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Iceland (Republic of)

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Iceland (Republic of)

Major Rating Factors

Sovereign Credit Rating
Foreign Currency
A/Negative/A-1
Local Currency
AA-/Negative/A-1+

Strengths:

- Stable and mature political institutions
- Very high per capita income
- Low government debt burden

Weaknesses:

- Significant contingent fiscal risks from high level of external debt and weak external liquidity
- Poor fiscal and monetary policy mix in management of macroeconomic imbalances
- Small, relatively undiversified, and volatile economy

Rationale

The ratings on the Republic of Iceland reflect the mounting economic policy challenges facing the sovereign, largely related to pressure on Iceland's external funding for the nation's commercial banks. Iceland's banks rely on wholesale funding, particularly from overseas, and higher funding costs are hurting their profitability and growth. Due in part to banks' financing of their own rapid expansion abroad as well as that of several local entrepreneurs, net external debt of the financial system has risen to 362% of current account receipts (CARs) in 2007, from 161% in 2003, and domestic credit to GDP has risen to over 384% from 130% during the same period. These are among the highest ratios for rated sovereigns.

The banks' higher funding costs, combined with the recent 27% effective depreciation of the Icelandic krona, increase the chances that the economy will contract more and for a longer period than we had foreseen when we lowered the ratings on Iceland on Dec. 22, 2006. Although pronounced swings have been a recurrent feature of the Icelandic economy, the economy's leverage has reached an unprecedented level. Household and corporate debt combined has risen to over 400% of GDP at year-end 2007, from 184% in 2004. Domestic demand is expected to contract severely in the next two years as the rapid pass-through of the depreciating krona manifests itself in a temporary surge in the inflation rate, which not only diminishes real income but also raises mortgage payments, which are mostly inflation linked. At the same time, cheap credit will also dry up, as the Icelandic banks face high funding costs and increasing difficulties in securing external financing. Net exports will partly offset the effect of shrinking domestic demand, but a recession seems unavoidable.

As a result of difficulties in external financing for Iceland's banks and the ensuing recession, we expect the composition of the country's external debt to change: commercial banks will lower their reliance on external funds by shrinking their balance sheet and the government will increase its share of external financing. We project that sizable fiscal deficits during the downturn will increase gross general government debt to 36% of GDP by 2010 (comparable to the 'A' median) from 28% in 2007, but the debt burden could rise much faster if the government is forced to provide direct assistance to its country's commercial banks.

Outlook

The negative outlook reflects prevailing downside risks. The outlook would revert to stable if the banks or the government take actions to restore market confidence and to induce a narrowing of the Icelandic bank risk premium. Conversely, if banks fail to undergird their financial profile (external and domestic liquidity, profitability, and asset quality), vulnerability in the nation's external profile would fester, and could lead to a further one-notch downgrade of the sovereign rating.

Table 1

Republic of Iceland Selected Items

	2005	2006	2007	2008e	2009f	2010f	2011f	Median A
GDP per capita ($)	54,923	54,440	63,798	62,595	57,807	57,401	58,970	17,802
Real GDP (% change)	7.1	4.3	3.8	1.0	(1.9)	(1.5)	1.6	4.7
Real GDP per capita (% change)	5.9	1.4	0.9	0.0	(2.4)	(2.0)	0.9	4.0
General government balance (% of GDP)	4.9	6.3	4.8	(2.0)	(5.5)	(5.0)	(3.2)	(1.3)
General government debt (% of GDP)	25.5	30.3	28.3	27.5	31.7	36.1	30.8	30.7
Net general government debt (% of GDP)	18.0	12.1	11.7	12.5	17.1	21.4	23.8	25.9
General government interest expenditures (% of revenues)	4.7	4.5	5.2	5.6	5.6	6.1	5.4	5.7
Domestic credit to private sector and NFPEs* (% of GDP)	248.4	321.0	383.7	339.1	289.6	263.3	259.1	94.5
Consumer price index (average; % change)	4.0	6.8	5.0	8.9	6.4	4.0	3.0	4.5
Gross external financing needs (% of CARs and usable reserves)	235.9	271.0	287.7	512.9	564.0	590.2	625.6	100.1
Current account balance (% of GDP)	(16.2)	(25.5)	(15.6)	(16.2)	(15.5)	(12.8)	(10.4)	0.0
Narrow net external debt¶ (% of CARs)	400.1	446.8	467.8	431.0	496.8	516.0	541.8	2.2

*Standard & Poor's estimates that, in a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 30% of bank credit; see Appendix 3 in "S&P's Banking Industry Country Risk Assessments: Global Annual Roundup," published on Aug. 9, 2007, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis. ¶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. f--Forecast. e--Estimate. NFPEs--Nonfinancial public enterprises. CARs--Current account receipts. f--Forecast. e--Estimate.

Comparative Analysis

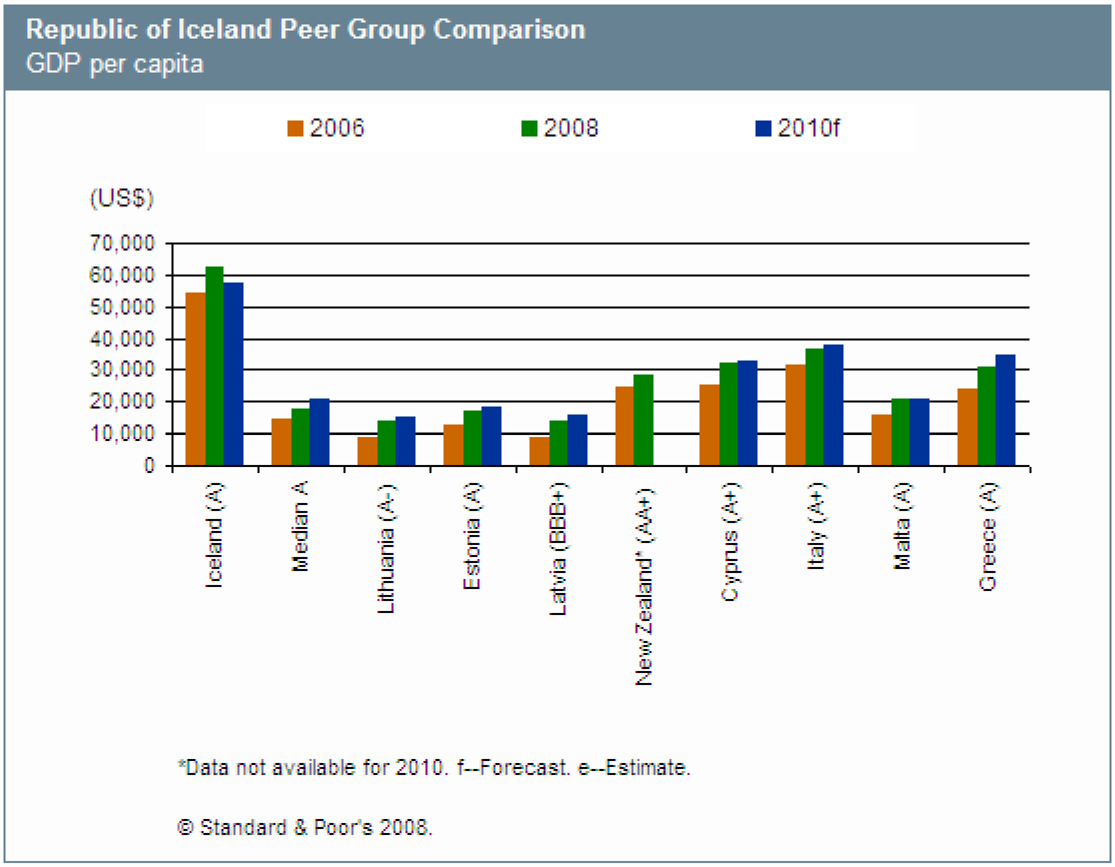
- The Icelandic economy is wealthier but also more volatile compared with peers.
- Iceland's low debt burden compares favorably with its peers, but it has the highest contingent liabilities in the group.
- Iceland has one of the highest external exposures among all rated sovereigns.

