

## **Announcement: Moody's affirms Iceland's Baa3/P-3 ratings with negative outlook**

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London, 23 November 2012 -- Moody's Investors Service has today affirmed the Baa3/P-3 long and short-term ratings of the Government of Iceland. The outlook remains negative.

Today's rating affirmation reflects the following key factors:

(1) Iceland's economy, its public finances and debt trajectory remain on an improving trend. The economic recovery is expected to continue at a reasonable pace notwithstanding risks emanating from the slowdown in the EU. Fiscal policy remains prudent, and the budget deficit has been reduced substantially with the recently presented budget plan for 2013 envisaging a further reduction in the fiscal deficit next year. This will allow Iceland's very high public debt-to-GDP ratio to start declining from 2012 onwards.

(2) Set against that, risks to the outlook remain substantial and exceed those for Iceland's similarly rated peers whose ratings carry a stable outlook. Moody's therefore maintains the negative outlook despite the clear improvements referred to above. In particular, public and external debt ratios remain very high, which severely limits the government's ability to deal with future shocks. Such shocks may arise from (1) large and destabilising capital outflows that might result from the relaxation of Iceland's strict capital controls, (2) a negative outcome of the "Icesave" litigation or (3) further problems in the still weak banking sector.

Moody's has also lowered the foreign-currency bond ceiling to Baa3 and has affirmed the foreign-currency deposit ceiling at Baa3. The local-currency bond and deposit ceilings have been lowered to Baa2.

### RATINGS RATIONALE

#### RATIONALE FOR AFFIRMING THE Baa3 RATING

Firstly, the Icelandic economy has clearly emerged from the crisis-induced recession and is now expanding at a reasonable pace. Real GDP growth is expected at around 2% and 2.5% in 2012 and 2013 respectively. While the slowdown in the EU negatively affects Iceland's exports, private consumption and investment have been strong and are expected to continue to support Iceland's growth in 2013.

Secondly, the government has started to establish a track record of prudent fiscal policies, even after the termination of the IMF Stand-By agreement last August. This year's general government budget deficit is expected to be around 2% of GDP, compared with last year's deficit of 5.4% of GDP. The 2013 budget proposal envisages a broadly balanced budget and a significant primary surplus of over 3% of GDP for the central government. Moody's own forecasts are a little less optimistic -- the rating agency expects the fiscal deficit to reach 1.6% of GDP next year as a consequence of lower-than-forecast asset sales, higher spending pressures in the run-up to the parliamentary elections in April and the need for further capital injections into the Housing Financing Fund (HFF) (BCA of b2, final rating Baa3, negative). However, even under Moody's more conservative budget forecasts the public debt ratio will continue on a downward trend. The rating agency's public debt calculations are higher than the government's as it includes the loans extended by the IMF and Norway to the central bank in its public debt calculations. After reaching a peak of close to 119% of GDP in 2011, the public debt ratio is forecast to decline to 104% of GDP by the end of 2013 and below the 100% mark in 2014. Moody's also views positively the new Organic Budget Law that is expected to be in force next year and which would be an important step to reduce the pro-cyclicality of Iceland's public finances.

#### RATIONALE FOR MAINTAINING THE NEGATIVE OUTLOOK

While Moody's recognises the clear improvements that Iceland has made, the risks to the rating remain biased to the downside and greatly exceed those of other similarly rated sovereigns whose ratings carry a stable outlook. Moody's therefore maintains the negative outlook which has been in place since July 2010.

In particular, the country's public and external debt ratios remain very high at 112% of GDP and around 173% of GDP (even when taking into account the likely settlements of the failed banks' liabilities). The Icelandic authorities will need to run consistent and substantial primary surpluses in the coming years in order to materially reduce

these high debt ratios. Significant risks to the outlook for public finances remain, in particular (1) an uncertain outlook for economic growth over the medium term and (2) the possible crystallisation of further contingent liabilities onto the government's balance sheet. Regarding the latter, while the banking sector recapitalisation has been more or less completed HFF remains thinly capitalised and will almost certainly require further capital support from the government. In addition, the government has guaranteed significant amounts of HFF's debt and the major Icelandic power company Landsvirkjun (Baa3, negative). Overall, state guarantees amount to around 75% of GDP. The high debt ratios imply that the government has very limited ability to deal with further shocks which may arise from (1) an unduly rapid relaxation of the strict capital controls, (2) a negative outcome of the "Icesave" litigation or (3) further problems in the still very weak banking sector.

