. Offsetting the high level of wealth are the small size and limited diversification of the economy, which increase its vulnerability to shocks.

We assess Iceland's Institutional Strength as `very high', reflecting the country's strong scores on the Worldwide Governance Indicators (WGI). Iceland ranks at the 86th percentile of the WGI's measure of "Government Effectiveness" and the 87th percentile of "Rule of Law", well above the Baa and A rating category medians. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative business sector, an efficient labor market and well-developed infrastructure.

In addition, the authorities have made significant progress in bringing the economy, the financial system and the public finances back onto a sustainable path. The government has implemented important changes to its institutions and to the banking sector's regulatory framework – with the latter focusing on exclusively on domestic operations – so as to avoid a repetition of the crisis. Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between government, employer and employee associations, which is a credit strength.

We consider Iceland's Fiscal Strength to be `moderate (+)', a function of Iceland's relatively high, albeit declining, gross general government debt-to-GDP ratio. The foreign currency portion of the government's debt is also shrinking quickly, have fallen to 20.3% in 2015, exposing the sovereign balance sheet to less exchange rate risk. However, the government's contingent liabilities are very large, mainly guarantees for Housing Financing Fund (HFF) liabilities. A mitigating factor is the significant financial assets that the government has acquired as part of the resolution of the failed bank estates.

We assess Iceland's Susceptibility to Event Risk as `moderate', mainly reflecting the risks to economic and financial stability emanating from the process of capital control liberalization. Risks to financial stability from the banking sector have moderated significantly since the 2008 banking sector crisis. In our view, the banking system should be able to withstand the relaxation of capital controls, as the central bank and the banking regulator require the banks to maintain very high levels of liquidity and capital.

## Rating Outlook

We placed Iceland's Baa2 issuer and government bond ratings on review for upgrade on June 10, 2016. During the review, we will assess whether the government's new fiscal strategy and tax reform will further improve its debt sustainability in the medium term. We will also determine whether the upcoming auction of offshore krónur assets will be effective in reducing or containing vulnerabilities in the country's external position and thus facilitating the generalized liberalization of capital controls.

## Factors that Could Lead to an Upgrade

We would upgrade the Icelandic government's Baa2 ratings if our ratings review concludes that the government's current plans will likely be effective in reducing or containing the country's external vulnerabilities through the upcoming auctions and other measures recently announced, while securing a medium-term downward debt trajectory that would position the government's future debt levels significantly and persistently lower than Baa2-rated peers.

## Factors that Could Lead to Confirming the Current Baa2 Rating

Although less likely in light of the current review for upgrade, we would confirm the Icelandic government's Baa2 rating if we perceive that the government's financial strength is not expected to improve enough to position the rating more appropriately among higher-rated sovereigns.

## Recent Developments

In many respects, such as employment levels, real incomes, inflation rates and the size of real GDP, the Icelandic economy has recovered fully from the banking sector collapse of October 2008 and subsequent deep recession. The economy is now growing rapidly, led by robust household spending and investment, including expansion of the fast-growing tourist infrastructure. Moreover, the authorities are finally resolving the external debt overhang that led to the systemic crisis, which will allow the gradual removal of the capital account controls put in place at that time.

Iceland's economic recovery has also benefitted from favorable terms of trade and steady current account surpluses, also helped by extremely rapid growth of tourism income, higher global fish prices, lower oil prices and a strong dollar (boosting revenues from the mostly dollar-denominated export base). We expect growth to reach 5% this year, led by buoyant domestic demand and tourism.

We expect the current account surplus to narrow in the coming years as aggregate demand strengthens, pulling in imports, and as the benefits of lower oil prices tail off. Positive and sustained balance of payments dynamics have allowed the Central Bank (CBI) to purchase substantial foreign exchange in recent years, bolstering the country's external position and facilitating the upcoming auction of offshore krónur.

The impact of high public and private sector wage settlements on inflation has been kept in check by the tightening of monetary policy last year and the renewed downturn in oil prices. Inflation moderated to 1.7% yoy in May, below the Central Bank's 2.5% inflation target but barely changed from 1.6% in 2015. We nonetheless expect the Central bank will quickly tighten further in 2016 should upward inflation pressures develop that threaten to take price rises above the target.

A new Organic Budget Law (OBL) was approved at the end of 2015, which is extremely comprehensive and aims to improve accountability and supervision and provide process to developing fiscal policy. Following on from that law, the government recently announced its five-year Fiscal Strategy and a new tax reform package. All levels of government were involved in the preparation of the medium-term budget, which is intended to ensure that such fiscal problems as emanated from the municipal sector during and after the crisis will be avoided.

Iceland's capital control liberalization strategy unveiled in June 2015 underpins an improved outlook for Iceland's economy and government finances as the estates of the failed banks have now paid the equivalent of billions of dollars in cash and assets to the Icelandic authorities in order to settle their local obligations and gain access to the banks' foreign assets. The final resolution of the failed bank estates at the end of last year led to a significant reduction in Iceland's net external debt, which dropped to 5.7% of GDP at the end of 2015 following the write-off of the external claims on the failed bank estates.

The massive improvement in the external position serves as an important buffer to maintain the government's room to maneuver during the next phase of capital controls liberalization, the upcoming FX auction to buy back offshore krónur. On 16 June, in a voluntary auction, the central bank will offer to buy the entire remaining stock of offshore krónur (non-resident-owned domestic assets that were trapped in the country by the imposition of capital controls in November 2008), which amounts to about ISK320 billion (13% of GDP), for euros from its foreign exchange reserves.

