# Republic of Iceland Outlook Revised To Negative On Hard Landing Risk; Ratings Affirmed


**Publication date:** 05-Jun-2006

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LONDON (Standard & Poor's) June 5, 2006--Standard & Poor's Ratings Services said today it revised its outlook on the Republic of Iceland to negative from stable, on the increasing likelihood of a hard landing for the country's economy. At the same time, Standard & Poor's affirmed its long-term 'AA-' foreign and 'AA+' local, and its short-term 'A-1+' foreign and local currency sovereign credit ratings on the republic.

Standard & Poor's also revised the outlook on its long-term foreign currency issuer credit rating on Ibudalanasjodur, the Icelandic Housing Financing Fund (HFF), to negative from stable, and affirmed its 'AA-' long- and 'A-1+ short-term foreign currency credit ratings on HFF. The 'AA+' long-term and 'A-1+' short-term local currency ratings remain on CreditWatch negative, which is expected to be resolved in the third quarter of 2006.

"The outlook revision reflects the growing possibility of a hard landing for Iceland's credit and investment boom that started in 2004, as pent-up economic imbalances begin to unwind," said Standard & Poor's credit analyst Eileen Zhang. "Accelerating wage growth and other inflationary pressures will prompt further increases in interest rates, from their current level of 12.25%, depressing domestic demand and raising contingent fiscal risk from private and public sector financial institutions."

Buoyant domestic demand, the recent depreciation of the krona, and rapid wage growth have pushed inflation well above the central bank's upper tolerance limit of 4%, despite repeated hikes in its policy rate. Moreover, fiscal policy is not expected to support the central bank in its disinflation task in the run-up to the 2007 general election, and the resulting inflationary pressure will likely lead to further increases in real and nominal interest rates, risking an adjustment process that is more painful and more disruptive to the economy.

Iceland will enter this period of a weakening economy with a low public debt burden of 24% of GDP in 2006, one-half the level of five years earlier. However, a severe contraction of the economy would affect both budget balances and contingent liabilities for the government, such as those posed by the guaranteed debt of HFF, or stemming from the financial sector.

Moreover, Iceland's external financing needs are among the highest of any rated sovereign, driven by very high levels of external debt throughout the economy and by large current account deficits, exacerbated by foreign direct investment and portfolio equity outflows. Consequently, levels of net external debt are set to remain at almost 300% of current account receipts until the end of the current decade, notwithstanding surging export performance in 2007-2008 as new aluminum production capacity becomes available.

"If no effective measures to contain domestic demand and inflation are undertaken, and if the scenario of a pronounced economic contraction and worsening of public and private sector balance sheets unfolds, the result would be a downward revision of the ratings," said Ms. Zhang. "Conversely, if the policy mix manages to lead to an orderly unwinding of economic imbalances and the concomitant risks, the outlook would be revised back to stable."

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