

## Iceland (Republic of)

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# Iceland (Republic of)

## Major Rating Factors

### Strengths:

- Stable and mature political institutions, although cohesion has weakened following the onset of the economic and financial crisis.
- Very high per capita income of four times the 'BBB' median and a flexible economy, which have contributed to a swift correction of external imbalances.
- Strong international funding support and an improved international investment position after the default of the Icelandic banks.

### Weaknesses:

- High government debt following the collapse of the financial sector in 2008.
- A relatively undiversified and volatile economy, with the main export sectors subject to supply-side constraints.
- Risks related to the lifting of capital-account controls imposed after bank failures and currency depreciation, in particular, while negotiations relating to the Icesave bank controversy remain unresolved.

Sovereign Credit Rating
<i>Foreign Currency</i> BBB-/Negative/A-3
<i>Local Currency</i> BBB/Negative/A-3

## Rationale

The ratings on the Republic of Iceland reflect Standard & Poor's Ratings Services' 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 the country 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 from the likely delay of future disbursements from the International Monetary Fund (IMF) and Nordic governments. However, exchange controls will not be a long-term solution to Iceland's fragile external liquidity situation, and 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 the 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 2010, Iceland's prosperous and very flexible economy supports an investment-grade rating, in our view. What's more, 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 a credible program to reverse the high government debt ratio could stabilize the ratings in the 'BBB' category.

**Table 1**

Republic of Iceland Selected Indicators								
	2005	2006	2007	2008	2009	2010e	2011f	2012f
GDP per capita (\$)	54,358	54,097	64,748	52,603	38,204	41,325	44,296	45,759
Real GDP (% change)	7.48	4.60	5.95	0.96	(6.49)	(1.50)	1.97	2.50
Real GDP per capita (% change)	5.22	1.95	3.33	(0.28)	(5.96)	(0.53)	1.97	2.50
General government balance (% of GDP)	4.89	6.32	5.40	(13.55)	(13.50)	(10.50)	(7.00)	(3.00)
General government debt (% of GDP)	25.39	30.14	28.59	69.70	100.95	125.77	124.41	119.76
Net general government debt (% of GDP)	23.16	28.61	22.79	42.41	67.51	96.14	98.32	96.97
General government interest exp. (% of revenues)	4.67	4.50	5.43	7.57	8.58	11.28	13.72	13.62
Domestic credit to private sector & NFPEs* (% of GDP)	215.50	256.41	296.33	393.62	348.94	279.59	249.73	234.04
Consumer price index (average; % change)	4.05	6.76	5.03	12.42	11.99	6.00	4.00	3.00

Table 1

Republic of Iceland Selected Indicators (cont.)								
Gross ext. financing needs¶ (% of CARs and usable reserves)	271.24	293.25	320.29	604.91	635.97	136.74	128.06	124.84
Current account balance (% of GDP)	(16.14)	(25.59)	(16.29)	(18.50)	0.41	4.30	5.35	7.50
Narrow net external debt§ (% of CARs)	398.69	445.25	451.76	598.08	246.95	283.15	247.82	220.80

\*Standard & Poor's estimates that, in a reasonable worst-case economic downturn, gross problematic assets could reach 50% of domestic credit to the private sector and NFPEs; see "Banking Industry Country Risk Assessments", published monthly on RatingsDirect. ¶Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. §Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public-sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. NFPEs--Nonfinancial public-sector enterprises. CARs--Current account receipts. e--Estimate. f--Forecast.

## Comparative Analysis: Iceland Faces Bigger Challenges Than Peers, But Has Stronger Economic Fundamentals

- Iceland has been confronted with the worst economic shock in its peer group.
- Strong institutions and a flexible and prosperous economy are positive distinguishing features.
- Iceland is now one of the most indebted governments in the investment-grade category.

Iceland is an economy of extremes. It is a rich country with robust political institutions and high standards of human development. At the same time, it is very small and narrowly based and prone to large external shocks. The high flexibility of its economy allows Iceland to respond to these large shocks more effectively than most peers, in our opinion.

We believe other relatively small economies in the 'BBB' and 'BB' categories provide useful comparators. Most of them have also recently experienced the consequences of overheating economies and face the task of reducing leverage. These countries include the Republics of Latvia (BB/Stable/B; This and subsequent ratings in this section refer to the foreign currency sovereign credit ratings) and Lithuania (BBB/Stable/A-3), Romania (BB+/Stable/B), the Hellenic Republic (Greece; BBB+/Negative/A-2), as well as the higher-rated State of Israel (A/Stable/A-1) and the Republic of Ireland (AA/Negative/A-1+), owing to their high fiscal leverage.

### Iceland's financial crisis overshadows that of its peers ...

Since 2008, financial and economic turmoil has hit most members of the peer group, but none more severely than Iceland. Following the boom years of ample global liquidity earlier in the last decade, Iceland's banking system imploded in late 2008 and all three systemically important Icelandic banks went bankrupt.

Some of Iceland's peers also had to deal with serious difficulties in their financial sectors, but were spared the wholesale collapse of their banking systems. Latvia had to bail out one domestic bank (Parex Banka), but the rest of the banking system was kept afloat by stronger Western European parent banks. Foreign-based ownership also features prominently in the banking systems of Lithuania and Romania, where parent institutions financed their subsidiaries' operations, but not expansion, which put a stop to the credit-fueled growth model of previous years. By contrast, Iceland's banking system is home-based and the domestic banks had accumulated sizable foreign debt to expand abroad.

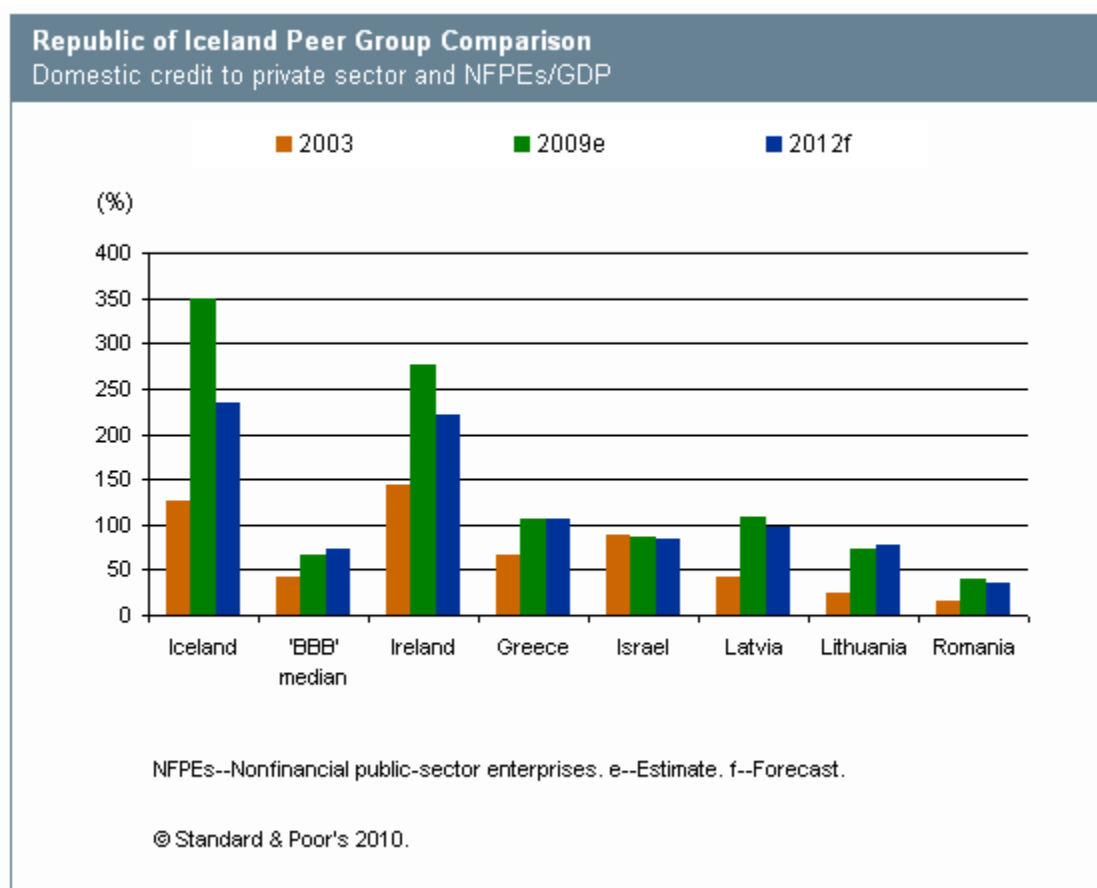
One of the casualties of Iceland's banking system collapse was Icesave, a brand of Iceland's Landsbanki. When Icesave's operations in the U.K. and The Netherlands failed, the Dutch and British governments compensated depositors through their respective deposit insurance programs. The ensuing conflict about reimbursement for the

U.K. and The Netherlands has strained Iceland's external relations, an additional complication none of its peers faces.