According to the plan, the central bank will buy the offshore assets offered in the auction at euro exchange rates similar to the average rate at which its previous smaller auctions were held, offering more favorable exchange rates of up to ISK190 per euro the more that asset holders sell collectively. The upcoming auction gives investors whose money is currently trapped in offshore krónur an exit, if they so wish, and helps relieve some of the pressure that has built up on Icelandic domestic assets as a result of the capital controls, as reflected by a steep appreciation of the onshore exchange rate over the past two years.

The central bank will also continue to buy assets not tendered in the 16 June sale up until 1 November 2016 but at a less favorable exchange rate of ISK220 per euro. If the funds remain in the country, they can continue to be held as they are now, although offshore krónur invested in ISK-denominated Treasury bonds are no longer given an exemption from the Foreign Exchange Act that had previously permitted them to be rolled over into new bonds. In the interest of discouraging large speculative capital inflows, the government now limits offshore krónur to investments in bank deposits, treasury bills or lastly, central bank certificates of deposit.

The exercise to reduce and contain external vulnerability via the purchase of offshore krónur assets should help to further normalize the economy in the years ahead. In the third and final stage of capital control liberalization, which is likely to occur over the next one-two years, the government aims to implement an incremental release of the capital account restrictions on Icelandic residents, including pension funds, and then ultimately a general unfreezing of cross-border transactions in Icelandic krónur. That said, we anticipate that some form of capital flow mechanism such as was recently adopted to stem disruptive short-term capital flows in and out of the very small economy will be a permanent fixture.

## Rating Methodology and Scorecard Factors

### Rating Factors Grid - Iceland

| Rating Factors | Sub-Factor Weighting | Indicator | Factor Score |
|---|---|---|---|
| **Factor 1: Economic Strength** | | | M+ |
| **Growth Dynamics** | **50%** | | |
| Average Real GDP Growth (2011-20F) | | 3.1 | |
| Volatility in Real GDP Growth (Standard Deviation, 2006-15) | | 4.0 | |
| WEF Global Competitiveness Index (2015) | | 4.8 | |
| **Scale of the Economy** | **25%** | | |
| Nominal GDP (US$ billion, 2015) | | 17 | |
| **National Income** | **25%** | | |
| GDP per Capita (PPP, US$, 2015) | | 46,097 | |
| **Factor 2: Institutional Strength** | | | VH |
| **Institutional Framework and Effectiveness** | **75%** | | |
| Worldwide Government Effectiveness Index (2014) | | 1.5 | |
| Worldwide Rule of Law Index (2014) | | 1.7 | |
| Worldwide Control of Corruption Index (2014) | | 1.8 | |
| **Policy Credibility and Effectiveness** | **25%** | | |
| Inflation Level (%, 2011-20F) | | 3.2 | |
| Inflation Volatility (Standard Deviation, 2006-15) | | 3.7 | |
| **Economic Resiliency (F1xF2)** | | | H+ |
| **Factor 3: Fiscal Strength** | | | M+ |
| **Debt Burden** | **50%** | | |
| General Government Debt/GDP (2015) | | 68.5 | |
| General Government Debt/Revenues (2015) | | 162.2 | |
| **Debt Affordability** | **50%** | | |
| General Government Interest Payments/Revenue (2015) | | 10.5 | |
| General Government Interest Payments/GDP (2015) | | 4.4 | |
| **Government Financial Strength (F1xF2xF3)** | | | H |
| **Factor 4: Susceptibility to Event Risk** | **Max. Function** | | M |
| **Political Risk** | | | |
| Worldwide Voice & Accountability Index (2014) | | 1.4 | |
| **Government Liquidity Risk** | | | |
| Gross Borrowing Requirements/GDP | | 7.1 | |
| Non-Resident Share of General Government Debt (%) | | 36 | |
| Market-Implied Ratings | | Baa1 | |
| **Banking Sector Risk** | | | |
| Average Baseline Credit Assessment (BCA) | | -- | |
| Total Domestic Bank Assets/GDP | | 189 | |
| Banking System Loan-to-Deposit Ratio | | 123 | |
| **External Vulnerability Risk** | | | |
| (Current Account Balance + FDI Inflows)/GDP | | 7.1 | |
| External Vulnerability Indicator (EVI) | | 47.7 | |
| Net International Investment Position/GDP | | -5.9 | |
| **Government Bond Rating Range (F1xF2xF3xF4)** | | | **A2 - Baa1** |
| **Assigned Foreign Currency Government Bond Rating** | | **Baa2** | |

**Note:** While the information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range.
For more information please see our Sovereign Bond Rating Methodology

**Footnotes: (1) Rating Range:** Factors 1, Economic Strength, and Factor 2, Institutional Strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3, Fiscal Strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the preliminary Government Financial Strength rating range as given by combining the first three factors. **(2) 15 Ranking Categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- **(3) Indicator Value:** If not explicitly stated otherwise, the indicator value corresponds to the latest data available.

## Moody's Related Research

- **Rating Action:** Moody's places Iceland's Baa2 sovereign rating on review for upgrade, June 10, 2016
- **Issuer Comment:** Iceland Schedules Auction to Buy Offshore Kronur, a Credit Positive, 30 May 2016
- **Issuer Comment:** Iceland's Payment from Hold-Out Creditors Is Credit Positive for Sovereign, 5 October 2015
- **Credit Analysis**: Government of Iceland, 22 July 2015
- **Credit Focus**: Iceland, Government of: FAQ: Capital Controls and the New Liberalization Strategy, 15 July 2015
- **Country Statistics**: Iceland, Government of, 1 June 2016
- **Outlook**: Sovereigns - Global: Stable Outlook Despite Low Growth, Jittery Markets and Uneven Reforms, 4 November 2015
- **Rating Methodology**: Sovereign Bond Ratings, 18 December 2015

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