High level of immigrants may provide a buffer to an economic slowdown

The high level of Icelandic GDP per capita versus its peers reflects the superior productivity and flexibility of the country's labor force and the economy as a whole (see chart 1). Comparatively high wage levels have attracted substantial numbers of immigrant workers over the past several years, providing some buffer in the face of an expected economic contraction. This is in contrast to the lower-income Baltic states, Latvia (BBB+/Negative/A-2; all references to ratings hereafter are to foreign currency sovereign credit ratings), Lithuania (A-/Negative/A-2), and

Estonia (A/Negative/A-1), where significant emigration of the labor force to higher-wage Eurozone economies continues to push up wages and prices despite a marked deceleration in growth.

Chart 1



Economic growth is volatile

Icelandic GDP growth has been far more volatile relative to other wealthy European economies (see chart 2). Over the last cycle, which started in 2003 and ended in 2007, the peak and trough of GDP growth rates differed by nearly nine percentage points. Only the economies of Estonia, Lithuania, and Latvia have exhibited similarly wide highs and lows, with growth differentials averaging 5-7 percentage points over the same period. This is largely explained by these economies' small size, but it is also a function of unusually rapid declines and falls in domestic credit growth in all three economies.

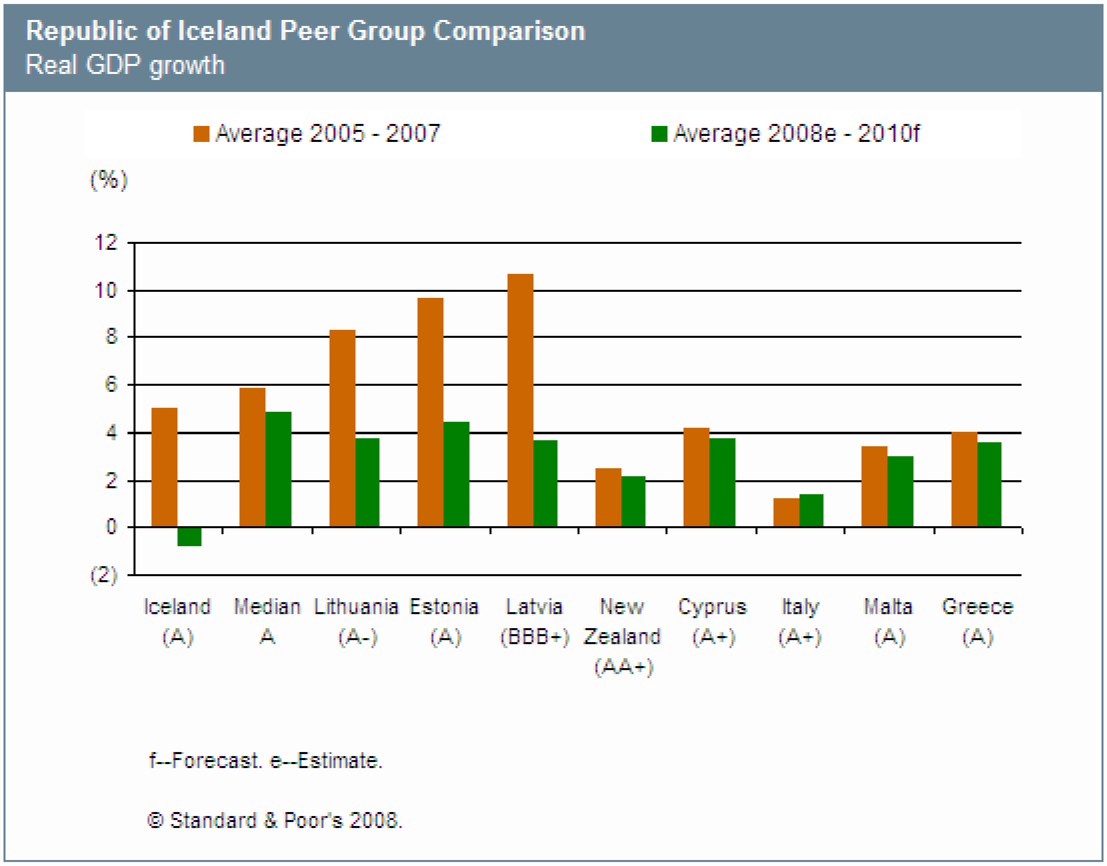
Deleveraging to add volatility to the cycle

Over the medium term, growth in Iceland (as well as in all three Baltics) will remain more volatile versus other rich European economies, as the dominant Icelandic commercial banks downsize their balance sheets and tighten lending conditions--a process essential to ensure their survival. A similar shrinkage of banking system loan books (and hence domestic demand) is underway in Kazakhstan (BBB-/Negative/A-3), where credit growth is forecast to be negative throughout 2008, after having averaged just under 70% from 2005-2007. By almost all measures (loan-to-deposit ratios or net external debt as a percentage of CARs), leverage in the Icelandic economy is even higher than in Kazakhstan.

A highly skilled labor force

In almost all sovereigns we rate, there is a positive long-term correlation between the quality of primary education and per capita GDP levels. On the World Economic Forum's measurement of the quality of health and primary education, Iceland ranked second out of all 131 countries surveyed. This placed it well ahead of highly rated credits including Sweden, Norway, Canada, France, Austria, and Ireland (all rated AAA/Stable/A-1+).

