MOODY'S INVESTORS SERVICE

Announcement: Moody's: Iceland's creditworthiness supported by improving economy and public finances, but capital account liberalisation risks remain

Global Credit Research - 17 Jul 2013

London, 17 July 2013 -- In its annual credit report on Iceland, Moody's Investors Service says that Iceland's Baa3 government bond rating reflects the improving economy and public finances. At the same time, the rating is constrained by the challenges associated with liberalising the strict capital controls in place and the government's still elevated debt burden.

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

Moody's determines a country's sovereign rating by assessing it on the basis of four key factors -- economic strength, institutional strength, government financial strength and susceptibility to event risk -- as well as the interplay between them.

The rating agency's moderate assessment of Iceland's economic strength balances the high levels of wealth with the small size and undiversified structure of the economy. The post-crisis recovery is under way and Iceland's short-term growth outlook is relatively favourable, although growth has moderated in the last year. Over the medium term, Iceland's growth prospects depend crucially on the outlook for investment, which is in turn largely dependent on the speed with which the extensive capital controls are removed.

Moody's assesses Iceland's institutional strength as high, given the significant progress that the authorities have made in bringing the economy, the financial system and the public finances back onto a sustainable path. The government has implemented important changes to its institutions and to the banking sector's regulatory framework so as to avoid another crisis.

Government financial strength is considered by Moody's to be low, mainly on account of the still elevated debt burden. At the same time, the government has managed to reduce the budget deficit significantly from its 2008 peak and in 2012 the public debt ratio started to decline for the first time since the crisis began. A material reduction in the debt burden in the coming years will depend on the ability of government to further strengthen the country's fiscal position and run consistent and substantial primary surpluses. In addition, the government's contingent liabilities are very large and mainly arise from its guarantee for Housing Financing Fund liabilities.

Susceptibility to event risk is assessed as moderate, mainly reflecting the risks emanating from the process of capital control liberalisation. As the size of potential capital outflows is substantial, the risk of too rapid a loosening in capital controls remains the key event risk for Iceland in Moody's view. At the same time, the rating agency acknowledges that the authorities are well aware of these risks. In addition, the banking system should be able to withstand the relaxation of capital controls, as the central bank and the banking regulator require the banks to maintain very high levels of liquidity and capital. Moreover, the Icesave dispute is no longer a relevant risk following the EFTA Court decision in favour of Iceland earlier this year.

Moody's annual credit report on Iceland is now available on www.moodys.com.

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