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ISSUER COMMENT

# Iceland: 2012 Budget Plan Is Positive, But Full Implementation of Targets Will Be Crucial

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The continued fiscal consolidation targeted by Iceland's 2012 budget plan is positive. It follows two years of significant fiscal consolidation which are expected to reduce the general government deficit from a peak of 13.5% of GDP in 2008[1] to an estimated 5.7% of GDP this year. Fiscal risks associated with litigation are receding following the recent Supreme Court decision related to the Emergency Legislation. At the same time, we note that the government's fiscal plan envisages a slower pace of implementation than had been agreed earlier under the IMF Stand-By Agreement. With Iceland's public debt ratio still at very high levels, full implementation of the fiscal targets is essential to bring public debt back onto a sustainable path and ease the downward pressure on its Baa3 rating, which currently carries a negative outlook.

The Icelandic government presented its budget plan for 2012 to parliament last month. The draft budget which needs to obtain parliamentary approval before year-end aims to achieve the following targets:

» A central government budget deficit of 1% of GDP, compared to an estimated deficit of 2.6% of GDP in 2011. When including the recapitalisation of HFF (Housing Finance Fund) and savings banks, the 2011 deficit increases by 2.2% of GDP to 4.8% of GDP.[2]

» A central government primary surplus of 2.2% of GDP compared to a broadly balanced primary budget this year.

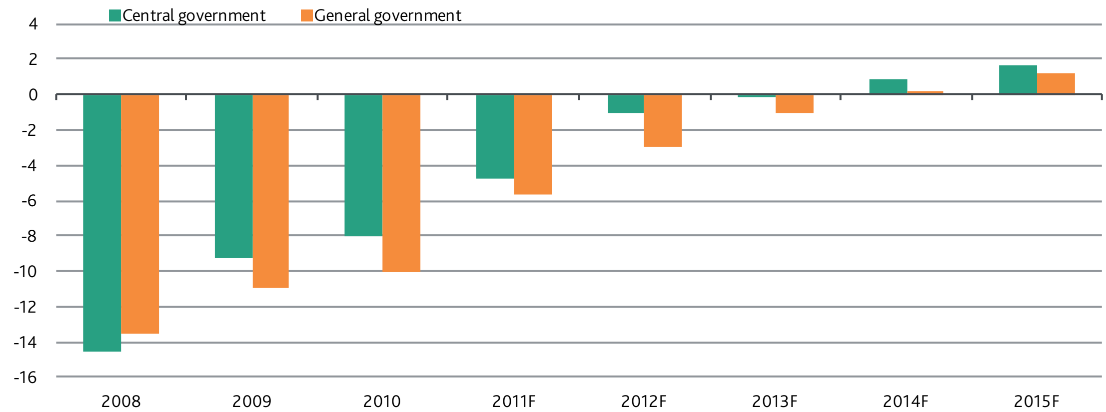
» Most of the improvement in the deficit is to come from increased revenues through targeted tax hikes and reductions in tax deductions (amounting to 1.2% of GDP), which will largely remain in place until 2015.

» Measures on the expenditure side are more moderate, accounting for less than 30% of the fiscal adjustment or 0.5% of GDP.

[1] This includes write-offs amounting to 13% of GDP. The write-offs were mainly the result of central bank recapitalization and securities lending contracts that failed after the "old" banks collapsed.

[2] In addition, we estimate the aggregate deficit at the municipal level to add close to 1% of GDP to the overall budget deficit.

FIGURE 1
**Fiscal Balance**
(% of GDP)



