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CREDIT OPINION
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Update

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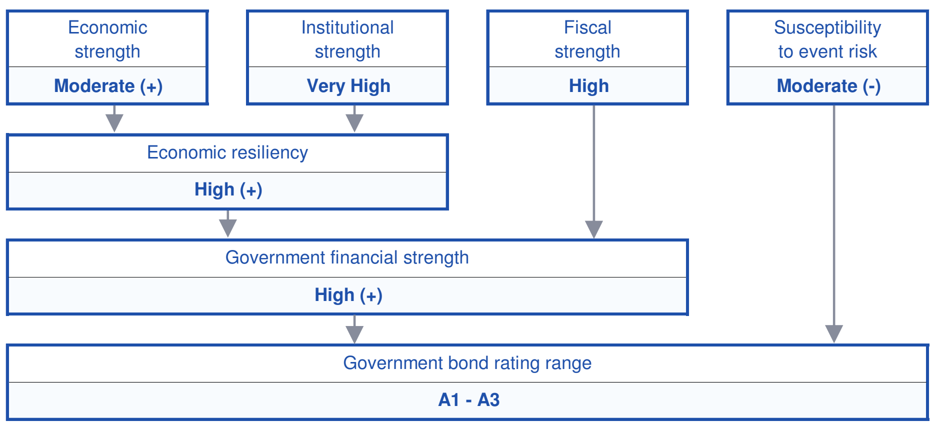
Government of Iceland - A3 positive

Update following outlook change to positive

Summary

The credit profile of Iceland (A3 positive) is supported by its wealthy, flexible economy, benefiting from a natural resource base that affords robust growth potential. The credit profile is constrained by the economy's small size, relatively limited diversification, openness and small currency area, which increase its vulnerability to shocks and can cause volatility in growth.

Exhibit 1
Iceland's credit profile is determined by four factors



Source: Moody's Investors Service

Credit strengths

» Economic flexibility and very high wealth provide significant shock-absorption capacity

» Strong fiscal position and low share of foreign currency debt

» Well-funded pension system, long working lives and favorable demographics

Credit challenges

» Small, open economy and currency area subject to volatility

» Substantial, albeit significantly reduced, exposure to external risks

» Large contingent liabilities derived from state-owned companies

Rating outlook

The positive outlook reflects the Icelandic economy's improving economic resilience afforded by a net external creditor position, more balanced growth and ongoing strengthening of the country's banking system. The positive outlook also reflects the progress made in the past two years on the major preconditions we laid out at the time of the upgrade to A3 in September 2016, including the smooth removal of capital controls and the settlement of the offshore kronur debt.

Factors that could lead to an upgrade

We would consider upgrading Iceland's A3 ratings should the authorities achieve the expected further improvement in the government's debt metrics and be successful in managing a soft landing of the economy amidst the maturation of the tourism sector and coming wage round without a material degradation of the external position.

Factors that could lead to a downgrade

We would consider removing the positive outlook or downgrading Iceland's A3 ratings if a disruptive slowdown or outright contraction in tourism revenues or other economic shocks were to weaken public or external debt sustainability or threaten financial stability, particularly should Iceland again have to resort to capital controls.

Key indicators

Exhibit 2

Iceland	2012	2013	2014	2015	2016	2017	2018F	2019F
Real GDP (% change)	1.3	4.3	2.2	4.3	7.5	3.6	3.5	3.0
Inflation (CPI, % change, Dec/Dec)	4.2	4.1	0.8	2.0	1.9	1.9	2.8	3.1
Gen. gov. financial balance/GDP (%)	-3.7	-1.8	-0.1	-0.8	12.6	1.5	1.4	1.2
Gen. gov. primary balance/GDP (%)	1.0	2.7	4.6	3.7	16.6	5.5	4.3	3.3
Gen. gov. debt/GDP (%)	99.7	90.8	84.0	67.6	53.7	43.3	39.5	35.9
Gen. gov. debt/revenues (%)	240.5	216.8	187.1	162.2	92.9	99.6	91.0	82.9
Gen. gov. interest payment/revenues (%)	11.3	10.9	10.4	10.9	6.9	9.2	6.7	4.9
Current account balance/GDP (%)[1]	0.7	7.4	5.4	5.9	7.7	3.4	2.4	1.4