The recapitalization of Ireland's banking system also required massive government support, but the amounts needed for the bailouts did not jeopardize Ireland's solvency. Iceland, however, had no alternative but to allow banks to fail, owing to their large size. Greece's banking system has so far avoided the need for state aid, but we expect deteriorating asset quality at home and at Balkan subsidiaries to impede the profitability and capitalization of Greek financial institutions.

The rapid increase in private-sector leverage in Iceland over the past decade has exceeded that of the banking systems of its peers (see chart 1). Similarly, we expect the subsequent debt reduction to be more rapid than peers'.

**Chart 1**



In all the peer countries, except for Israel, where the banking sector showed resilience, the sudden stop in credit creation led to a severe recession and a rapid rise in government debt. This situation was exacerbated in Iceland, Ireland, and Latvia by the direct cost of financial-sector intervention (see charts 2 and 3).

Chart 2

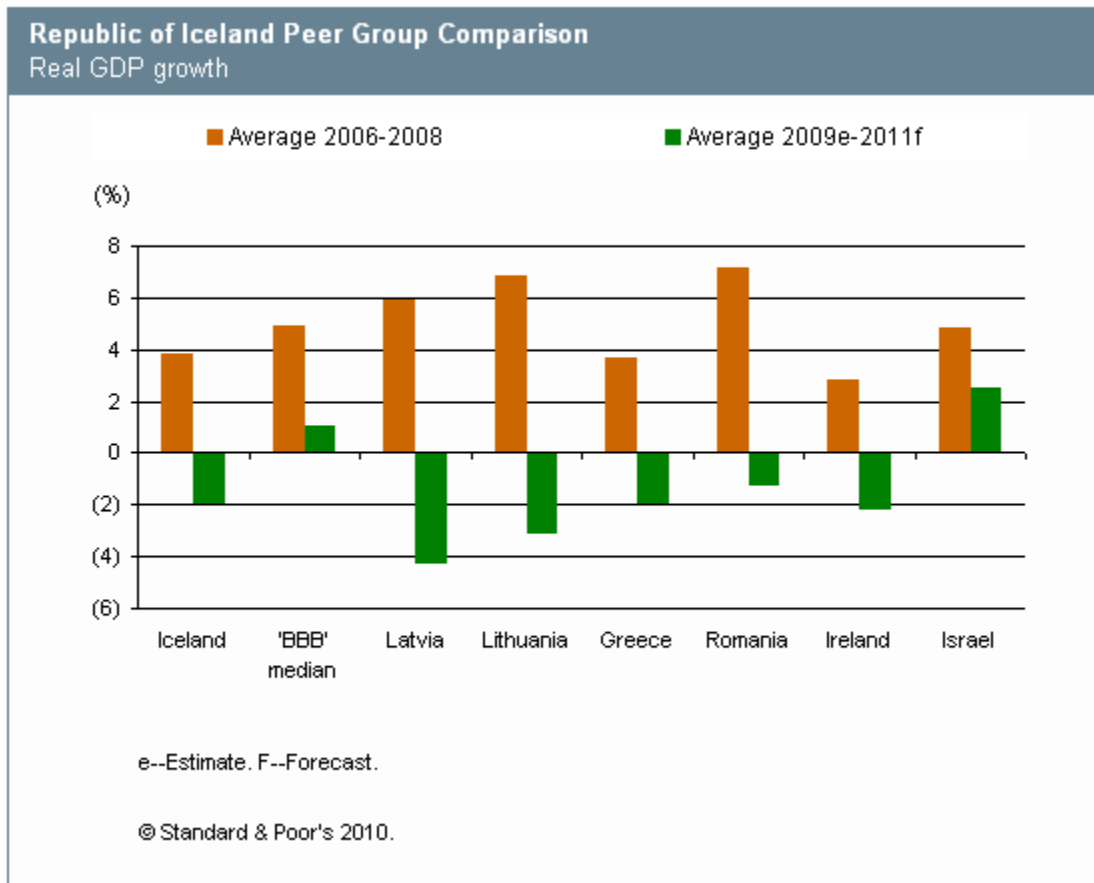
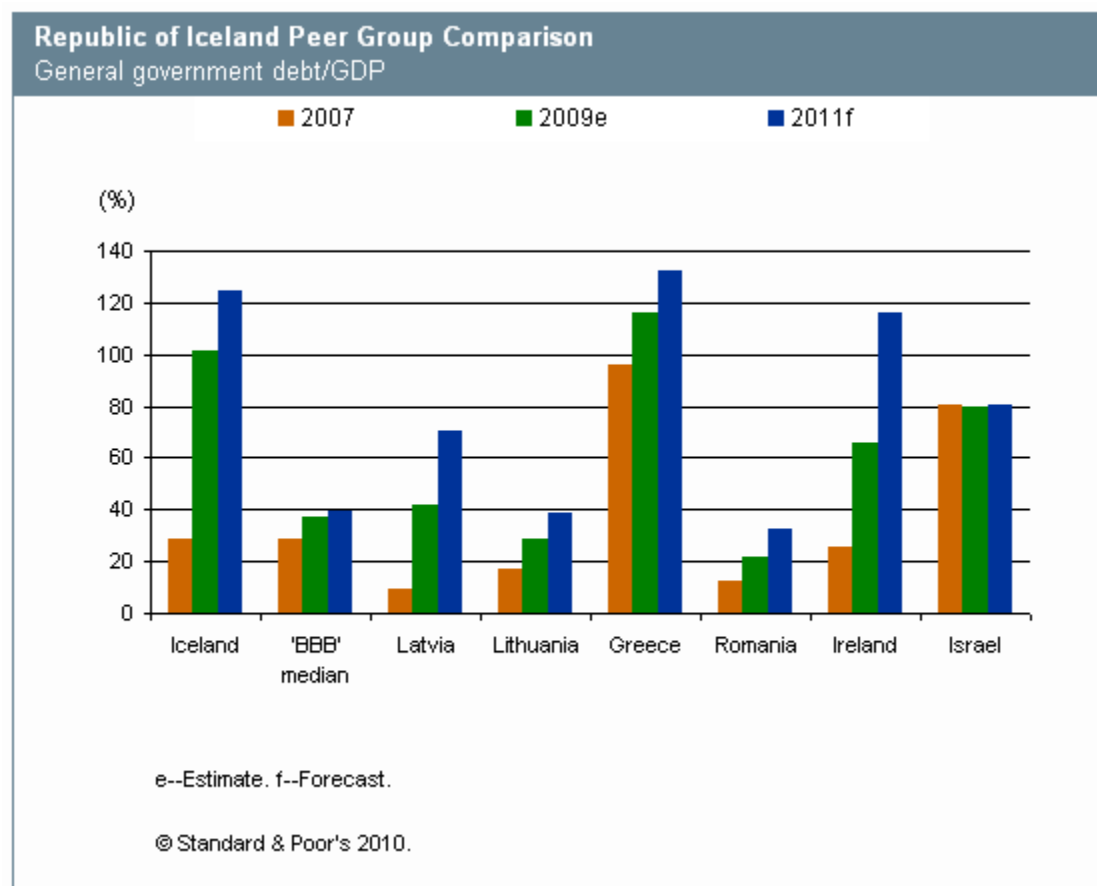


