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Republic of Iceland Cut To FC 'A+/A-1', LC 'AA/A-1+' On Unbalanced Policy Mix; Outlook Stable

On Dec. 22, 2006, Standard & Poor's Ratings Services lowered its foreign currency sovereign credit ratings on the Republic of Iceland to 'A+' long-term and 'A-1' short-term, from 'AA-' and 'A-1+', respectively. At the same time, the long-term local currency rating on Iceland was lowered to 'AA' from 'AA+', and the short-term local currency rating was affirmed at 'A-1+'. The outlook is stable.

The downgrade reflects the loosening of fiscal policy by the Icelandic government ahead of the 2007 election, demonstrated by the recent expansionary amendments to the 2007 budget at a time when the macroeconomic imbalances in the economy due to excessive domestic demand are in urgent need of readjustment. This expansionary stance reveals an increasingly unbalanced policy mix, forcing further monetary tightening by the central bank, as evidenced by the 25 basis point interest rate hike, to 14.25%, on Dec. 21, 2006. This exacerbates the risk of a hard landing by the Icelandic economy, as the macroeconomic imbalances built up in the credit and investment boom in the past two years unwind.

Moreover, a widening income deficit as demonstrated in the recent balance of payment data also leads to an upward revision of the outlook for current account deficit and worsening international investment position going forward.

Conversely, the ratings on Iceland remain supported by its stable and flexible political institutions, high level of prosperity, and strong long-term economic growth prospects and low and declining government debt level due to a sizable fiscal surplus in the past three years.

Recently passed amendments to the 2007 budget reduce the targeted surplus by 0.5% of GDP to 1.0% of GDP for 2007. Excluding self-financing and an upward revision in revenues, the actual gross fiscal stimulus provided by the amendments, in comparison with the original budget proposal, is Icelandic krona (ISK) 13.6 billion, or the equivalent of 1.2% of forecast GDP. This additional fiscal loosening, at a time when the economy is still operating at its full capacity, is expected to continue to fuel the overheated Icelandic economy and further increase the risk of a hard landing.

The expansionary fiscal policy and tight labor market pose the risk of further inflationary pressures. This could lead to additional increases in interest rates, which could result in an adjustment process that is more painful and more disruptive to the economy.

The Icelandic economy is likely to stagnate in 2007, but to recover gradually to an annual growth 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, such as those posed by guaranteed debt, or stemming from the financial sector.

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 current account deficits, exacerbated by net foreign direct investment and portfolio equity outflows. Consequently, levels of narrow net external debt are expected to reach nearly 500% of current account receipts by the end of the current decade, notwithstanding surging export performance in 2007-2008 as new aluminum production capacity becomes available.

Outlook:

The stable outlook balances the high levels of prosperity and flexibility in the Icelandic economy with the highly leveraged external sector and very weak external position. The high levels of income and wealth, as well as the strong fiscal account, would provide a cushion for the readjustment of the economy.