Chart 2



Fiscal consolidation compares well with peers but surpluses mask rapid nominal expenditure growth

In 2005-2007, Iceland's high general government surpluses were matched partly by Estonia, though in both cases substantial 2007 fiscal surpluses masked an over-stimulatory fiscal stance (see chart 3). In Iceland, Estonia, and Lithuania, nominal government expenditure growth easily exceeded nominal GDP growth in 2007.

Chart 3

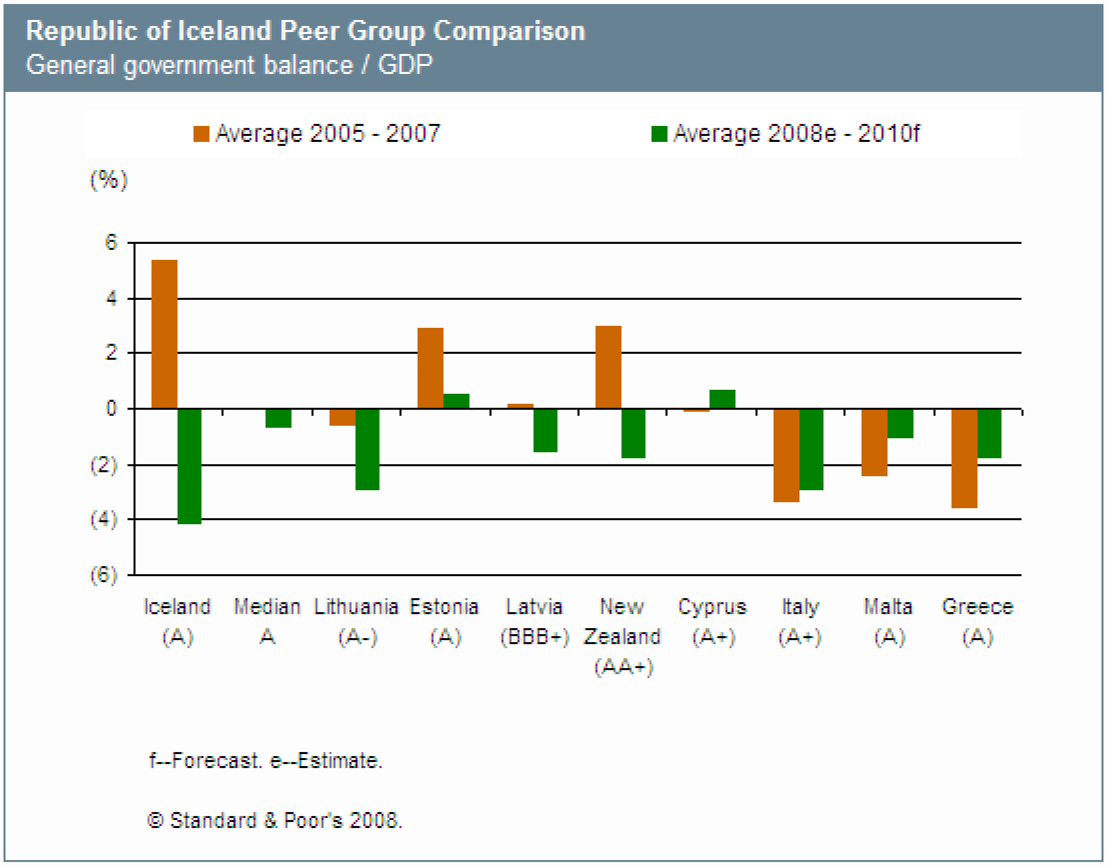

Republic of Iceland Peer Group Comparison
General government balance / GDP
Average 2005 - 2007
Average 2008e - 2010f
(%)
6
4
2
0
(2)
(4)
(6)
Iceland (A)
Median A
Lithuania (A-)
Estonia (A)
Latvia (BBB+)
New Zealand (AA+)
Cyprus (A+)
Italy (A+)
Malta (A)
Greece (A)
f--Forecast. e--Estimate.
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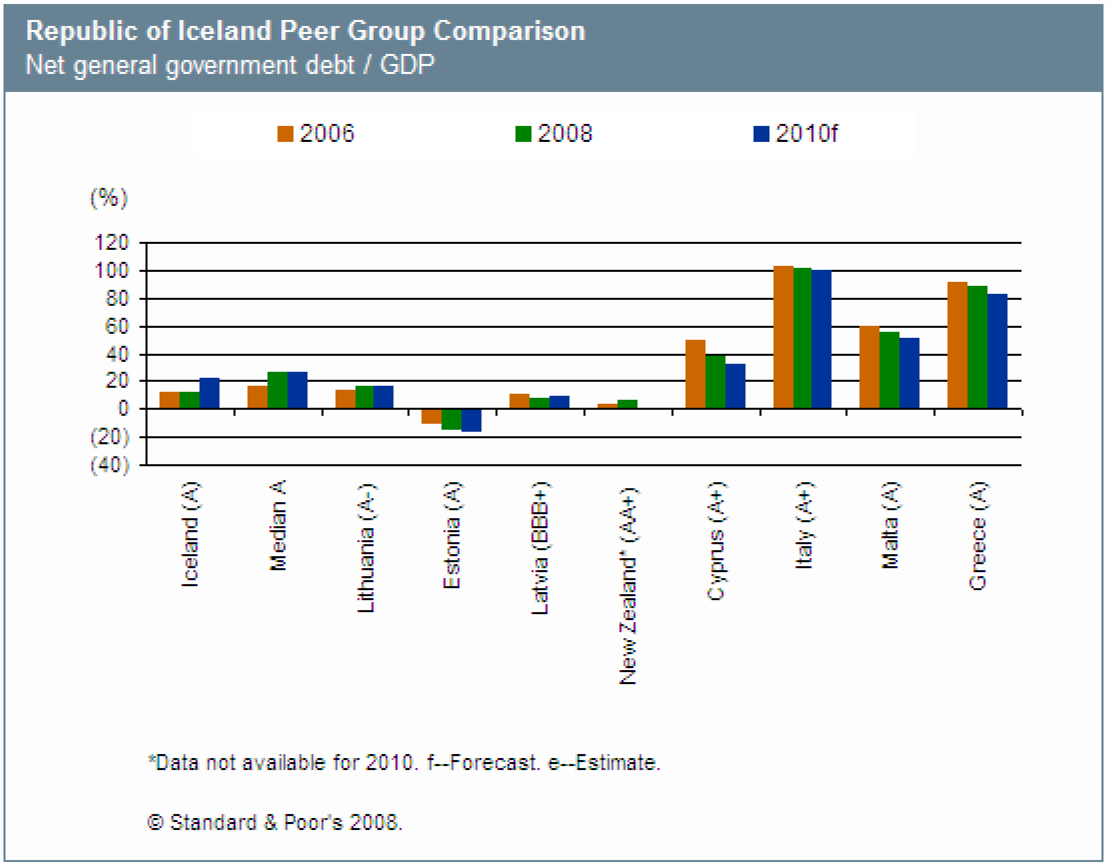
