

**Rating Action: Moody's places Iceland's Baa2 sovereign rating on review for upgrade**

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Global Credit Research - 10 Jun 2016

New York, June 10, 2016 -- Moody's Investors Service has today placed Iceland's Baa2 issuer and government bond ratings on review for upgrade.

The key drivers of the review for upgrade are:

1. To evaluate whether the government's new fiscal strategy and tax reform will further improve its debt sustainability in the medium term;
- 2.. To 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.

Iceland's local currency debt and deposit ceilings remain unchanged at Baa1 and the foreign currency debt and deposit ceilings remain unchanged at Baa2/P-2.

**RATINGS RATIONALE**

**RATIONALE BEHIND REVIEW FOR UPGRADE**

**1. TO EVALUATE WHETHER THE GOVERNMENT'S NEW FISCAL STRATEGY AND TAX REFORM WILL LEAD TO FURTHER IMPROVEMENTS IN ITS DEBT SUSTAINABILITY, AND WHETHER THE UPCOMING ELECTION POSES ANY RISKS TO THEIR IMPLEMENTATION**

Moody's expects Icelandic government debt to drop materially in the near term, mainly due to funds and assets received from the creditors of the failed bank estates in last year's winding-up operations, which by law must be used to pay down government debt. The rating agency also expects the Icelandic economy to register economic growth at rates consistently higher than the European or advanced country average thanks to improved consumer and investor confidence and relatively favorable demographics. In the context of this supportive economic environment and based on the government's fiscal strategy, Moody's believes the general government debt-to-GDP ratio will decline to below 60% by year end 2016.

During the review, Moody's plans to evaluate the effectiveness of the new five-year fiscal strategy and tax reform announced in early May, which set out a very ambitious plan to maintain persistent fiscal surpluses to achieve ever-lower government debt ratios. As part of its assessment, Moody's will investigate the extent to which these reforms are supported across the political spectrum in light of the early election tentatively scheduled for the autumn.

**2. TO ASCERTAIN WHETHER THE UPCOMING AUCTION OF OFFSHORE KRÓNUR WILL BE EFFECTIVE IN REDUCING OR CONTAINING THE COUNTRY'S EXTERNAL RISKS AND THUS FACILITATING THE GENERALIZED LIBERALIZATION OF CAPITAL CONTROLS**

As part of the review, Moody's will assess the potential impact of the central bank's upcoming auction of euros from its foreign exchange reserves for the entire remaining stock of offshore krónur, which amounts to about ISK320 billion (13% of GDP). The term is used to refer to non-resident-owned domestic assets that were trapped in the country by the imposition of capital controls in November 2008, after the country's three large banks accounting for 90% of the banking system failed.

Moody's notes that although the value of the remaining trapped funds is now much lower than when the banking collapse occurred, it is still large enough to be destabilizing if not handled in a controlled sale such as is now planned. The Icelandic parliament approved a bill on May 24th that identified the assets eligible to be tendered in the auction and subsequently the Ministry of Finance set the date and established the terms and conditions under which the auction would take place.

According to the new plan, the central bank will buy the 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 auction is purely voluntary. 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 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.

Moody's says that the results of the auction are scheduled to be announced on June 22nd. If successful in reducing or containing the vulnerability posed by the remaining trapped ISK assets held by non-residents, the government's plan calls for 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, probably over the next one-two years.

In addition to assessing the extent to which the June auction will succeed in reducing or containing the country's external vulnerability stemming from the remaining stock of offshore krónur, Moody's will assess during the review period whether the measures being introduced to deter disruptive speculative inflows of short-term capital, such as the new capital flow mechanism, are likely to be effective.

#### FACTORS THAT WOULD LEAD TO A RATING UPGRADE

Moody's would upgrade the Icelandic government's Baa2 rating if its 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 WOULD LEAD TO CONFIRMING THE CURRENT Baa2 RATING

Although less likely in light of the current review for upgrade, Moody's would confirm the Icelandic government's Baa2 rating if it perceives that the government's financial strength is not likely to improve enough to position the rating more appropriately among higher-rated sovereigns. The rating agency would also confirm the Icelandic government's Baa2 rating if it was to decide that the upcoming auction of offshore krónur and other recently announced measures would not improve the sovereign's external position.

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 08 June 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 economic fundamentals, including its economic strength, have increased. The issuer's fiscal or financial strength, including its debt profile, has increased.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings Methodologies page on [www.moody's.com](http://www.moody's.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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Kristin Lindow  
Senior Vice President  
Sovereign Risk Group  
Moody's Investors Service, Inc.  
250 Greenwich Street  
New York, NY 10007  
U.S.A.  
JOURNALISTS: 212-553-0376  
SUBSCRIBERS: 212-553-1653

Yves Lemay  
MD - Sovereign Risk  
Sovereign Risk Group  
JOURNALISTS: 44 20 7772 5456  
SUBSCRIBERS: 44 20 7772 5454

Releasing Office:  
Moody's Investors Service, Inc.  
250 Greenwich Street  
New York, NY 10007  
U.S.A.  
JOURNALISTS: 212-553-0376  
SUBSCRIBERS: 212-553-1653

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