

**Announcement: Moody's issues annual credit analysis on Iceland**

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**Global Credit Research - 19 Jul 2011**

London, 19 July 2011 -- In its annual credit report on Iceland, Moody's Investors Service says that the Baa3 government bond rating reflects the country's moderate level of economic strength as well as its high institutional strength. The negative outlook on the rating mainly reflects the government's budgetary challenges as well as a high susceptibility to event risk.

Iceland has made significant progress to bring its economy, financial system and public finances back onto a sustainable path, with the economy showing the first signs of positive growth. Moody's moderate assessment of economic strength balances the high levels of wealth with the small size and undiversified structure of the economy. Iceland's GDP per capita is among the highest in Moody's rating universe, despite the significant loss in wealth due to the recent banking and currency crisis. Overall, Moody's expects Iceland to experience a moderate recovery, based predominantly on exports and investment. However, uncertainties remain, mainly related to the outlook for investment, against a background of slow corporate debt restructuring and funding constraints due to capital controls.

Moody's considers Iceland's institutional strength to be high. The authorities are still in the process of adapting the policy framework in major areas. The banking sector has been recapitalized and regulation and supervision have been improved, although some weaknesses persist. The first steps in relaxing the strict capital controls have been taken but the process is generally expected to take some time. The Icesave dispute is less of a risk to public finances than previously thought, but remains unresolved.

The fiscal picture is improving. The budget deficit has been reduced according to plans in 2010 and the 2011 target is also achievable. Nevertheless, the government's financial strength is currently assessed as low, mainly based on: (i) uncertainties regarding the commitment to maintain a sufficiently restrictive fiscal policy and (ii) the very rapid increase in public debt since 2008 and the ongoing legal risks to the government's balance sheet emanating from litigation against the Emergency Law and the Icesave dispute. Both of the above issues should become clearer in the coming months, which could lead Moody's to reassess our view on the government's financial strength.

Susceptibility to event risk is assessed as high, mainly on account of the remaining litigation risks and the risks entailed in the process of capital control liberalisation. Moody's could consider moving its assessment to moderate once there is a track record of successful steps in liberalising the capital controls. An overly rapid relaxation of the controls constitutes the biggest event risk for Iceland, as the size of trapped holdings of foreign investors is substantial and their exit needs to be managed carefully.

The rating agency's report is an annual update to the markets and does not constitute a rating action.

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