Rating Action: Iceland, Government of

Moody's downgrades Iceland's ratings to Baa1; negative outlook

London, 04 December 2008 -- Moody's Investors Service has today downgraded the foreign and local currency ratings of the Government of Iceland to Baa1 with a negative outlook from A1, thereby concluding the rating agency's review for possible downgrade announced on 8 October 2008. The government's short term rating was changed to P-2 from P-1.

"The downgrade reflects Moody's view that the Icelandic government's financial strength has been significantly damaged by the banking and currency crisis," says Kenneth Orchard, Vice-President/Senior Analyst in Moody's Sovereign Risk Group. "The impact of the crisis on the economy, the restructuring of the banking sector and the task of stabilising the currency will force the government to assume sizeable amounts of debt that will weigh on the public sector balance sheet for many years to come."

Although the acute phase of the Icelandic banking and currency crisis has now passed, Mr. Orchard emphasises that the outlook for the next 2-3 years remains difficult. "The collapse of the banking system and exchange rate in September and October 2008 is already having far-reaching implications for the broader economy," says Mr. Orchard. Many Icelandic businesses and households had contracted foreign currency-denominated loans, and are now facing much higher debt service payments. Moreover, asset prices have plummeted and unemployment is rising.

The decline in economic activity will have a major influence on government revenues and expenditures, according to Mr. Orchard. "Indeed, government revenues are expected to contract substantially in 2009 even while expenditures on social transfers and debt service grow. The net result will be very large budget deficits that will persist over the medium term."

Orchard highlights that government debt will soar over the next 12-24 months as the government borrows to stabilise the currency, re-capitalise the banking sector and finance the large budget deficit. "Including loans from the IMF and European governments, gross domestic and foreign government debt/GDP could rise from 28% in 2007 to over 150% in 2009-10," says Mr. Orchard.

Despite the high headline figure, Moody's expects the debt burden to remain manageable. Much of the new debt will be used to increase the central bank's foreign exchange reserves and provide capital to the new banks, which will eventually be sold. The largest portion of the debt -- acquired as part of a deal with the British and Dutch governments to compensate former depositors of the old Landsbanki's Icesave internet accounts -- will be reduced once the old banks' assets are wound up and sold.

"Net debt/GDP, taking into account government assets that were acquired during the takeover of the old banks, should remain below 100% -- a high but manageable level for a wealthy country such as Iceland," says Mr. Orchard. "Moreover, re-financing risk is low. Most of the new debt will be non-market -- owed to official multilateral and bilateral lenders -- with flexible maturities, whereas market debt maturing in the next few years is modest."

Moody's base case scenario is for the Icelandic currency to stabilise quickly, allowing the central bank to minimise its intervention in the foreign markets and retain the bulk of its new debt in official reserves. "The implementation of tight capital controls and the rapid reversal of the current account from deficit to surplus should alleviate downward pressure on the krona and may even lead to a gradual appreciation. Such a scenario would reduce stress on foreign currency borrowers and allow the central bank to lower interest rates, easing the strain on the broader economy."

"A gradual economic recovery, perhaps beginning in 2010-11, would allow for fiscal consolidation that -- combined with some currency appreciation and a satisfactory resolution to the Icesave problem -- would cause gross government debt ratios to decline rapidly," explains Mr. Orchard.

"Ultimately, Moody's expects the government's gross debt ratios to decline to around 70%-90% of GDP, comparable to several highly-rated European countries, whose debt will also drift upward during the course of the global crisis," adds Mr. Orchard.

However, Mr. Orchard emphasises that there is execution risk and that this is the reason for the negative outlook. "There is a slight risk that the central bank will struggle to stabilise the exchange rate, given the ongoing global credit crunch and despite initially tight capital controls. If this were to occur, the economic contraction would likely be worse than anticipated and government debt ratios would end up being higher." Mr. Orchard cautions that such a scenario would lead to additional modest downward pressure on Iceland's rating.

As part of today's rating action, Moody's also downgraded Iceland's foreign currency bond ceiling to A2/negative, based on the government's bond rating of Baa1/negative and Moody's assessment of a low risk of an external payments moratorium. The foreign currency deposit ceiling was downgraded to Baa1, also with a negative outlook. The short term foreign currency bond and deposit ceilings are both P-2.

In addition, the local currency deposit ceiling (LCDC) was lowered to A1 from Aaa. The LCDC measures the ability of public authorities to support the banking system in times of crisis through local currency injections -- amongst other means -- and also represents the rating that Moody's would give to the central bank's debt in krona. Moody's notes that this ability to support domestic banks has been somewhat ineffectual in the context of a sudden and massive banking crisis where a large part of the liabilities were denominated in foreign currencies. In such rare circumstances, the nature of the banks' liabilities and also their size impede the orderly resolution of a systemic crisis. The rating agency cautions that, in extremis, even the ability of the central bank to control the local currency can be endangered. Accordingly, while the LCDC at A1 is still higher than the government bond rating, it is lower than Aaa to reflect the very low, albeit not negligible, risks that the situation may be very difficult to control.

The previous rating action with respect to the Government of Iceland was implemented on 8 October 2008 when Moody's downgraded the rating from Aa1 to A1, and left it on review for further possible downgrade.

The principal methodology that Moody's uses in rating the Government of Iceland is its Sovereign Bond Methodology, which can be found at www.moodys.com in the Credit Policy & Methodologies directory. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Credit Policy & Methodologies directory on Moody's website.

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