

**Credit Opinion: Iceland**
**Iceland**
**Ratings**

Category	Moody's Rating
Outlook	Rating(s) Under Review
Country Ceiling: Fgn Currency Debt	*Aa1/P-1
Country Ceiling: Fgn Currency Bank Deposits	*A1/P-1
<b>Iceland, Government of</b>	
Outlook	Rating(s) Under Review
Government Bonds	*A1
Commercial Paper	P-1
Other Short Term	P-1

\* Placed under review for possible downgrade on October 8, 2008

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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	-2.7	-5.5
Inflation (CPI, % change Dec/Dec)	2.2	3.2	4.0	6.8	5.9	27.0	8.9
Gen. Gov. Financial Balance/GDP (%)	-2.8	0.0	4.9	6.3	5.2	2.8	-4.5
Gen. Gov. Primary Balance/GDP (%)	-0.1	2.5	7.1	8.5	7.7	5.2	0.2
Gross Gen. Gov. Debt/GDP (%)	40.6	35.4	25.5	28.9	28.0	30.0	59.0
Gross Gen. Gov. Debt/ Gen. Gov. Revenue (%)	95.1	80.3	54.2	60.3	58.0	63.6	137.5

**Opinion**
**Credit Strengths**

The credit strengths of Iceland include:

- Advanced level of economic and political development, consensus-based society
- Strong institutions and flexible labor force
- Moderate level of explicit government debt with benign debt profile

**Credit Challenges**

The credit challenges facing Iceland include:

- Possibly heavy contingent liabilities for the government and severe recession likely after the banking system's collapse

- Small, open economy susceptible to a high degree of macroeconomic volatility
- Massive external liquidity needs have driven steep declines in the currency and complicated trade and financial transactions

## **Rating Rationale**

The Icelandic government's ratings are primarily based upon the country's medium levels of economic strength and very high levels of institutional strength. Per capita incomes were among the highest in the world prior to the current financial crisis, but these levels will tumble because of the near-term economic contraction and the steep decline in the exchange rate. Moody's also discounts the country's relatively high level of wealth due to the small size of the economy, which increases its vulnerability to shocks. However, incomes should rebound over the medium-term due to the large stock of natural resources, flexible labor force and high productivity.

Iceland's ratings are refined by the government's medium financial strength. Access to external liquidity is virtually impossible at present, except through official channels. The government's net debt burden is currently moderate but this is expected to rise significantly over the near term due to the financial crisis. Public funds will be required to recapitalise the banking system and compensate insured foreign depositors. Large budget deficits may also be necessary to stimulate the economy, which is currently reeling from the combined effects of the shock.

Medium susceptibility to event risk reflects the ongoing financial crisis and the uncertain outlook following the collapse of the banking sector. Of particular concern are the authorities' ability to secure sufficient external liquidity to support normal trade and financial transactions, the evolution of the currency regime, and the impact of the crisis on the broader economy.

## **Rating Outlook**

The government's ratings were downgraded to A1 from Aa1 on 8 October 2008. They remain on review for possible downgrade based on Moody's assessment that Iceland now faces a more durable and severe impairment of the government balance sheet.

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

The ratings are unlikely to return to the Aa range in the foreseeable future. Moody's believes that it will take many years for the economy to restructure and for volatility to subside. An Aa rating could only be possible if the economy transitions to a more stable, sustainable growth model, which is expected to be difficult.

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

Three potential scenarios were outlined at the time of the recent downgrade. The first, 'crisis management', is consistent with the current A1 rating. The second, 'crisis containment', considered to be the most likely, would lead to mild additional downward pressure on the rating. The third scenario, 'uncontrolled crisis', is the least likely, but would place heavy downward pressure on the rating. Additional details can be seen in Moody's Special Comment "Iceland - Downgrade Reflects Dislocations from Global Banking Crisis" published 9 October 2008.

## **Recent Developments**

The unprecedented seizing-up of global credit markets in September/October led to a mega-devaluation of the krona and precipitated a number of events that culminated in the authorities taking control of the country's three major banks. Several bilateral and multilateral parties have been approached for foreign currency loans to bolster external liquidity, and the exchange rate regime may be reformed. Intermediate steps have been taken to ration existing FX reserves. 'New' local banks have been set up and the authorities are attempting to wind down the international operations of their predecessors, while limiting their exposure to the banks' foreign creditors. The large FX-denominated component of domestic lending is likely to lead to higher nonperforming loans, and the shortage of credit and foreign currency resulting from the crisis will probably lead to a severe recession from Q408 into 2009 and perhaps beyond.

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