Chart 3

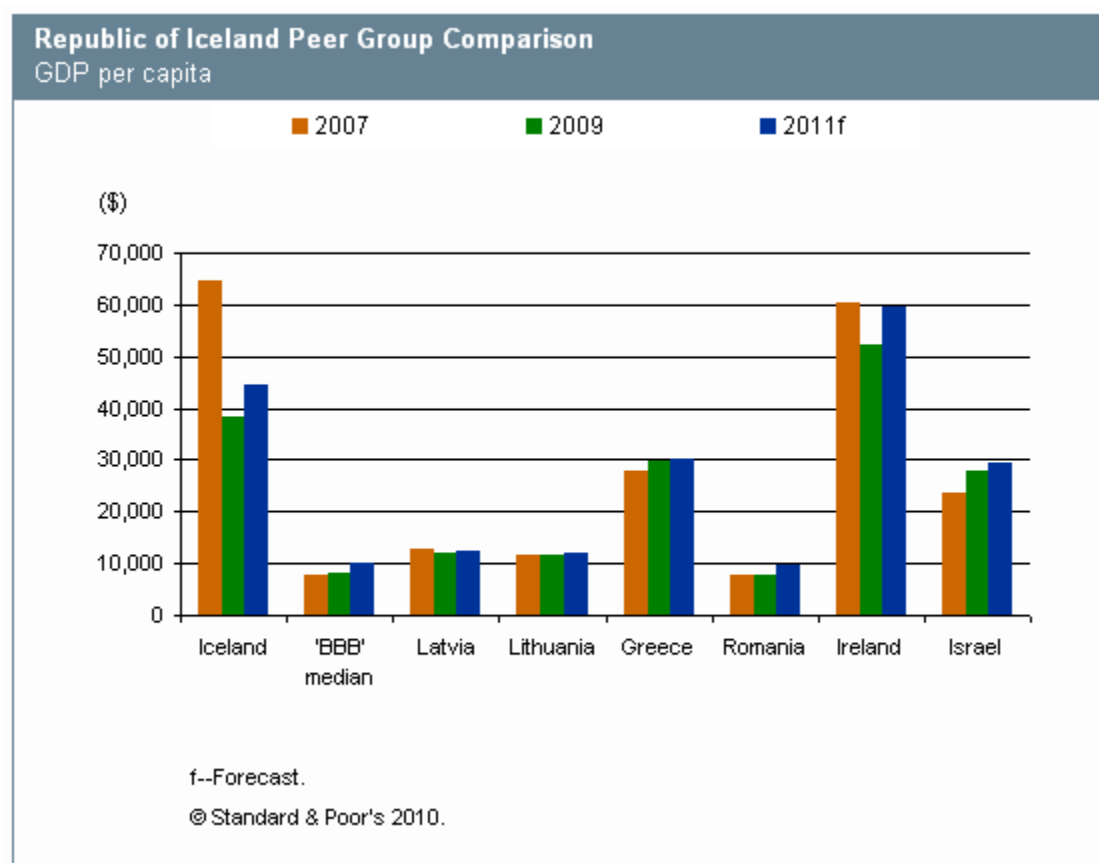


### ... but the real economy has been less hit, thanks to superior flexibility

We see that despite the dramatic demise of Iceland's entire banking sector, the drop in economic output has been less pronounced than that of peers. In 2009, Iceland's real GDP decline was about 6.5%, which is less than that of Romania (down 7.2%) and Ireland (7.5%), Lithuania (15%), and Latvia (18%). In our view, this relatively benign development reflects Iceland's flexibility and strong institutions.

Inward and outward migration provide a buffer to economic decline, as does Iceland's elevated standard of living. Even at the height of the crisis in 2009, GDP per capita was four times the 'BBB' median (see chart 4). Moreover, high educational standards allow individuals to leave the labor market to pursue higher education.

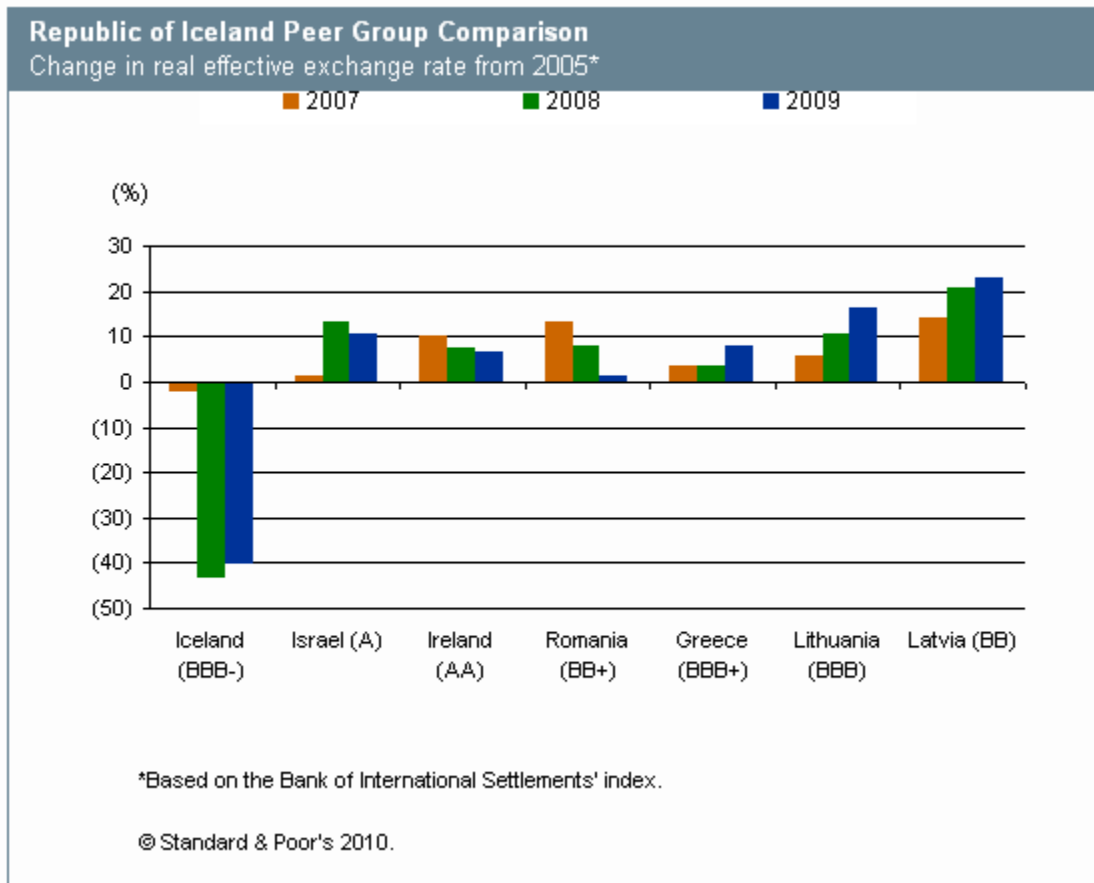
Chart 4



Iceland's recession was also mitigated by the steep depreciation of its currency in 2008 that was only halted after the government imposed strict exchange controls (see chart 5). By contrast, the adherence of Iceland's Baltic peers to fixed exchange rate regimes caused their adjustments to come about through real economic contraction. Greece and Ireland, as members of the European Monetary Union (EMU), also had no nominal ability to lower the real effective exchange rate and so regain competitiveness and dampen the contraction. Among Iceland's peers only Romania, with its flexible exchange rate, was able to generate a real depreciation, albeit a modest one.

