Moody's Investors Service

Rating Action: **Moody's changes outlook on Iceland's Baa3 rating to stable from negative**

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London, 07 February 2013 -- Moody's Investors Service has today changed the outlook on the Baa3 rating of the Government of Iceland to stable from negative. The country's Baa3/Prime-3 long and short-term ratings remain unchanged.

Moody's decision to revise the outlook to stable is based on the reduced event risk following the European Free Trade Association's (EFTA) Court decision in January, which adds to a series of positive developments in Iceland over the past 12 months.

RATIONALE FOR STABLE OUTLOOK

On 28 January 2013, the EFTA Court dismissed the EFTA Surveillance Authority's (ESA) case against Iceland for an alleged violation of its obligation under the European Union's Deposit Guarantee Directive. The Court's decision frees the Icelandic government of the potentially large costs related to the Icesave dispute with the British and Dutch governments. The liabilities associated with Icesave claims will instead remain fully and exclusively with the estate of the failed Landbanki. The EFTA Court decision is the most favourable possible outcome for the Icelandic government and removes a key negative event risk for the sovereign (see Moody's Issuer Comment, "Court Decision Frees Iceland from Failed Landsbanki Liabilities, a Credit Positive", published on 31 January 2013.

Moody's says that the EFTA's decision adds to a series of positive developments in Iceland over the past year, in particular with regards to Iceland's public finances and its expected debt trajectory. The Icelandic government has made substantial progress in returning the public finances to a sustainable path. Concerns that the government might not maintain a strict fiscal consolidation path after the termination of the IMF programme have lessened significantly as it has continued to reduce the budget deficit, albeit at a somewhat slower pace than agreed with the IMF. Moody's estimates that the 2012 budget deficit was in the region of 3% of GDP and the primary balance in surplus for the first time since the crisis unfolded in 2008. The 2013 budget targets a broadly balanced overall budget and a significant primary surplus so as to continue to reduce the public debt level. Moody's expects government debt, including loans extended by IMF and Norway, to decline to around 105% of GDP and below the 100% mark in 2014, from a peak of close to 120% in 2011. Today's outlook change also incorporates the view that the Organic Budget Law that is expected to come into force this year is credit positive, as it will help to reduce the pro-cyclicality of Iceland's public finances.

In addition, the Icelandic economy has clearly emerged from the crisis-induced recession and is now expanding at a reasonable pace. Moody's expects real GDP growth at around 2.5% this year, following growth of 2.6% in 2011 and an estimated 2.2% in 2012. While the economic slowdown in the EU continues to negatively affects Iceland's exports, private consumption and investment have been strong and are expected to continue to support Iceland's growth in 2013.

RATIONALE FOR UNCHANGED Baa3 RATING

A key factor supporting the rating is Moody's view that the Icelandic authorities are able and willing to pursue economic policies that allow the country to return to a sustainable economic, fiscal and external position within a reasonable period of time. Iceland's position is now broadly comparable to closely rated peers in all these aspects.

While lifting the extensive capital controls currently in place remains a challenge for policymakers, today's action incorporates the expectation that policymakers will manage this process in a way that reduces severe downside risks. Maintaining the controls for an extended period would restrict access to external financing for most entities in Iceland and negatively impact the economy, while a rapid relaxation would likely result in substantial capital outflows with a destabilising effect on the currency. While the Icelandic authorities are fully aware of the risks of a too-rapid relaxation, the progress on reducing foreigners' ISK holdings so far has been slower than expected and there is pressure to move more rapidly to the next stage of the liberalisation strategy. In addition, the current authorisation for maintaining the extensive controls will expire at the end of 2013 and would need to be extended by parliament unless the controls were to be lifted by then.

The country's public and external debt ratios remain very high at 105% of GDP and around 157% of GDP (even when taking into account the likely settlements of the failed banks' liabilities). The Icelandic authorities will need to run consistent and substantial primary surpluses in the coming years in order to materially reduce these high debt ratios. Risks to the outlook for public finances remain, particularly as the outlook for economic growth over the medium term remains uncertain. Iceland's economy is small, dependent on large foreign-financed investment inflows and is inherently volatile due to its undiversified economic structure.

WHAT COULD MOVE THE RATING UP/DOWN

Upwards pressure could develop on Iceland's rating if the remaining event risks recede significantly. This applies in particular to the lifting of the capital controls in place. Public and external debt ratios would also need to be on a significantly declining trajectory.

Downwards pressure would develop on the rating if Moody's expectations regarding orderly capital control liberalisation did not materialise, leading to large and/or sudden capital outflows and a severe weakening of the exchange rate, with negative consequences for the domestic economy. The rating could also come under downward pressure if no further progress was made in addressing the still elevated public debt ratio or if further problems emerged in the banking sector. A severe weakening of the euro area could also put pressure on Iceland's rating given the important trade linkages.

The principal methodology used in this rating was Sovereign Bond Ratings published in September 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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