

Ratings

Category	Moody's Rating
Outlook	Negative
Government Bonds	Baa3
Commercial Paper	P-3
Other Short Term	(P)P-3
Iceland	
Outlook	Negative
Country Ceiling: Fgn Currency Debt	Baa2/P-3
Country Ceiling: Fgn Currency Bank Deposits	Baa3/P-3

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Key Indicators

Iceland	2005	2006	2007	2008	2009	2010	2011F	2012F
Real GDP (% change)	7.2	4.7	6.0	1.3	-6.7	-4.0	2.5	2.5
Inflation (CPI, % change Dec/Dec)	4.1	7.0	5.9	18.1	7.5	2.5	5.6	3.0
Gen. Gov. Financial Balance/GDP (%)	4.9	6.3	5.4	-13.5	-10.0	-10.1	-5.7	-3.0
Gen. Gov. Debt/GDP (%)	25.4	30.1	29.1	70.3	85.6	90.7	97.9	94.6
Gen. Gov. Debt/Gen. Gov. Revenue (%)	57.7	63.9	60.7	147.4	194.2	221.1	236.1	229.0
Gen. Gov. Int. Pymt/Gen. Gov. Revenue (%)	4.7	4.5	5.4	7.6	16.0	13.3	12.1	12.9
Current Account Balance/GDP (%)	-16.2	-24.0	-15.6	-24.7	-11.7	-10.6	2.1	3.2
External Debt/CA Receipts (%) [1]	704.7	911.0	1,077.3	1,114.9	510.5	529.2	414.3	281.5
External Vulnerability Indicator [2]	865.4	1,242.8	1,333.2	2,039.5	1,376.8	222.6	237.5	172.1

[1] Current Account Receipts [2] (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
- Strengthened institutions since the crisis and a flexible, skilled labour force
- Significant unexploited natural resource base, offering long term economic growth potential

Credit Challenges

The credit challenges facing Iceland include:

- Achieving an appropriate sequencing of capital control liberalisation and normalising official and private international financial flows to the country to bring the economy back onto a sustainable growth pattern
- Further reducing the still high budget deficits and the very high government and external debt ratios

Rating Rationale

The Icelandic government's ratings were affirmed at Baa3 on 20 April 2011, despite the rejection of the revised Icesave agreement in a popular

referendum on 9 April 2011. The underlying dispute over the government's responsibilities under the EU directive on deposit-insurance schemes will probably be resolved in the EFTA court. The rating has nevertheless been affirmed as the potential liability to the government will most likely be significantly reduced as asset recoveries from the Landsbanki estate are higher than expected earlier. First payments to priority claimholders (such as the UK and Dutch deposit insurance funds) are expected to be made early next year.

On a fundamental assessment, Iceland exhibits moderate economic strength. Although a significant amount of wealth was destroyed during the currency and banking crisis in late 2008, per capita incomes remain comparatively high on a global scale. Offsetting the high level of wealth is the small size of the economy, which increases its vulnerability to shocks. The economy has finally started to improve since Q3 2010 and is expected to rebound moderately this year and over the medium term, stimulated by the weak exchange rate and new investment in power-intensive industries. However, there are significant uncertainties, in particular regarding the outlook for investment which depends to an important extent on the speed with which the strict capital controls will be abolished.

Iceland's ratings are limited by the government's strained balance sheet, which has been significantly damaged because of the assumption of large financial liabilities following the banking and currency crisis. The government has implemented important fiscal consolidation measures since 2009. This year, the budget deficit is forecast to decline to 5.7% of GDP for the general government, compared to a deficit of 13.5% of GDP in 2008. This includes the cost of recapitalising the Housing Finance Fund and several small savings banks in 2011. The public debt ratio is expected to stabilise this year at around 100% of GDP and then decline from 2012 onwards. However, this scenario requires ongoing strong commitment to fiscal consolidation for many years to come. The recently presented 2012 budget proposal and the revised medium-term fiscal strategy give some comfort regarding the authorities' resolve to return public debt to a more easily manageable level. But significant risks to the outlook for public finances remain, in particular (i) the uncertain outlook for economic growth over the next several years and (ii) the possible crystallisation of further contingent liabilities onto the government's balance sheet. The banking sector recapitalisation has been more or less completed although HFF remains thinly capitalised. But the government has guaranteed significant amounts of debt of the Housing Financing Fund and the major Icelandic power company Landsvirkjun. A mitigating factor are the significant financial assets that the government has acquired as part of the recapitalisation of the "new" banking system. Taking those assets into account reduces the government's net debt burden to around 66% of GDP this year (excluding Icesave due to the uncertainty over the eventual obligation). Moreover, the existence of large domestic pension funds allows the government to finance itself in the local capital markets at low interest rates and relatively long maturities, which is an important funding support given the capital controls in place.

