MOODY'S
INVESTORS SERVICE

Rating Action: Moody's upgrades Iceland's government ratings to A3; outlook stable

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New York, September 01, 2016 -- Moody's Investors Service (MIS) has today upgraded Iceland's government bond and issuer ratings to A3 from Baa2. The rating outlook is stable. This rating action concludes the review for upgrade that commenced on June 10, 2016.

The two-notch upgrade of Iceland's government rating reflects the speed and extent of the country's recent progress in recovering from its 2008 banking crisis. Sustained growth and fiscal restraint allowed a very sizeable reduction in government debt over the past year, which Moody's expects to continue and to be sustained with the deployment of the proceeds of the failed banks' estates over the coming years. Cautious but steady progress in addressing the problems in the banking sector and in relaxing capital controls has considerably reduced the risks to economic and financial stability from the final stages of capital account liberalization.

The stable outlook speaks to the balance of risks that Moody's foresees for the rating over the next two years. It balances the positive impact of moderate but sustained growth and continued fiscal consolidation against, for example, the residual risks from capital account liberalization, the potential economic and financial pressures associated with substantial capital inflows and tight labor markets, and finally the evolving political dynamics.

In a related move, Moody's also raised Iceland's foreign- and domestic-currency country ceilings: the ceilings on local currency debt and deposits were raised from Baa1 to A1 and the ceilings on long-term foreign currency debt and deposits were raised to A3 from Baa2. The ceilings on short-term foreign currency debt and deposits are unchanged at P-2.

RATING RATIONALE

RATIONALE FOR THE UPGRADE OF ICELAND'S GOVERNMENT BOND AND ISSUER RATINGS TO A3

FIRST DRIVER: FURTHER SIGNIFICANT IMPROVEMENT IN GOVERNMENT DEBT METRICS EXPECTED

The sharp drop in Iceland's indebtedness has continued apace over the past year, and Moody's expects the trend to continue in the years ahead. Iceland's general government debt to GDP ratio is expected to decline to under 50% by the end of 2017 and to around 40% by 2020 from 68.5% at the end of 2015 -- a fall of roughly 75 percentage points from the 2011 peak. Such ratios will be consistent with or better than A3 peers.

The anticipated further reduction in debt to GDP will derive in large part from the deployment of the assets received in last year's resolution of the failed bank estates to pay down debt. It also reflects Moody's expectation of ongoing fiscal consolidation, enacted under a medium term fiscal strategy devised in line with the Organic Budget Law of December 2015 and its accompanying fiscal rules.

The favorable debt to GDP dynamics are also expected to continue to benefit from strong economic growth, which Moody's forecasts at 5% in 2016 and 3.9% next year, led by domestic demand. Exports are still profiting from the competitive edge gained with the depreciation of the currency at the time that the crisis erupted, and the trade and current account surpluses remain large. Some of that advantage has been eroded by the krona's appreciation since the start of 2015, and net exports are now a drag on growth. However, key export sectors continue to perform well, especially tourism, which has surpassed fishing as the largest sector of the economy.

Recent appreciation of the exchange rate plus falling energy costs have helped keep inflation low even after generous multi-year wage increases granted in 2015 and amidst a widening positive output gap. That said, above-potential growth for several successive years signals potential overheating risks, exacerbated by sizeable capital inflows in recent years. The government aims to address these risks in part by moving forward with the final stages of capital control liberalization.

SECOND DRIVER: REDUCED EVENT RISK DUE TO THE CAUTIOUS LIBERALIZATION OF CAPITAL CONTROLS

Iceland's rating trajectory has lagged the improvement in some of its core fundamentals since the financial crisis, because of the residual risks posed to economic and financial stability by the complex process of removing the capital controls first imposed in 2008. The second driver for the upgrade of Iceland's government rating to A3 at this point in time reflects Moody's expectation that the phasing out of capital controls will proceed smoothly to completion and therefore not disrupt economic and financial stability.

The first two stages of the liberalization process are now complete. The resolution of the failed bank estates was completed in late 2015. In June 2016, the central bank auctioned part of its FX reserves for 'offshore krónur' (mainly non-resident-owned ISK assets trapped when capital controls were imposed in late 2008 at the time the old banks collapsed), thereby further reducing the overhang of such assets. Moody's view is that while the few remaining holdings of offshore krónur are sizeable at 8% of GDP, the event risk they pose for Iceland's external position is limited. The liberalization of capital controls on residents will begin immediately following parliamentary approval of the relevant legislation. A further easing of controls on residents is scheduled to take place on January 1, 2017.

In Moody's view, the planned relaxation of capital controls on residents poses only a limited risk to the Icelandic economy and financial system. National savings are high and the external position is in surplus, both on a flow (current account) and a stock (Net International Investment Position) basis. Icelandic banks are highly liquid and have access to both foreign and domestic capital markets. The central bank's FX reserves are above the IMF's Reserve Adequacy Metric, the level recommended by the IMF for the start of capital controls being liberalized. While some downward pressure on the 'onshore' exchange rate is to be expected in the next few months, the inflationary impact is likely to be rather contained and the devaluation would support competitiveness and narrow the gap between the onshore and offshore exchange rates.

RATIONALE FOR ASSIGNING A STABLE OUTLOOK

The stable outlook speaks to the balance of risks that Moody's foresees for the rating at the A3 level. Moody's expects growth in the coming years to be moderate but balanced, supported by the further liberalization of capital controls. Enhanced regulation is expected to maintain the capitalization and stability of the banking system, including by preventing its overseas expansion along the lines seen prior to the crisis.

Countervailing risks are being addressed. Iceland has been attracting substantial capital inflows, which are likely to continue given higher interest rates, low inflation and the economy's favorable prospects. In response, the central bank put in place a Capital Flow Mechanism (CFM) in June this year to discourage short-term speculative capital inflows. The authorities are alive to the potential pressures implied by high employment levels and the high pay awards granted last year. And while the emergence of the Pirate Party creates a level of uncertainty as to the direction of future policy following the upcoming election on October 29, Moody's does not believe that it will change materially given the country's consensus-based politics.

WHAT COULD CHANGE THE RATING UP/DOWN

Moody's could upgrade Iceland's ratings i) once the relaxation of controls on capital outflows, including the liberalization of offshore krónur, is completed, ii) if accompanied by an improvement in government debt and debt service metrics by end-2018 that is materially beyond current expectations, and iii) assuming the rating agency continues to expect that the government's management of the economy and banking system will ensure that the boom-bust cycles and macro imbalances of the past will be avoided.

Conversely, downward pressure on Iceland's ratings could develop if economic or financial volatility were to re-emerge and threaten debt sustainability, particularly should Iceland again have to resort to capital controls.

GDP per capita (PPP basis, US$): 46,097 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.9% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -0.5% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 4.8% (2015 Actual) (also known as External Balance)

External debt/GDP: 177.2% (2015 Actual)

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 30 August 2016, a rating committee was called to discuss the rating of the Iceland, Government of. The main points raised during the discussion were: The issuer's institutional strength/ framework, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially increased. The issuer has become less susceptible to event risks. Very high institutional strength supports the smooth liberalization of capital controls.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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