

Republic of Iceland Cut To FC 'A+/A-1', LC 'AA/A-1+' On Unbalanced Policy Mix; Outlook Stable

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LONDON (Standard & Poor's) Dec. 22, 2006--Standard & Poor's Ratings Services said today it lowered its foreign currency sovereign credit ratings on the Republic of Iceland to 'A+' long-term and 'A-1' short-term, from 'AA-' and 'A-1+', respectively. At the same time, the long-term local currency rating on Iceland was lowered to 'AA' from 'AA+', and the short-term local currency rating was affirmed at 'A-1+'. The outlook is stable.

"The downgrade reflects the loosening of fiscal policy by the Icelandic government ahead of the 2007 election, demonstrated by the recent expansionary amendments to the 2007 budget at a time when the macroeconomic imbalances in the economy due to excessive domestic demand are in urgent need of readjustment," said Standard & Poor's credit analyst Eileen Zhang. "This expansionary stance reveals an increasingly unbalanced policy mix, forcing further monetary tightening by the central bank, as evidenced by the 25 basis point interest rate hike, to 14.25%, on Dec. 21, 2006."

This exacerbates the risk of a hard landing by the Icelandic economy, as the macroeconomic imbalances built up in the credit and investment boom in the past two years unwind.

Moreover, a widening income deficit as demonstrated in the recent balance of payment data also leads to an upward revision of the outlook for current account deficit and worsening international investment position going forward.

Conversely, the ratings on Iceland remain supported by its stable and flexible political institutions, high level of prosperity, strong long-term economic growth prospects, and low and declining government debt levels due to sizable fiscal surpluses in the past three years.

"The high levels of prosperity and flexibility in the Icelandic economy are offset by the highly leveraged external sector and very weak external position," said Ms. Zhang. "Nevertheless, the high levels of income and wealth, as well as the strong fiscal account, would provide a cushion for the readjustment of the economy."

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