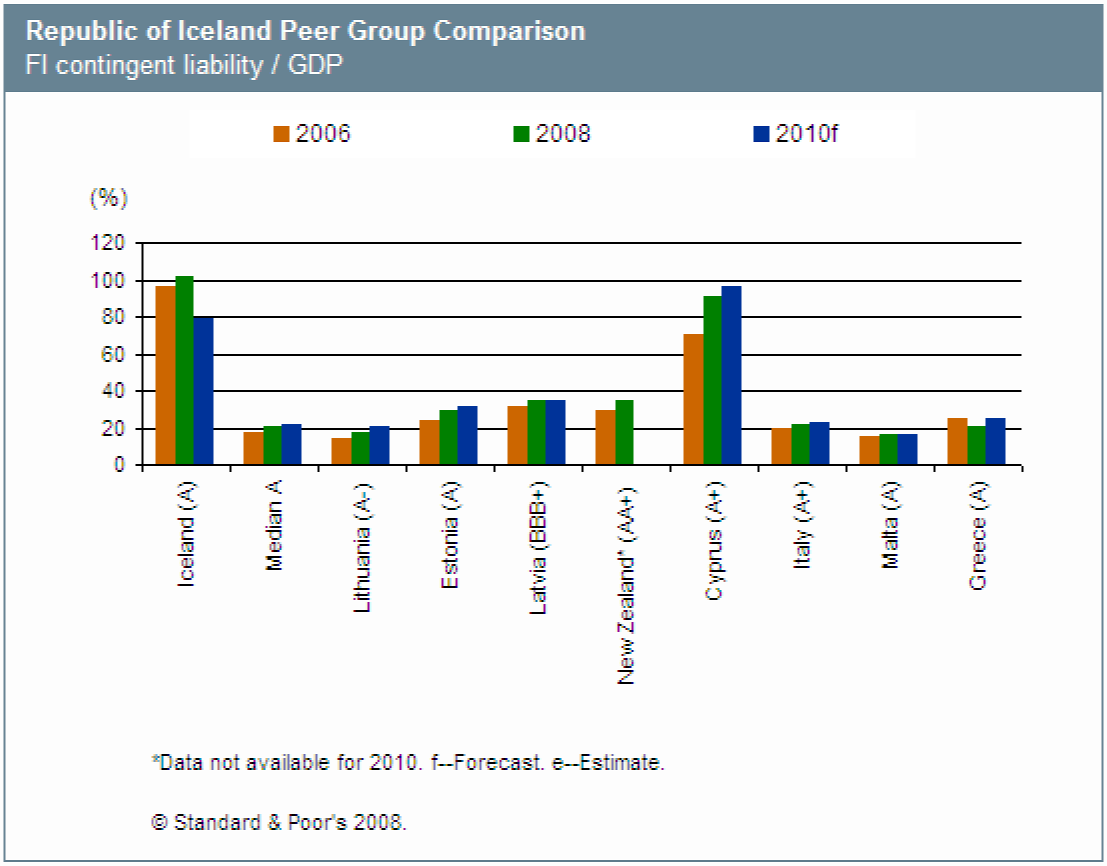
Chart 4



Iceland has the highest contingent liabilities among all peers

In a reasonable worst-case scenario, we estimate the contingent liability for the government from the financial sector to remain over 100% of GDP in 2008 or more than 5x the 'A' median of 20% (see chart 5). This degree of private sector leverage is the highest among all rated sovereigns. Domestic credit-to-GDP ratios in nearly all other rated sovereigns are considerably less than one-half of Iceland's staggering 340%. The exception is Cyprus (A+/Stable/A-1), where domestic credit also exceeds 240% of GDP. The Cypriot banking sector is, however, considerably less dependent on external financing compared with Iceland.

Chart 5



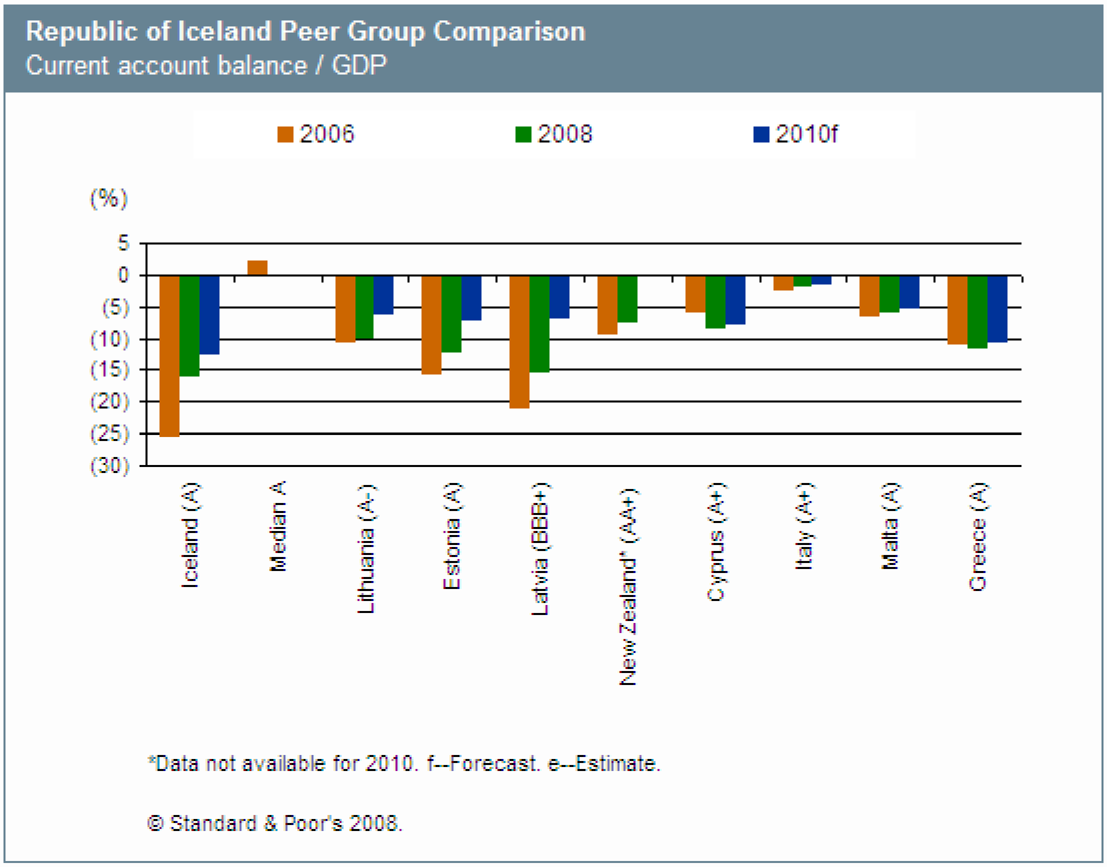
Relatively weak monetary transmission channel versus larger economies with less open capital accounts

