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Iceland (Republic of)

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Table Of Contents

Iceland (Republic of)

Major Rating Factors

Sovereign Credit Rating
BBB-/Stable/A-3

Strengths:

- Stable and mature political institutions.
- Prosperous and flexible economy as seen in robust export performance since 2008.
- Regained market access after completing the IMF program, with foreign currency debt maturity to 10 years.

Weaknesses:

- High public sector and external debt burden.
- Uncertainties related to the lifting of foreign exchange controls imposed since 2008.
- Banking sector restructuring continues, in light of still-high private sector nonperforming loans.

Rationale

The ratings on Iceland are supported by our opinion of its prosperous and flexible economy, and its institutional capacity to address financial sector problems and build an environment more conducive to full employment and sustainable economic growth. The rapid post-crisis adjustment, on both the fiscal and external accounts, has allowed Iceland to complete the IMF program and regain market access, with its foreign currency debt maturity extended up to ten years. The ratings on Iceland are constrained by high external and public-sector debt that we believe could become higher still, if not for capital controls limiting residents' right to invest overseas and nonresidents' ability to exchange krona holdings for foreign currencies. The banking sector has undergone significant restructuring, but private sector nonperforming loans remain high.

Since the 2008 onset of the financial and economic crisis, the Icelandic economy has demonstrated its resilience by reigning in its twin deficits, both fiscal and external. After having contracted more than 10% during 2009-2010, Iceland's GDP began to recover from 2011 onward. Economic rebalancing was facilitated by the 36% depreciation in Iceland's real effective exchange rate since mid-2007. We expect the Icelandic economy to continue to expand by nearly 2% annually between 2012 and 2015. As goods' export volumes are constrained by supply rather than demand factors, we do not expect export volume to contract significantly during the anticipated global slowdown; on the other hand, terms of trade are likely to worsen as demand weakens, and this already looks to be leveling off the current account position (excluding deposit institutions in winding-up proceedings) at a deficit of just under 1% of GDP.

In our view, exceptionally lax financial sector oversight contributed to the boom-bust cycle in Iceland. That said, other long-standing economic policies have served the economy well. These include measures to ensure high labor-market participation; at 85%, Iceland's is the highest in Europe and one of the highest in the world. We also expect that efforts to attract net foreign investment in Iceland (which totaled 8% of GDP in 2011) will bear fruit, enhancing the already high capital intensity and productivity levels in the small and increasingly open Icelandic economy.

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The recovery of domestic demand in 2011 improved tax receipts, allowing the general government deficit to narrow to 4% of GDP, from 10% in the previous two years. We expect the fiscal account to continue to improve and reach balance by 2014. In May 2012, the Icelandic government successfully issued a $1 billion 10-year bond using the receipts to prepay an estimated $1.4 billion of official borrowing from the IMF and Nordic countries; this transaction has significantly lengthened the maturity of the Icelandic government's external liabilities.

The high public sector and external debt burden, however, remains a key ratings constraint. In 2008, foreign exchange controls were implemented to limit capital flight and stabilize the foreign exchange rate. The government is following a two-step strategy to gradually lift the capital controls, but significant risks are associated with potential capital flight and further weakening of exchange rates, which would push up the public and external debt burden further as a percentage of GDP. Iceland's relatively shallow domestic capital markets continue to represent a constraint on its sovereign rating.

The Icelandic financial sector has undergone significant restructuring since the default of the old banks in 2008. The new commercial banks have made notable progress in restructuring their balance sheets, loan loss provisions have declined steadily, and we expect the restructuring process to conclude during 2012. However, nonperforming loans remain significant, already-large exposure risks have increased, and further meaningful losses could not be ruled out. The private sector debt restructuring also significantly weakened the state-owned mortgage lender, Housing Financing Fund's capital position and we expect it to receive additional capital support from the government. The financial sector could also be vulnerable when in the process of lifting the exchange rate controls, as there might be an outflow of deposits. In addition, a significant depreciation of the krona could disrupt the economic recovery, in particular domestic demand, and increase nonperforming loans at banks.

Outlook

The stable outlook balances our view of Iceland's improved economic fundamentals with downside risks associated with capital controls being lifted over the next few years.

