Republic of Iceland Ratings Affirmed; Outlook Remains Negative

Credit Analyst:
Moritz Kraemer, London (44) 20-7847-7114; David Cooling, London (44) 20-7847-7109

LONDON (Standard & Poor's) May 3, 2002--Standard & Poor's said today it affirmed all its ratings on the Republic of Iceland, including the single-'A'-plus/'A-1'-plus foreign currency issuer credit ratings, balancing the country's ability to react to economic challenges against external imbalances. The outlook remains negative.

"The swift and nonrecessionary reduction of external imbalances in 2001 highlighted Iceland's capacity to absorb economic shocks. The government has also made important progress in consolidating public finances and is expected to continue on this course after the current hiatus," said Standard & Poor's credit analyst Moritz Kraemer. "Nevertheless, the ratings remain constrained by external debt ratios, which have rapidly risen to levels untypical of similarly rated sovereigns."

Despite a faster-than-expected reduction of the current account deficit, net external debt is expected to reach 246% of current account receipts (CARs) in 2002 and will decline only gradually to 223% in 2005 as privatization falls short of ambitious expectations. The envisaged net external debt decline could be smaller still if net portfolio outflows recover from the sharp fall experienced during 2001. Iceland's negative net investment position could improve as international equity markets recover, due to substantial shareholdings abroad.

Net general government external debt is also expected to rise to 56% of CARs in 2002, due to a debt strategy that substituted domestic with foreign debt and to external liquidity injections into the Central Bank.

The government is expected to reverse the recent trend of increased reliance on short-term foreign debt.

Official foreign exchange reserves remain at very low levels, covering just more than 12% of the 2002 external financing requirement. A fast build-up of net official reserves is unlikely and liquidity will remain a critical issue for years to come.

Most of recent foreign borrowing was conducted by the private sector, especially commercial banks, at relatively short maturities, increasing yearly financing requirements going forward. In the current recessionary environment, Icelandic banks' capitalization might prove to be low in relation to the risks that they have taken on. The banking sector's profitability improved last year, but a further tightening of credit could still pose risks to the banks, a substantial proportion of which are government-owned.

As a result, there is still a prevalence of downside risks to Iceland's economic stability, as reflected in the outlook on the sovereign.

Looking ahead, Mr. Kraemer added: "A faster-than-expected reduction of external refinancing requirements or an increase of nondebt capital inflows could strengthen the ratings on Iceland. By contrast, a resumption of large structural capital portfolio outflows would exert additional downward pressure on the ratings, as would deteriorating prudential indicators in the banking sector and failure to improve the external liquidity position and rein in the external refinancing requirement."

A complete list of rating actions is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. They are also available on Standard & Poor's public Web site at www.standardandpoors.com; under Rating Actions, select Newly Released Ratings Listings. Alternatively, call the Standard & Poor's Ratings Desk in London at (44) 20-7847-7400.

ANALYTICAL E-MAIL ADDRESSES
moritz_kraemer@standardandpoors.com
david_cooling@standardandpoors.com
SovereignEurope@standardandpoors.com