International Credit Update

Republic of Iceland

Ratings

	Current Ratings
Foreign Currency	
Long-Term IDR	BBB-
Short-Term IDR	F3
Local Currency	
Long-Term IDR	A-
Country Ceiling	BBB-

Watch

Foreign Long-Term IDR	Negative
Foreign Short-Term IDR	Negative
Local Long-Term IDR	Negative
Country Ceiling	Negative

Financial Data

Iceland

	2007
GDP (USDbn)	20.2
GDP per head (USD)	67,004
Real GDP (% change)	4.9
Consumer prices (% change)	5.1
Government debt (% GDP)	28.3
Net external debt (% CXR)	438.5
International liquidity ratio	77.7

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Rating Rationale

- On 8 October 2008, Fitch Ratings downgraded the Republic of Iceland's Long-Term Foreign and Local Currency Issuer Default Ratings (IDRs) to 'BBB–' and 'A-' from 'A-' and 'AA' respectively. The Short-Term IDR was also downgraded to 'F3' from 'F2' and the Country Ceiling to 'BBB-' from 'A'. All Iceland's sovereign ratings remain on Rating Watch Negative (RWN).
- These downgrades follow the tumultuous bank-related credit events in Iceland since the last sovereign rating action on 30 September 2008. On 6 October the Icelandic authorities enacted sweeping new legislation enabling the state to initiate a comprehensive restructuring of the financial sector. This step was triggered by acute financial sector distress and the elevated risk posed to sovereign creditworthiness. All three of the major banks — Glitnir Banki, Kaupthing Bank and Landsbanki Islands — are now in state administration and Fitch has downgraded their Foreign Currency IDRs to 'D'.
- Maintenance of investment-grade status for the sovereign reflects the Icelandic authorities' stated commitment to prioritise sovereign debt service. Fitch has been assured that the Central Bank of Iceland has set aside foreign-exchange reserves to fund some USD600m of EUR- and USD-denominated commercial paper that matures over coming months. Thereafter, sovereign external debt service is small in 2009-2010.
- The immediate fall-out from the financial crisis has been severe, with steep falls culminating in the temporary suspension of trading on both the currency and stock markets and the introduction of some exchange controls. A severe recession now looks unavoidable, pointing to a material deterioration in banks' domestic assets. Comparable banking crises in emerging markets have exacted a high cost in terms of lost output and deteriorating public finances.
- Public debt, currently low at 28% of GDP at end-2007, is set to rise sharply in the face of increased external borrowing to bolster international reserves, rising fiscal deficits and the risk of contingent liabilities migrating to the sovereign's balance sheet. It remains unclear to what extent the government can distance itself from external claims on the failed banks amounting to over USD100bn, while there is a high probability that the newly restructured domestic banks will require additional capital in the face of deteriorating asset quality at home.

What Could Trigger a Downgrade?

- There is an urgent need for a credible macroeconomic stabilisation programme, backed by sizeable external funding to meet potentially heavy demands on the international reserves to honour guarantees on overseas deposits and fund the essential operational needs of the economy. A timely approach to the IMF, coupled with adequate external funding, could moderate financial dislocation and shorten the duration of what promises to be a severe economic downturn. The longer the authorities delay, the greater the risk that Iceland's sovereign ratings will be downgraded again, as deeper financial difficulties ensue.
- A protracted workout of banks' external liabilities entailing extensive sovereign burden sharing could put additional downward pressure on Iceland's sovereign ratings. Resolution of deposit guarantee liabilities in the UK and the Netherlands is proceeding apace, while banks are liquidating external assets; but it is still far from clear how other external creditors will fare.