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RATINGSDIRECT®

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Iceland (Republic of)

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Iceland (Republic of)

Major Rating Factors

Sovereign Credit Rating

Foreign Currency
A+/Negative/A-1

Local Currency
AA/Negative/A-1+

Strengths:

- Stable and mature political institutions
- Very high per capita income and strong long-term growth prospects
- Healthy public finances and a rapidly declining public debt burden

Weaknesses:

- Inadequate fiscal and monetary policy mix in management of macroeconomic imbalances
- Significant contingent fiscal risks from high level of external debt and weak external liquidity
- Small, relatively undiversified, and volatile economy

Rationale

The ratings on the Republic of Iceland are supported by its stable and flexible political institutions. They are key building blocks in the economy's high level of prosperity, which is among the highest of rated sovereigns, with a GDP per capita forecast to reach $57,740 in 2007. At the same time, economic growth has remained high, averaging 6.4% over the period 2004-2006 during the recent investment, credit, and real-estate booms, but is set to slow considerably as the economy cools off, and to recover again to 3.0% by 2011. Nevertheless, considerable downside risks to this scenario remain and could emanate from nominal adjustments in the exchange rate, the property market, or the credit market.

Public finances improved considerably during the economic boom, with general government surpluses averaging 5.6% of GDP over 2005-2007. Together with sizable privatization receipts, this will help push net general government debt to below 10% of GDP in 2007, from 38% in 2003. At the same time, however, contingent liabilities from the financial sector have grown rapidly, due to fast growth in domestic credit.

The ratings are constrained by the continued build-up and persistence of macroeconomic imbalances in the Icelandic economy, compounded by an insufficiently tight fiscal policy. Although the central bank's short-term real interest rate has risen to over 8%, the effectiveness of monetary transmission is constrained by the rapid rise in foreign currency borrowing by households and the weak reaction of mortgage rates to monetary tightening.

A renewed surge in consumption and delayed export growth imply that the current account deficit will not fall as quickly as previously expected, further driving the rapid build-up in external debt. Continued strong mortgage lending, fueled by competition between the still unreformed, state-owned Housing Financing Fund (Ibudalanasjodur [HFF]; foreign currency A+/Negative/A-1, local currency AA-/Negative/A-1+) and commercial banks, is further driving up housing prices, interrupting the downward trend in inflation. This has prompted the central bank to again raise its policy rate to 13.75% in November 2007. Furthermore, the continued build-up in domestic credit is further increasing the already high contingent liabilities to the government from the financial sector.

Outlook

The negative outlook reflects the increased risk of a hard landing for the Icelandic economy. The economic slowdown currently under way will facilitate an unwinding of macroeconomic imbalances, but the process is likely to be impeded by the planned rapid acceleration in public expenditure, as well as sustained failure to reform the HFF. In combination with high and rising domestic and international interest rates, this exacerbates the risk of a hard landing for the Icelandic economy, or at least the risk of a protracted adjustment period. The ratings could be revised downward should a disorderly unwinding of imbalances take place, affecting public finances as government deficits increase and contingent liabilities materialize. Conversely, should imbalances unwind in an orderly fashion and the concomitant risks be contained, the outlook could revert back to stable.

Table 1

Republic of Iceland Selected Indicators

	2011f	2010f	2009f	2008f	2007e	2006	2005	2004	'A' Median 2007e
GDP per capita ($)	64,579	61,983	59,843	60,824	57,737	54,440	54,930	45,254	16,111
Real GDP (% change)	3.0	2.0	1.3	0.7	1.5	4.3	7.1	7.7	5.4
Real GDP per capita (% change)	2.0	1.0	0.3	(0.3)	0.5	1.4	5.9	6.5	4.1
General government balance (% of GDP)	0.0	0.0	(0.5)	1.0	4.5	7.0	5.2	0.2	(0.5)
General government debt (% of GDP)	13.6	16.3	19.1	22.7	28.7	30.3	25.5	34.4	34.0
Net general government debt (% of GDP)	7.9	8.2	8.4	8.3	9.8	12.1	18.0	32.5	24.4
General government interest expenditures (% of revenues)	2.2	2.6	3.0	4.3	5.2	4.4	4.5	5.4	5.8
Domestic credit to private sector and NFPEs* (% of GDP)	351.4	346.4	339.6	356.4	375.4	321.0	248.4	164.8	97.5
Consumer price index (average; % change)¶	2.5	2.5	2.7	4.1	4.9	6.8	4.0	3.2	3.0
Gross external financing needs (% of CARs and usable reserves)	324.0	328.6	337.3	325.8	308.3	269.1	233.0	213.1	100.5
Current account balance (% of GDP)	(9.2)	(9.6)	(9.5)	(11.1)	(17.4)	(25.7)	(16.2)	(9.8)	(2.2)
Narrow net external debt§ (% of CARs)	464.4	458.3	457.7	453.0	501.8	445.5	400.1	363.1	2.8

*Standard & Poor's estimates that, in a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 30% of bank credit; see Appendix 3 in "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup," published on Aug. 9, 2007, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis. ¶National definition, including housing cost. §Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. f--Forecast. e--Estimate. NFPEs--Nonfinancial public enterprises. CARs--Current account receipts.

Comparative Analysis

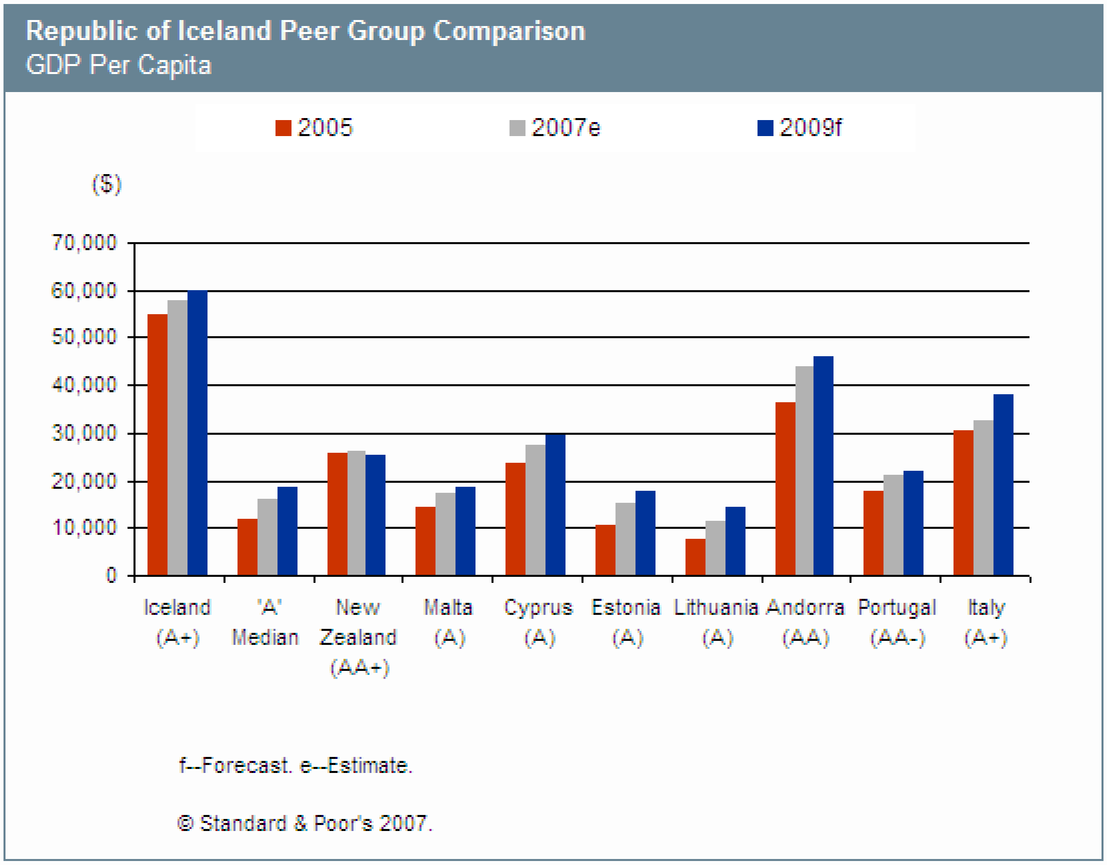
- The Icelandic economy is prosperous and flexible, with per capita incomes substantially higher than all peers.
- Iceland's fiscal stance and declining general government debt levels compare favorably with its peers, but it has the highest contingent liabilities in the group.
- Iceland compares unfavorably with virtually all its peers in terms of external exposure.