Countries operating floating exchange rates typically surrender exchange rate stability in order to gain the right to set the cost of money for domestic markets. Iceland's commitment to operate a floating exchange rate has not, however, guaranteed monetary authorities large influence over domestic credit dynamics. The difficulty for Iceland has been the ability of domestic economic agents to access foreign capital at interest rates determined abroad. Structural impediments owing to the state-owned mortgage company Housing Financing Fund's (HFF; A/Negative/A-1) privileged access to long-term Icelandic krona funding have also exacerbated the situation. Icelandic monetary authorities have set very high local currency policy rates. At 15.50%, the April 2008 policy rate is 25 basis points (bps) above Turkey's benchmark rate. As in the case of Turkey (BB-/Negative/B) and Romania (BBB-/Negative/A-3), until very recently, Iceland's high rates had tended to attract "fast money" portfolio inflows, leading to the appreciation of the exchange rate, without the desired tightening of credit conditions.

Exchange rate volatility has reinforced the boom-bust cycle

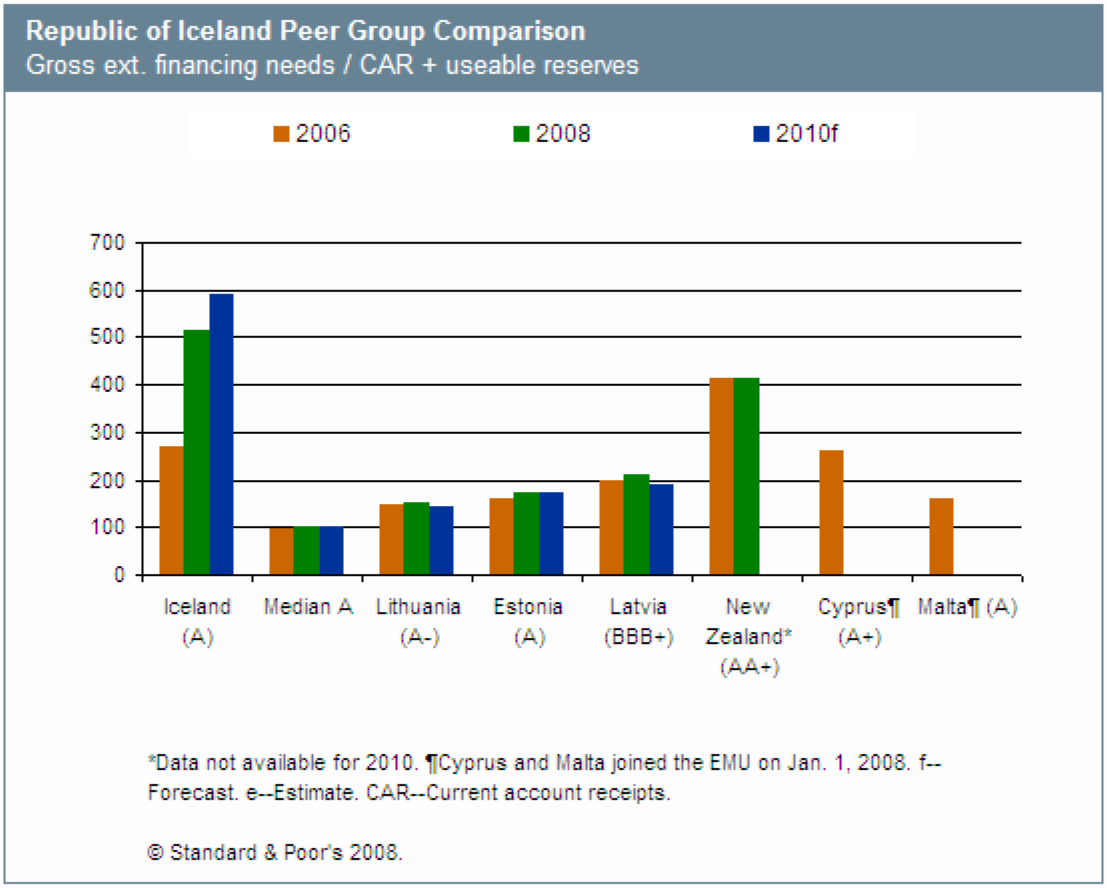
From year-end 2003 to year-end 2005, Iceland's real effective exchange rate appreciated by 27%, which was followed by a rapid depreciation of the krona versus all major currencies. Then, from June 2006 until July 2007, the real exchange rate again appreciated 16%, a move immediately followed by a 20% depreciation of the real exchange rate during the six months to March 2008. Compared with Iceland, real exchange rate volatility in other high interest rate economies, such as Turkey and Brazil (BBB-/Stable/A-3), has been far lower. A key difference is that Turkey's and especially Brazil's capital markets are more liquid than Iceland's, making them much more difficult to manipulate.

Chart 6



High current account deficits, combined with significant net FDI outflows as Icelandic enterprises have expanded abroad, have led to a quick build-up in external debt. As a consequence, Iceland's gross external financing needs (current account payments plus external debt with a residual maturity of up to one year) as a share of CARs plus usable reserves have continued to grow (see chart 7). Among all rated sovereigns, only the U.K. (AAA/Stable/A-1+), the U.S. (AAA/Stable/A-1+), and New Zealand (AA+/Stable/A-1+) have higher financing needs. Nevertheless, all three benefit from internationally more liquid currencies. Compared to the three Baltic states, the refinancing risk of Iceland's external debt is much higher, given the Baltic banking sectors are majority foreign-owned and the Nordic parent banks have strong deposit bases and ample liquidity.

Chart 7



Political Environment: Stable And Flexible

- Iceland's political institutions enjoy broad public backing and provide the flexibility to respond quickly to changing economic circumstances.
- The changed composition of the government following the May 2007 election is unlikely to alter major policy priorities.
- The issue of EU membership is debated intermittently, but Iceland is highly unlikely to apply to join in the foreseeable future.

Iceland's creditworthiness faces no appreciable political risks. The country enjoys well established, stable, and predictable institutions, and both internal and external security risks are negligible. The government has explicitly stated its commitment to macroeconomic stability, a commitment that is shared across the political spectrum. We expect the government to broadly continue with the previous government's pro-market reform course, but, due to the inclusion of the Social Democratic Alliance (SDA), it will have a stronger focus on social justice.

