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Research Update:

Republic of Iceland FC Ratings Affirmed On Nordic Support; LC Ratings Lowered To 'BBB-/A-3'; Outlook Negative

Primary Credit Analyst:
Eileen X Zhang, CFA, London (44) 20-7176-7105;eileen_zhang@standardandpoors.com

Secondary Contact:
Marie Cavanaugh, New York (1) 212-438-7343;marie_cavanaugh@standardandpoors.com

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Overview

- The threats to Iceland's external financing requirements have receded.
- We are therefore affirming our 'BBB-/A-3' foreign-currency sovereign credit ratings on Iceland.
- Iceland likely would have limited additional flexibility to service local-currency debt if not for current and capital account controls.
- We are lowering our long-term local-currency rating to 'BBB-' from 'BBB'.
- We are removing both the foreign- and local-currency ratings from CreditWatch negative. The outlook is negative, reflecting the risks to Iceland's economic recovery and debt reduction.

Rating Action

On May 17, 2011, Standard & Poor's Ratings Services affirmed its 'BBB-/A-3' long- and short-term foreign-currency sovereign credit ratings on the Republic of Iceland. At the same time, we lowered the long-term local-currency sovereign credit rating to 'BBB-' from 'BBB' and affirmed the 'A-3' short-term local-currency rating. We removed the ratings from CreditWatch, where they were placed with negative implications on April 13, 2011. The outlook is negative. The transfer and convertibility assessment is unchanged at 'BBB-'.

Rationale

We removed the ratings on Iceland from CreditWatch because we believe the immediate threat to Iceland's external financing gap has receded. We lowered the long-term local-currency rating and assigned a negative outlook on both the foreign- and local-currency ratings because of Iceland's high external and fiscal debt burdens, which we believe could grow were it not for the capital controls that limit residents' capacity to invest overseas and nonresidents' ability to exchange krona holdings for foreign exchange.

Iceland relies on official funding to close its external financing gap through the end of this year. Although the Icelandic electorate rejected, for a second time, the government-negotiated Icesave agreement with the U.K. and the Netherlands at a referendum on April 9, 2011--which had put Iceland's IMF program at risk--we believe that the IMF and Nordic countries will continue to provide funding. The Icelandic authorities and the IMF have reached an agreement--subject to approval by the Executive Board on completion of the fifth review--and the Nordic governments are about to extend or have already extended the availability of their bilateral loans in support of Iceland's program. This arrangement should complete Iceland's external financing requirements over the next few years.

The flexibility of Iceland's prosperous economy supports our investment-grade ratings on the sovereign. We expect the Icelandic economy to grow again in 2011 after having contracted more than 10% during 2009-2010. We expect positive terms of trade and more optimistic domestic sentiment to support a moderate recovery in the near term, while planned energy-intensive investment projects are also likely to increase investments and exports from 2012 onwards. In addition, we expect the restructuring of household and corporate-sector balance sheets to accelerate during the next 12 months as a few key court cases related to lending in foreign currency are resolved. Uncertainty in Iceland's legal framework has depressed the new banks' willingness to lend.

On the back of expected positive growth and continued fiscal consolidation, we estimate that the government will reach a primary surplus in 2011, enabling the general government debt burden to start to decline in 2012. Including the IMF and Norwegian lending to the central bank, gross general government debt peaks at 128% of GDP in our forecast, while net debt peaks at about 82% of GDP. Our forecast includes additional support for Ibudalanasjodur (Housing Financing Fund) and the few remaining savings banks.

Outlook

The negative outlook reflects the likelihood of a downgrade if the government debt burden increases further, either because the economy stalls, the fiscal position reverses, or the capital account liberalization fails.

The economic recovery in Iceland is fragile and could be hurt by a number of factors, such as weaker external demand, worsening terms of trade, loss of competitiveness (because of a return to wage growth outstripping productivity growth), or further delays in private-sector balance sheet restructuring. Government debt could also increase further if significant fiscal slippage results from political instability, higher-than-expected needs to further support the banking sector, or substantial currency depreciation as the capital controls ease. We likely would lower our ratings on Iceland if net government debt levels increase significantly.

On the other hand, if the private-sector debt restructuring makes good progress in the next 12 months, the Icelandic enterprises start to invest again, and the reformed financial system functions more effectively, growth should pick up and result in better fiscal outcomes and a faster reduction in government debt. These factors likely would improve confidence and allow a swifter lifting of capital controls. In this case, the investment-grade ratings on Iceland would stabilize.

Related Criteria And Research

- Ratings On The Republic Of Iceland Placed On Watch Negative After The Electorate Rejects Icesave Agreement A Second Time, April 13, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Iceland (Republic of)		
Sovereign Credit Rating		
Local Currency	BBB-/Negative/A-3	BBB/Watch Neg/A-3

Downgraded; CreditWatch/Outlook Action

	To	From
Iceland (Republic of)		
Senior Unsecured		
Local currency	BBB-	BBB/Watch Neg

Ratings Affirmed

Iceland (Republic of)	
Transfer & Convertibility Assessment	BBB-

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign Currency	BBB-/Negative/A-3	BBB-/Watch Neg/A-3
Iceland (Republic of)		
Senior Unsecured		
Foreign Currency	BBB-	BBB-/Watch Neg
Short-Term Debt	A-3	A-3/Watch Neg
Commercial Paper	A-3	A-3/Watch Neg

Additional Contact:
Sovereign Ratings;SovereignLondon@standardandpoors.com

Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.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)

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