Moody's Investors Service

Announcement: **Moody's: Iceland's exit from crisis complicated by President's refusal to sign Icesave agreement**

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London, 06 January 2010 -- Moody's Investors Service said today that the Icelandic President's refusal to approve amendments to the "Icesave" agreement with the British and Dutch governments has uncertain credit implications, but will certainly complicate any near-term plans to exit from its financial and economic crisis.

"On the one hand, the government's financial position is well placed to weather a period of temporary uncertainty without impact on its current Baa3 rating," said Kenneth Orchard, a Moody's Vice President-Senior Credit Officer in Moody's Sovereign Risk Group. On the other, Orchard cautioned that "any indication of renewed political instability and/or serious international pressure would signal real credit concerns and could lead to a negative rating action."

The President's decision means that the agreement will probably be subjected to a referendum over the next two months. However, Moody's notes that a "no" vote in a referendum would not lead to an outright repudiation of Iceland's debts to the British and Dutch governments and that the August 2009 "Icesave Act", which contained a government guarantee for the Icesave debt, would remain in force. Nevertheless, the August Act also specified limits on the re-payments of the Icesave debt, which the British and Dutch governments did not fully agree with. The legislation that President Grimsson refused to sign was the compromise subsequently reached with the creditor governments to lengthen the payment horizon and the government guarantee until the loans are fully repaid.

Moody's says it is currently unclear how the situation will evolve, both domestically and internationally. "Even though the coalition government had indicated earlier that it would stand or fall with approval of the Icesave agreement, it does not appear that the government will resign," explains Orchard. In fact, the government responded to the President's decision by re-affirming its commitment to its economic programme, of which the Icesave agreement is a part.

The analyst notes that internationally, the British and Dutch governments could renew pressure on the Icelandic government through the IMF and EU, although the President's action suggests that there are practical limits to this approach. Clearly, a significant proportion of the Icelandic population remains unconvinced that the most recent Icesave agreement is in the country's best long-term interest, and additional international pressure seems unlikely to change this popular sentiment anytime soon.

Moody's cautions that renewed political uncertainty, together with intensified international pressure, would complicate Iceland's emergence from crisis. The fiscal consolidation could be delayed, while foreign financing from the Nordic governments -- and therefore the IMF -- is likely to be suspended, at least temporarily. The authorities would also struggle to remove capital controls without access to additional foreign financing and with diminished confidence in the currency. At the extreme, Iceland's international trade and investment could be impacted by sanctions.

However, Moody's maintains that the Icelandic's government's financial position is not precarious, so it can afford a delay of weeks or even months until the situation is resolved. "Official international reserves are more than ample to maintain the current exchange rate with capital controls. Also, the government is able to fund its budget deficit in the local capital markets, and does not have any major foreign debt payments until December 2011," explains Mr. Orchard. Both the Icesave debts and multilateral loans have long grace periods before re-payment commences. Moreover, recent macroeconomic indicators show that the recession is likely to be shorter and shallower than previously expected.

The principal methodology used in rating the Government of Iceland is Moody's Sovereign Bond Methodology, published in September 2008, which can be found at www.moodys.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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