Credit Opinion: Iceland, Government of

Global Credit Research - 21 Feb 2012

Ratings

Category	Moody's Rating
Outlook	Negative
Government Bonds	Baa3
Commercial Paper	P-3
Other Short Term	(P)P-3
Iceland	
Outlook	Negative
Country Ceiling: Fgn Currency Debt	Baa2/P-3
Country Ceiling: Fgn Currency Bank Deposits	Baa3/P-3

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Key Indicators

Iceland

	2005	2006	2007	2008	2009	2010	2011E	2012F	2013F
Real GDP (% change)	7.2	4.7	6.0	1.3	-6.7	-4.0	3.0	2.5	2.5
Inflation (CPI, % change Dec/Dec)	4.1	7.0	5.9	18.1	7.5	2.5	5.3	3.8	3.2
Gen. Gov. Financial Balance/GDP (%)	4.9	6.3	5.4	-13.5	-9.0	-9.0	-6.2	-2.5	-1.2
Gen. Gov. Debt/GDP (%) [1]	25.4	30.1	29.1	75.4	96.8	103.0	117.3	108.3	94.0
Gen. Gov. Debt/Gen. Gov. Revenue (%)	57.7	63.9	60.7	158.1	219.5	250.6	277.2	264.2	226.5
Gen. Gov. Int. Pymt/Gen. Gov. Revenue (%)	4.7	4.5	5.4	7.6	5.1	6.9	8.8	12.0	13.3
Current Account Balance/GDP (%)	-16.2	-23.8	-15.7	-24.5	-11.7	-8.0	1.7	1.9	-0.4
External Debt/CA Receipts (%) [2]	704.7	911.0	1,077.3	1,073.7	451.6	465.6	431.5	306.5	301.6
External Vulnerability Indicator [3]	865.4	1,242.8	1,333.2	2,039.5	1,376.8	222.6	237.5	172.1	134.3

[1] General Government debt includes the IMF and Nordic loans. [2] Current Account Receipts [3] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/ Official Foreign Exchange Reserves

Opinion

Credit Strengths

The credit strengths of Iceland include:

- Advanced economic and political development

- Strengthened institutions since the crisis and a flexible, skilled labour force

- Significant unexploited natural resource base, offering long term economic growth potential

Credit Challenges

The credit challenges facing Iceland include:

- Achieving an appropriate sequencing of capital control liberalisation and normalising official and private international financial flows to the country to bring the economy back onto a sustainable growth pattern

- Further reducing the budget deficit and the still very high government and external debt ratios

Rating Rationale

The Icelandic government's rating has been at Baa3 since end-2009. On a fundamental assessment, Iceland exhibits moderate economic strength. Although a significant amount of wealth was destroyed during the currency and banking crisis in late 2008, per capita incomes remain comparatively high on a global scale. Offsetting the high level of wealth is the small size of the economy, which increases its vulnerability to shocks. The economy is emerging slowly from the deep recession following its financial and banking crisis. The economy is expected to rebound moderately this year and over the medium term, stimulated by the weak exchange rate and new investment in power-intensive industries. However, there are significant uncertainties, in particular regarding the outlook for investment which depends to an important extent on the speed with which the strict capital controls will be abolished.

The government's financial strength is considered to be low, due mainly to high public debt level, following the assumption of large financial liabilities following the banking and currency crisis. The government has implemented important fiscal consolidation measures since 2009. The recently presented 2012 budget and the revised medium-term fiscal strategy give some comfort regarding the authorities' resolve to return public debt to a more easily manageable level. In addition, the government is putting in place budgetary structures to ensure that fiscal policy remains on track over the medium term. A revised fiscal framework for the local authorities is being implemented and the government is developing a new organic budget law with the technical support from the IMF to preserve fiscal discipline and prevent a reversion to the strong pro-cyclicality of fiscal policy prior to the crisis. Provided that the fiscal consolidation path is adhered to, the fiscal adjustment in Iceland would be in line or slightly better than that of the Nordic countries following their banking crises in the early 1990s. The public debt ratio probably reached its peak last year at close to 118% of GDP (including the liabilities to the IMF and Norway which were extended to the central bank rather than the government) and is expected to decline from 2012 onwards. However, this scenario requires ongoing strong commitment to fiscal consolidation for many years to come. Significant risks to the outlook for public finances remain, in particular (i) the uncertain outlook for economic growth over the next several years and (ii) the possible crystallisation of further contingent liabilities onto the government's balance sheet. The banking sector recapitalisation has been more or less completed although HFF remains thinly capitalised and will probably require further capital support from the government. Also, the government has guaranteed significant amounts of debt of the Housing Financing Fund and the major Icelandic power company Landsvirkjun. A mitigating factor are the significant financial assets that the government has acquired as part of the recapitalisation of the "new" banking system. Taking those assets into account reduces the government's net debt burden to around 78% of GDP this year (excluding Icesave due to the uncertainty over the eventual obligation). Moreover, the existence of large domestic pension funds allows the government to finance itself in the local capital markets at low interest rates and relatively long maturities, which is an important funding support given the capital controls in place.