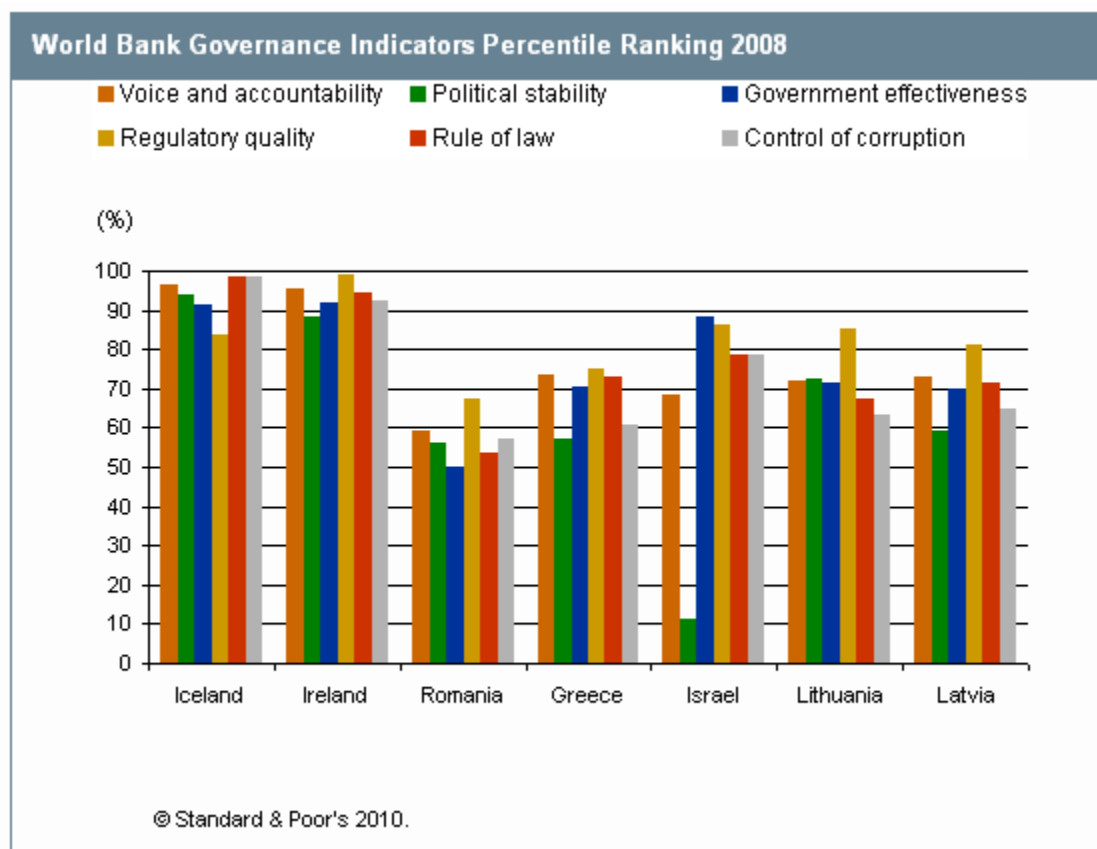


Chart 5



Iceland's flexibility relative to peers is also partly attributable to its stronger institutions. Apart from Ireland, no other country comes close to the sophistication and effectiveness of Iceland in terms of governance, according to World Bank indicators (see chart 6). However, we see that Iceland compares relatively poorly in "Regulatory quality", a reflection of which is to be found in the collapse of the banking system.

Chart 6

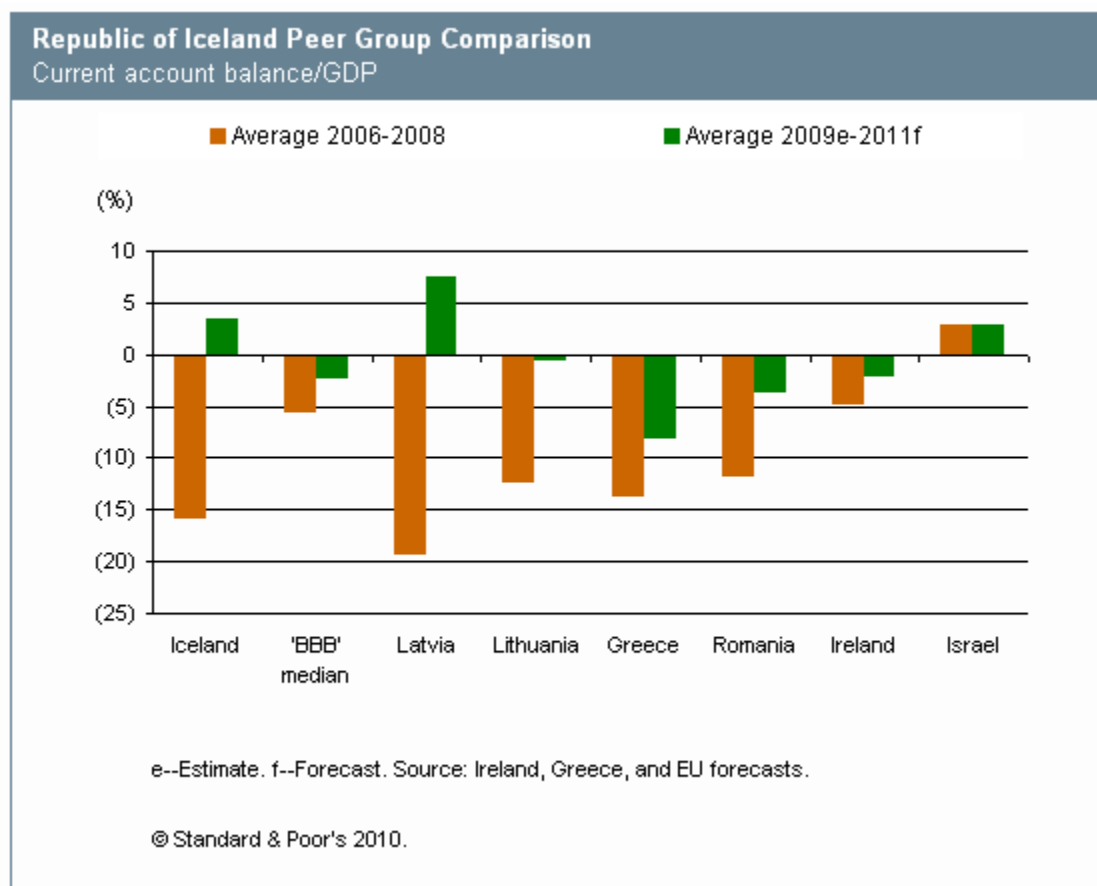


Iceland's political stability has been put to a severe test since the start of the crisis and, as in some peer countries, the political climate has clearly become more confrontational and less cohesive. Nevertheless, it appears that although smaller countries in the peer group have experienced large economic shocks, their close-knit political environments seem to facilitate a swift reaction.

