Rating Action: Iceland

Moody's downgrades Iceland's ratings to A1 from Aa1; review continues

London, 08 October 2008 -- Moody's Investors Service downgraded to A1 from Aa1 the government bond ratings and country ceiling for foreign currency bank deposit ceiling of Iceland. Both the bond ratings and ceiling remain under review for possible downgrade.

"In recent weeks, the unprecedented seizing up of global credit markets has compounded the difficulties of Icelandic banks and considerably complicated the task of the government to restore financial stability" says Moody's Vice President Kenneth Orchard, lead analyst for Iceland.

"While the sources of the crisis were well identified, its severity is clearly magnified by current global financial market dislocations. In such circumstances, the long term credit standing of the country depends on the authorities' crisis management skills and the extent to which the government's balance sheet will be durably impaired, both in absolute and comparative terms," adds Orchard.

The rating actions are based on the assessment that Iceland now faces a more durable and severe impairment of the government balance sheet as the result of the recent impact of the global liquidity crunch on the country's oversized banking system. Government attempts to stabilize the ailing banking system will likely lead to a sustained increase in public debt as the prospects for a rapid rebound have grown more remote.

"While our assumption was a severe but orderly banking crisis, only dissimilar in scale but not in nature with what happened in some other Nordic countries in the early 1990's, we now doubt that the weakening of government's finances will only be temporary."

In addition, the Icelandic authorities' resolution not to save the whole banking system at the cost of jeopardizing the government's creditworthiness -- reflected in decisions damaging to bank creditors' interests -- is fraught with operational difficulties.

Indeed, the attempt by the authorities to effectively "ring-fence" public finances from the fall-out of the banking crisis may only provide some needed short-term respite. "Such a crisis management approach is likely to allow Iceland some breathing space, but some of the banks' external liabilities will eventually filter through to the government's balance sheet," says Orchard. "Ultimately, the rating of the government is dependent on how the burden will be shared between Icelandic taxpayers and the banks' external creditors."

Moody's had placed Iceland's ratings under review on September 30, with the stated goal of analyzing "how the government intended to maintain financial stability and extend some support to banks, including in foreign currency, while not endangering its own credit standing."

The rating agency emphasized that the government is itself not facing any near-term foreign currency liquidity risk. Debt maturities in the next three years are light, although amortizations due from other parts of the public sector will likely require some support in the current environment. Official foreign exchange reserves plus the government's accumulated foreign exchange assets should be more than ample for this purpose.

However, looking through the current turbulence, gross government debt will increase significantly as the government borrows abroad to bolster confidence in its external liquidity. The current account deficit will shrink quickly as foreign financing becomes more limited, forcing a major macroeconomic adjustment. A deep recession will likely lead to large budget deficits, perhaps for an extended period of time, a stark contrast to the fiscal surpluses of recent years.

"The impact in terms of net debt is less certain of course," adds Orchard, "but the combination of a domestic recession in an unsupportive global environment, the rebuilding of a banking system and the lingering legacy cost of bank failures will durably weaken public finances."

The rating agency's continuing review will focus on whether the deleveraging of the banking system now underway can be accomplished in a reasonably orderly fashion so as to minimize the further loss of market confidence, and for the economy to regain its composure relatively quickly. The review will also seek to gain greater clarity on the government's potential obligations vis-à-vis the banking sector's foreign liabilities.

The situation remains fluid, and new events and developments are happening quickly. To provide some clarity around the possible future path of the ratings, Moody's outlines three potential scenarios, with the "crisis stabilization" scenario appearing, at this juncture, as slightly less likely than the more protracted "crisis containment" scenario:

The first scenario ("crisis stabilization") would see the foreign operations of the banking sector gradually wound up with limited losses. The government would be able to effectively manage the restructuring of the local banks such that the impact on the overall economy is contained. Gross debt would increase but then rapidly fall (although not as far as the current low levels) as the economy recovered. Foreign liquidity would also return quickly, both due to better global conditions and improved estimations of the country's prospects. This scenario of "crisis stabilization" would be consistent with the current A1 rating.

In the second scenario ("crisis containment"), the foreign operations of the banking sector would be liquidated, causing significant losses for foreign creditors, potentially including depositors. As the ultimate administrator of the banks, the government would eventually be forced to provide compensation for some creditors (but not all). The collapse of the foreign side of the banking sector would cause a sharp adjustment to the economy as external credit becomes limited. Despite additional pressure on the currency, the central bank would ultimately be able to stabilize the macro-economy at a rather moderate cost. Public debt would increase significantly as, in addition to providing some compensation for foreign bank creditors, the government recapitalizes the domestic parts of the banks and stimulates aggregate demand. This scenario of a costly "containment" of the crisis is consistent with mild additional downward pressure on the current rating.

In the third scenario ("uncontrolled crisis"), deemed to be least likely, the government is forced to renege on its earlier statements and provide significant financial support for the banks' foreign liabilities. The collapse of the banking sector causes speculative attacks to worsen, possibly leading to a deep confidence crisis in the currency, and massive foreign borrowing becomes necessary to stabilize the macro-economy. The impact on the domestic economy is severe and the government is forced to run very large budget deficits for some time to prevent a collapse of domestic demand. Government debt increases significantly and stabilizes at a very high level. This scenario is consistent with additional downward pressures on the rating.

The foreign currency bond ceiling was also downgraded from Aaa to Aa1 and placed on review for possible downgrade.

New York

Kristin Lindow

Senior Vice President

Sovereign Risk Group

Moody's Investors Service - New York NY

JOURNALISTS: 212-553-0376

SUBSCRIBERS: 212-553-1653

London
Kenneth Orchard
Vice President - Senior Analyst
Sovereign Risk Group
Moody's Investors Service Ltd.
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

New York
Joan Feldbaum-Vidra
Asst Vice President - Analyst
Sovereign Risk Group
Moody's Investors Service
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653