Iceland is considered to have a high susceptibility to event risk, mainly on account of the risks entailed in the process of capital control liberalisation. On the one hand, the lifting of the capital controls and renewed access to external funding are crucial elements for a sustained recovery in Iceland. On the other, a too rapid relaxation of capital controls risks creating excessive exchange rate weakness. Foreign investors - trapped in the country when the capital controls were introduced in late 2008 - hold an estimated ISK465 billion (approx. 30% of GDP) in assets in the country. Most, if not all, will want to exit as soon as possible, with significant implications for the exchange rate, if their exit is not properly sequenced and managed. Once there is a track record of successful steps in liberalising the capital controls, we will probably consider moving our assessment of susceptibility to event risk back to moderate.

There is still litigation risk related to the EFTA Surveillance Authority (ESA) decision to take Iceland to court over the Icelandic government's breach of the Deposit Guarantee Directive. A decision will likely be taken by the end of 2012. The Landsbanki Winding-Up Board already paid out a first tranche to priority claimants in December 2011. The total amount disbursed was equivalent to ISK 432 billion, which is close to one-third of the recognized priority claims of ISK 1,319 bn. Total assets of the Landsbanki estate as of September 2011 were ISK 1,285 billion. Recovery estimates have been steadily increasing over the past quarters. Clearly, not all assets are currently liquid and the Icelandic government expects that the recovery process will take until the end of 2013. However, the outstanding Icesave obligation and potential liability to the government (if found liable) will most likely be quite limited by the time the legal process has run its course.

Rating Outlook

The outlook on the ratings remains negative given the risks to fiscal consolidation and the process of capital control liberalisation.

What Could Change the Rating - Up

The ratings could be upgraded if there are signs of a robust and sustained economic recovery, significant fiscal consolidation continues and the exchange rate remains broadly stable during the process of gradual capital control relaxation.

What Could Change the Rating - Down

The rating could be downgraded if the current commitment to fiscal consolidation showed signs of declining or the remaining legal risks related to a resolution of the Icesave issue resulted in a significantly higher liability for the government than is currently expected.

Going forward, the speed and sequencing of capital account liberalization will become a more important rating driver and Moody's will closely monitor the impact of the next steps on the exchange rate and financial stability.

Recent Developments

The first budget after the end of the IMF program (which provided an important external anchor for fiscal policy in our view) for 2012 is compatible with a further reduction in the budget deficit compared to 2011. While the pace of fiscal consolidation has been slowed down compared to plans under the IMF program, the budget still indicates strong commitment. It envisages a primary surplus of around 2% of GDP for the central government, a swing of around 8 percentage points of GDP since 2009. The overall budget deficit is targeted at 1.15% of GDP, compared to a deficit of 9.3% of GDP in 2009. The central bank estimates the overall fiscal adjustment between 2009 and 2012 at 14% of GDP. Hence, there is no doubt that substantial fiscal consolidation has been achieved in the past few years, against the backdrop of a severe recession (GDP/capita at end-2011 was 33% below the peak reached in 2007). 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) most of which are expected to remain in place until 2015. Measures on the expenditure side are more moderate, accounting for less than 30% of the fiscal adjustment.

The authorities have recently successfully concluded the first of its planned foreign-currency auctions, as part of their strategy to relax the capital controls, involving direct investment in the Icelandic economy. Half of the investment amount can be obtained at the offshore ISK exchange rate and funds will have to remain committed for a period of five years. Alternatively, investors buy long-term government bonds. The central bank auctioned a larger-than-expected amount of EUR 141 million, which are being added to the foreign-exchange reserves. We continue to expect the liberalisation process to take several years to complete.