Moody's Investors Service

Global Credit Research
Credit Opinion
20 AUG 2007

Credit Opinion: Iceland, Government of

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Ratings

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

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Key Indicators

Iceland

	2002	2003	2004	2005	2006	2007F	2008F
Real GDP (% change)	-1.3	3.0	7.6	7.2	2.6	-0.1	2.0
Inflation (CPI, % change Dec/Dec)	4.8	2.2	3.2	4.0	6.8	4.5	3.1
Gen. Gov. Financial Balance/GDP (%)	-2.6	-2.8	0.2	5.3	5.3	3.2	-1.1
Gen. Gov. Primary Balance/GDP (%)	0.4	-0.1	2.6	7.4	7.5	5.8	1.2
Gross Gen. Gov. Debt/GDP (%)	43.5	40.7	35.5	25.5	30.1	30.9	29.0
Gross Gen. Gov. Debt/ Gen. Gov. Revenue (%)	104.1	95.0	80.1	53.6	64.5	65.3	63.9

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 require the maintenance of 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. Government debt stands at about 30% of GDP, less than half the level of many 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 represent contingent liabilities for the government, 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 remains 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 a careful balancing 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 exert downward pressure on the ratings.

Recent Results and Developments

The Icelandic economy is cooling down fast after an episode of overheating, with negative GDP growth expected to be recorded this year. Next year's growth performance should improve partly due to fiscal relaxation (lower VAT and income tax in 2007, plus increased infrastructure spending). The recent decisions to lower the loan-to-value ratio for mortgages offered by the state-owned Housing Finance Fun from 90% to 80%, plus the large cuts in allowable fish catches for the next fishing year, should dampen demand pressures. The adverse conditions in the financial markets have not left Iceland unscathed; indeed the ISK has depreciated significantly in recent weeks, and this should also contain demand pressures, as will the Central Bank of Iceland's tight monetary policy stance.

These conditions, plus fiscal loosening pressures in the run-up to the May parliamentary elections, are leading to a weakening of government finances, with the fiscal surplus expected to fall to about 3% from over 5% in 2005-2006. The MOF expects the fiscal accounts to record a deficit next year as infrastructure projects are accelerated.

The new grand coalition of the center-right IP and the center-left SDA has a strong 2/3rds majority in parliament. It pledges to continue a business-friendly policy and will further tax cuts. It is also dedicated to achieving a more stable macroeconomic environment than the past few years have witnessed.

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