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R&I Assigns AA+, Outlook Stable: Republic of Iceland

Rating and Investment Information, Inc. (R&I) has announced the following:

ISSUER: **Republic of Iceland**
Foreign Currency Issuer Rating

R&I RATING: AA+
RATING OUTLOOK: Stable

RATIONALE:

Despite its small population of 300,000, Iceland's per capital gross domestic product (GDP) in excess of US$ 50,000 ranks it among the world's leading high-income countries. In marine products, financial services, hydro- and geothermal energy, aluminum and a limited range of high-tech industries, Iceland demonstrates world-class competitiveness, and a comparatively rapid economic growth can still be expected over the medium to long term. Merely because of its small size, the economy is affected easily by exchange rate and interest rate volatility, and Iceland's fiscal balance is buffeted correspondingly, but public debt is small and ample pension assets have been accumulated, and the risk of fiscal deterioration is limited. Because net external debt (external debt - external assets) has reached a high level, against the backdrop of the large current account deficit and advance of Iceland's banks into overseas markets, the exchange risk resulting from not participating in the EU and euro cannot be overlooked. Nevertheless, the banking sector, which holds the majority of the external debt, is extremely sound and has thoroughly implemented conservative liquidity controls, and the risk of external debt leading to a financial crisis is minimal. Based on these points, R&I has assigned a Foreign Currency Issuer Rating of AA+. The Rating Outlook is Stable.

An island country with land area roughly one-quarter the size of Japan, Iceland sits to the northwest of Europe. Its citizens are highly educated, and given the relatively high equality in distribution of wealth, politics and society are stable. Blessed with rich fishing banks and geothermal and water resources, the economy traditionally was reliant on agriculture and the fishing industry. Iceland has used the European Economic Area (EEA) agreement, which came into effect in 1994 and guarantees the free movement of goods, services, individuals and capital and fair competition with the European Union (EU), as a springboard to liberalize its economy. Together with fostering services such as finance, real estate, transportation and logistics, Iceland continues to use expanded investment in industries such as aluminum refining as a lever to diversify its manufacturing sector. Aluminum ingot and ferrosilicon products are also supported by a bullish international market, providing the second largest source of merchandise exports after marine products. Over the twelve-year period until 2006, real GDP expanded at an average annual rate topping 4%. Against the backdrop of factors such as increasing national disposable income and a housing boom, personal consumption is expected to grow at a steady pace in the future as well.

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As a result of high domestic interest rates, the value of the Icelandic krona rose by nearly 20% from October 2004 to January 2006, despite a rapidly expanding current account deficit that reflected economic overheating. Driven by the market's sense the currency was overvalued, by June 2006 the krona had plunged by about 25% from its value in the latter half of February, and as of May 2007 had returned to the level of three years ago. Iceland's economy now faces a deceleration phase, with the rate of real growth for 2006 in the upper 2% range. Following completion of aluminum plant investment projects in 2007, the current account deficit that has deteriorated over the past several years is expected to return to a sustainable level against GDP, as capital goods imports decrease and exports expand once new plants come on stream. From 2008, a slowdown in fixed capital formation will be supplemented by growth in exports, and the real economic growth rate is expected to rise to 3% or higher.

Iceland's government is of the stance to smooth out business cycles by utilizing its large maneuvering room from a fiscal perspective. As such the size of swings in the fiscal balance tends to fluctuate on boom-and-bust conditions, but balance is expected even for 2007 when slower growth is projected. At 34%, the level of outstanding general government debt to GDP at the end of 2006 ranked Iceland among the advanced countries with the lightest debt burden. In addition, corporate pensions are well funded, and the pension assets together with private pensions (excluding the public pension plan) had reached 126% of GDP at the end of 2006. With a young population structure, a high participation ratio of women in the workforce and an age minimum of 67 for the start of legal retirement benefits, social security contributions exceed benefit payments and pension assets are accumulating rapidly. Therefore even if the government runs a small fiscal deficit in the future, it can finance the deficit domestically using Iceland's ample pension assets.

On the other hand, net external debt at the end of 2006 had climbed rapidly to 119% of GDP. This was caused mainly by the fact the banking sector, which used subordinated debt and other means to raise funds for its overseas acquisitions on the one hand, increased foreign currency-denominated financing for residents because of high krona interest rates. Although the goodwill resulting from overseas equity acquisitions is not reflected in the external assets, recent operating results in the international businesses acquired by Iceland's major banks are good, so there also is a possibility the country's external investment position has not deteriorated to the extent the headline figure would suggest. Furthermore, each bank has taken steps to limit its overall currency mismatch risk. Specifically, banks restrict their foreign currency-denominated financing to firms with a low percentage of foreign currency income to only their best customers, and such loans are secured, so the banks are protected against the risk from deteriorating financial conditions at borrowers when the krona weakens. Therefore the probability of the high level of net indebtedness to other countries being actualized as a substantial economic risk factor is low.

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Issuer Rating is R&I's opinion regarding an issuer's overall capacity to repay its entire financial obligation, and it will be assigned to all issuers. The rating of individual obligations (i.e. bonds and loans etc.) includes the prospect of recovery and reflects the terms and conditions of the agreement and it may be lower or higher than the Issuer Rating.

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