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Research Update:

Republic of Iceland Outlook Revised To Stable From Negative On Icesave Bill; Ratings Affirmed

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Research Update:

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Overview

- The Icelandic parliament has approved the Icesave agreement, a step that will contribute significantly to securing crucial external financing throughout 2010.
- We are revising our outlook on Iceland's sovereign ratings to stable from negative.
- We are affirming our 'BBB-/A-3' foreign currency and 'BBB+/A-2' local currency ratings on the sovereign.
- The stable outlook balances the challenges of the high public debt ratio and remaining external vulnerabilities with our belief that Iceland's economy and institutions have above-average flexibility to deal with these challenges.

Rating Action

On Dec. 31, 2009, Standard & Poor's Ratings Services revised its outlook on the Republic of Iceland's sovereign ratings to stable from negative. At the same time, we affirmed our long- and short-term 'BBB-/A-3' foreign currency and 'BBB+/A-2' local currency ratings on the sovereign. The 'BBB-' transfer and convertibility assessment was also affirmed.

Rationale

The outlook revision is based on the successful passage through the Icelandic parliament on Dec. 30, 2009, of legislation securing a sovereign guarantee from the Republic for a loan by the Dutch and U.K. governments to the Icelandic deposit guarantee fund. With this loan, Iceland is fulfilling its obligation to compensate depositors in Icesave, a branch in The Netherlands and the U.K. of the failed Icelandic bank Landsbanki. We expect that the president of the Republic will sign the bill into law in due course.

While parliamentary passage of the "Icesave agreement" will add significantly to the general government's debt burden, it is a decisive step to unlock further disbursements of up to €2.3 billion from the International Monetary Fund (IMF) and from bilateral loans from Nordic governments. These funds will alleviate Iceland's still weak external liquidity position by raising the Central Bank's foreign exchange reserves (currently around €2.5 billion). Increasing foreign exchange reserves are an important precondition for Iceland to loosen its capital account controls, which were imposed in late November

2008.

Other significant and encouraging developments include the conclusion of the restructuring of Iceland's failed banks and the passage of a tight 2010 budget, underpinned by an ambitious medium-term consolidation framework with a view to bringing Iceland's 13% of GDP deficit (2009 estimate) back to balance by 2013. While we consider that this target may be missed, the fiscal program should succeed in containing gross general government debt at 130% of GDP in 2010, after which we see it declining gradually. If the tight fiscal policy is adhered to in 2010 and beyond, the peak of net government debt will remain in our view close to 100% of GDP. These assumptions hinge on a successful capital account liberalization that would not lead to a renewed plunge of the Icelandic krona, as this would not only inflate the krona equivalent of the government's foreign currency debt, but also undermine future growth and therefore revenue prospects. The long-delayed passage of the unpopular Icesave agreement, which has been hotly debated throughout 2009, will in our view support investor confidence in the ability of the government to formulate and implement cohesive policies and secure necessary external financing, which will make a disorderly opening of the capital account less likely and, other things being equal, should support the currency. The recapitalization of the failed banks was concluded in December 2009 and at 13% of GDP turned out to be only half as costly to the Treasury as originally envisaged. Nevertheless, contingent liabilities remain substantial, as downside risks to asset quality linger in the context of an overleveraged private sector, a deep recession, and record unemployment. Given the private sector's exposure to foreign-currency loans, further depreciation of the krona would exacerbate these risks.

Outlook

The stable outlook balances the challenges of the high public debt ratio and remaining external vulnerabilities with our opinion that Iceland's economy and institutions have above-average flexibility to deal with these challenges. Any clear signs that the prudent macro-approach of Iceland's authorities might weaken (for example, significant fiscal slippages or the breakdown of Iceland's IMF- and Nordic-supported adjustment program) could rapidly bring Iceland's sovereign rating under renewed downward pressure and the rating could drop below investment grade. Conversely, a successful continuation of Iceland's hitherto appropriate policies, especially a smooth lifting of capital controls and the implementation of a credible medium- to long-term public debt-reduction strategy, would provide uplift to Iceland's rating.

Iceland has applied for EU membership with a view to eventually adopting the euro. While monetary union would be a credit positive, as it would shield Iceland's economy from some balance-of-payment pressures, we do not at this point factor it into Iceland's sovereign rating. In our opinion, while Iceland would be well prepared to successfully conclude accession negotiations, domestic support and a required referendum result remain highly uncertain and will largely hinge on the flexibility of the EU to grant Iceland special waivers from the common fisheries policy.

Related Research

- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign Currency	BBB-/Stable/A-3	BBB-/Negative/A-3
Local Currency	BBB+/Stable/A-2	BBB+/Negative/A-2
Transfer & Convertibility Assessment	BBB-	
Commercial Paper	A-3	

NB: This list does not include all affected ratings.

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Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4011.