Credit Opinion: Iceland

Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Country Ceiling: Fgn Currency Debt	Aaa/P-1
Country Ceiling: Fgn Currency Bank Deposits	Aa1/P-1
Iceland, Government of	
Outlook	Stable
Government Bonds	Aa1
Commercial Paper	P-1
Other Short Term	P-1

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Key Indicators

Iceland

	2003	2004	2005	2006	2007	2008F	2009F
Real GDP (% change)	2.4	7.7	7.5	4.4	3.8	1.0	-3.0
Inflation (CPI, % change Dec/Dec)	2.2	3.2	4.0	6.8	5.9	12.0	6.5
Gen. Gov. Financial Balance/GDP (%)	-2.8	0.0	4.9	6.3	5.2	2.0	-1.1
Gen. Gov. Primary Balance/GDP (%)	-0.1	2.5	7.1	8.5	7.3	4.5	1.1
Gross Gen. Gov. Debt/GDP (%)	40.6	35.4	25.5	28.9	28.0	32.0	30.0
Gross Gen. Gov. Debt/ Gen. Gov. Revenue (%)	95.1	80.3	54.2	60.3	58.0	66.0	65.0

Opinion

Credit Strengths

The credit strengths of Iceland include:

- Advanced level of economic and political development with a GDP per capita among the highest in the world

and evenly distributed standard of living

- Healthy government finances, low public direct debt

- Longstanding political stability and consensus-based society

- Increasingly diversified economic base

Credit Challenges

The credit challenges facing Iceland include:

- Heavy contingent liabilities for the government deriving from a large, internationalized banking sector

- Small, open economy susceptible to an unusual degree of macroeconomic volatility for a highly developed country

- Limited capacity of monetary policy to control macro imbalances, given the openness of the financial market

Rating Rationale

The Icelandic government's foreign- and domestic-currency debt ratings were downgraded to Aa1 on May 20, 2008 because the government's very large foreign-currency contingent liabilities raise uncertainties whether it has "unquestioned access to finance" -- which is a key characteristic of a triple-A sovereign. These potential liabilities stem mostly from its large, internationalized banks whose financial strength ratings were recently downgraded to C-, lower than any other Aaa-rated country. Still, Moody's believes that the government could handle a crisis in any sector, including the outsized banking sector and that the risk of disruptive systemic stress is low.

Iceland has many credit features that compare positively with other Aa rated countries, namely exceptionally strong institutional robustness and very high government financial strength. Regarding this latter criteria, Iceland has a low government debt burden, a nearly fully-funded pension system, and favorable labor force demographics. Its economic strength is lower than some other similarly rated peers because of its small size and concentration, although the economy has proven itself to be unusually flexible and highly capable of withstanding shocks. Strong private sector and commercial bank expansion in foreign markets and large foreign investment projects continue to help diversify the economy away from fishing, even as they introduce exaggerated but temporary macroeconomic imbalances. Iceland also diverges from many highly-rated countries because of more significant event risk stemming from the possible need to bail out the banking sector's large foreign operations.

Rating Outlook

The rating outlook is stable on all of Iceland's country ceilings and government ratings.

What Could Change the Rating - Up

The ratings could revert to Aaa if the risk of a call on the government to assume enormous foreign currency exposure to support its banks would diminish significantly, thereby reducing event risk. It could also move up if uncertainties surrounding Iceland's unquestioned access to finance were to disappear.

What Could Change the Rating - Down

Iceland's Aa1 ratings incorporate a low-probability/high-severity banking crisis. Downward pressure would emerge only if Iceland displayed an inability to manage such a crisis, whether because of lack of access to sufficient financing or poor policy decisions.

Recent Developments

Difficult liquidity conditions for the banks and a sharp depreciation of the exchange rate are adding to domestic factors causing a rebalancing of growth this year. Real growth came in at 4% in the first half of 2008, down less than expected from the revised 4.9% of 2007. The source of growth has shifted to net exports, thanks to the coming onstream of the new aluminum plant and depressed import demand, whereas domestic expenditure is declining.

The fiscal accounts are officially budgeted to remain in surplus for the year, but the slowdown in tax receipts due to weaker consumption and tax cuts already took the budget into deficit in the second quarter. The further widening of the current account deficit in spite of the virtual elimination of the once-large merchandise trade deficit speaks to difficulties in accounting for investment income flows, as indicated by the large errors and omissions item in the capital account. Whereas the current account is likely to shrink going forward, it is unlikely to disappear because of the structural deficit on investment income.