The two coalition parties, SDA and the Independence Party (IP), differ in their policy views on EU membership and further large-scale energy-intensive projects. While the IP is against further EU integration, the SDA is in favor and the coalition agreement foresees no steps toward EU membership.

Currency volatility and high interest rates continue to kindle demands to consider the adoption of the euro. Given the current market turmoil, the prospect of EU and Eurozone membership is debated intermittently and remains a divisive topic. The EU is likely to oppose unilateral euro adoption, and further EU integration remains unlikely as long as it entails Iceland adopting the EU's Common Fisheries Policy. Iceland is part of the European Economic Area (EEA), however, together with the Kingdom of Norway and the Principality of Liechtenstein (both AAA/Stable/A-1+). This grants the country many of the benefits of EU membership, particularly free trade and free movement of capital and labor.

The debate on the new energy-intensive projects also divides the main parties, although this hasn't stopped new projects coming on line. A few months after a local referendum rejected the Alcao project in Hafnarfjordur, Nordural received a positive opinion in the Icelandic Planning Agency's Environmental Impact Assessment for a proposed greenfield smelter to be constructed near Helguvik, southwest of Iceland.

Economic Prospects: Long, Deep Contraction On The Cards

- Iceland's economy is one of the wealthiest in the world, dominated by fishery, energy-intensive industries, and financial services.
- Massive macroeconomic imbalances point to an unavoidably painful contraction in domestic demand.
- Increased public spending and foreign investment on the Helguvik energy project could provide some cushion for the contracting economy.

Table 2

Republic of Iceland Economic & Financial Indicators

	2005	2006	2007	2008e	2009f	2010f	2011f
Nominal GDP (bil. ISK)	1,023.5	1,162.9	1,279.4	1,418.8	1,528.3	1,597.2	1,655.2
Nominal GDP (bil. $)	16.3	16.6	20.0	19.8	18.4	18.3	19.0
GDP per capita ($000s)	54,922.8	54,439.5	63,797.5	62,594.5	57,807.2	57,400.5	58,969.9
Real GDP (% change)	7.1	4.3	3.8	1.0	(1.9)	(1.5)	1.6
Real GDP per capita (% change)	5.9	1.4	0.9	0.0	(2.4)	(2.0)	0.9
Real domestic demand (% change)	14.0	9.4	(2.7)	(1.7)	(4.1)	(2.3)	1.6
Real investment (% change)	33.9	19.8	(14.8)	(5.5)	(2.0)	0.5	3.0
Gross domestic investment (% of GDP)	28.1	34.5	27.7	26.2	24.8	24.3	24.7
Gross domestic savings (% of GDP)	11.9	9.0	12.1	10.0	9.2	11.5	14.3
Real exports (% change)	7.2	(5.1)	18.0	4.6	0.5	3.0	2.0
Unemployment rate (average claimant count; %)	2.6	2.9	2.0	3.6	4.0	4.5	4.0
Real GDP per employee (% change)	7.1	(1.9)	(2.0)	6.9	(1.9)	(1.5)	1.6
Consumer price index (% change)	4.0	6.8	5.0	8.9	6.4	4.0	3.0
Domestic credit to private sector and NFPEs (% change)	66.1	46.8	31.5	(2.0)	(8.0)	(5.0)	2.0
Domestic credit to private sector and NFPEs (% of GDP)	248.4	321.0	383.7	339.1	289.6	263.3	259.1

f--Forecast. e--Estimate.

Economic structure

Iceland's population is among the richest in the world, with an estimated per capita income of $62,600 in 2008. Despite its geographic isolation, Iceland will export 40% of its GDP in 2008. The importance of fishing and fish-processing continues to decline, while the financial, insurance, and real-estate sector has grown substantially over recent years, contributing to 26% of GDP in 2007, from 17% in 1998.

Large-scale investment projects in aluminum smelters, along with the necessary expansion of energy generation, have transformed the Icelandic economy. A first wave of investment will be concluded by 2008, almost tripling aluminum smelting capacity from 2000 levels and making Iceland one of the 10 largest aluminum producers in the world. In the process, gross fixed investment rose to a peak of 35% of GDP in 2006, from 20% in 2003. Three further projects already under consideration, amounting to total investment of 10% of GDP spread over three years (2009-2011), are likely to go ahead, including the aforementioned Helguvik project.

Icelandic companies, particularly in the financial sector, are generally profitable and, due to the limited size of the domestic market, have increasingly sought to diversify abroad. We expect this will provide a more stable source of income for Icelandic companies and improve their profitability in the long run. As these companies take on increasing leverage (especially external), however, they are also increasingly exposed to external financing risks and to global credit market sentiment.

Unemployment in Iceland has historically been very low, and the labor market is very flexible, accommodating volatility in the business cycle. Labor force participation rates exceed 80% and are among the highest in Europe, while the regular pension age is 70. The current economic boom has also attracted immigration that has contributed to considerable growth in the labor force.

In its previous boom-bust cycle, the Icelandic economy demonstrated remarkable flexibility in unwinding the macroeconomic imbalances without major economic repercussions. Since then, the economy has become more flexible and robust, thanks to comprehensive structural reforms and the privatization and restructuring of the financial sector.

Economic growth

The expected cool-down of the economy did not materialize in 2007 as lending and consumption growth remained persistent despite a contraction in investment. The 2004-2007 economic boom has fueled significant macroeconomic imbalances, leading to rapidly increasing external leverage, strong asset price inflation, and high and rising short-term interest rates. During the first part of 2008, all tides turned almost simultaneously when banks tightened up credit, the krona depreciated, and the housing market manifested signs of weakness, with household balance sheets under pressure from multiple channels. Meanwhile, the rapid pass-through of the depreciating krona is pushing inflation higher, which not only diminishes real incomes, but also raises the level of mortgage payments, which are mostly inflation linked or in foreign currency.

At the same time, the access to credit also dried up, as the Icelandic banks face increasing difficulties in secure financing in the tight global credit environment. We expected the credit crunch to last until at least the end of 2008 and only moderately recover in 2009. As Icelandic banks are considered to have higher-than-average risk, we don't expect them to expand their lending again until the later part of 2010. Private consumption is therefore expected to contract, the main reason behind the negative real GDP forecast during the same period. On the other hand, net exports will support real GDP growth, as imports contract in conjunction with contracting consumption. The tighter quota on marine products, however, will partly offset export growth from the aluminum smelters. Public sector investment and the construction of the Helguvik project will also support economic growth over the forecast period. The unemployment rate is expected to start to rise in the later part of 2008, but the increase in publicly funded constructions and the departure of immigrants workers are likely to provide some buffer against any rapid shift in the labor market.