[1] Excludes DMBs undergoing winding up in 2008-2015
Source: Moody's Investors Service

Detailed credit considerations

On 20 July, we changed Iceland's outlook to positive from stable and affirmed the A3 ratings to reflect (i) Iceland's improving economic resilience afforded by a net creditor position, more balanced growth and ongoing strengthening of the country's banking system and (ii) anticipated further improvement in the government's debt and debt affordability metrics.

The credit profile of Iceland reflects its "Moderate (+)" **economic strength**, "Very High" **institutional strength**, "High" **fiscal strength**, and "Moderate (-)" **susceptibility to event risk**.

We assess Iceland's **economic strength** as "Moderate (+)", below the indicative score of "High (-)" because of the country's small size and associated history of economic boom and bust episodes. At $51,842 as of 2017 on a purchasing power basis, Iceland's GDP per-capita is higher than over 89% of the universe of Moody's rated sovereigns and has overcome the significant loss in output after the banking and currency crisis. Real GDP growth decelerated to 3.6% from the torrid 7.5% pace in 2016 as a result of declining contributions from the tourism sector, however we expect growth to remain robust and more balanced, with contributions from both domestic and net external demand.

As evidenced by its ranking at 28th globally by the World Economic Forum's Global Competitiveness Index for 2017-2018, Iceland's economy is highly competitive – standing out compared with close peers, particularly given the economy's small size and overvalued currency.

We assess Iceland's **institutional strength** as “Very High”, mainly reflecting the country's very high scores in the Worldwide Governance Indicators (WGI) and track record of effective macroeconomic management to restore financial stability after the banking crisis. Iceland ranks in the 86th percentile of the WGI's measure of government effectiveness, in the 87th percentile for rule of law, and in the 94th for control of corruption, well above the A-rating category median. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative and high tech-oriented business sector, an efficient and flexible labor market and well-developed infrastructure. Iceland's peers with the same “Very High” assessment are all higher rated, including Austria (Aa1 stable), Belgium (Aa3 stable), and Ireland (A2 stable).

The progress that the authorities have achieved in restoring macroeconomic, financial, and fiscal health also informs our assessment of Iceland's institutions. For example, the regulatory framework for the banking sector has strengthened considerably – with domestic banks focusing inward to mitigate risk. Our assessment also recognizes the careful and ultimately successful liberalization of capital account restrictions in March 2017.

Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between the government, employers and employee associations, which contribute positively to policy effectiveness.

We assess Iceland's **fiscal strength** as “High”. After peaking at 114.7% of GDP in 2011, Iceland’s gross government debt burden has declined precipitously, with persistent budget surpluses, debt buybacks and rapid economic growth. Compositionally, the government's debt burden is now significantly less exposed to exchange rate risk, because the foreign currency share of gross government debt has declined to 13% from a 41.9% in 2011, and the debt's maturity remains relatively long. Peers with a similar fiscal strength assessment include higher rated Bermuda (A2 stable) and France (Aa2 positive).

We assess Iceland's **susceptibility to event risk** as “Moderate (-)”. The “Moderate (-)” score is driven by our banking system risk assessment and, which is set below the indicative score of “Moderate (+) ”. Given our lack of a published baseline credit assessment (bca) for the Icelandic banking system, which leads to incomplete data for calculation of an indicative banking sector risk score, we incorporate our aggregate analysis of the Icelandic banking system developed from publically available information into the final score. As a consequence, we believe banking sector risk is lower than the indicative score produced by the scorecard.

Furthermore, risks to financial stability from the banking sector have diminished significantly since the 2008 banking sector crisis. Strong capitalization and liquidity, lower NPLs and otherwise solid operating performance at the three main domestic money banks (DMBs) are however somewhat tempered by the banking sector’s concentration within three institutions, all successors of the old failed banks.

