Announcement: Moody's publishes annual sovereign credit analysis on Iceland

Global Credit Research - 27 Jul 2012

London, 27 July 2012 -- In its annual credit report on Iceland, Moody's Investors Service says that Iceland's Baa3 government bond rating is based on the country's moderate economic and high institutional strength as well as low government financial strength and high susceptibility to event risk. The downside risks facing Iceland's sovereign creditworthiness are reflected in the currently negative outlook on the rating.

The rating agency's report is an annual update to the markets and does not constitute a rating action. Moody's determines a country's sovereign rating by assessing it on the basis of four key factors -- economic strength, institutional strength, government financial strength and susceptibility to event risk -- as well as the interplay between them.

Iceland's moderate economic strength score balances the high levels of wealth with the small size and undiversified structure of the economy. The post-crisis recovery is now under way and Iceland's short-term growth outlook is favourable. A further escalation of the euro area crisis is a risk as the EU is Iceland's main trading partner. Moody's assesses Iceland's institutional strength as high, given the important progress that the authorities have made in bringing the economy, the financial system and the public finances back onto a sustainable path. The government is in the process of implementing wide-ranging changes to the institutional set-up so as to avoid a repetition of the crisis.

Government financial strength is considered to be low, mainly on account of the still elevated debt burden. At the same time, the government has managed to reduce the budget deficit significantly since the peak in 2008. Fiscal consolidation continues this year and will likely result in the first decline in the public debt ratio since the crisis erupted. While an important and positive first step, the Icelandic authorities will need to strengthen the country's fiscal position further and run consistent and substantial primary surpluses in the coming years in order to materially reduce the still very high debt ratio. The Icesave dispute is less of a risk to public finances than previously thought, but remains to be solved.

Susceptibility to event risk is assessed as high, mainly reflecting the risks entailed in the process of capital control liberalization. The size of potential capital outflows is substantial and the risk of policy mistakes in the context of loosening the controls remains the key event risk for Iceland. At the same time, Moody's acknowledges that the authorities are well aware of the risks of a too rapid liberalization. Also, by repaying early some of its own obligations the government has reduced some of the potential pressure on the ISK exchange rate in the years 2013-2014, which are most likely the years with significant steps in liberalizing the capital control regime.

The negative outlook on Iceland's Baa3 rating reflects the above risks. The outlook could be returned to stable provided the government remains on track to achieve its fiscal target for the year and there are no further legal developments that have a negative impact on the government's fiscal and debt position. The ratings could be upgraded if the economic recovery is sustained, significant fiscal consolidation continues and the exchange rate remains broadly stable during the process of gradual capital control relaxation. Conversely, 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.

Moody's annual credit report on Iceland is now available on www.moodys.com.

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