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Outlook on Republic of Iceland Revised to Stable; 'A+/A-1+' Ratings Affirmed

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LONDON (Standard & Poor's) Nov. 15, 2002--Standard & Poor's Ratings Services said today it revised its outlook on the Republic of Iceland to stable from negative. At the same time, Standard & Poor's affirmed all its ratings on Iceland, including its 'AA+/A-1+' local currency and 'A+/A-1+' foreign currency issuer credit ratings.

"The outlook revision reflects the stabilization of Iceland's external imbalances, progress in the privatization of state-owned banks, and the undented profitability of the banking system in the aftermath of the recent credit boom, which has now come to an end," said Standard & Poor's credit analyst Moritz Kraemer.

After several years of rapid growth in domestic demand, Iceland's current account deficit had reached 10% of GDP in 2000. External liquidity was also strained by capital outflows of portfolio investment. The central bank's foreign exchange reserves had been reduced by attempts to defend the currency, before eventually floating it in March 2001. Since then, however, Iceland's external finances have improved markedly, and Standard & Poor's expects the current account to be broadly in balance both this year and next, before recording mild deficits again from 2004 onward, when imports will recover as the growth of domestic demand gathers pace after its sharp contraction in 2001 and 2002. The central bank is in the process of gradually building up foreign reserves, improving the country's tight external liquidity.

The banking sector, which had largely financed the external deficits through foreign borrowing up to 2001, has been successful at weathering the correction of the macroeconomic imbalances and the end of the domestic credit boom. To date, prudential indicators have remained sound, and the quality of bank lending practices and the robustness of banks' operations suggest that the system's earnings will be sufficient to cover amply any higher loan losses that might still emerge from the sharp slowdown of the economy in 2002. The financial sector's net external debt is expected to stabilize at about 100% of current account receipts in the medium term, after peaking at 125% in 2000. The results posted by the major banks for the first nine months of 2002 indicate increasing financial robustness, reducing the probability of contingent liabilities for the government.

The government is now making good progress on the privatization of its remaining stakes in state-owned banks. In October, the Executive Privatization Committee reached an agreement with an Icelandic investor group on the sale of the government's 45.8% stake in Landsbanki for Icelandic krona (ISK) 12.3 billion ($138 million), or 1.5% of estimated 2003 GDP. The government will retain only 2.5% of the bank, which is expected to be sold off in due course. The sale of the government's 46.6% stake in Bunadarbanki is also advancing and could be concluded as early as the end of this year, raising ISK10-12 billion. With the privatization of Bunadarbanki, the government will complete its withdrawal from the commercial banking sector.

Privatization receipts will accelerate the reduction of government debt to 41% of GDP in 2003, from a 47% peak in 2001 after the krona weakened substantially in the wake of its floating.

The stable outlook reflects the more balanced risks to Iceland's economy, where improving--but still low--external liquidity and indebtedness balance the healthy public finances and high flexibility of the economy.

"Any significant increase in external leverage or a worsening of the financial sector's prudential indicators could bring the ratings under renewed pressure," added Mr. Kraemer. "Conversely, further consolidation on the fiscal and external accounts could support further rating improvements in the future."

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Fixed Income in the left navigation bar, select Credit Ratings Actions. Alternatively, call one of the Standard & Poor's Ratings Desks: London (44) 20-7847-7400; Paris (33) 1-4420-6705; Frankfurt (49) 69-33-999-221; Stockholm (46) 8-440-5916.

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