Iceland is considered to have a high susceptibility to event risk, mainly on account of the risks entailed in the process of capital control liberalisation. On the one hand, the lifting of the capital controls and renewed access to external funding are crucial elements for a sustained recovery in Iceland. On the other, a too rapid relaxation of capital controls risks creating excessive exchange rate weakness. Foreign investors - trapped in the country when the capital controls were introduced in late 2008 - hold an estimated ISK465 billion (approx. 30% of GDP) in assets in the country. Most, if not all, will want to exit as soon as possible, with significant implications for the exchange rate, if their exit is not properly sequenced and managed. Once there is a track record of successful steps in liberalising the capital controls, we will probably consider moving our assessment of susceptibility to event risk back to moderate.

The risk of a negative impact on the government's balance sheet from litigation has recently been reduced further. The Supreme Court upheld the Emergency Law imposed at the end of 2008 to award priority status to depositors over other creditors. This decision removes a significant (though in our view low probability) risk to the government's finances. In the context of the Icesave issue, it means that the expected asset recovery from the Landsbanki estate will most likely be sufficient to repay the UK and Dutch deposit insurance funds in full. First repayments are expected to be made early next year. Litigation risks related to the eventual resolution of the Icesave issue remain but we note that the high asset recovery from the Landsbanki estate also mitigates this risk to an important degree.

Rating Outlook

The outlook on the ratings is currently negative given the risks to fiscal consolidation and the process of capital control liberalisation.

What Could Change the Rating - Up

The ratings could be upgraded if there are signs of a robust and sustained economic recovery, significant fiscal consolidation continues and the exchange rate remains broadly stable during the process of gradual capital control relaxation.

What Could Change the Rating - Down

The rating could be downgraded if the current commitment to fiscal consolidation showed signs of declining or the remaining legal risks related to a resolution of the Icesave issue resulted in a significantly higher liability for the government than is currently expected.

Going forward, the speed and sequencing of capital account liberalization will become a more important rating driver and Moody's will closely monitor the impact of the next steps on the exchange rate and financial stability.

Recent Developments

The government presented its budget plan for 2012 to parliament on 1 October. The draft budget which needs to obtain parliamentary approval before year-end targets a budget deficit for the central government of 1% of GDP, compared to an estimated deficit of 2.6% of GDP in 2011 (central government only). The primary balance is targeted to be in surplus by 2.2% of GDP versus a broadly balanced primary budget this year. Most of the improvement in the deficit is to come from increased revenues through targeted tax hikes and reductions in tax deductions (amounting to 1.2% of GDP) most of which are expected to remain in place until 2015. Measures on the expenditure side are more moderate, accounting for less than 30% of the fiscal adjustment or 0.5% of GDP.

The government also published its revised medium-term fiscal consolidation plan until 2015 which foresees continued fiscal consolidation in the coming years although at a somewhat slower pace than the government had agreed earlier with the IMF under its Stand-By Program. The earlier plan had assumed that an overall surplus in the budget would be achieved in 2013, which is now being postponed by a year. Also, the primary surplus targeted for the medium term has been lowered by a percentage point from the previous 6% of GDP. According to the government, the slower pace of deficit reduction is justified given that the country's public debt burden has turned out to be smaller than initially expected. The original plan would have been more effective in further strengthening its fiscal credibility following the completion of the IMF program, which provided a crucial external "anchor" for fiscal credibility over the past three years. Under the government's revised plan the (central) government's debt ratio would reach a peak of 84.9% of GDP this year and then gradually decline towards 66% of GDP by 2015. On

the general government level, the debt ratio is forecast to decline from a peak of close to 100% of GDP this year to around 87% of GDP in 2015.

The economy is emerging from the deep recession of the last two years. In the first half of the year, real GDP increased by 2.5% compared to the same period last year. This compares to a negative year-over-year growth rate of 1.9% in H2 2010. But the uncertainty over the economic outlook remains considerable. In the short term, the slowdown in global growth might well affect Iceland's exports and delay foreign investment further. The private sector remains highly indebted. In a more medium-term view, growth in Iceland's undiversified and small economy depends crucially on a few large-scale investment projects and will also be determined to an important degree by the pace of capital account liberalisation. GDP growth could thus turn out significantly lower, requiring further fiscal adjustment measures beyond those assumed in the government's fiscal plan.

The authorities are planning to launch the second step in their strategy to relax the capital controls, involving direct investment in the Icelandic economy. Half of the investment amount can be obtained at the offshore ISK exchange rate and funds will have to remain committed for a period of five years. We continue to expect the liberalisation process to take several years to complete.



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