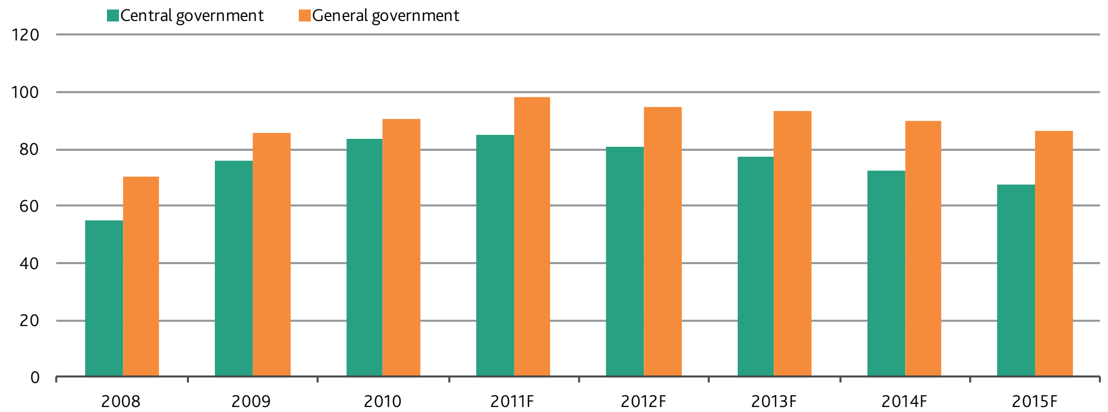

*Source: Ministry Finance of Iceland, 2011 and 2012 general government deficit are Moody's forecasts*

The government also presented its revised medium-term fiscal consolidation plan until 2015 which foresees continued progress over the coming years, but at a somewhat slower pace than had previously been agreed with the IMF under its Stand-By Program. While the earlier plan had assumed that an overall surplus in the general government budget would be achieved in 2013, this is now being postponed by a year. Also, the primary surplus targeted for the medium term is now being lowered by a percentage point from the previous 6% of GDP. The government argues that the slower pace of deficit reduction is feasible as the public debt burden is smaller than initially expected[3]. A slower deficit reduction would also support economic growth.

Under the government's revised plans the debt ratio would indeed be on a firm downward path in the coming years (see chart below). Still, aiming for more aggressive targets would have provided a stronger platform for rating stability as it would allow the authorities to establish full fiscal credibility early on after the completion of the IMF program, which provided an important external "anchor" for fiscal credibility over the past three years.

[3] The IMF now forecasts a peak in Iceland's gross public debt ratio of 100% in 2011, compared with its earlier forecasts which predicted a debt ratio peak at 136% of GDP in 2010.

FIGURE 2
**Public Debt Ratio**
(% of GDP)

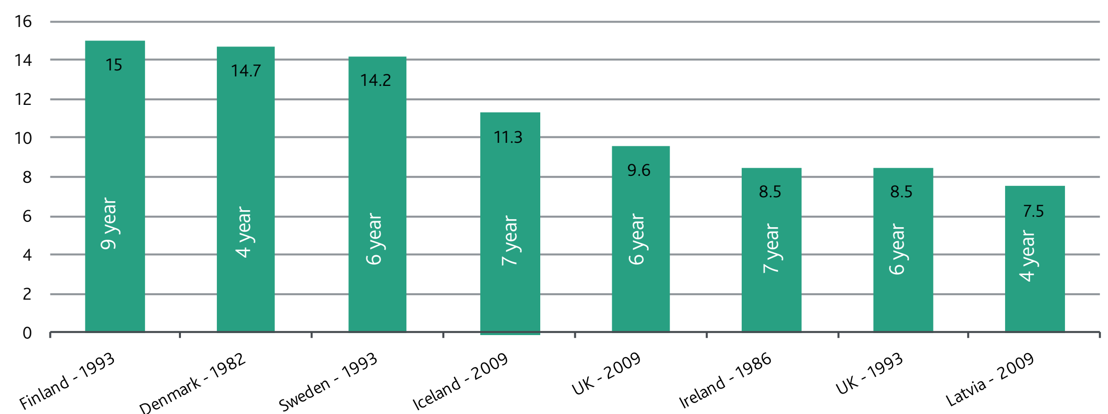



*Source: Ministry of Finance of Iceland; IMF and Moody's*

## Significant fiscal consolidation has been achieved

We acknowledge that the Icelandic authorities have been implementing important fiscal consolidation measures over the last two years. Assuming that the 2012 budget target will be achieved, the total fiscal adjustment will amount to 8% of GDP between 2009 and 2012. This is a significant achievement, in particular against the background of the deep recession over the past two years in Iceland. The new budget plan envisages a further (more moderate) adjustment of 2.4% of GDP in the primary balance between 2012 and 2015, thereby bringing the total fiscal adjustment for the period 2009-2015 to more than 11% of GDP. This is broadly in line with the fiscal adjustment achieved by the Nordic countries during the resolution of their crises in the early 1990s.

