



Moody's Investors Service

## Credit Opinion: Iceland

Global Credit Research - 16 Nov 2009

### Ratings

Category	Moody's Rating
Outlook	Stable
Country Ceiling: Fgn Currency Debt	Baa2/P-3
Country Ceiling: Fgn Currency Bank Deposits	Baa3/P-3
<b>Iceland, Government of</b>	
Outlook	Stable
Government Bonds	Baa3
Commercial Paper	P-3
Other Short Term	P-3

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### Key Indicators

#### Iceland

	2004	2005	2006	2007	2008	2009F	2010F
Real GDP (% change)	7.7	7.5	4.3	5.6	1.3	-8.5	-2.1
Inflation (CPI, % change Dec/Dec)	3.2	4.0	6.8	5.9	18.1	8.4	3.0
Gen. Gov. Financial Balance/GDP (%)	0.0	4.9	6.3	5.4	-13.6	-14.3	-10.7
Gen. Gov. Debt/GDP (%)	34.5	25.4	30.1	28.7	87.2	142.6	147.1
Total Gen. Gov. Direct & Guaranteed Debt/GDP [1]	34.5	25.4	30.1	28.7	87.2	142.6	147.1
Gen. Gov. Debt/Gen. Gov. Revenue	78.2	53.9	62.8	59.9	197.1	371.2	363.3
Gen. Gov. Int. Pymt/Gen. Gov. Revenue	5.5	4.7	4.5	5.4	7.6	24.1	27.5
Current Account Balance/GDP (%)	-9.9	-16.2	-26.1	-20.5	-39.6	-4.5	-2.0
External Debt/CA Receipts (%) [2]	474.0	704.0	951.7	1,161.7	2,147.4	489.6	420.0
External Vulnerability Indicator [3]	753.0	1,103.8	742.3	2,267.2	1,186.9	232.6	167.9

[1] Excludes Domestic Guarantees [2] Current Account Receipts [3] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/ Official Foreign Exchange Reserves

### Opinion

#### Credit Strengths

The credit strengths of Iceland include:

- Advanced economic and political development
- Strong institutions and flexible, skilled labor force
- Unexploited natural resource base, offering long term economic growth potential

#### Credit Challenges

The credit challenges facing Iceland include:

- Extremely high government debt ratios caused by the collapse of the banking system
- Deep economic recession caused by the banking and currency crisis

- Rejuvenating the economy and financial system in the context of the global recession

### **Rating Rationale**

The Icelandic government's Baa3 ratings are supported by the country's "medium" economic strength and "very high" institutional strength. A significant amount of wealth was destroyed during the currency and banking crisis in late 2008. Nevertheless, per capita incomes remain comparatively high on a global scale, despite having tumbled severely from their peak. Domestic demand will probably continue to decline for the next 12-18 months due to rising unemployment and cuts in public expenditures. The economy is expected to rebound over the medium term, however, stimulated by the weak exchange rate and new investment in power-intensive industries. Offsetting the high level of wealth is the small size of the economy, which increases its vulnerability to shocks.

Iceland's ratings are limited by the government's "low" financial strength, which has been significantly damaged by the banking and currency crisis. Debt obligations are being issued to re-capitalise the banking sector, repay depositors of the old banks and support the balance of payments. The budget deficit will be above 10% of GDP in both 2009 and 2010, and it will take several years to return to a budget surplus in even the more optimistic scenarios. Gross government debt/GDP could rise to about 150% in 2010. However, the government's net debt burden is expected to remain below 100% of GDP, which is very high but should be manageable. Moreover, much of the new debt will be non-market - owed to the new banks and official lenders - with low interest rates and flexible maturities, and market debt maturing in the next two years is modest.

"Medium" susceptibility to event risk primarily reflects the ongoing risks related to the stabilisation of the currency. Although restrictive capital controls are in place, the currency has remained weak, forcing the central bank to maintain higher interest rates. The IMF programme and capital controls are sufficient to support the balance of payments for the time being, but the outlook for the currency remains highly uncertain. An additional risk is that a renewed global downturn could delay the economic recovery and push down aluminium prices. Sustained low aluminium prices would diminish prospects for new investment. 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.

### **Rating Outlook**

The outlook on the ratings is stable, reflecting the divergent trends of an improving economic outlook, severe strains on public finances and the still uncertain exit strategy from capital controls.

### **What Could Change the Rating - Up**

The ratings could be upgraded if the economic recovery continues and confidence in the currency improves, allowing the gradual removal of capital controls.

### **What Could Change the Rating - Down**

The rating could be downgraded if confidence in the financial system, as proxied by the exchange rate, fails to improve. The rating could also be downgraded if significant, additional contingent liabilities are transferred onto the government's balance sheet.

### **Recent Developments**

Recent economic performance has been better than expected, and it now 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.

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 progress 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 size and scale of private sector debt restructuring required is enormous, and will overshadow the Icelandic financial sector until resolved.



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