#### External liquidity remains Iceland's Achilles heel

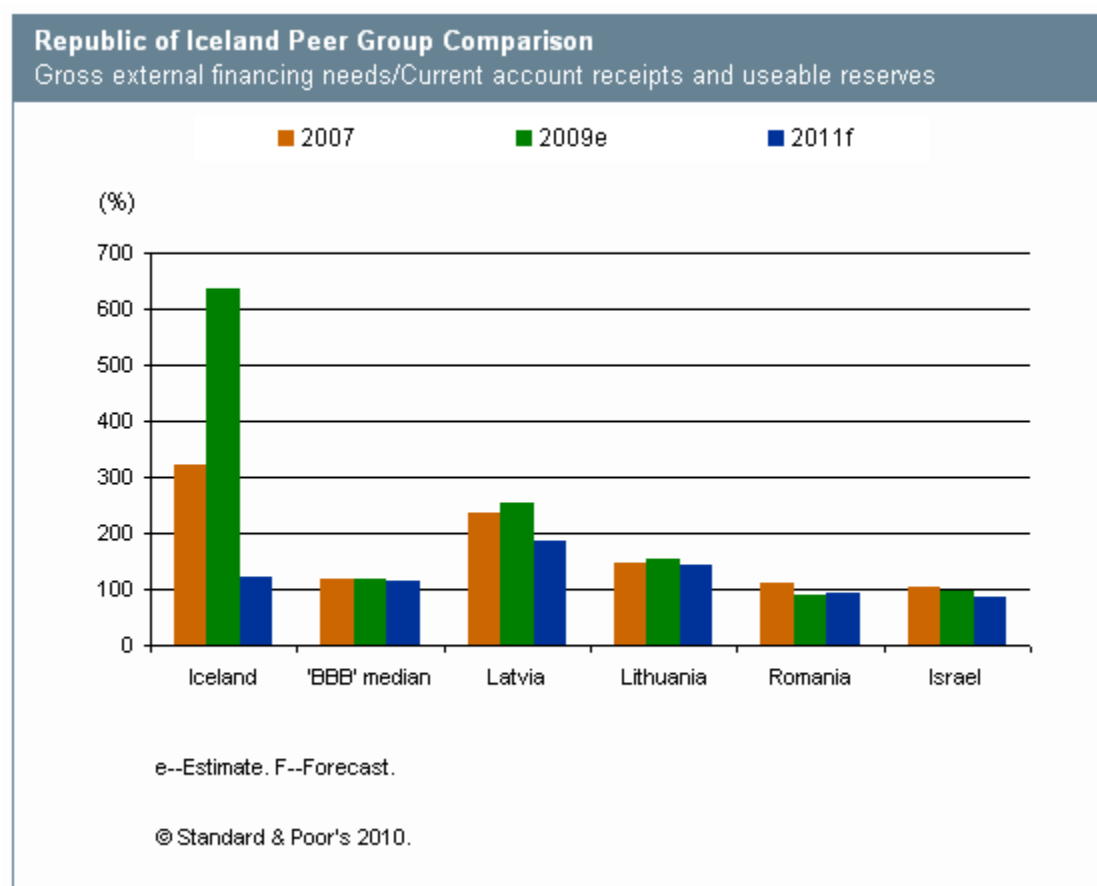
The credit-fueled boom of the mid-2000s caused large external imbalances in the peer group, except in Israel (see chart 7). This is because national saving rates fell well short of investment, often in activities that displayed disappointing returns, such as the aggressive international expansion of Icelandic banks and corporates. However, real estate bubbles were seen more broadly across the peer group. All the countries in the peer group showed extremely large current-account deficits as a result.

Chart 7



Iceland, Romania, and Latvia have sought financing from the IMF, which they complement with funding from other official creditors. Even Greece, a member of the EMU, has been considering turning to the IMF. Rapid reversals of the external imbalances (Iceland and Latvia are even displaying current account surpluses), together with official financing to bolster foreign exchange reserves, has stabilized external liquidity positions, as measured by gross external financing needs (current account balance plus external debt due within 12 months) as a share of current account receipts plus unencumbered foreign reserves (see chart 8).

Chart 8



The remarkable improvement in Iceland's current account position was thanks to a better income balance following the banks' external debt defaults. Although the country's external liquidity position is now close to the 'BBB' median, this strengthening overstates the underlying improvement. Alone among its peers, Iceland had to resort to foreign exchange controls to safeguard its foreign reserves. This means that foreign creditors that want to convert their krona holdings are prevented from doing so, which restricts foreign reserves and ultimately external liquidity. External liquidity therefore remains a key weakness of Iceland's credit profile, in our view.

## Political Environment: Tensions Have Become More Visible With Tough Economic Decisions

- The fallout of the economic crisis has made politics more adversarial.
- The IMF program acts as an anchor to economic policy-making, but the unresolved Icesave conflict is likely to delay disbursements.
- Iceland has formally applied to join the EU, but popular support remains uncertain.

We believe that Iceland's creditworthiness faces no appreciable political risks. Iceland is a country with deep democratic roots, robust political institutions, and high social and educational standards. Internal and external security risks are negligible, in our view.

Following the failure of the Icelandic banks in September and October 2008, alongside a steep devaluation of the local currency, the then government coalition, led by the long-ruling Independence Party (IP), dissolved. It was replaced by a coalition of the Social Democratic Alliance (SDA) of Prime Minister Johanna Sigurdadotir and the Left-Green Movement (LGM), which emerged victorious from the April 2009 general election. The new coalition holds a narrow three-seat majority in the 63-member Althingi (parliament).

The coalition partners disagree on several important issues, such as EU membership and the expansion of the energy-intensive aluminum industry in Iceland (SDA is in favor of both, LGM against). Nevertheless, we believe that both parties have strong incentives to prevent a collapse of the coalition, largely because the government's popularity has weakened owing to its austerity measures and its inability to resolve the Icesave conflict.

The IP, which has widely been credited with the country's economic boom and subsequent bust, has been able to recover quickly under its new leader Bjarni Benediktsson. Opinion polls show that the IP once again enjoys the largest following, which should provide added incentive for the coalition parties to stick together. We understand an independent investigative report compiled for the Icelandic parliament into the cause of Iceland's financial crisis and possible political misconduct will be published in mid-April and could undermine the IP's recovering popularity.

Economic policy-making in Iceland is guided by a two-year \$2.1 billion stand-by program agreed with the IMF in November 2008, which is supported by \$2.5 billion of bilateral loans from Nordic governments. Disbursements of the Nordic government loans are tied to successful IMF reviews and are being delayed by the dispute with the Dutch and British governments over the failed Internet bank Icesave, an offshore branch of collapsed Icelandic bank Landsbanki.

Under international agreements, the Icelandic Deposit Guarantee Fund (IDGF) is required to reimburse the Dutch and British authorities for the amounts their respective deposit insurance schemes paid out to Icesave depositors in their countries. The amount to be reimbursed is about Icelandic krona (ISK) 700 billion (about €4 billion), more than 45% of Iceland's 2009 GDP. We understand this figure is well beyond the resources of the IDGF, which would need to borrow from the Dutch and British authorities to make the payment. However, four LGM Members of Parliament voted against the intergovernmental agreements reached in June 2009. Moreover, Althingi set several preconditions to passing the bill, the most important of which is the restriction of the yearly payment amount to a certain percentage of Iceland's GDP growth, measured in foreign currency.

Another agreement was forged with the Dutch and British governments to take this conditionality into account. However, the opposition tried to block passage of the bill, based partly on the widespread unpopularity of the deal, stemming from the U.K.'s decision in 2008 to seize the U.K.-based assets of a failed Icelandic bank under its antiterrorism legislation. The guarantee law finally passed on Dec. 30, 2009, but President Grimsson refused to sign it, prompting a referendum over the issue, which was resoundingly rejected in early March 2010.

We expect Iceland to continue negotiations with the U.K. and The Netherlands after general elections in these two countries, and a mutually agreeable compromise is likely later this year. None of the parties has anything to gain by allowing the negotiations to fail. Still, without a deadline, the negotiation process may drag on. Whatever the outcome, in our view, the financial crisis and the polarizing domestic conflict caused by the Icesave issue have stretched Iceland's previous political and societal cohesiveness to its limits.

With the Euro-skeptic IP out of power and a shift in public opinion following the collapse of the financial sector, Iceland submitted its application for EU membership in July 2009. Negotiations are likely to begin in the first half of

2010 and could be concluded relatively rapidly because Iceland, a member of the European Economic Area, has already implemented most of the necessary EU legislation. We understand the government will hold a referendum before accession, the outcome of which is highly uncertain. Since the second-half of 2009, popular support for EU membership has waned. In our view, unless Iceland receives an exemption from the EU's common fisheries policies, which could put it at a disadvantage, accession remains very unlikely.