FIGURE 3
**Fiscal Reversal in Selected Countries**
(% of GDP)




*Source: Central Bank of Iceland, Improvement in primary balance over time frame indicated*

## Legal risks to public finances are gradually being eliminated

A recent decision by the country's Supreme Court on the legality of the Emergency Legislation has removed a significant (albeit in our view low-probability) risk to the government's finances. The Court upheld the priority claimant position of depositors over other obligors (including bondholders) of the "old" banks in winding-up process. In the context of the Icesave issue, the decision means that the expected asset recovery from the Landsbanki estate will most likely be sufficient to repay the UK and Dutch deposit insurance funds in full.[4] The repayments are expected to start early next year at the latest. Litigation risks related to the eventual resolution of the Icesave issue remain, but we note that the high asset recovery from the Landsbanki estate also mitigates this risk to an important degree.[5]

## Sustained reduction of public debt will be key driver for Iceland's creditworthiness and rating

With legal and banking-sector related risks receding, our credit analysis is increasingly focusing on the Icelandic government's financial strength and its ability to reduce its very high public debt levels to sustainable levels over the coming years. While we acknowledge that the authorities have made important initial strides in this respect, the government will have to implement further sustained fiscal consolidation measures over several more years. Over the past three years, the IMF program has provided an important external "anchor". Going forward, the Icelandic government's ability to achieve its fiscal targets and steer its debt ratio along a clear and sustained downward path will be an important driver for Iceland's creditworthiness and rating.

## Risks to the fiscal outlook remain significant

The most significant risk to the government's medium-term fiscal plan emanates from the economy. According to the IMF's debt sustainability analysis, a permanent reduction in the average GDP growth rate by 0.5 percentage points would result in an increase of the debt ratio to 107% of GDP versus the baseline assumption of a decline to 81% of GDP by 2016.[6] The Icelandic economy has finally emerged from the deep recession of 2009-2010, with real GDP growth amounting to 2.5% in H1 2011 and leading indicators pointing to a continuation of this trend in Q3. But the government's growth assumption underpinning the draft budget for 2012 is quite optimistic at 3.1%, against the background of a slowdown in global growth, which would affect Iceland's exports and might well delay foreign investment. Although Iceland's key trading partners are in the EU, the impact of a slowdown in growth there is probably less pronounced. The prices of two of Iceland's key export products (aluminium and fish) are determined by global markets and export volumes for Iceland are constrained more by supply considerations than demand abroad.

The uncertainty over the medium-term economic outlook also remains considerable. Growth in Iceland's undiversified and small economy crucially depends on a few large-scale investment projects and will also be determined to a large extent by the pace of capital account liberalisation. GDP growth could therefore turn out to be significantly lower, thus requiring further fiscal adjustment measures beyond those assumed in the government's fiscal plan.

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[4] The latest information from the Winding-Up Committee of Landsbanki indicates a recovery ratio of 98% of all priority deposit claims as of June 2011.

[5] As of now, it is still unclear whether and if so when the EFTA Surveillance Authority (ESA) will refer the issue to the EFTA Court. Should the EFTA Court then find Iceland in breach of its obligations regarding deposit insurance, this may give rise to further liabilities for the Icelandic government.

[6] See IMF, Sixth Review, August 2011.

Secondly, the current fiscal projections are based on the assumption that the government will not take on any further additional liabilities as it did last year with the recapitalisation of HFF, which nevertheless remains thinly capitalised. Total outstanding guarantees for publicly owned companies (mainly HFF and the power company Landsvirkjun) amount to ISK1,335 billion or around 80% of GDP.

Thirdly, the local government sector will have to contribute to the fiscal consolidation effort. We view positively the recent approval (after some delays) of a new local government fiscal framework, which will become effective from 2012 onwards. It imposes strict limits on municipal borrowing, tighter monitoring of the municipalities' budget execution and a rolling three-year balanced budget target. Given that the debt levels of several municipalities are currently significantly above the newly established limit of 150% of revenues, we believe that full implementation of the new framework will be crucial.

## Moody's Related Research

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Issuer Comment:

- Iceland's Recent Supreme Court Decision on Foreign-Exchange-Linked Bank Loans Reduces Uncertainty But No Rating Impact, September 2010

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- Sovereign Bond Ratings, September 2008 (109490)

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Report Number: 137403

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