Fiscal Flexibility: Deficits And Debt To Surge With Mounting Contingent Risk

- High contingent liabilities are the major fiscal risk.
- The general government balance is expected to deteriorate rapidly as the economy contracts.
- Debt burden to increase to finance deficit and purchase additional foreign reserve in support of banks.

Table 3

Republic of Iceland Fiscal Indicators

	2005	2006	2007	2008e	2009f	2010f	2011f
(% of GDP)							
General government revenues	47.2	48.2	47.7	43.0	41.0	40.0	42.0
Of which central government	35.4	35.5	34.9	31.6	30.0	30.4	30.3
General government expenditures	42.2	41.8	42.9	45.0	46.5	45.0	45.2
Of which central government	31.0	30.1	31.2	33.0	33.5	33.4	32.7
General government balance	4.9	6.3	4.8	(2.0)	(5.5)	(5.0)	(3.2)
Of which central government	4.5	5.3	3.7	(1.5)	(3.5)	(3.0)	(2.4)
Of which local authorities	0.1	0.3	0.5	(0.5)	(1.5)	(1.5)	(1.0)
General government primary balance	7.1	8.5	7.3	0.4	(3.2)	(2.6)	(0.9)
Central government primary balance	6.2	7.1	5.9	1.1	(1.1)	(0.7)	(0.2)
General government balance (% of revenues)	10.4	13.2	10.1	(4.7)	(13.4)	(12.5)	(7.6)
General government interest payments (% of revenues)	4.7	4.5	5.2	5.6	5.6	6.1	5.4
Central government interest payments (% of revenues)	5.1	4.9	6.3	8.3	7.9	7.3	7.2
General government debt	25.5	30.3	28.3	27.5	31.7	36.1	30.8
Of which central government debt	19.2	25.2	24.1	23.2	25.7	28.3	22.4
General government net debt	18.0	12.1	11.7	12.5	17.1	21.4	23.8
Of which central government net debt	11.7	7.0	7.5	8.2	11.1	13.6	15.4

f--Forecast. e--Estimate.

Revenue, expenditure, and balance performance

On the back of our more negative economic growth expectation, compared with that presented in the government's 2008 budget, the government balance is expected to move into a deficit of around 2% in 2008, in contrast to the budget's moderate surplus. The budget has already set out a plan to increase public investment by 116% in real terms in 2008, mainly on road and other communications projects. We expect expenditure to increase to 45% of GDP in 2008 from 43% in 2007, as transfer payments will also increase more than planned under worse economic conditions. The tax revenue intake is expected to contract to 43% of GDP, from the 47%-48% during the previous three years, as income shrinks in real terms and a number of expected tax-relieving measures are introduced in addition to tax rate cuts.

We expect the continued slowdown to keep the general government balance in deep deficits of 5.5% of GDP in 2009 and 5.0% in 2010. This follows our expectation that revenues will continue to contract markedly to 40% of GDP in 2010, and government expenditure will remain high at 45% of GDP as transfers increase and government spending is used to stimulate the economy.

Government debt and interest burden

We expect net general government debt levels to trend upward to reach 24% of GDP by the end of the forecast period, from 11% in 2007, due to the higher fiscal deficits. Assuming the government will not withdraw its deposits at the central bank to maintain the monetary base, gross debt will increase to 36% of GDP by 2010. Over 6% of general government revenues would be spent on interest payments in 2009 and 2010, up from less than 5% in the past three years. Moreover, the debt burden could rise much faster if the government is forced to provide direct assistance to its country's commercial banks.

Off-budget and contingent liabilities

Contingent liabilities from the banking system are the major fiscal risk facing the government. The likelihood that the nation's three largest commercial banks: Glitnir Bank (BBB+/Negative/A-2), Landesbanki (not rated), and Kaupthing Bank (not rated) will require government support has increased substantially in the past few months as their funding costs surged under tight global credit conditions. All three banks rely on wholesale funding, particularly from overseas, and higher funding costs have dented their profitability and expansion plans. Partly due to the banks and local entrepreneurs' rapid expansion abroad, domestic credit to GDP has nearly tripled over the past five years to over 384% at Dec. 31, 2007. Total assets of the three largest banks were 887% of GDP at Dec. 31, 2007. These are among the highest ratios of rated sovereigns and, consequently, the fiscal burden for the sovereign in the case of financial sector stress could be enormous.

High funding costs and short-term liquidity requirements would be the most likely triggers for government support in the near term. That said, the three main banks have pre-financed some of their liabilities to some extent and continue to benefit from a previous build-up in liquidity over 2006 and 2007, with more than a few months of liquidity left. If high funding costs continue for longer than the 6-9 months currently expected, or in the unlikely event of a significant drawdown on their deposit base, the banks may run into liquidity problems. The central bank foreign currency reserve of $2.7 billion is not sufficient to cover all the financial institutions' external financing needs (including principal and interest payments), which amount to $5.7 billion (30% of GDP) in 2008 and $9.3 billion (55% of GDP) in 2009, based on debt outstanding as of year-end 2007. It is therefore likely the government will increase external borrowing to further boost reserves or tap a credit line from external sources. In the medium term, if the economic contraction and house price slump generate asset quality issues, the financial sector contingent liability would be above 100% GDP in 2008, but it is expected to decline markedly to below 80% in 2010 due to much tighter bank credit.

The stock of debt guaranteed by the government is high and amounts to an estimated 68% of GDP in 2008. More than 80% of these government guarantees are on HFF's debt, which is secured by real estate, but which has highly concentrated exposure to house prices in Iceland and the credit risk of Icelandic households.

Monetary Policy: Depreciation And Inflation Causing Monetary Headaches

- Inflation spikes as krona depreciates.
- Currency volatility poses a colossal challenge for monetary policy.
- Structural changes in the mortgage market have weakened the transmission mechanism of monetary policy.

Iceland is the smallest economy in the world to operate an independent monetary policy and fully floating exchange rate regime. The Central Bank Law of March 2001 reflects international best practice. In 2002, during the previous boom-and-bust cycle, the central bank successfully brought down record inflation levels of about 10%. However, over the same period, the transmission mechanism of monetary policy was weakened by the unfortunately timed structural changes in the mortgage market in 2004-2005, at the peak of the economic boom. Competition between and commercial banks led to sustained low long-term interest rates and fast credit growth averaging 51% in 2004-2006, despite the high and rising central bank policy rate. As a result, monetary policy had a limited effect on domestic demand, but led to further appreciation of the krona, which spurred strong consumption of foreign goods. Although major commercial banks have virtually stopped mortgage lending in 2008, HFF's lending rate remains linked with its funding cost, which tends to be lower when the inflation rate expectation is high, which further weakens the impact of central bank rate rises. (The current government has not yet discussed reform of HFF in detail.) A rapid increase in foreign currency mortgage lending, which accounts for 11% of household borrowing, could further weakenen monetary policy effectiveness.

