

Research Update:

Republic of Iceland FC Ratings Affirmed On Near-Term Stability; LC Ratings Lowered To 'BBB/A-3'; Outlook Negative

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

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Overview

- We consider that the near-term risks to Iceland's economy have subsided. We believe Iceland's external liquidity will remain weak, but stable, as exchange controls will remain in place and partly compensate for delayed official disbursements.
- We are therefore affirming our 'BBB-/A-3' foreign currency credit ratings on Iceland.
- However, prolonged application of foreign exchange controls will, in our view, restrict Iceland's monetary and fiscal flexibility and investment prospects.
- Consequently, we are lowering our local currency credit ratings on Iceland to 'BBB/A-3' from 'BBB+/A-2'. We are removing all the ratings from CreditWatch where they were placed with negative implications on Jan. 5, 2010.
- The negative outlook reflects the risk of a downgrade if the Icesave negotiations were to break down, undermining Iceland's prospects for external financing and exacerbating external liquidity pressures.

Rating Action

On March 30, 2010, 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, the long- and short-term local currency sovereign credit ratings were lowered to 'BBB/A-3' from 'BBB+/A-2'. The ratings were removed from CreditWatch where they were placed with negative implications on Jan. 5, 2010. The outlook is negative.

The transfer and convertibility assessment is unchanged at 'BBB-'.

Rationale

The rating affirmation reflects our view that Iceland's near-term financial outlook has stabilized since the electorate resoundingly rejected legislation at a referendum in early March that would have required Iceland to compensate The Netherlands and the U.K. for their deposit insurance outlays after the failure of Icelandic Internet bank Icesave.

In our view, the government coalition is likely to remain in place for the remainder of this year, reducing the risks of a policy vacuum. The current

account has swung into a surplus and the currency has appreciated 4% against the euro since the beginning of January. Moreover, the central bank has cut its policy rates twice this year and official foreign currency reserves have remained broadly stable.

We believe the authorities will now opt to keep exchange controls in place for longer than envisaged when they were first imposed after Iceland's banking system collapsed in late 2008. This should help preserve external liquidity that could otherwise have come under pressure by the likely delay of future disbursements from the International Monetary Fund (IMF) and Nordic governments. However, we still consider a successful second IMF review possible over the next few months. However, exchange controls will not be a long-term solution to Iceland's fragile external liquidity situation. They are likely to progressively weigh on investment prospects, which we believe are critical to economic recovery. Nevertheless, we see that, at 6.5%, GDP shrank less severely last year than we expected and the economy is likely to stabilize in 2010.

We expect the Icesave negotiations to continue after general elections in the U.K. and The Netherlands, and a mutually agreeable compromise will likely be found later this year. We believe none of parties would like to see the negotiations fail. However, the lack of a fixed deadline may prolong the negotiations, during which Iceland may need to keep capital controls in place. Lifting them without secured external financing sources could lead to depreciation pressure, which could result in renewed problems in the financial sector. This is because the population remains highly indebted, including in foreign currency.

The disbursement of the \$2.3 billion remaining under the IMF program is, in principle, not linked to the resolution of the Icesave conflict, and we believe that Iceland has broadly fulfilled the program's conditionality on fiscal adjustment and financial sector restructuring.

We believe that the IMF might release the funds linked to the second review, even if only some of the bilateral loans agreed with Nordic countries are also made available, so as to bolster Iceland's central bank foreign exchange reserves (\$3.7 billion in January 2010) and to cofinance the adjustment program. However, the Nordic governments have signaled their reluctance to disburse unless a solution to the Icesave dispute is found. In the meantime, Iceland's gross external financing needs have reached about 130% of its foreign exchange reserves and current account receipts, which is much higher than the 'BBB' median (114%).

Despite strong external financing pressures and a government debt ratio that quadrupled to 124% of GDP between 2007 and 2009, Iceland's prosperous and very flexible economy supports an investment-grade rating, in our view. Iceland's GDP per capita remains almost four times higher than the 'BBB' median, and its political institutions facilitate swift and decisive policy action to prevent default.

Outlook

The negative outlook indicates our opinion that downside risks to Iceland's creditworthiness remain. If the Icesave negotiations with the U.K. and The Netherlands were to break down, this would undermine Iceland's prospects for external financing, exacerbating external liquidity pressures and limiting growth opportunities because the capital account will remain closed.

Such a scenario could cause us to lower the rating on Iceland by one or two notches, as would economic policy decisions that lead to another sharp devaluation. An unexpected deterioration of political stability, jeopardizing Iceland's capacity to react in a timely manner to economic shocks, would also be detrimental to the country's creditworthiness, in our view. An orderly and lasting stabilization of Iceland's external accounts and the implementation of a credible program to reverse the high government debt ratio could stabilize the ratings in the 'BBB' category.

Related Criteria And Research

- Use Of CreditWatch And Outlooks, Sept. 14, 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-/Negative/A-3	BBB-/Watch Neg/A-3
Senior Unsecured	BBB-/Negative	BBB-/Watch Neg
Commercial Paper	A-3	A-3/Watch Neg

Downgraded; CreditWatch/Outlook Action

Iceland (Republic of)		
Sovereign Credit Rating		
Local Currency	BBB/Negative/A-3	BBB+/Watch Neg/A-2
Senior Unsecured	BBB	BBB+/Watch Neg
Short-Term Debt	A-3	A-2/Watch Neg

Ratings Unchanged

Iceland (Republic of)		
Transfer & Convertibility Assessment	BBB-	

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