## Economic Prospects: The Deepest Economic Slump In Iceland's History

- Iceland's economy contracted an estimated 6.5% in 2009 and will likely shrink moderately (by about 1.5%) in 2010, but remains the most prosperous of the peer group.
- Unemployment peaked at 10% by year-end 2009 and would have risen further were it not for outward emigration.
- As domestic demand will be held back by private-sector deleveraging, any recovery will likely stem from exports, which are subject to supply constraints, despite positive signs.

**Table 2**

Republic of Iceland Economic And Financial Indicators								
	2005	2006	2007	2008	2009	2010e	2011f	2012f
Nominal GDP (bil. ISK)	1,027	1,168	1,309	1,478	1,500	1,591	1,693	1,806
Nominal GDP (bil. \$)	16	17	20	17	12	13	14	14
GDP per capita (\$)	54,358	54,097	64,748	52,603	38,204	41,325	44,296	45,759
Real GDP (% change)	7.48	4.60	5.95	0.96	(6.49)	(1.50)	1.97	2.50
Real GDP per capita (% change)	5.22	1.95	3.33	(0.28)	(5.96)	(0.53)	1.97	2.50
Real domestic demand (% change)	14.21	9.76	(0.45)	(6.18)	(16.37)	(5.31)	1.14	0.62
Real investment (% change)	35.72	22.41	(11.10)	(20.99)	(49.94)	8.00	8.00	5.00
Gross domestic investment (% of GDP)	28.30	35.19	29.02	24.56	14.24	14.99	15.38	15.43
Gross domestic savings (% of GDP)	12.15	9.61	12.73	6.06	14.66	19.30	20.72	22.93
Real exports (% change)	7.53	(4.59)	17.74	7.12	6.19	1.00	3.00	5.00
Unemployment rate (average claimant count; %)	2.60	2.90	2.30	3.00	7.20	10.00	9.00	7.00
Real GDP per employee growth (%)	4.02	(0.52)	1.35	0.22	(0.47)	0.54	(0.03)	(1.43)
Consumer price index (% change)	4.05	6.76	5.03	12.42	11.99	6.00	4.00	3.00
Domestic credit to private sector and NFPEs (% change)	53.85	35.38	29.45	50.00	(10.00)	(15.00)	(5.00)	0.00
Domestic credit to private sector and NFPEs (% of GDP)	215.50	256.41	296.33	393.62	348.94	279.59	249.73	234.04

ISK--Icelandic krona. NFPEs--Nonfinancial public-sector enterprises. e--Estimate. f--Forecast.

### Economic structure

Although recession and depreciation caused per capita income to drop sharply in 2009 to less than \$38,000 from a peak of \$64,000 in 2007, Iceland's population remains far more prosperous than that of any other 'BBB' rated sovereign. Iceland's economy is small--in 2009, GDP was \$12.1 billion and the population 320,000--and it is open and flexible. Exports comprised 52% of GDP in 2009 and are dominated by marine products and aluminum, which account for about 80% of all merchandise exports. An important contribution comes from export services, mainly travel and transportation. Large-scale investment projects in aluminum smelters, along with the necessary expansion of energy generation, have transformed Iceland's economy, making the country one of the 10 largest aluminum producers in the world.

Because Iceland's economy is small, any corporate expansion necessitates diversification abroad. Consequently, many Icelandic corporations have taken this route, typically financed through external loans. This pattern was particularly prevalent among the three major Icelandic banks that collapsed in late 2008 under their unsustainable debt burdens. Domestic leverage had also risen to 400% of GDP by 2008 when a fall in the exchange rate inflated foreign-currency denominated loans from 300% in 2007 and 106% in 2006. We expect the nominal amount of outstanding credit to keep shrinking in the coming years as risk aversion increases, real interest rates remain high, and debtors default, bringing the ratio of domestic credit to a still high 250% of GDP by 2011.

As in previous boom-bust cycles, Iceland's economy has demonstrated remarkable flexibility in unwinding macroeconomic imbalances, including significant cuts in real wages. Nevertheless, unemployment has surpassed 9%, almost double the highest rate previously recorded, 5% in 1995. Unemployment has been cushioned by outward migration as the resident population decreased 0.5% for the first time since 1889.

### Economic growth will likely hinge on exports

We expect the private sector to continue to reduce its debt burden over the next few years, so we believe any growth would stem from net exports. Tourism could play a positive role as the massive real depreciation of the local currency has made Iceland a more affordable destination. The value of Iceland's main merchandise exports, marine products and aluminum, will depend more on global market conditions. This is because Iceland's ability to adjust supply to changes in demand is limited in the short to medium term, and products have traditionally been priced in foreign currency.

Fishing quotas are established yearly in accordance with scientific criteria to prevent overfishing and depletion of stocks. The quotas were lower in 2008 and in 2009. Higher aluminum production requires large-scale investments, which may be hampered if the state-controlled power company Landsvirkjun (BB/Stable/B-1) experiences funding difficulties. All smelters have been operating at full capacity since 2008, and production will only increase in 2012 when the new Helguvik smelter starts operating.

After an estimated 6.5% economic contraction in 2009 and possible shrinkage of 1.5% this year, we expect Iceland's economy to recover somewhat in 2011, but growth to remain at about 2%-3% as Iceland's private and public sectors consolidate their stretched balance sheets. Downside risks are significant, especially if consumer confidence were to falter in the aftermath of renewed pressure on the exchange rate as capital controls are lifted.

## Fiscal Flexibility: Public Debt To Surpass GDP

- The bank bailouts and the economic crisis devastated the government's balance sheet, and the debt ratio quadrupled in three years to almost 125% in 2010.
- Following four years of surpluses, the 2010 government deficit will likely fall from the peak level in 2009 of 13% of GDP. The government plans to cut the deficit to 3% by 2012.
- Contingent liabilities from the financial sector have migrated to the government's accounts. However, Iceland's financial sector remains large, and asset quality could still deteriorate, requiring additional public funds.

**Table 3**

Republic of Iceland Fiscal Indicators									
(% of GDP)	2005	2006	2007	2008	2009	2010e	2011f	2012f	
General government revenues	47.10	47.98	47.67	44.23	38.40	40.50	43.10	44.50	

Table 3

Republic of Iceland Fiscal Indicators (cont.)									
Of which central government	35.41	35.34	34.74	32.27	27.30	29.30	30.30	33.60	
General government expenditures	42.21	41.66	42.27	57.78	51.90	51.00	50.10	47.50	
Of which central government	30.97	30.04	30.81	45.25	39.00	38.00	36.00	36.00	
General government balance	4.89	6.32	5.40	(13.55)	(13.50)	(10.50)	(7.00)	(3.00)	
Of which central government	4.44	5.30	3.93	(12.97)	(11.70)	(8.70)	(5.70)	(2.40)	
Of which local authorities	0.10	0.33	0.61	(0.87)	(1.30)	(1.30)	(1.00)	(0.60)	
General government primary balance	7.09	8.48	7.99	(10.20)	(10.20)	(5.93)	(1.09)	3.06	
Central government primary balance	6.22	7.03	6.06	(10.18)	(8.72)	(4.51)	(0.24)	3.16	
General government balance (% of revenues)	10.39	13.17	11.33	(30.63)	(35.16)	(25.93)	(16.24)	(6.74)	
General government interest payments (% of revenues)	4.67	4.50	5.43	7.57	8.58	11.28	13.72	13.62	
Central gov't interest payments (% of revenues)	5.03	4.89	6.14	8.66	10.92	14.30	18.01	16.53	
General government debt	25.39	30.14	28.59	69.70	100.95	125.77	124.41	119.76	
Of which central government debt	19.10	25.04	23.77	63.03	92.58	116.07	114.00	109.40	
General government net debt	23.16	28.61	22.79	42.41	67.51	96.14	98.32	96.97	
Of which central government net debt	16.87	23.51	17.96	35.74	59.14	86.44	87.91	86.61	

e--Estimate. f--Forecast.

### Medium-term plan to address negative revenue and expenditure trend

The cost of saving the economy from an even more dramatic plunge has severely compromised Iceland's fiscal flexibility. General government revenue as a share of GDP fell almost 10 percentage points to 38% between 2007 and 2009 as incomes and demand plummeted. During the same period, the general government-expenditure ratio rose by almost 10 percentage points, as unemployment benefits and interest expenses surged.