We could consider raising the ratings on Iceland if, in attracting further foreign investment, its economic growth potential is boosted and external vulnerabilities are reduced. Under this scenario, we would anticipate public and external debt declining more rapidly than we currently assume, thereby helping to create favorable conditions for a smooth lifting of Iceland's capital controls. This would likely strengthen Iceland's credit standing.

We could consider lowering our ratings on Iceland if net government debt levels increase significantly on further fiscal slippage resulting from political tensions, higher-than-expected support of the banking sector, or substantial currency depreciation, as capital controls are lifted.

Table

Iceland (Republic of) -- Selected Indicators

	-- fiscal year-end Dec. 31 --								
ISK mil.	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Per capita GDP ($)	66,396	53,417	37,871	39,514	44,147	43,283	43,877	44,965	46,984

Table

Iceland (Republic of) -- Selected Indicators (cont.)									
Real GDP growth (%)	6.0	1.3	(6.8)	(4.0)	3.1	2.3	2.0	2.0	2.0
Real GDP per capita (% change)	3.3	(1.2)	(8.0)	(3.5)	2.8	2.3	2.0	2.0	2.0
General government balance (% of GDP)	5.4	(13.5)	(10.0)	(10.1)	(4.4)	(4.5)	(1.8)	0.0	0.0
General government debt (% of GDP)	28.5	77.3	99.3	105.5	119.9	104.0	101.4	97.1	92.9
Net general government debt (% of GDP)	12.4	50.1	58.2	65.4	67.1	63.6	62.8	60.1	57.5
General government interest exp. (% of revenues)	5.4	7.6	16.1	13.3	11.1	14.8	12.9	12.5	11.9
Bank claims on resident non-govt. sectors (% of GDP)	251.1	143.0	116.7	114.5	112.5	106.3	103.9	101.4	99.0
Consumer price index (% change)	5.0	12.4	12.0	5.4	4.0	4.0	3.0	3.0	3.0
Gross ext. financing needs (% of CARs and usable reserves)	320.3	669.8	158.0	139.6	119.1	90.4	91.7	89.3	87.0
Current account balance (% of GDP)	(16.3)	(24.6)	(0.4)	(2.0)	(0.6)	2.2	2.9	2.3	1.9
Narrow net external debt (% of CARs)	437.6	160.3	158.0	123.9	64.8	73.6	70.4	64.6	60.1

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Ratings Detail (As Of June 28, 2012)		
Iceland (Republic of)		
Sovereign Credit Rating		BBB-/Stable/A-3
Transfer & Convertibility Assessment		BBB-
Senior Unsecured		BB
Senior Unsecured		BBB-
Sovereign Credit Ratings History		
23-Nov-2011	*Foreign Currency*	BBB-/Stable/A-3
17-May-2011		BBB-/Negative/A-3
13-Apr-2011		BBB-/Watch Neg/A-3
30-Mar-2010		BBB-/Negative/A-3
05-Jan-2010		BBB-/Watch Neg/A-3
31-Dec-2009		BBB-/Stable/A-3
24-Nov-2008		BBB-/Negative/A-3
06-Oct-2008		BBB/Negative/A-3
29-Sep-2008		A-/Watch Neg/A-2
17-Apr-2008		A/Negative/A-1
01-Apr-2008		A+/Watch Neg/A-1
20-Nov-2007		A+/Negative/A-1
23-Nov-2011	*Local Currency*	BBB-/Stable/A-3
17-May-2011		BBB-/Negative/A-3
13-Apr-2011		BBB/Watch Neg/A-3
30-Mar-2010		BBB/Negative/A-3
05-Jan-2010		BBB+/Watch Neg/A-2
31-Dec-2009		BBB+/Stable/A-2
06-Oct-2008		BBB+/Negative/A-2

Ratings Detail (As Of June 28, 2012) (cont.)	
29-Sep-2008	A+/Watch Neg/A-1
17-Apr-2008	AA-/Negative/A-1+
01-Apr-2008	AA/Watch Neg/A-1+
20-Nov-2007	AA/Negative/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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