



Moody's Investors Service

Rating Action: **Moody's downgrades Iceland to Baa3 from Baa1; stable outlook**

Global Credit Research - 11 Nov 2009

London, 11 November 2009 -- Moody's Investors Service has today downgraded the Icelandic government's foreign and local currency bond ratings by two notches from Baa1 to Baa3. The foreign currency bond ceiling was downgraded to Baa2, while the foreign currency deposit ceiling was lowered to Baa3. The outlook on all ceilings and ratings has now been changed to stable from negative.

"Moody's has positioned Iceland at the bottom of the investment-grade rating scale and moved to a stable outlook," says Kenneth Orchard, Vice President/Senior Credit Officer in Moody's Sovereign Risk Group.

"The Baa3 rating weighs the enduring fiscal, financial and monetary challenges resulting from the crisis against Iceland's high wealth, economic flexibility and sound institutions," says Orchard. "Given the divergent trends of an improving economic outlook, severe strains on public finances and the still uncertain exit strategy from capital controls, we have determined that a stable outlook appropriately reflects the balance of future risks."

"Moreover, the stable outlook, which indicates that Iceland is likely to remain investment grade, is premised upon a complex package of policy measures and a moderate economic recovery beginning in 2011," Mr. Orchard continues. "Significant deviations in economic and fiscal performance from current forecasts will impact Moody's rating accordingly."

Moody's notes that Iceland's high wealth and economic flexibility have helped cushion the blow from the severe banking and currency crisis that erupted in October 2008. "Recent economic performance has been better than expected," remarked Mr. Orchard. "It appears that the recession will be shallower and shorter than previously anticipated."

The pace of future recovery will be largely dependent upon new investment in export industries, as domestic demand is expected to be weak for several years. Moody's central forecast assumes that investment in aluminium smelting and other power-intensive industries will pick up in 2010-13, thereby alleviating unemployment and supporting private consumption. However, the rating agency cautions that such investment is unlikely to occur if aluminium prices return to the levels seen in March 2009.

Moody's recalled that the government's financial strength has weakened considerably over the past year as the government has taken on liabilities related to the banking sector and the budget deficit has swelled. Gross government debt as a percentage of GDP is forecast to peak slightly below 150% in 2010, while net government debt is projected to reach around 100% of GDP.

Such levels of debt will place significant pressure on the government budget. "Net interest payments are forecast to reach 20% of government revenues in 2010, compared to the Baa rating category median of 9%, before declining to about 15% in 2012," says Mr. Orchard. "Such a high level of debt service will limit the upside potential for the Icelandic government's rating for the foreseeable future."

Moody's is concerned that government-guaranteed debt has also soared since the crisis, while the financial condition of the underlying entities has deteriorated. Unless a private sector solution can be found, this would place additional pressure on the government's financial strength.

Although signs of a fragile stabilization have emerged, Moody's expects Iceland's financial situation to remain fluid for at least the next 12-18 months. The persistent weakness of the Icelandic krona has complicated the re-instatement of an inflation-targeting regime and the removal of capital controls. Recent announcements regarding the banking system and resolution of the Icesave dispute, together with some fiscal tightening, should be sufficient to gradually restore confidence in the krona -- although the rating agency cautions that this is not assured as long as the banking sector restructuring is incomplete.

The Baa3 rating also incorporates risk related to a possible legal challenge against legislation passed in September 2008 that assigned priority claim to bank depositors in the event of bankruptcy.

In a related action, Moody's downgraded the short-term foreign currency bond and deposit ceilings to P-3 from P-2. The local currency bond ceiling, which is the highest possible rating that could be assigned to any issuer in the country, was also lowered to Aa3 from Aaa, prompted by a re-assessment of the country's susceptibility to event risk over the long term. Moody's believes that the vulnerability of the economy and financial system to shocks will persist for longer than previously expected.

Moody's previous rating action with respect to the Government of Iceland was implemented on 4 December 2008 when the rating agency downgraded the rating from A1 to Baa1 with a negative outlook.

The principal methodology used in rating the Government of Iceland is Moody's sovereign bond rating methodology, published in September 2008 and available on www.moody.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

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