Iceland's economic structure and export base remain somewhat narrow, depending largely on an array of marine products, aluminum, financial services, and tourism. As a small, open, and wealthy economy, Iceland's peers include New Zealand (rated foreign currency AA+/Stable/A-1+; all references to ratings hereafter are to foreign currency sovereign credit ratings), which is also an insular economy with a dependence on agriculture. The Republics of Cyprus (A/Positive/A-1), Malta (A/Stable/A-1), Estonia, and Lithuania (both A/Negative/A-1) are also small European economies with relatively high current account deficits, although the latter three are considerably less wealthy. The Principality of Andorra (AA/Negative/A-1+) is an even smaller wealthy sovereign, the second non-EU member among Iceland's peers. Unlike Iceland, however, it uses the euro rather than its own currency. The Republics of Italy (A+/Stable/A-1+) and Portugal (AA-/Stable/A-1+) are official members of the Eurozone, however, and consequently are not affected by the external pressures that are Iceland's major weakness.

Iceland is wealthier than peers

Iceland is substantially wealthier than all its peers, with GDP per capita forecast to reach $57,740 in 2007, compared with the 'A' median of $16,110 (see Chart 1). Among its peers, only Andorra and Italy get close to Iceland's wealth levels, while wealth in the young Republics of Estonia and Lithuania are still below the 'A' median, but catching up rapidly. The level of Icelandic GDP per capita reflects the high productivity and flexibility of the country's labor force and the economy as a whole. This has kept unemployment (2.8% of the workforce in 2007) lower than in any of Iceland's peers, and endows the country with a solid ability to digest external shocks.

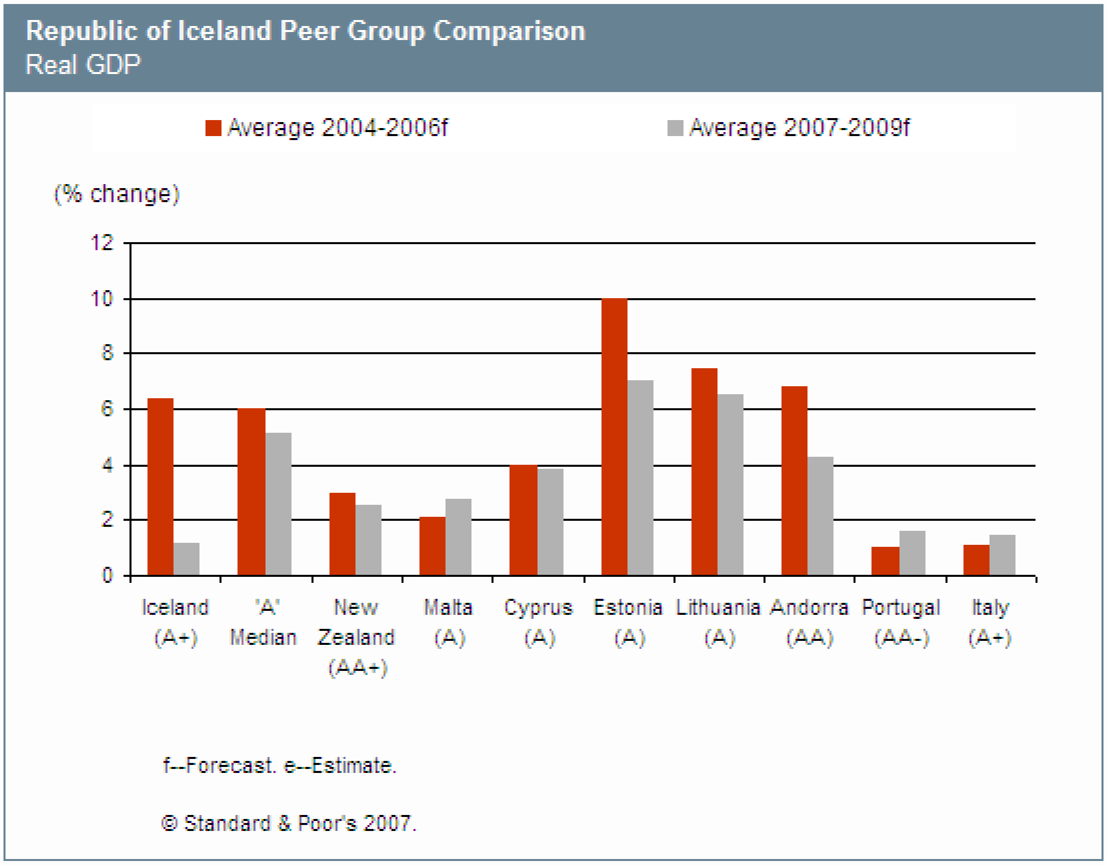
Chart 1



Growth is strong, but volatile

Despite its relative affluence, Iceland's growth performance exceeds that of most of its peers. Over the last boom cycle, which started in 2003 and is to end in 2007, the economy grew at an average 4.6% per year, with growth exceeding 7.0% in 2004 and 2005 (see Chart 2). In these years, growth exceeded the high 'A' median of 6.0%, as well as that of most of Iceland's peers. Only the economies of Estonia and Lithuania, also on the way toward overheating, exhibited higher growth. Iceland's growth prospects are changing, however, as the boom fed by investments in energy-intensive industrial projects, rapid credit growth, and a booming housing market is expected to come to an end and the economy will grow at only 1.0% on average in 2008-2009, as some of the built-up imbalances are unwound. Even during this low-growth period, however, Icelandic growth will not be much below that of Italy and Portugal, which suffer from eroding competitiveness and a backlog of structural reform. Growth in Iceland will remain more volatile than for most peers, as the economy swings from boom to bust and back.

