

Foreign Currency Outlook on Iceland Revised to Positive; 'A+/A-1+' FC Ratings Affirmed

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LONDON (Standard & Poor's) Dec 16, 2003--Standard & Poor's Ratings Services said today it revised its foreign currency outlook on the Republic of Iceland to positive from stable. At the same time, all the ratings on Iceland were affirmed, including the 'A+/A-1+' foreign currency and 'AA+/A-1+' local currency sovereign credit ratings. The local currency outlook remains stable.

"The revision of the foreign currency outlook reflects Standard & Poor's positive reappraisal of developments in the financial sector, as well as the beneficial impact of large-scale investments on the structure of the economy and its growth prospects," said Standard & Poor's credit analyst Kai Stukenbrock.

Tighter regulation and supervision, privatization of two of the largest banks, and consolidation have strengthened the financial sector, following the imbalances resulting from the credit boom of 1996-2000. Improved prudential indicators and increasing profitability for three consecutive years indicate that the sector is in a better position than at the beginning of the decade.

Large-scale investment projects in aluminum smelting and power generation, set to be carried out during 2004-2010, will lead to significant net foreign direct investment (FDI) inflows over the coming years, precipitating strong economic growth, and strengthening Iceland's economic structure.

Iceland's wealthy and flexible economy generates one of the highest per

capita GDPs in the world. The flexibility of the economy was highlighted by the swift unwinding of imbalances that had mounted during the credit-fuelled boom of 1996-2000. Credit growth slowed to virtually zero in 2002 from 44% in 2000, and the current account returned to balance from a deficit of 10.1% in 2000, without major economic repercussions. Economic growth has since accelerated again, to reach 5.5% in 2005, following 1.7% in 2003 and a slight contraction in 2002.

Public finances are healthy. The general government balance will be slightly negative in 2003, at 1.1% of GDP, partly as a result of the economic downturn and discretionary measures on both the expenditure and revenue sides. Going forward, the budget balance is expected to return to a slight surplus until at least 2006. General government debt will resume its decline, to reach 32.9% of GDP in 2006, down from 46.2% in 2002.

"Going forward, a potential upgrade of Iceland's foreign currency ratings within the next year or two hinges on further strengthening of the financial sector, as well as the maintenance of a prudent macroeconomic policy stance throughout the period of high investments," Mr. Stukenbrock added.

In particular, the government will need to maintain fiscal discipline, as called for in its medium-term fiscal plan, in order not to exacerbate the country's demand for foreign savings during the construction phase of the investment projects.

"Conversely, any significant increase in Iceland's already very high external leverage could result in a revision of the outlook back to stable," said Mr. Stukenbrock.

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