Iceland's 2010 budget is based on what we see as conservative assumptions, a 1.9% output contraction, a 5% rise in inflation, and an 11.4% drop in disposable incomes. It forecasts significant consolidation measures to reduce the deficit of more than 13% in 2009 and is in line with the ambitious medium-term plan Iceland agreed with the IMF to record a primary surplus by 2011 and bring its public finances back into balance by 2013.

This strategy implies to us that Iceland would need to increase GDP by a discretionary fiscal adjustment of 3.5% of GDP per year. Over 2009-2013, just over half of the adjustment will come from expenditure reductions, although the focus would likely be on improving revenues in the short term. The 2010 budget includes an array of tax increases, especially for the medium- to higher-income brackets, as well as additional environmental and consumption taxes. The government is also implementing wage cuts of up to 10% for medium- to high-earning officials, and government ministries have been asked to cut spending by 5%-10%.

We believe the government understands the importance of the credible implementation of the fiscal-adjustment strategy because funding costs might otherwise rise sharply. This is especially considering that almost half of all short-term treasury notes are held by nonresidents, mostly investors in matured Glacier-bonds (ISK-denominated bonds issued by non-Icelandic entities), who cannot convert and repatriate their funds because of the capital controls.



### **Government debt and interest burden likely to stay high**

The general government debt ratio quadrupled to almost 125% of GDP in 2010 from about 30% in 2006-2007. This stemmed from large deficits, the cost of refinancing the banking system, reimbursements to Icesave's depositors, and loans from the IMF and Nordic governments to prop up foreign exchange reserves, which we assume will resume later this year if, as we expect, the Icesave controversy is resolved.

The public debt ratio also increased because of the severe depreciation of the krona. The krona lost half its value against a trade-weighted basket of currencies in 2008 alone, before steadying during 2009 and first-quarter 2010, thanks to stringent capital controls and signs that the economic crisis was abating. The public debt ratio could start decreasing in 2011, supported by significant budgetary belt-tightening. Still, we believe it could take two decades for the debt ratio to return to precrisis levels, even if the government were to run balanced budgets from 2013 onward and nominal GDP were to rise by 5%-6% annually.

A successful disposal of the assets the government acquired in the aftermath of the bank failures could bring down public debt faster than we currently envisage. We also expect the net burden of Icesave-related liabilities to be significantly below the gross figures, owing to substantial assets in the estate of Landsbanki, Icesave's parent institution. As Iceland and global economies recover, the value of these assets will likely appreciate. Nevertheless, we see considerable uncertainty regarding their valuation, so we recognize only fairly liquid assets that can be liquidated over the short to medium term. On a positive note, unlike in many other high-income countries, Iceland's early pension reform should alleviate some of the pressure the country is expected to face as its still relatively youthful population ages.

### **The bulk of the contingent liabilities from the banking sector are now on the state's books**

Most of the sizable contingent liabilities from the financial sector are now on the government's balance sheet. Nevertheless, we still consider the gross problematic assets of the reestablished Icelandic banks to be substantial and could total up to 50% of system loans if the country were to fall back into a deep recession. Considering the still very high level of intermediation, the contingent liabilities from the financial sector remain a concern, although less so than before the collapse of the "old" banks.

At ISK184 billion, or 13% of GDP, the cost of recapitalizing the failed banks was much lower than we initially expected. About 73% came from direct equity injections and the rest from subordinated loans. The restructuring of Landsbanki, formerly Iceland's largest financial institution, consumed about two-thirds of the cost. Landsbanki is now the only commercial bank majority-owned (81%) by the state.

Government-guaranteed debt is high at almost 90% of GDP in 2010. More than four-fifths of these government guarantees are on debt issued by Iðudalanasjóður (Housing Financing Fund) (HFF; foreign currency BBB-/Watch Neg/A-3; local currency BBB-/Watch Neg/A-3) and collateralized mortgages with recourse to the ultimate borrower. However, the government's liability is subject to the development of house prices in Iceland and the credit risk of Icelandic households. Most of the remaining guarantees are on the debt of state-owned power company Landsvirkjun, which we consider to have a very weak stand-alone credit profile of 'B-'.

## **Monetary Policy: Lifting Capital Controls Could Prove Difficult**

- We expect capital controls to remain in place longer than expected because the ongoing Icesave dispute delays disbursement of financing from the IMF and Nordic governments.

- Recapitalization of the banking system is now complete.
- Disinflation has been slow, but steady, owing to currency depreciation.

The Icelandic krona was free floating until the banking system collapsed. The currency had already depreciated considerably during 2008 because market participants felt that Iceland's weak external liquidity could make it one of the economies worst hit by the global financial market crisis.

After Iceland's banking system collapsed, the currency tumbled, and to avert a financial meltdown, the Central Bank of Iceland (CBI) complemented its tighter monetary stance with comprehensive currency controls on portfolio investment outflows. Exchange rate stability is key to rebuilding confidence and reigniting demand because individual and corporate borrowers have very large exposures to foreign-currency or inflation-indexed debt (one- and four-fifths, respectively).

In addition to capital-account controls, Iceland's foreign exchange reserves were bolstered by an IMF disbursement of ISK560 million (about €655 million) in November 2008. To support the krona's stability, the CBI has made repeated, albeit modest, foreign exchange interventions, spending about €90 million in 2009.

The CBI started to relax capital-account restrictions in November 2009. After this date, all registered capital inflows can now also be withdrawn at any time. We see that many investors are remaining on the sidelines for the time being. However, the CBI's move should provide the exchange rate with additional short-term relief. More importantly, however, funds invested in krona before November last year remain locked in.

Iceland's formulated liberalization strategy is to open up the capital account as the conditions merit, so as to prevent another large depreciation. We expect capital restrictions to loosen further in 2010, but investors in short-term treasury bills are likely to be locked in the longest. This includes many nonresident investors in matured Glacier-bonds and HFF bonds, all of which are denominated in Icelandic krona.

Consumer price inflation has soared because of the drop in the value of the krona, peaking at 19% in January 2009. Despite the relative stability of exchange rates in 2009, inflation remained high, only dropping to single digits in the last quarter of the year. Although housing costs have been the main impetus for inflation in recent years, house prices in Iceland fell throughout 2009, exerting deflationary pressure. Instead, we see that inflation stems from imported goods.

Based on inflationary expectations derived from the yield differential of indexed and fixed-rate bonds, we believe price inflation could remain close to 4%, which is higher than the official inflation target mid-point of 2.5%. Real wages and, more recently in some occupational groups, nominal remuneration have fallen since 2008 and, in conjunction with rising unemployment, will likely push down prices.

We believe that in the short term the central bank will continue to face the choice of opening up the capital account or lowering interest rates. The key central bank rate has now dropped by half, from a peak of 18% in early 2009, but is not providing any meaningful stimulus to Iceland's faltering economy. Over the course of 2009, the CBI decided to lower rates rather than open up the capital account. We expect this preference to persist throughout the first half of 2010 until the economy firmly stabilizes and disbursements from the IMF and Nordic government loans resume.

The restructuring of the failed banks was largely completed in December 2009 at a total cost to the treasury of about ISK184 billion (13% of 2009 GDP, including subordinated loans), which is ISK200 billion lower than the

original estimate of about 27% of GDP. Only some smaller savings institutions are still to be recapitalized.

The state has an 81% majority stake in the new Landsbanki, the largest bank in the system, whereas it holds minority stakes in Arion banki (formerly Kaupthing) and Islandsbanki (formerly Glitnir Bank). This is because the creditors of the defaulted banks exchanged their claims for equity. We expect the level of private-sector credit to fall for several years as debtors default in line with lower disposable incomes and collateral values, banks become more risk averse, and the government's financing needs crowd out those of private borrowers. Even so, we believe financial intermediation will remain high by international standards, reaching close to 250% of GDP by 2011.