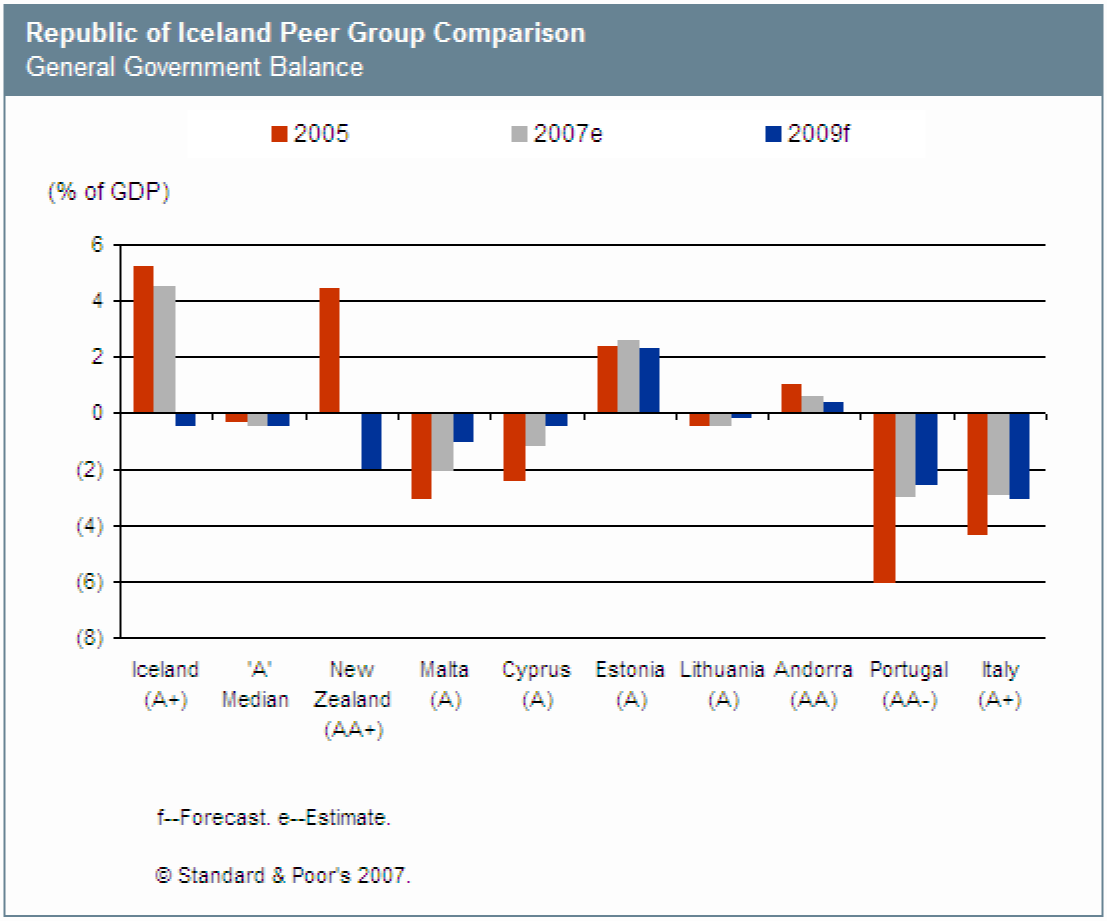
Chart 2



Fiscal consolidation compares favorably with peers

Iceland's government has made good progress in consolidating its fiscal accounts. Sizable budget surpluses in 2005 to 2007, averaging 5.6% of GDP, followed from buoyant revenue growth driven by the current economic boom (see Chart 3). Public finances are expected to return to balance in the medium term, as the economy cools. Iceland's currently high surpluses are matched partly only by Estonia, where they will be sustained, however. Yet, even after a return to balance, Iceland's budget will continue to compare favorably with peers. Cyprus, Lithuania, and Andorra will exhibit balanced budgets, and the remaining peers deficits of up to 3.1% of GDP (Italy).

Chart 3



f--Forecast. e--Estimate.

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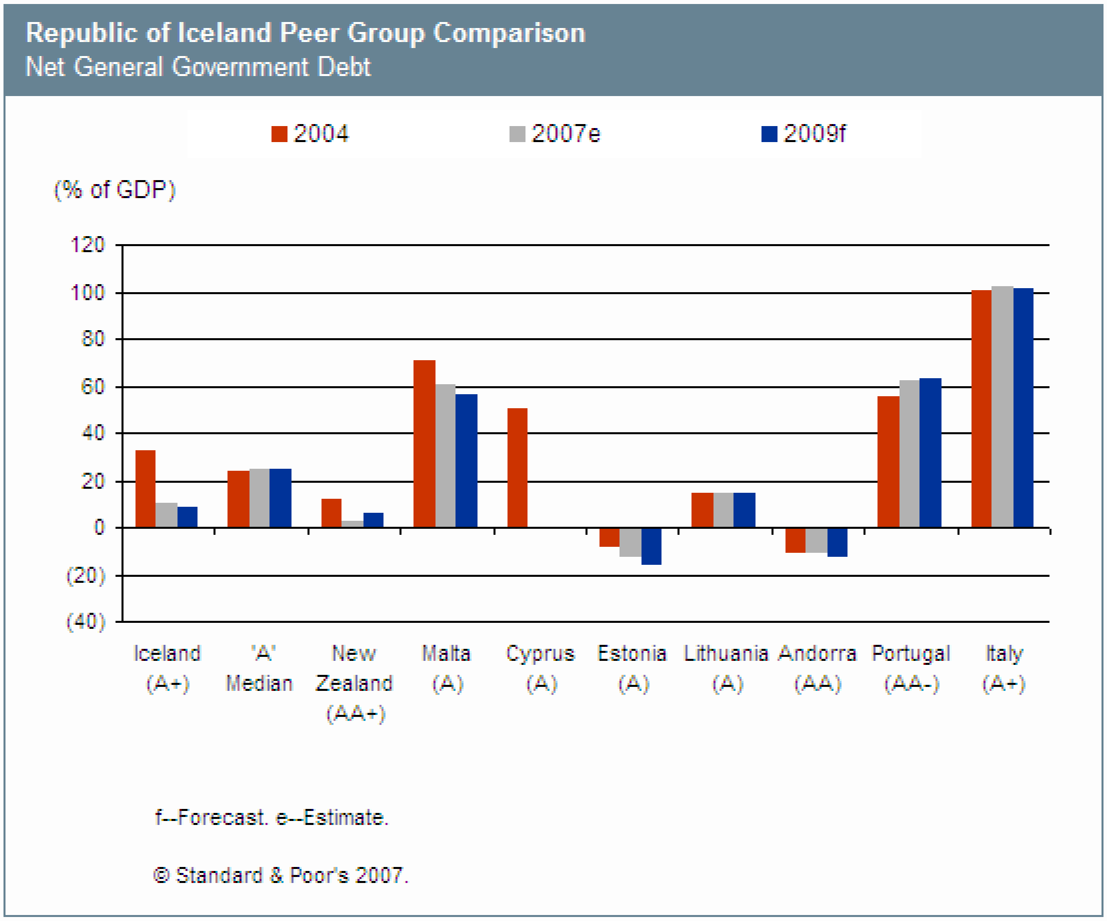
The Icelandic net general government debt-to-GDP ratio has declined more rapidly than those of any peers over the past few years, as a result of conservative fiscal policies, sizable privatization proceeds, the current high surpluses, as well as high nominal GDP growth. The net debt burden was reduced to an estimated 10% of GDP in 2007, from 42% in 2001. This decline is expected to come to a halt, but net debt at 8% in 2009 will remain among the lowest of peers and well below the 'A' median of 24% (see Chart 4). Estonia and Andorra, however, will stay in comfortable net creditor positions, while debt levels in New Zealand remain slightly below those in Iceland. In contrast, debt levels in Italy, and to a lesser degree in Portugal, are the highest among Iceland's peers, at 101% and 63%, respectively, in 2007, and do not show a falling tendency.

