

Credit Opinion: Iceland

Iceland

Ratings

Category	Moody's Rating
Outlook	Stable
Country Ceiling: Fgn Currency Debt	Aaa/P-1
Country Ceiling: Fgn Currency Bank Deposits	Aaa/P-1
Iceland, Government of	
Outlook	Stable
Government Bonds	Aaa/--
Commercial Paper	P-1
Other Short Term	P-1

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Key Indicators

Iceland

	2001	2002	2003	2004	2005	2006F	2007F
Real GDP (% change)	3.3	-1.3	3.0	8.2	7.5	4.2	1.0
Inflation (CPI, % change Dec/Dec)	6.4	5.2	2.4	4.0	4.0	7.3	4.5
Gen. Gov. Financial Balance/GDP (%)	0.2	-0.8	-2.0	0.5	5.5	3.8	1.5
Gen. Gov. Primary Balance/GDP (%)	3.7	2.1	0.9	3.1	7.7	7.2	4.6
Gross Gen. Gov. Debt/GDP (%)	44.4	43.2	40.2	35.7	26.5	23.7	23.2
Gross Gen. Gov. Debt/ Gen. Gov. Revenue (%)	103.4	98.5	90.3	77.9	54.4	50.9	51.7

Opinion

Credit Strengths

The credit strengths of Iceland include:

- High and evenly distributed standard of living; longstanding political stability
- Healthy government finances, low public direct debt
- Increasingly diversified economic base

Credit Challenges

The credit challenges facing Iceland include:

- Small, open economy susceptible to macroeconomic volatility sparked mainly by foreign investment activity
- Large contingent liabilities increase the importance of maintaining low government debt levels to ensure flexibility in handling potential systemic problems in the economy.

Rating Rationale

The government of Iceland's debt is rated Aaa/Prime 1. The foreign currency country ceiling of Iceland is also Aaa, reflecting the Aaa government bond rating and the minimal risk of government bond default or payments moratorium. The ratings are based on the country's advanced economic development, its longstanding political stability, its high and evenly distributed standard of living, and its healthy government finances. Public debt is expected to register 23.7% of GDP this year, less than half the level of other Aaa-rated sovereigns. Public finances will continue to benefit from favorable labor force demographics going forward, with a young population, low unemployment, and long working lives, along with a very healthy pension situation. The guaranteed debt of state-owned entities such as the National Power Company adds to the government's contingent liabilities, as do the banks that have grown dramatically in size. Given Iceland's volatile economic performance by industrial country standards, it is vital that the government's direct debt remain low in order to be able to absorb any additional payment obligations that could derive from these sources.

Rating Outlook

The rating outlook is stable. Strong private sector expansion in foreign markets and large foreign investment projects continue to help diversify the economy away from fishing, even as they introduce temporary macroeconomic imbalances. The country's large foreign private sector indebtedness magnifies the importance of managing the consequences of these and other future investments with an appropriate blend of monetary, fiscal, and incomes policies in order to avoid cyclical extremes.

The Icelandic economy has proven itself to be unusually flexible and highly capable of withstanding shocks, further substantiating the Aaa rating.

What Could Change the Rating - DOWN

The government's exceptionally strong government finances are critical to offsetting the risks to macroeconomic stability generated by the large private sector external debt. A substantial, persistent deterioration of public finances would therefore exert downward pressure on the ratings.

Recent Results and Developments

The current largest-ever investment wave in Iceland's power-intensive industries, and structural changes in the financial markets that have fueled rapid credit creation are resulting in outsized current account deficits (about 16% in 2005 and 18.7% 2006). The Central Bank of Iceland has been aggressively tightening monetary conditions, but the depreciation of the ISK since the beginning of the year continues to fuel inflation way above target.

Project and non-project external debt has grown rapidly. Gross external debt is approaching 50% of GDP-- more than double the level just three years ago. In spite of the recent inevitable fall in the nominal exchange rate, an FX-generated banking system crisis is highly unlikely. FX on-lending has overwhelmingly financed borrowers with FX income streams. Large acquisitions abroad have significantly diversified bank balance sheets, insulating the system from Icelandic shocks. The banking system is well-capitalized, amply liquid and has strong oversight. Next year's large amortizations are already almost fully funded. Regardless, public finances are extremely strong and flexible enough to handle a crisis in the remote event it were to occur, without increasing the risk of a sovereign default.

In face of the overheating conditions (and given the experience of looser fiscal policy during past boom times) fiscal policy was tightened considerably last year, as revealed by major revisions to the accounts. However, because the tightening wasn't so evident during the year -- in April 2005 the surplus was expected to be a mere 0.9% of GDP -- this gave a boost to demand. The fiscal surplus is expected to shrink to 3.8% of GDP in 2006 because of the deceleration of growth. A few months ago the government pledged to delay planned infrastructure projects and slice planned tax cuts in the face of the inflationary pressures in the economy, but the fiscal budget for 2007, in the run-up to parliamentary elections next year, backtracks on these promises. The result will likely be further interest rate hikes from the already high level of 14%.

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