STANDARD & POOR'S SOVEREIGNS

Publication date: 10-Feb-2005

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Research Update: Republic of Iceland LT FC Rating Raised To 'AA-' On Better Financial Stability; Outlook Stable

	Local Currency	Foreign Currency
Credit Rating:	AA+/Stable/A-1+	AA-/Stable/A-1+

Rationale

On Feb. 10, 2005, Standard & Poor's Ratings Services raised its long-term foreign currency sovereign credit rating on the Republic of Iceland to 'AA-' from 'A+', and affirmed the 'AA+' long-term local currency and the 'A-1+' short-term foreign and local currency ratings. The outlook is stable. The upgrade reflects significant and sustained improvements in the resilience and structure of the Icelandic banking sector, as well as the positive perspective for public finances, which should lead to a rapid decline in general government debt levels. The financial sector in Iceland has recovered from the imbalances created by the pre-2001 lending boom. Improved regulation and supervision, as well as the expansion of operations within the Scandinavian region and beyond, leave the sector much more resilient and less sensitive to developments in the Icelandic economy, as well as providing easier access to funds. The recent entry of the commercial banks into the Icelandic mortgage market provides the private financial sector with additional domestic stability and profitability. Public finances continue to be healthy. As a consequence of strong growth, privatization proceeds, and budget surpluses throughout 2006, gross general government debt will continue to decline rapidly, to less than 25% of GDP by 2007, from 46% in 2002. Iceland boasts stable and flexible political institutions, which enjoy broad public backing. The country's flexible economy generates one of the highest per capita GDPs in the world. Growth is forecast to average 5.1% in 2005-2006, driven by large-scale investment projects and strong domestic demand. Levels of net external debt are very high throughout the economy and continue to rise, reaching 350% of current account receipts (CARs) in 2006. Driven by high real interest rates in Iceland, foreign funds are channeled into the Icelandic economy mainly through domestic banks, which account for about two-thirds of net external debt. In the past two years, however, foreign investors have also been investing strongly in Icelandic bonds, particularly local currency housing bonds. External liquidity is further restrained by high current account deficits. Upcoming investment projects will put further strain on the balance of payments and push the deficit to almost 11.7% of GDP in 2006. Thereafter, however, the beneficial effects of exports from these projects should help to push the deficit down to 3.0% in 2008. Nevertheless, Iceland's external liquidity will remain among the weakest of any rated sovereign.

Outlook

Economic developments in Iceland are currently dominated by the large-scale investment projects in aluminum smelting, lasting until 2007. In accommodating the expansionary pressures resulting from these projects, monetary policy is already carrying the majority of the burden, increasing the risk of unbalanced economic adjustment once the large investments come to an end. Consequently, adherence to the government's medium-term fiscal framework is central to maintaining the ratings. Further unforeseen adjustment needs would need to be accommodated through fiscal policy, not monetary policy. Any significant increase in net external leverage, or a recurrence of entrenched macroeconomic imbalances on the back of the large investment projects could weaken Iceland's creditworthiness.

Ratings List

To From Foreign currency sovereign credit ratings AA-/Stable/A-1+ A+/Positive/A-1+ Local currency sovereign credit ratings AA+/Stable/A-1+ AA+/Stable/A-1+ Commercial paper A-1+ A-1+ NB: This list does not include all ratings affected. Ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: London Ratings Desk (44) 20-7176-7400; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5916; or Moscow (7) 095-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.

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