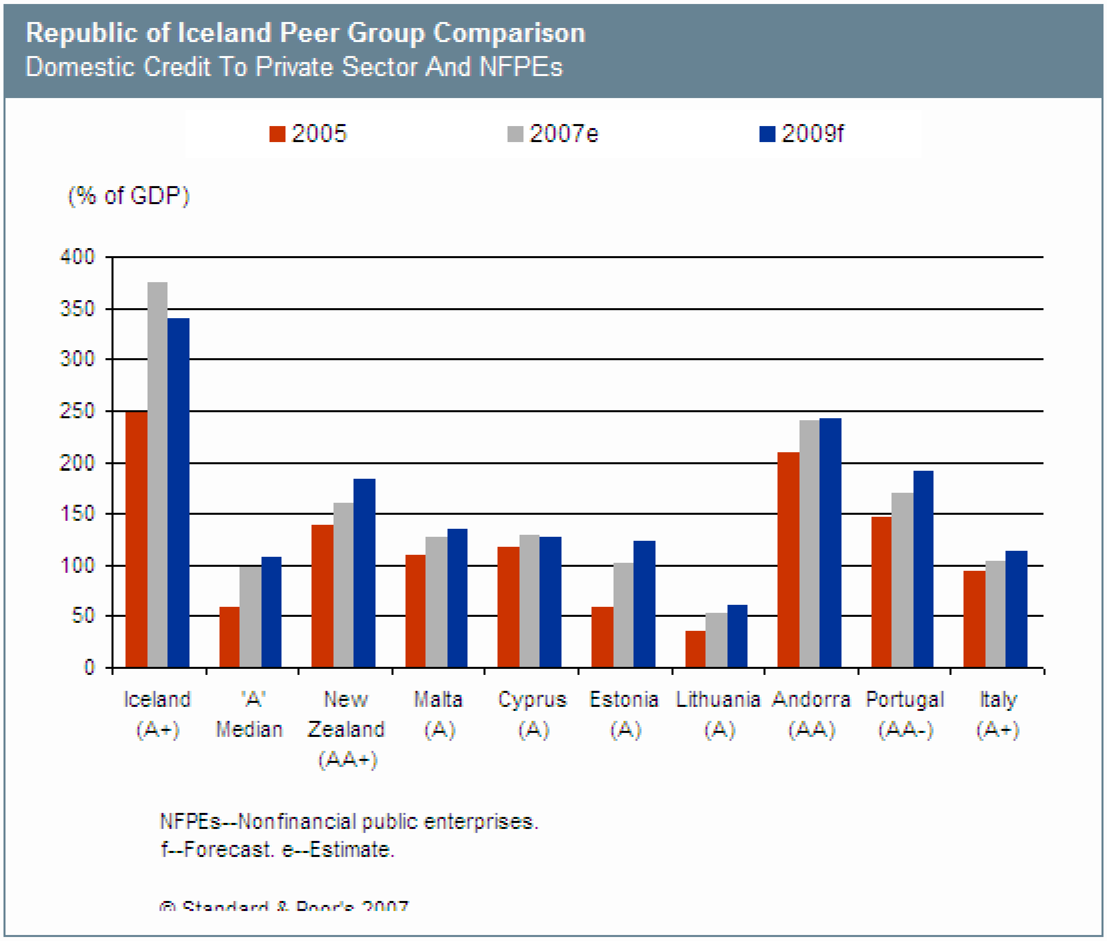
Chart 4



Iceland has the highest contingent liabilities among all peers

The recent credit boom in Iceland has created a high level of contingent liabilities from the financial sector. In a reasonable worst-case scenario, Standard & Poor's Ratings Services estimates the contingent liability for the government from the financial sector to amount to 113% of GDP in 2007, more than five times the 'A' median of 20% (see Chart 5). Most peers have a domestic credit-to-GDP ratio considerably less than one-half of Iceland's, which is 375%. The exception is Andorra, where domestic credit also exceeds 240% of GDP, but the banking sector has a lower risk profile in general. Domestic credit in New Zealand is also comparatively high, at 160% of GDP, but in contrast to Iceland the banking sector in New Zealand benefits from predominant foreign ownership, which we consider reduces the contingent risk to the sovereign. Moreover, government guaranteed debt is 70% of GDP in 2007 in Iceland, compared with 0%-7% for its peers.

