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Moody’s: Iceland’s Rating Pressured by Breakdown in Icesave Talks

London, <Rating Date Pending> -- Moody’s Investors Service said today that the breakdown in the talks between the governments of Iceland, the United Kingdom and Netherlands to resolve the Icesave dispute puts the Icelandic government’s Baa3 rating under downward pressure. This is because Moody’s believes the failure to reach a new agreement is likely to lead to an extended delay of the IMF programme, a weaker economic recovery and potentially, political instability. Overall, Moody’s believes that Iceland’s path out of the crisis now appears more difficult.

The renewed talks to reach a new agreement on Icesave were required because intense popular opposition to the earlier arrangement had prompted Iceland’s President to refuse to sign the legislation in early January. At that time, Moody's considered that – despite concerns that a protracted standoff with the British and Dutch governments would complicate Iceland’s exit from the crisis – it was premature to take any rating action. All parties had a strong interest in a new agreement that would put Iceland on the road to recovery and possible EU accession. “However, Moody’s now believes that this assumption may turn out to be optimistic in light of recent events,” explains Kenneth Orchard, Vice President – Senior Credit Officer in Moody’s Sovereign Risk Group.

The Icelandic government has announced that a referendum on the previous agreement will be held on 6 March 2010, but opinion polls suggest that the agreement will be voted down by a wide margin.

Moody’s notes that a “no” vote in the referendum may prevent access to significant external liquidity from the IMF and Nordic governments, as the UK and Netherlands have been blocking progress on the IMF programme pending a resolution of the Icesave dispute. The lack of extraordinary external liquidity from the IMF and Nordic governments could decrease confidence in the currency and delay the removal of capital controls. It also eliminates an emergency backstop should the government encounter difficulties in re-financing the external debt that matures in late 2011 and 2012.

“A rejection of the agreement would also prolong the uncertainty surrounding the economic and political outlook, and threaten to derail the nascent recovery,” adds Mr. Orchard. Although the economy performed better than expected in 2009, a robust recovery may not emerge until 2012 or even later. New investment in the aluminium and power sectors was expected to materially dampen the depth of the economic contraction this year, but the halt in the IMF programme may preclude access to the foreign capital necessary for such investment.

Moody’s emphasises that Iceland’s path out of the crisis now appears more difficult. The government’s budget deficit and debt affordability indicators are among the worst of any investment grade-rated sovereign. The government is planning substantial fiscal tightening over the next five years to bring the deficit under control and reduce the debt service burden to a manageable level. However, the possible emergence of political instability following the referendum could prevent the government from returning its attention to such important domestic matters.

The last rating action on Iceland was implemented on 11 November 2009, when Moody’s downgraded the ratings to Baa3 (stable outlook) from Baa1 (negative outlook).

The principal methodology used in rating the Government of Iceland is Moody's Sovereign Bond Methodology, published in September 2008, which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody’s website.

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