The largest event risk in Moody's view will be finding the right sequence and pace in terms of relaxing the strict capital controls currently in place. Maintaining the controls for an extended period would restrict access to external financing for most entities in Iceland and negatively impact the economy while a rapid relaxation would likely result in substantial capital outflows which will have a destabilising effect on the currency. While the Icelandic authorities are fully aware of the risks of a too rapid relaxation, the progress on reducing foreigners' ISK holdings so far has been slower than expected and there is pressure to move more rapidly to the next stage of the liberalisation strategy. Also, the current authorisation for maintaining the extensive controls will expire at the end of 2013 and would need to be extended by parliament unless the controls were to be lifted by then.

Secondly, the sovereign's balance sheet might also be affected by a negative outcome from the "Icesave" litigation. While asset recoveries from the Landsbanki estate now exceed priority deposit claims - mitigating to a certain extent the severity of this risk - the risk to the government's balance sheet has not disappeared and could still be substantial. According to recent IMF estimates, the cost to government could be close to 20% of GDP in a worst-case scenario (although significantly lower at 3.5-6% of GDP in more favourable scenarios). The European Free Trade Association (EFTA) Court is expected to rule on the case before the end of the year, although Moody's notes that this does not necessarily remove the uncertainty over the final cost to government as the financial liability would have to be determined through further litigation unless the parties reach an agreement.

Finally, Moody's notes that the financial system remains weak. While the commercial banks are highly capitalised at the moment, asset quality remains comparatively poor with non-performing loans at around 10% (19% according to the cross-default method used by the Icelandic authorities) and the relaxation of capital controls might place substantial pressure on the banks' currently comfortable liquidity positions. Given the government's own elevated debt burden, it is unlikely to be in a position to support the banking system in case of new problems emerging.

#### WHAT COULD MOVE THE RATING UP/DOWN

Moody's would consider stabilising the outlook on Iceland's Baa3 rating if the above-mentioned key risks substantially diminish.

Downwards pressure would develop on the rating if Moody's expectations regarding capital control liberalisation did not materialise, leading to large and disorderly capital outflows and a severe weakening of the exchange rate, with negative consequences for the domestic economy. The rating could also come under downward pressure if no further progress was made in addressing the still elevated public debt ratio or if further problems emerged in the banking sector. A severe weakening of the euro area could also put pressure on Iceland's rating given the important trade linkages.

#### COUNTRY CEILINGS

The foreign-currency bond ceiling has been lowered to Baa3 and is now in line with the sovereign rating. The foreign-currency deposit ceiling remains unchanged at Baa3. Given the capital controls in place, which give the government and central bank extensive control over capital flows out of the country, Moody's views that the government's issuer and bond ratings constitute an upper limit to all other foreign-currency ratings. The local-currency bond and deposit ceilings have been lowered to Baa2 (from Aa3 and A1 respectively). All short-term ceilings remain at Prime-3.

The principal methodology used in this rating was Sovereign Bond Ratings published in September 2008. Please see the Credit Policy page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

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Kathrin Muehlbronner  
Vice President - Senior Analyst  
Sovereign Risk Group  
Moody's Investors Service Ltd.  
One Canada Square  
Canary Wharf  
London E14 5FA  
United Kingdom  
JOURNALISTS: 44 20 7772 5456  
SUBSCRIBERS: 44 20 7772 5454

Bart Oosterveld  
MD - Sovereign Risk  
Sovereign Risk Group  
JOURNALISTS: 212-553-0376  
SUBSCRIBERS: 212-553-1653

Releasing Office:  
Moody's Investors Service Ltd.  
One Canada Square  
Canary Wharf  
London E14 5FA  
United Kingdom  
JOURNALISTS: 44 20 7772 5456  
SUBSCRIBERS: 44 20 7772 5454



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