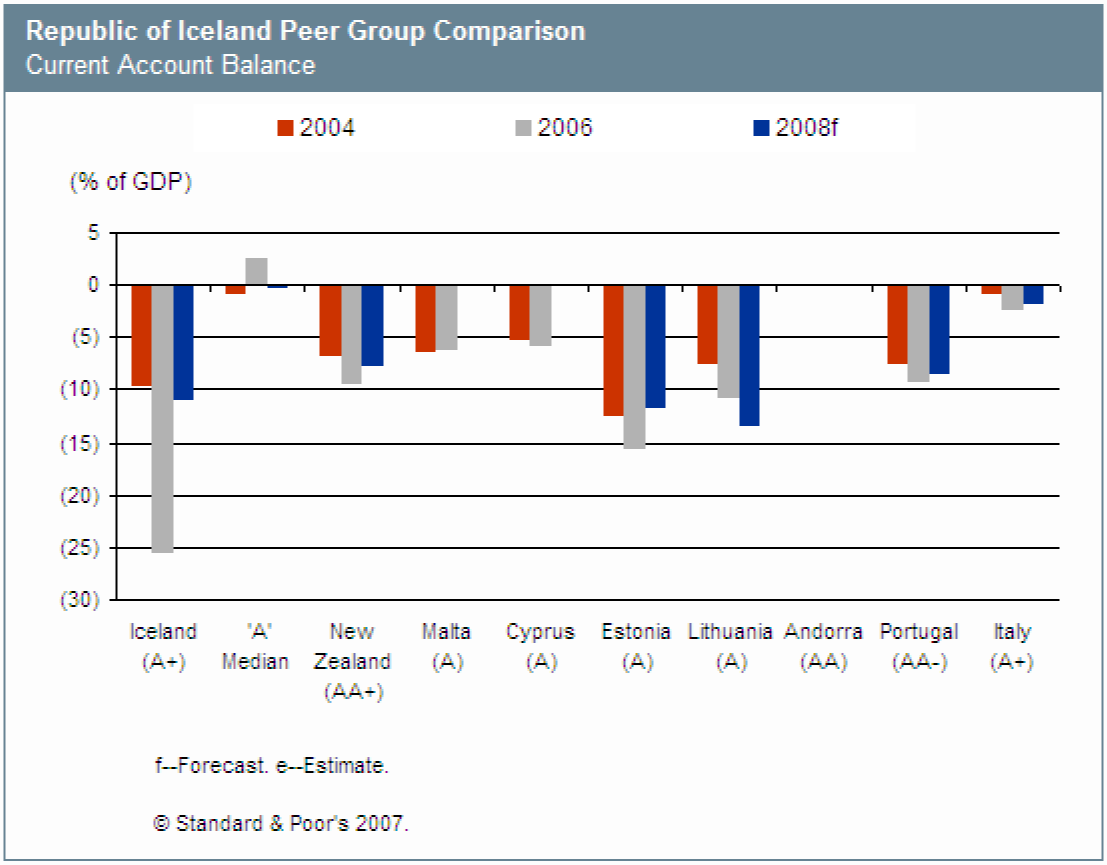
Chart 5



External solvency and liquidity compare unfavorably

Iceland's peers that are part of the Eurozone or use the euro as their currency--namely Italy, Portugal, Andorra, Cyprus and Malta (which will join EMU in 2008)--are all effectively shielded from balance-of-payments pressures, and instead enjoy the benefits of the very strong external balance sheet of the Eurozone as a whole. By contrast, New Zealand, Iceland, Estonia, and Lithuania are similar in that they have comparatively small and narrow economies that are highly dependent on imported goods to satisfy domestic demand. Their current account balances therefore fluctuate widely with GDP growth rates. For all four sovereigns, external deficits have been widening since 2004, reaching double-digit deficits. For none of the peers has this widening been as dramatic as in Iceland, however, where the current account deficit reached 26% of GDP in 2007, after a small surplus in 2002 (see Chart 6). As in Lithuania and Estonia, Iceland's current account deficit deteriorated rapidly on the back of an overheating economy. With the economy now slowing down and considerable aluminum-smelting capacities coming online for export, Iceland's current account deficit is expected to fall below levels in Estonia and Lithuania, but remain at about 10%.

Chart 6



f--Forecast. e--Estimate.

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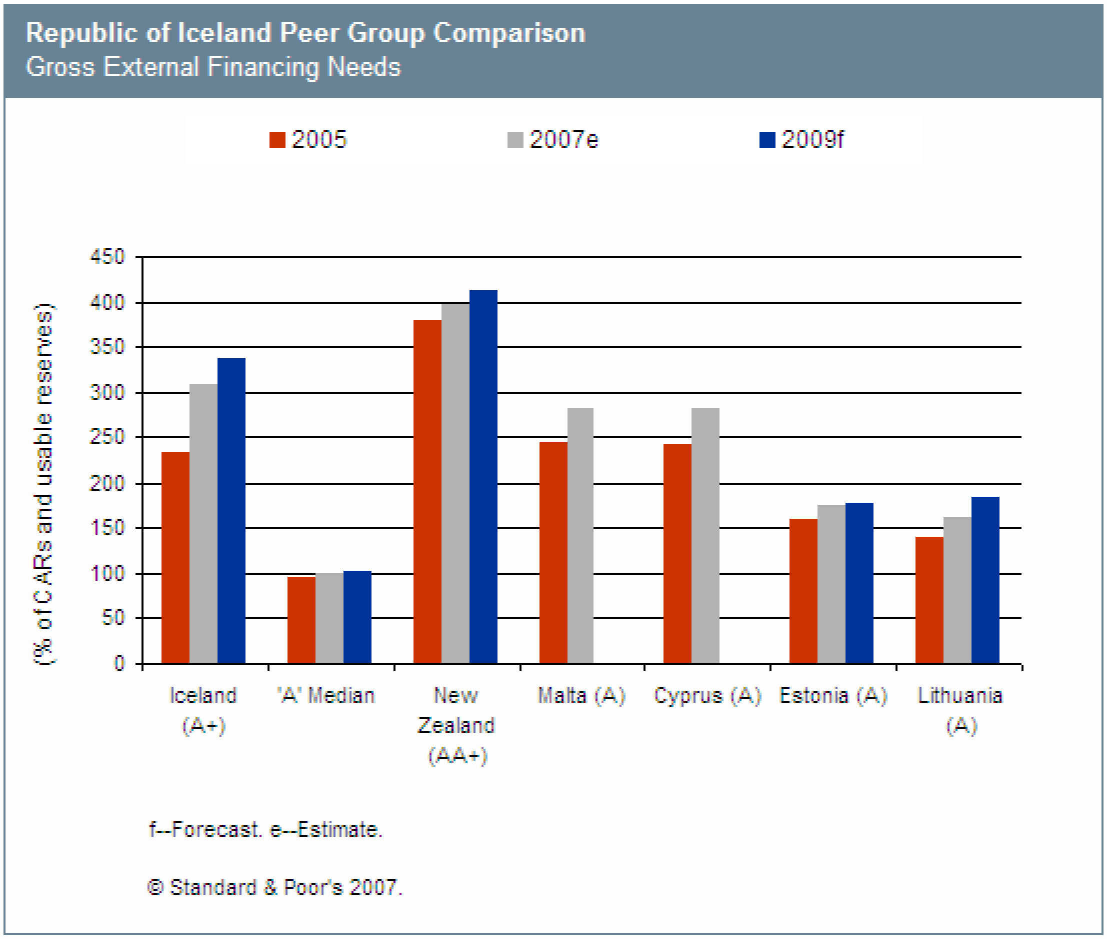
High current account deficits, combined with significant net FDI outflows, as Icelandic enterprises have expanded abroad, have led to a quick build-up in external debt. As a consequence, Iceland's gross external financing needs (current account payments plus external debt with a residual maturity of up to one year) as a share of current account receipts (CARs) plus usable reserves have continued to grow (see Chart 7). Among all rated sovereigns, only the U.K. (AAA/Stable/A-1+), the U.S. (AAA/Stable/A-1+), and New Zealand have higher financing needs. Nevertheless, all three benefit from internationally more liquid currencies (the British pound sterling, the U.S. dollar, and the New Zealand dollar, respectively).

Chart 7



Political Environment: Stable And Flexible

- Iceland's political institutions enjoy broad public backing and provide the flexibility to respond quickly to changing economic circumstances.
- The changed composition of the government following the May 2007 election is unlikely to change major policy priorities.
- The issue of EU membership is debated intermittently, but Iceland is highly unlikely to apply to join in the foreseeable future.

Iceland's creditworthiness faces no appreciable political risks. The country enjoys well established, stable, and predictable institutions, and both internal and external security risks are negligible.

