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Republic of Iceland's Debut €1 Bil. Benchmark Bond Due 2011 Assigned 'AA-' Rating

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LONDON (Standard & Poor's) Nov. 21, 2006--Standard & Poor's Ratings Services assigned its 'AA-' senior unsecured debt rating to the Republic of Iceland's debut (foreign currency AA-/Negative/A-1+, local currency AA+/Negative/A-1+) €1 billion bond maturing in 2011. The issue represents the first euro benchmark bond issued by the Republic. The entire amount of the planned borrowed funds will be allocated toward strengthening the Central Bank of Iceland's foreign reserves.

"The ratings on Iceland are supported by its stable and flexible political institutions, high level of prosperity, and strong long-term economic growth prospects," said Standard & Poor's credit analyst Eileen Zhang. "In the near term, however, the Icelandic economy faces stagnation in 2007 and the potential risk of a hard landing, as the macroeconomic imbalances built up in the credit and investment boom in the past two years unwind."

Large fiscal surpluses could not completely offset excessive domestic demand during the period of large-scale investment projects and rapidly expanding bank credit in 2003-2006. Accelerating wage growth and other inflationary pressures have prompted the Central Bank of Iceland to hike interest rates, to their current level of 14.00%. Although the economy is showing signs of cooling, the depreciation of the Icelandic krona could represent a further inflationary pressure. This could lead to additional increases in interest rates, risking an adjustment process that is more painful and more disruptive to the economy.

After a likely stagnation in 2007, the annual growth rate of Icelandic economy is expected to recover gradually to of about 3% by 2010. Iceland will enter this period of a weakening economy with a low general government debt burden of 24% of GDP in 2006, one-half the level of five years earlier. The possibility of a significant economic contraction remains real, however. In this case, there will be increasing pressure on both budget balances and contingent liabilities for the government.

The resilience of Iceland's financial sector has increased in recent years as a result of improved regulation and supervision, as well as local banks' international diversification, good profitability, and entry into the mortgage market. Nevertheless, the banks' very high external leverage, their dependency on wholesale funding, and the risk of a deterioration of credit quality in the country remain a major source of concern.

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, but declining current account deficits, exacerbated by foreign direct investment and portfolio equity outflows. Consequently, levels of narrow net external debt are set to remain at more than 400% of current account receipts until the end of the current decade.

"The negative outlook on Iceland reflects the risk posed by the large imbalances in the economy. High and rising interest rates increase the risk of a disorderly unwinding of these imbalances, and might have an adverse impact on private sector, and consequently public sector balance sheets." said Ms. Zhang. "If measures taken to contain domestic demand and inflation do not prove effective, and if the above scenario of a pronounced economic contraction and worsening balance sheets unfolds, the result would be a downward revision of the ratings. Conversely, if economic imbalances unwind in an orderly fashion and the risks are contained, the outlook would be revised back to stable."

For further information about the ratings on the Republic of Iceland, please see full analysis report titled "Iceland (Republic of)" published on Oct. 31, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis.

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