

## Outlook on Republic of Iceland Revised To Negative; Ratings Affirmed

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LONDON (Standard & Poor's) Oct. 22, 2001--Standard & Poor's today revised its outlook on the Republic of Iceland to negative from stable. At the same time, the ratings on Iceland were affirmed, including the double-'A'-plus/'A-1'-plus local currency and the single-'A'-plus/'A-1'-plus foreign currency issuer credit ratings.

The outlook revision reflects a weakening in general government debt ratios and heightened risks in the domestic financial sector, which could reverse the progress in fiscal consolidation achieved since the mid-1990s. The credit-driven economic expansion that had started in 1996 is now coming to an end, at a time when the external economic environment has deteriorated markedly. This could potentially lead to an extended period of subpar growth and deteriorating asset quality in the banking sector. In Standard & Poor's view, leading indicators of financial distress are present in Iceland, including a credit-driven demand boom, real estate price inflation, and external imbalances. Standard & Poor's placed Iceland on the list of financial systems showing symptoms of stress, as the rapid buildup of debt is a reason for concern (see commentary article titled "Global Financial System Stress", published on Oct. 9, 2001, which can be found on RatingsDirect, Standard & Poor's Web-based credit analysis system). The potential for deteriorating asset quality in the financial sector is compounded by reduced growth prospects and the deteriorating external net debt

position.

In the event of more serious financial distress, these developments could require additional capital for Iceland's financial institutions, including a potential call on the government for direct financial support. Iceland's net external debtor position is high (estimated at 280% of exports in 2001). A sharp fall in the Icelandic krona's real effective exchange rate underscores the high external leverage of the country's corporate and banking sectors.

Real output growth has fallen steadily from the 5% seen in 2000, and the economy is now expected to contract in 2002, before resuming moderate positive growth in 2003. The economic slowdown, compounded by the depreciation of the currency, has already had an impact on fiscal performance and has led to a reversal of falling public debt ratios, independently of developments in the financial sector. The 2002 budget plan presented in early October 2001 projects a small surplus but is based on optimistic assumptions on output and revenue growth. Standard & Poor's considers that the 2002 central government deficit could reach 1.8% of GDP. Substantial tax cuts could further complicate the resumption of fiscal consolidation.

A detailed comment on the fiscal outlook and the prospects for the Icelandic economy has been published by Standard & Poor's (see commentary article titled "Slowdown Raises Challenges for Economic Policy in Iceland", published on Oct. 22, 2001, which can be found on RatingsDirect, Standard & Poor's Web-based credit analysis system).

A complete list of ratings is available on RatingsDirect, Standard & Poor's on-line credit research service, or by calling the Standard & Poor's ratings desk at (44) 20-7847-7400.

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