Republic of Iceland 'A+/A-1+' Foreign Currency Ratings Affirmed; Outlook Stable

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LONDON (Standard & Poor's) June 19, 2003--Standard & Poor's Ratings Services said today it affirmed all its ratings on the Republic of Iceland, including its 'AA+/A-1+' local currency and 'A+/A-1+' foreign currency issuer credit ratings. The outlook is stable.

"Iceland is a wealthy and flexible economy, with GDP per capita forecast to reach $36,870 in 2003," said Standard & Poor's credit analyst Kai Stukenbrock. "The economy demonstrated its flexibility through the relatively swift correction of the large macroeconomic imbalances caused by rapid growth in domestic credit and demand in recent years."

Credit growth slowed to virtually zero in 2002 from 44% in 2000, and the current account balance returned to a surplus of 0.3% from a deficit of 10.1% over the same period, without any major economic repercussions. Growth turned slightly negative in 2002 (0.5% contraction), but is forecast to resume at 2.5% in 2003.

Public finances remain healthy, despite recurring expenditure overruns and the absence of a medium-term budgeting framework. The general government balance will turn slightly negative in 2002 and 2003 (at negative 0.7% and 0.5% of GDP, respectively) due to the economic downturn and discretionary measures on both the expenditure and revenue sides. The budget is forecast to be broadly balanced thereafter, however. On the back of the improvement in the general government balance and robust economic growth, general government debt will resume its declining trend over the coming years, to reach 31.5% of GDP in 2006.

Net external debt levels remain very high in all sectors of the economy, at 244% of current account receipts overall in 2002, and the share of short-term debt has recently been rising. Capital outflows from Icelandic pension funds diversifying abroad put additional structural pressure on the balance of payments. Despite the rapid return to a current account surplus and the systematic rebuilding of foreign exchange reserves by the central bank, Iceland's external liquidity has increased only slightly and will remain one of the weakest among rated sovereigns.

Off-budget and contingent liabilities for the government remain large. Imbalances in the financial sector have been significant as a result of the credit boom, and the sector remains vulnerable as it unwinds these imbalances. Although bank profitability has recovered and prudential indicators are once again improving, the financial sector remains vulnerable due to its very large external leverage and a volatile exchange rate. This vulnerability is underscored by the sector's increasing reliance on short-term external borrowing.

The stable outlook reflects the balanced risks to Iceland's economy, where weak external liquidity and high indebtedness are balanced against healthy public finances and the high flexibility of the economy.

Upcoming large-scale investment projects in aluminum smelting and power generation, set to be carried out during 2004-2009, will lead to significant net foreign direct investment inflows over the coming years, precipitating strong economic growth. Although the investments should contribute to a strengthening of Iceland's economic structure in the future, they pose important challenges for economic policy. A tight fiscal and monetary stance will be required to prevent the recurrence of macroeconomic imbalances, which could exacerbate the country's large net debtor position.

"Any significant increase in external leverage or a recurrence of macroeconomic imbalances on the back of the country's large investment projects could bring the ratings under downward pressure," added Mr. Stukenbrock. "Conversely, significant and sustained improvements in the net external debt position and further improvement of the financial sector's prudential indicators would strengthen the ratings."

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. Alternatively, call one of Standard & Poor's Ratings Desks: London (44) 20-7847-7400; Paris (33) 1-4420-6705; Frankfurt (49) 69-33-999-223; or Stockholm (46) 8-440-5916. Members of the media may contact the Press Office Hotline on (44) 20-7826-3605 or via media_europe@standardandpoors.com.

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