## External Finances: External Conditions Have Improved, But Remain Precarious

- The default of the collapsed banks has reduced the debt on Iceland's extremely leveraged external balance sheet.
- The public sector is now the main external debtor.
- External liquidity concerns have eased because reserves have risen and the current account will likely swing into surplus.

**Table 4**

Republic of Iceland External Indicators								
	2005	2006	2007	2008	2009	2010e	2011f	2012f
<b>(% of GDP)</b>								
Current account balance	(16.14)	(25.59)	(16.29)	(18.50)	0.41	4.30	5.35	7.50
Trade balance	(9.07)	(13.40)	(6.72)	(0.45)	7.16	9.63	10.17	11.33
Net foreign direct investment	(24.59)	(7.64)	(55.23)	30.92	(10.00)	3.00	3.20	1.80
<b>(% of CARs)</b>								
Current account balance	(40.03)	(54.47)	(29.25)	(31.83)	0.64	7.69	8.62	10.72
Net external liabilities	209.86	257.14	248.04	451.22	111.90	128.26	107.32	81.48
Gross external debt	685.39	892.94	966.95	1,095.51	309.74	347.00	299.92	266.99
General government external debt	37.30	43.64	34.58	45.20	144.14	126.78	93.11	80.00
Narrow net external debt*	398.69	445.25	451.76	598.08	246.95	283.15	247.82	220.80
Net nonfinancial private sector external debt	45.32	63.59	55.80	60.58	49.96	49.19	37.27	24.44
Net financial sector external debt	310.32	343.12	355.02	473.15	51.23	55.02	46.28	39.76
Net investment payments	9.36	16.75	10.61	27.39	12.12	13.81	11.92	10.09
Net interest payments	9.72	17.05	19.54	14.31	9.05	11.96	12.50	12.89
Reserves/CAPs (months)	1.40	1.06	1.91	2.45	5.52	6.98	5.53	4.68
Gross external financing needs (% of CARs and usable reserves)¶	271.24	293.25	320.29	604.91	635.97	136.74	128.06	124.84

\*Narrow net external debt is defined as the stock of foreign and local currency public and private sector borrowings from nonresidents (including nonresident deposits in resident banks) minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. ¶Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. f--Forecast. e--Estimate. CARs--Current account receipts. CAPs--Current account payments.

### External liquidity low

The default of the banks on their external obligations has greatly reduced the income deficit of the balance of payments. Together with the contraction in imports, this has led to a very rapid turnaround of the current account. We exclude interest payments due but not paid by the bankrupt banks, even if they continue to appear in the official balance-of-payments statistics until the banks are fully wound down and the debts are written off. The underlying

current account balance has swung from an average deficit of 20% of GDP in 2006-2008 (38% of current account receipts) to a broadly balanced position in 2009, and we expect surpluses to rise from 2010 onward.

Iceland's foreign exchange reserves rose to about €2.5 billion from just over €1.5 billion at the onset of the financial crisis, thanks to disbursements under the IMF package and the first tranche of Nordic bilateral loans. Another €2.3 billion are still available, but eligibility to draw on these balances depends on successful IMF reviews. We consider that the CBI's foreign exchange interventions were relatively modest in 2009 at less than €100 million. We estimate that Iceland's useable reserves at year-end 2009 can cover almost seven months of forecast 2010 current account payments, versus just 1.9 months as recently as 2007 and 1.1 months in 2006.

Standard & Poor's preferred external liquidity measure is gross external financing requirements as a percentage of useable reserves and current account receipts. This ratio has exceeded 200% every year since 2000 and surpassed 300% in 2007 and 2008, but we expect it to drop to an estimated 137% in 2010 and to 125% in 2012. This moderation is highly welcome but still compares unfavorably with the 'BBB' median, which we forecast to average 114% over the 2010-2012 period.

External liquidity therefore remains a credit weakness in Iceland, in our view. We also consider that the country's future gross financing needs are particularly difficult to predict because they partly depend on how investors in krona react when capital-account controls are finally lifted.

We estimate that nonresident investors' funds totaling several hundred billion krona still remain in the local ISK market, including ISK52 billion of Glacier bonds maturing in 2010. Some of these funds are likely to remain invested in krona after capital-account restrictions are removed, to take advantage of relatively high Icelandic interest rates. Nevertheless, the risks of a badly managed capital liberalization are obvious, and foreign exchange reserves are likely to fall once the restrictions are lifted. The authorities are aware of the risks and are reluctant to engage in a hasty repeal of the restrictions before confidence in the outlook of Iceland's economy and currency is reestablished.

### **Narrow net external debt still sizable**

Iceland's gross external debt has fallen from more than 10x annual current account receipts in 2007 and 2008 to just over 3x in 2009, a multiple last seen in 2002. Even so, this is still very high and three times higher than the 'BBB' median.

Narrow net external debt, net of foreign reserves and liquid financial-sector external assets, has declined less markedly because banks' external assets were seized by creditors when the banks defaulted on their external obligations. By this measure, Iceland remains the most externally leveraged economy that does not control a global reserve currency.

The composition of Iceland's external debt has changed dramatically since the shock of the financial sector collapse. In 2007, only 4% of gross external debt was owed by the government and 90% by Icelandic financial institutions. By the end of 2009, we expect the respective ratios to have stood at 62% and 11% respectively. Corresponding to this change in sectoral debtors, Iceland's external debt has become less short term, reducing rollover risks somewhat.

Note: Amit Anand and Aparajita Sen provided research assistance for this report.

<b>Ratings Detail</b> (As Of March 31, 2010)*		
<b>Iceland (Republic of)</b>		
Sovereign Credit Rating		
<i>Foreign Currency</i>		BBB-/Negative/A-3
<i>Local Currency</i>		BBB/Negative/A-3
Commercial Paper		
<i>Foreign Currency</i>		A-3
Senior Unsecured (22 Issues)		BB
Senior Unsecured (5 Issues)		BBB
Senior Unsecured (5 Issues)		BBB-
Short-Term Debt (1 Issue)		A-3
Short-Term Debt (2 Issues)		B-1
<b>Sovereign Credit Ratings History</b>		
30-Mar-2010	<i>Foreign Currency</i>	BBB-/Negative/A-3
05-Jan-2010		BBB-/Watch Neg/A-3
31-Dec-2009		BBB-/Stable/A-3
24-Nov-2008		BBB-/Negative/A-3
06-Oct-2008		BBB/Negative/A-3
29-Sep-2008		A-/Watch Neg/A-2
17-Apr-2008		A/Negative/A-1
01-Apr-2008		A+/Watch Neg/A-1
20-Nov-2007		A+/Negative/A-1
22-Dec-2006		A+/Stable/A-1
05-Jun-2006		AA-/Negative/A-1+
30-Mar-2010	<i>Local Currency</i>	BBB/Negative/A-3
05-Jan-2010		BBB+/Watch Neg/A-2
31-Dec-2009		BBB+/Stable/A-2
06-Oct-2008		BBB+/Negative/A-2
29-Sep-2008		A+/Watch Neg/A-1
17-Apr-2008		AA-/Negative/A-1+
01-Apr-2008		AA/Watch Neg/A-1+
20-Nov-2007		AA/Negative/A-1+
22-Dec-2006		AA/Stable/A-1+
05-Jun-2006		AA+/Negative/A-1+
<b>Default History</b>		
None		
<b>Population</b>		0.32 million (2010)
<b>Per Capita GDP</b>		\$41,300 (2010)
<b>Current Government</b>		
Prime Minister Jóhanna Sigurðardóttir heads a coalition composed of her Social Democratic Alliance and the Left-Green Movement. President Ólafur Ragnar Grímsson is head of state.		

**Ratings Detail** (As Of March 31, 2010)\*(cont.)

**Election Schedule**

General elections

Last: April 2009

Next: April 2013

Presidential elections

Last: June 2008

Next: June 2012

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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