We assess external vulnerability risk and political risk at “Low” and “Very Low”, respectively, because both pose minimal risks to Iceland's credit profile. External vulnerability risk is set at “Low”, which is below the indicative score of “Moderate (+)” to reflect a data-driven aberration of a large decline in gross FDI liabilities during 2017 owing to accounting treatment of ownership changes in the pharmaceuticals sector and the winding-up of special purpose entities established before the financial crisis, which are fully netted out elsewhere in the capital account. Peers sharing the “Low” assessment of external vulnerability risk include Ireland, Lithuania (A3 stable), and Poland. Government liquidity risk assessed at “Very Low”, consistent with the government's low refinancing needs, small share of external government debt, and otherwise a significantly improved debt management framework. Peers with the same assessment include Botswana (A2 stable) and Romania (Baa3 stable).

Recent developments

Strong growth continues into first quarter of 2018, despite slowing tourism activity

Real GDP growth accelerated in the first quarter of 2018 to 6.7% year-over-year from the 1.5% rate registered in the fourth quarter of 2017. Household consumption continued its recent strength against the backdrop of rising real incomes and virtually full employment. Government spending picked up substantially, while growth in investment spending returned to double-digits after a soft patch during the prior quarter. Import demand continued to rise in line with domestic spending, while exports of goods increased 17.5% year-over-year - the fastest rate in nearly a decade – as the weaker króna helped bolster exports of marine and manufacturing products.

The slowdown in tourism growth, which was the main driver behind 2013-2016's fast expansion, likely relates to the strength of the króna as well as to continued capacity constraints in flight and hotel availability, of which the former has been allayed by new hotels, AirBNB rental flats and other types of accommodation. Year-to-date 2018 tourist arrivals have increased a modest 4.2%, down from the torrid 34.1% pace achieved over the same period in 2017.

We expect that the levelling off of growth in the tourism sector – at least relative to recent years' growth – portends a soft landing for the economy generally. As a consequence, we forecast a gradual downshifting of real GDP growth to 3.5% in 2018 and 3.0% in 2019.

Net international investment creditor position (net IIP) continues to improve

On the external side, the first quarter of 2018 saw the current account surplus narrow to ISK0.3 billion, as a result of a goods deficit of ISK27.8 billion, a services surplus of ISK32.6 billion and a combined primary and secondary income deficit of ISK4.4 billion. During the first quarter, domestic consumption has continued to drive strong import growth, net revenues from tourism were weaker and the króna appreciated 3.5% in trade-weighted terms.

2017 had ended with a current account surplus amounting to 3.4% of GDP, and despite the small Q1 surplus, on a four-quarter rolling sum basis, the current account surplus came in at 3.1% of GDP in the first quarter. Net IIP also continued to improve – reaching ISK235 billion at the end of the first quarter of 2018, or 9.2% of 2017 GDP, despite declines in foreign securities market prices and the appreciation of the króna having a negative impact on the external position.

A depreciation of the currency in subsequent months, the recovery of tourism growth and the likely widening of the current account surplus is expected to have increased the net creditor position further thereafter. Those data will be published in September.

Monetary and fiscal policy stance expected to remain relatively tight

Even as overall demand pressures have eased, we expect that the stance of both monetary and fiscal policy will remain relatively tight, in light of still strong domestic demand and labor market pressures. The Central Bank of Iceland (CBI) is cautious to strike a balance to assure that strong domestic demand, and upcoming labor negotiation rounds that are likely to yield higher nominal wage increases, do not result in inflation and inflation expectations persistently above the CBI's 2.5% target for headline inflation. With headline inflation picking up to 2.6% in June 2018, tighter monetary policy is likely in store as wage settlements approach early next year.

With respect to fiscal policy, spending increases are set for 2018-19, in line with the new left-to-right coalition government's plan to increase infrastructure and social services, especially health care, spending. Still, the strictures imposed by the organic budget law and the commitment to fiscal surpluses and debt reduction by successive parliaments will keep these increases marginal and both the nominal and primary fiscal positions in surplus.