The annual average inflation rate (including house prices) is expected to reach nearly 10% of GDP in 2008 as the result of the rapid pass-through effect of the depreciating krona, which has lost 27% since the beginning of 2008. This has triggered two rate increases by the central bank in March (1.25bps) and April (50bps), with interest rates now at 15.50%, the highest in Europe. The central bank doesn't expect the inflation rate to fall into the target band (2.5% plus/minus 1.5%) until 2010. If cost pressures continue, further rises cannot be excluded. In an attempt to improve liquidity by kick starting the swap market, the central bank is issuing six-month certificates of deposits at 25bps below the policy rate. Issuance has reached ISK50 billion and will soon move to ISK75 billion. The bank will hold issuance at this level for some time to counteract worries about squeezing the krona market.

The inflation outlook is complicated by the uncertainty regarding real estate market development, the volatile currency, and the effect of weakening household balance sheets on domestic demand. The recent wage settlement completed in February 2008 may also be revised if inflation is higher than expected. The issuance of "glacier bonds" (foreign issuance of bonds denominated in krona), with around 30% of GDP outstanding at the end of 2007, helps to deepen the krona market, but their lumpy maturity structure could increase volatility in the exchange rate.

External Finances: High Narrow Net External Debt

- Higher interest cost on the external debt stock pushes up current account deficits despite improvement in trade balance.
- External financing needs driven by very high levels of short-term external debt and large current account deficits.
- The external leverage of the financial sector remains very high.

Table 4

Republic of Iceland External Indicators

	2005	2006	2007	2008e	2009f	2010f	2011f
(% of GDP)							
Current account balance	(16.2)	(25.5)	(15.6)	(16.2)	(15.5)	(12.8)	(10.4)
Trade balance	(9.1)	(13.5)	(6.9)	(5.4)	(3.8)	(3.5)	(3.4)
Net foreign direct investment	(24.7)	(8.0)	(45.3)	1.9	1.9	2.9	0.9
(% of CARs)							
Current account balance	(40.1)	(53.8)	(26.0)	(25.7)	(25.1)	(20.7)	(17.3)
Net external liabilities	209.9	258.2	192.1	210.8	256.3	276.7	294.1

Table 4

Republic of Iceland External Indicators(cont.)							
Total external debt	687.8	893.7	937.1	892.2	999.1	1,020.5	1,050.9
General government external debt	59.2	69.4	67.3	73.2	66.5	63.7	51.9
Narrow net external debt*	400.1	446.8	467.8	431.0	496.8	516.0	541.8
Net public sector external debt	21.2	13.7	10.9	6.3	8.0	9.1	(1.3)
Net nonbank private sector external debt	45.5	66.9	74.0	51.3	57.9	59.5	61.3
Net banking sector external debt	311.4	341.6	362.0	341.2	388.6	398.1	425.5
Net investment payments	9.3	15.8	8.5	12.6	15.5	11.9	8.5
Net interest payments	9.7	17.0	20.0	24.7	30.3	27.8	23.5
Reserves/CAPs (months)	1.4	1.1	1.9	2.0	2.3	2.5	2.8
Gross external financing needs (% of CARs and usable reserves)	235.9	271.0	287.7	512.9	564.0	590.2	625.6

*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. f--Forecast. e--Estimate. CARs--Current account receipts. CAPs--Current account payments.

External liquidity low, despite a strong increase in reserves

The main contributor to the high current account deficit will be the income deficit, as opposed to the trade deficit in the past few years. The external trade balance is expected to improve further in the forecast period, as imports contract on the back of weakening consumption and the completion of large investment projects, and as the new aluminum plant (which became fully operational in April) boosts exports. With cod quotas cut, the fish catch is down and is expected to remain so in 2008, but the weaker krona and the higher proportion of the catch frozen-at-sea (that is, higher value-added) will partly offset this. Tourism is also expected to be stronger in the wake of the krona's depreciation. In 2009 and 2010, the planned new smelter at Helguvik may push up investment-related imports, but this rise would be relatively small compared with the three new projects completed.

We expect the high external debt stock and increasing cost of financing to push up income deficits in 2008-2011. These deficits are highly sensitive to the refinancing interest rate. It is estimated that in 2008 every 100bps increase in refinancing costs translates to a rough increase of 10bps on average interest rates and a 0.6% of GDP increase in the deficit.

Gross external financing needs (current account payments plus short-term debt by residual maturity) will triple by 2010 as banks find it increasingly difficult to secure medium- to long-term borrowing, resulting in an increasing proportion of short-term debt to external debt. The short-term portion of gross external debt is expected to increase from the less than 20% in the past few years to over 50% in 2010. Similar to what has been announced by Icelandic firms Baugur and Glitnir, a positive inflow of funds from a reduction of FDI and equity investment abroad will cover some of the external financing needs.

Narrow net external debt

Gross external debt is forecast to reach nearly 600% of GDP by 2008, compared with less than 145% in 2003, despite more scaling back of operations by the banks, either through asset sales or rolling back loans abroad. Iceland has a significant narrow net external debtor position, at nearly 431% of CARs in 2008, which is a substantial build-up from 280% in 2003.

The financial sector is the economy's main external debtor. It accounts for 86% of Iceland's net external debt in

2008, and is forecast to exceed 400% of CARs by the end of 2011, up from 161% in 2003.

We forecast net public sector external debt to remain below 10% of CARs as the government is expected to finance main through the local currency market. Net nonfinancial private sector debt is expected to fall to 52% of CARs in 2008 from the peak 74% in 2007, as Icelandic corporations scale down some activities abroad due to the tighter funding conditions.

Aarti Sakhuja provided research assistance for this report.

Ratings Detail (As Of May 8, 2008)*		
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign Currency		A/Negative/A-1
Local Currency		AA-/Negative/A-1+
Commercial Paper		
Foreign Currency		A-1
Senior Unsecured		
Foreign Currency		A
Local Currency		AA-
Short-Term Debt		
Local Currency		A-1+
Subordinated		
Foreign Currency		A
Sovereign Credit Ratings History		
17-Apr-2008	*Foreign Currency*	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+
10-Feb-2005		AA-/Stable/A-1+
16-Dec-2003		A+/Positive/A-1+
17-Apr-2008	*Local Currency*	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+
Population		0.31 million
Per Capita GDP		$62,600 (2008)
Current Government		
Prime Minister Geir H. Haarde heads a coalition composed of the center-right Independence Party and the Social Democratic Alliance. President Olafur Ragnar Grimsson is head of state.		

Ratings Detail (As Of May 8, 2008)***(cont.)**
Election Schedule
General elections Last......May 2007 Next......May 2011 Presidential elections Last......June 2004 Next......June 2008

*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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