Following general elections in May 2007, the outgoing government comprising the center-right Independence Party (IP) and its junior partner the centrist Progressive Party (PP), decided not to renew its coalition, after 12 years in power. While the IP managed to gain an additional three seats in parliament, now holding 25 out of 63, the PP obtained seven seats, losing almost one-half. The IP opted to form a coalition with the Social Democratic Alliance

(SDA) instead, which achieved 18 seats in parliament.

The election outcome is unlikely to lead to a material shift in policy. The swift formation of the government following the elections reflects the ease with which the two parties were able to reach agreement on the government's agenda. The government's two-thirds majority in parliament, as well as broad public support augur well for political stability, although disagreement within the coalition will be more visible than under the previous government. The government has explicitly stated its commitment to macroeconomic stability, a commitment shared across the political spectrum and political parties in Iceland. We expect the government to broadly continue the pro-market reform course of the previous government, but, due to the inclusion of the SDA, with a stronger focus on social justice.

The prospect of EU and Eurozone membership is debated intermittently and remains a divisive topic. Currency volatility and high interest rates continue to kindle demands to consider adoption of the euro. The SDA is in favor of further EU integration, while the IP is against it, and the coalition agreement foresees no steps toward EU membership. Unilateral euro adoption is likely to be opposed by the EU, and further EU integration remains unlikely as long as it would entail adopting the EU's Common Fisheries Policy. Iceland is part of the European Economic Area (EEA), however, together with the Kingdom of Norway and the Principality of Liechtenstein (both AAA/Stable/A-1+). This grants the country many of the benefits of EU membership, particularly free trade and free movement of capital and labor.

Economic Prospects: Slowdown Ahead

- Iceland's economy is one of the wealthiest in the world, dominated by fishery, energy-intensive industries, and financial services.
- As the economic boom draws to a close, growth is expected to slow to just 1.2% in the period 2007-2009, after 6.4% in 2004-2006.
- A robust and flexible economy provides a buffer for the slowdown ahead, but the extent of macroeconomic imbalances will make this a daunting task, nevertheless.

Table 2

Republic of Iceland Economic And Financial Indicators

	2011f	2010f	2009f	2008f	2007e	2006	2005	2004
Nominal GDP (bil. ISK)	1,405.7	1,357.9	1,319.4	1,257.2	1,193.4	1,162.9	1,023.7	929.4
Nominal GDP (bil. $)	20.6	19.6	18.7	18.9	17.7	16.6	16.3	13.2
GDP per capita ($000s)	64.6	62.0	59.8	60.8	57.7	54.4	54.9	45.3
Real GDP (% change)	3.0	2.0	1.3	0.7	1.5	4.3	7.1	7.7
Real GDP per capita (% change)	2.0	1.0	0.3	(0.3)	0.5	1.4	5.9	6.5
Real domestic demand (% change)	2.7	2.0	(0.8)	(4.5)	(3.7)	9.4	14.0	10.4
Real investment (% change)	4.0	2.0	0.0	(17.0)	(20.0)	19.8	33.9	28.5
Gross domestic investment (% of GDP)	22.2	21.7	21.5	21.9	26.7	34.5	28.1	23.5
Gross domestic savings (% of GDP)	13.0	12.1	12.0	10.7	9.2	8.8	11.9	13.7
Real exports (% change)	4.0	4.5	5.0	14.0	5.0	(5.1)	7.2	8.4
Unemployment rate (average claimant count; %)	3.0	3.2	3.6	3.2	2.8	2.9	2.6	3.1
Consumer price index (% change)*	2.5	2.5	2.7	4.1	4.9	6.8	4.0	3.2

Table 2

Republic of Iceland Economic And Financial Indicators(cont.)

Domestic credit to private sector and NFPEs (% change)	5.0	5.0	0.0	0.0	20.0	46.8	66.1	39.6
Domestic credit to private sector and NFPEs (% of GDP)	351.4	346.4	339.6	356.4	375.4	321.0	248.4	164.8
Short-term interest rate (three-month REIBOR, annual average) (%)	N/A	N/A	N/A	N/A	14.3¶	12.4	9.4	6.3
Long-term (10 yrs) government bond yield, annual average§ (%)	N/A	N/A	N/A	N/A	9.2¶	8.4	7.6	7.6
Real exchange rate (% change)**	N/A	N/A	N/A	N/A	3.8¶¶	(6.4)	13.5	2.2
Equity share index (OMXI15; % change)	N/A	N/A	N/A	N/A	14.0¶	15.8	51.9	58.9

*National definition, including housing prices. ¶Until Nov 12, 2007. §RIKB 13 0517. **Relative CPI, positive values represent appreciation of the exchange rate, negative values depreciation. ¶¶Q1-Q3. f--Forecast. e--Estimate. NFPE--Nonfinancial public enterprise. ISK--Icelandic krona.

Economic structure

Iceland's population is among the richest in the world, with an estimated per capita income of $57.740 in 2007. Despite its geographic isolation, Iceland will export about 32% of its GDP in 2007. The importance of fishing and fish-processing continues to decline, in contribution both to GDP (6% of GDP in 2006, down from 16% in 1980) and to merchandise exports (51% of merchandise exports in 2006, down from 82% in 1991). The fastest growing economic sector over recent years was the financial, insurance, and real-estate sector, which increased its share in GDP to 26% in 2006, from 17% in 1998.

Large-scale investment projects in aluminum smelters, along with the necessary expansion of energy generation, have contributed to the transformation of the Icelandic economy. A first wave of investment will be concluded by 2008, almost tripling aluminum smelting capacity since 2000, and making Iceland one of the 10-largest aluminum producers in the world. In the process, gross fixed investment per GDP rose to a peak of 35% of GDP in 2006, from 20% in 2003. Although the new government is unlikely to support further rapid expansion of energy-intensive industries due to rising concerns about their economic and environmental impact, this will not affect three projects already under consideration, of which at least one, amounting to total investment of 10% of GDP spread over three years, is likely to go ahead.

Icelandic companies, particularly in the financial sector, are generally profitable and, due to the limited size of the domestic market, have increasingly sought to diversify abroad. This is expected to provide a more stable source of income for Icelandic companies and to improve their profitability in the long run. In the process, however, as the companies take on increasing (especially external) leverage, these Icelandic firms are also increasingly exposed to external financing risks and to global credit market sentiment.

Unemployment in Iceland has historically been very low, and the labor market is very flexible, accommodating volatility in the business cycle. Labor force participation rates exceed 80% and are among the highest in Europe, while the regular pension age is 70. The current economic boom has led to strong wage growth, peaking at 11% in October 2006 (and not including considerable wage drift), despite considerable growth in the labor force due to immigration.

Economic growth

The concurrent booms in gross fixed investment, credit, and real estate have led to average economic growth of 6.4% over 2004-2006. The subsequent cool-down of the economy is materializing more slowly than expected, as lending and consumption growth have been more persistent than expected, and the economy will still grow at 1.5% in 2007.