Rating methodology and scorecard factors

Rating factors grid - Iceland

Rating factors	Sub-factor weighting	Indicator	Indicative factor score	Final factor score
Factor 1: Economic strength			H-	M+
Growth Dynamics	**50%**			
Average real GDP growth (2013-2022F)		3.6		
Volatility in real GDP growth (standard deviation, 2008-2017)		4.0		
WEF Global Competitiveness index (2017)		5.0		
Scale of the economy	**25%**			
Nominal GDP (US$ billion, 2017)		23.9		
National income	**25%**			
GDP per capita (PPP, US$, 2017)		51,842		
Automatic adjustments	**[-3; 0]**	Scores applied		
Credit boom		0		
Factor 2: Institutional strength			VH	VH
Institutional framework and effectiveness	**75%**			
Worldwide Government Effectiveness index (2016)		1.4		
Worldwide Rule of Law index (2016)		1.5		
Worldwide Control of Corruption index (2016)		2.0		
Policy credibility and effectiveness	**25%**			
Inflation level (%, 2013-2022F)		2.4		
Inflation volatility (standard deviation, 2008-2017)		4.1		
Automatic adjustments	**[-3; 0]**	Scores applied		
Track record of default		0		
Economic Resiliency (F1xF2)			**H+**	**H+**
Factor 3: Fiscal strength			H	H
Debt burden	**50%**			
General government debt/GDP (2017)		43.3		
General government debt/revenue (2017)		99.6		
Debt affordability	**50%**			
General government interest payments/revenue (2017)		9.2		
General government interest payments/GDP (2017)		4.0		
Automatic adjustments	**[-6; +4]**	Scores applied		
Debt trend (2014-2019F)		0		
Foreign currency debt/general government debt (2017)		0		
Other non-financial public sector debt/GDP (2017)		0		
Public sector assets/general government debt (2017)		0		
Government financial strength (F1xF2xF3)			**H+**	**H+**
Factor 4: Susceptibility to event risk	**Max. function**		M+	M-
Political risk			*VL*	*VL*
Worldwide voice & accountability index (2016)		1.3		
Government liquidity risk			*VL*	*VL*
Gross borrowing requirements/GDP		1.7		
Non-resident share of general government debt (%)		22.2		
Market-Implied Ratings		Baa2		
Banking sector risk			*M+*	*M-*
Average baseline credit assessment (BCA)		--		
Total domestic bank assets/GDP		188		
Banking system loan-to-deposit ratio		143		
External vulnerability risk			*M+*	*L*
(Current account balance + FDI Inflows)/GDP		-25.7		
External vulnerability indicator (EVI)		--		
Net international investment position/GDP		7.2		
Government bond rating range (F1xF2xF3xF4)			**A2 - Baa1**	**A1 - A3**
Assigned foreign currency government bond rating		**A3**		

Note: While 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) Indicative factor score: rating sub-factors combine with the automatic adjustments to produce an Indicative factor score for every rating factor, as detailed in Moody's Sovereign Bond Methodology. **(2) Final factor score:** where additional analytical considerations exist, Indicative factor scores are augmented to produce a Final factor score. Guidance on additional factors typically considered can be found in Moody's Sovereign Bond Methodology; details on country-specific considerations are provided in Moody's research. **(3) 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. **(4) 15 Ranking categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- **(5) Indicator value:** if not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's related publications

Rating Action

» Moody's changes Iceland's outlook to positive from stable and affirms A3 ratings, July 2018

Issuer Comment

» Government of Iceland: Iceland's Keflavik Airport investment will expand economic benefits of tourism, January 2018

Sector Comment

» Banks - Arion Bank's IPO plans help further restore confidence in Iceland's banks, a credit positive, May 2018

Outlook

» Sovereigns - Global: 2018 outlook stable as healthy growth tempers high debt, geopolitical tensions, November 2017

Country Statistics

» Iceland, Government of, May 2018

Methodology

» Sovereign Bond Ratings, December 2016

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