The economic boom has fueled considerable macroeconomic imbalances, leading to rapidly increasing external leverage, strong asset price inflation, and high and rising short-term interest rates. While investment has now begun to contract, consumption will still grow by about 3.5% in 2007, thanks to the strong krona, availability of credit, and accelerated public consumption. We expect investment to contract further in 2008, and consumption finally to fall in 2008 and 2009, driven by falling disposable income, rising interest rates, and a cooling real-estate market. Net exports, driven by additional aluminum-smelting capacity, will become the main driver of growth in 2007-2008 and, to a lesser extent, in 2009. While we do not expect a recession, per capita GDP growth will turn slightly negative in 2008, before overall growth recovers to 3.0% by 2011.

In its previous boom-bust cycle, the Icelandic economy demonstrated remarkable flexibility in unwinding the macroeconomic imbalances without major economic repercussions, which led to zero growth in 2002. Since then, the economy has become more flexible and robust, thanks to comprehensive structural reforms, the introduction of a flexible exchange rate, and the privatization and restructuring of the financial sector. On the other hand, the very high external leverage of the economy, particularly of the financial sector, combined with rising domestic and foreign funding cost, increase the risk of a rapid deterioration of private sector balance sheets and, therefore, disruptive readjustment of the current imbalances.

Fiscal Flexibility: Strong Balances, But High Contingent Risk

- The general government budget is expected to return to balance over the medium term from currently high surpluses.
- Debt continues to trend downward and net general government debt will fall below 10% of GDP in 2007.
- Contingent liabilities remain very high and are the major fiscal risk.

Table 3

Republic of Iceland Fiscal Indicators

(% of GDP)	2011f	2010f	2009f	2008f	2007e	2006	2005	2004
General government revenues	46.0	47.0	46.6	47.5	48.5	48.8	47.5	44.2
Of which central government	33.1	33.9	33.9	34.5	35.7	35.5	35.4	33.0
General government expenditures	46.0	47.0	47.1	46.5	44.0	41.8	42.2	44.0
Of which central government	33.1	33.9	33.9	33.5	31.7	30.1	31.0	32.0
General government balance	0.0	0.0	(0.5)	1.0	4.5	7.0	5.2	0.2
Of which central government	0.0	0.0	0.0	1.0	4.0	5.3	4.5	1.0
Of which local authorities	0.0	0.0	(0.5)	0.0	0.5	0.9	0.4	(0.6)
General government primary balance	1.0	1.2	0.9	3.0	7.0	9.1	7.4	2.6
Central government primary balance	0.8	1.0	1.2	2.8	6.2	7.0	6.4	3.0
General government balance (% of revenues)	0.0	0.0	(1.1)	2.1	9.3	14.3	11.0	0.4
General government interest payments (% of revenues)	2.2	2.6	3.0	4.3	5.2	4.4	4.5	5.4
Central government interest payments (% of revenues)	2.4	2.9	3.6	5.3	6.2	4.8	5.6	5.9
General government debt	13.6	16.3	19.1	22.7	28.7	30.3	25.5	34.4
Of which central government debt	9.3	11.9	14.5	18.4	24.2	25.2	19.2	27.2
General government net debt	7.9	8.2	8.4	8.3	9.8	12.1	18.0	32.5

Table 3

Republic of Iceland Fiscal Indicators(cont.)

Of which central government net debt	3.6	3.8	3.9	4.1	5.3	7.0	11.7	25.3

f--Forecast. e--Estimate.

Revenue, expenditure, and balance performance

General government balances improved significantly on the back of the economic boom to a surplus of 7.0% of GDP in 2006, from a deficit of 2.8% in 2003. While the government acknowledged the critical importance of tightening fiscal policy during the economic boom, most of the improvement in public finances stems from the revenue side. In its previous medium-term fiscal plan for 2004-2006, the government foresaw some expenditure tightening, most notably a cutback on public investment. As the boom accelerated, however, there was no further tightening of expenditure or delay of tax cuts in 2006 and 2007. In fact, 2006 general government nominal expenditure grew at virtually the same rate as nominal GDP, as local governments increased their investment spending considerably.

Public finances have embarked on an expansionary path again in 2007, in anticipation of the economic slowdown. The budget surplus is expected to amount to still 4.5% of GDP in 2007, but will fall further to 1.0% in 2008, as revenue growth comes to a halt, public investment spending is increased, and the government increases its focus on social, health, and education spending. We expect a return to a slight deficit in 2009, but the budget is likely to remain broadly in balance thereafter, absent further tax cuts considered by the government.

Government debt and interest burden

Net general government debt levels continue on a downward path and will fall below 10% of GDP this year, from 38% in 2003. Gross debt levels jumped five percentage points to 30% of GDP in 2006, however, due to the issuance of a €1 billion eurobond to increase the central bank's foreign reserves. About 50% of central government debt is in foreign currency. About 5.2% of general government revenues will be spent on interest payments in 2007, down from 8.0% in 2001. The consolidation of the government's debt issuance and management activities at the central bank in October 2007--through the merger of the debt management agency responsible for local currency issuance with the corresponding foreign currency debt department at the central bank--should enhance the coordination, transparency, and efficiency of the government's debt management.

Off-budget and contingent liabilities

Government off-budget and contingent liabilities stemming from the banking sector have increased substantially in volume because of fast-expanding domestic credit and the increased leverage of Icelandic banks. Standard & Poor's estimates the contingent liability from the financial system to amount to 113% of GDP, from 40% in 2003. The financial sector has undergone significant restructuring following the conclusion of privatization in 2003. Banks have moved into the mortgage market to improve their risk profiles, yet competition from the state-owned HFF complicates cost recovery for the banks in this market. Banks have also greatly expanded their operations abroad, significantly reducing their reliance on the Icelandic economy, with about 60% of banks' income and 75% of lending originating abroad. Following concerns about the liquidity of the banking sector in 2006, banks have increased their liquidity and funding, and improved their transparency. Their dependency on wholesale foreign currency funding, and very high external leverage expansion policy, however, constrain their creditworthiness and pose significant contingent risk to the government.

The stock of debt guaranteed by the government is high, amounting to an estimated 68% of GDP in 2006. More than 80% of the government guarantees are on the debt of HFF, the debt of which is secured by real estate, but which has highly concentrated exposure to house prices in Iceland and the credit risk of Icelandic households.

Monetary Policy: Inflation Above Target, Despite Tight Policy

- Inflation will not fall back to the target of 2.5% before mid-2009.
- Currency volatility and potential depreciation of the krona could pose additional challenges for monetary policy.
- Structural changes in the mortgage market have weakened the transmission mechanism of monetary policy.

The Central Bank Law of March 2001 reflects international best practice. The central bank's track record of independent monetary policy remains short, but dominated by considerable challenges. In the previous boom and bust cycle, the central bank successfully brought down record inflation levels of about 10% in 2002. After a period of loose monetary policy, it is again combating the inflation rates exceeding its target band (2.5% inflation--including housing prices--plus/minus 1.5%, including housing prices). This is because strong aggregate demand, a tight labor market, and krona depreciation have led to mounting inflation. After peaking at 8.6% in August 2006, inflation has been receding, but not as quickly and sustainedly as expected. Instead, a renewed spike in demand and the housing market led to an uptick in inflation, and the central bank does not expect inflation to return to the targeted 2.5% level before the mid 2009 (although, excluding housing costs, inflation levels have already fallen to below 2%). In response, the central bank raised its policy rate in November 2007 to 13.75%, compared with 5.30% in May 2004 (rates are not fully comparable, as the first is a nominal rate, while the latter an annual yield). The economic slowdown ahead will support disinflation progress, but stronger than expected depreciation of the volatile krona could have a strong pass-through effect on the domestic price level. The issuance of "glacier bonds" (foreign issuance of bonds denominated in krona), with nearly 50% of GDP outstanding as of October 2007, helps to deepen the krona market, but their lumpy maturity structure could increase volatility in the exchange rate.

The transmission mechanism of monetary policy remains weakened by the unfortunately timed structural changes in the mortgage market in 2004 and 2005, the peak of the economic boom. Competition between the state-owned and guaranteed HFF and commercial banks led to sustained low long-term interest rates, and fast credit growth averaging 51% 2004-2006, despite the high and rising central bank policy rate. As a result, monetary policy had a limited effect on domestic demand, but led to further appreciation of the krona, which spurred strong consumption of foreign goods. Reform of the HFF, taking account of the changed mortgage financing market, has been pondered by the government since early 2006 and we had expected it to be implemented quickly after this year's general elections. This has not happened so far, however, but a working group is expected to present a reform proposal within the coming weeks. This could preempt the pending EFTA court decision on the legality of state aid for HFF, expected later this year or in 2008. A rapid increase in foreign currency mortgage lending, accounting for 11% of household borrowing, risks further weakening the effectiveness of monetary policy.

External Finances: High External Debt

- External financing needs remain driven by very high levels of external debt and large current account deficits.
- The external leverage of the financial sector remains very high.
- Public sector net external debt continues to fall on the back of improving public finances.

Table 4

Republic of Iceland External Indicators

	2011f	2010f	2009f	2008f	2007e	2006	2005	2004
(% of GDP)								
Current account balance	(9.2)	(9.6)	(9.5)	(11.1)	(17.4)	(25.7)	(16.2)	(9.8)
Trade balance	(3.9)	(4.1)	(4.0)	(5.5)	(9.3)	(13.5)	(9.1)	(3.9)
Net foreign direct investment	(5.0)	(5.0)	0.0	0.0	(15.0)	(6.1)	(24.7)	(13.9)
(% of CARs)								
Current account balance	(15.4)	(16.2)	(16.8)	(21.0)	(37.2)	(54.6)	(40.1)	(26.2)
Net external liabilities	241.3	241.5	244.6	240.7	265.4	242.6	207.3	207.1
Total external debt	773.0	802.0	838.0	849.0	966.0	894.9	687.8	530.7
General government external debt	30.0	33.0	36.0	39.0	43.0	47.1	41.6	70.2
Narrow net external debt*	464.4	458.3	457.7	453.0	501.8	445.5	400.1	363.1
Net public sector external debt	3.4	6.3	8.7	12.0	12.8	17.2	25.4	48.6
Net nonbank private sector external debt	68.0	68.0	68.0	68.0	68.0	67.6	41.3	42.7
Net banking sector external debt	358.0	351.0	350.0	344.0	394.0	336.0	311.4	257.1
Net investment payments	9.3	9.4	9.7	9.2	11.6	16.5	9.3	11.2
Net interest payments	13.4	13.3	14.4	15.0	16.0	17.1	9.7	7.7
Reserves/CAPs (months)	2.6	2.6	2.6	2.5	2.5	1.1	1.4	1.6
Gross external financing needs (% of CARs and usable reserves)	324.0	328.6	337.3	325.8	308.3	269.1	233.0	213.1

*Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. f--Forecast. e--Estimate. CARs--Current account receipts. CAPs--Current account payments.

External liquidity low, despite a strong increase in reserves

Gross external financing needs (current account payments plus short-term debt by residual maturity) in Iceland are among the highest of all rated sovereigns, at a forecast 308% of CARs plus usable reserves in 2007. Financing needs remain driven by large current account deficits and high levels of external debt. The current account deficit has deteriorated significantly on the back of the economic boom, reaching a peak of 26% of GDP in 2006. The deficit will decline in 2007--albeit more slowly than expected due to delays in additional aluminum export capacities--reaching 17% of GDP. It will decline further but stay above 9% in the period 2009-2011.

Gross external debt will reach 450% of GDP in 2007 compared with less than 100% in 2000, driven by high domestic real interest rates and current account deficits and by Icelandic companies' leveraged acquisitions abroad. The rapid growth in external debt is expected to abate, but will still be about 460% in 2011. Despite foreign direct investment (FDI) inflows related to the investment projects, net FDI has been significantly negative, as Icelandic companies have aggressively expanded abroad, pushing net FDI outflows to an average 15% of GDP 2004-2006.

Narrow net external debt

Iceland has a significantly narrow net external debtor position, at 502% of CARs in 2007 (assets considered in this definition are private and public sector nonequity external obligations minus reserves, public sector liquid external assets, and financial institutions' external assets). This is a substantial build-up from 280% in 2003.

The financial sector is the main external debtor of the economy, accounting for 80% of Iceland's net external debt.

Its net external debt is forecast to peak at 394% of CARs in 2007, up from 161% in 2003. Banks continue to borrow heavily abroad, and have financed a series of domestic corporate takeovers by external borrowings in past years. The expected slowdown in lending, as well as rising current account receipts are forecast to lower the ratio to a still high 351% by 2010.

Net public sector debt is forecast to continue falling on the back of sound public finances, to about 6% of CARs in 2010, from 56% in 2003, while net non-financial private sector debt is expected to remain fairly constant at about 68% of CARs.

Ratings Detail (As Of November 21, 2007)*		
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign Currency		A+/Negative/A-1
Local Currency		AA/Negative/A-1+
Commercial Paper		
Foreign Currency		A-1
Senior Unsecured		
Foreign Currency		A+
Local Currency		AA
Short-Term Debt		
Local Currency		A-1+
Subordinated		
Foreign Currency		A+
Sovereign Credit Ratings History		
20-Nov-2007	*Foreign Currency*	A+/Negative/A-1
22-Dec-2006		A+/Stable/A-1
05-Jun-2006		AA-/Negative/A-1+
10-Feb-2005		AA-/Stable/A-1+
16-Dec-2003		A+/Positive/A-1+
20-Nov-2007	*Local Currency*	AA/Negative/A-1+
22-Dec-2006		AA/Stable/A-1+
05-Jun-2006		AA+/Negative/A-1+
Population		0.31 million
Per Capita GDP		$57,740

Current Government

Prime Minister Geir H. Haarde heads a coalition composed of the center-right Independence Party and the Social Democratic Alliance. President Olafur Ragnar Grimsson is head of state.

Election Schedule

General elections
Last......May 2007
Next......May 20011
Presidential elections
Last......June 2004
Next......June 2008

*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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