

International  
Credit Update

# Republic of Iceland

## Ratings

	Current Ratings
<b>Foreign Currency</b>	
Long-Term IDR	A-
Short-Term IDR	F2
<b>Local Currency</b>	
Long-Term IDR	AA
Country Ceiling	A

## Watch

Foreign Long-Term IDR	Negative
Foreign Short-Term IDR	Negative
Local Long-Term IDR	Negative
Country Ceiling	Negative

## Financial Data

Iceland	2007
GDP (USDbn)	20.2
GDP per head (USD)	67,004
Real GDP (% change)	4.9
Consumer prices (% change)	5.1
Government debt (% GDP)	28.3
Net external debt (% CXR)	438.5
International liquidity ratio	77.7

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## Rating Rationale

- On 30 September 2008, Fitch Ratings downgraded the Republic of Iceland's Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) to 'A-' and 'AA' from 'A+' and 'AA+' respectively. The Short-Term IDR was also downgraded to 'F2' from 'F1' and the Country Ceiling to 'A' from 'AA-'. All the ratings are on Rating Watch Negative (RWN).
- This rating action was precipitated by the Icelandic authorities' decision to take a majority stake in Glitnir Banki ('BBB-/RWN) on 29 September, underlining the deteriorating credit profile of Iceland's major banks. Following this action and the ensuing Fitch downgrades of Iceland's three largest banks – Glitnir, Kaupthing Bank ('BBB'/RWN) and Landsbanki Islands ('BBB'/RWN) – the agency believes the risks to macroeconomic stability and sovereign creditworthiness arising from distress in the banking system have materially increased.
- Iceland's sovereign ratings had been on Negative Outlook since April 2008 in recognition of the banks' heightened vulnerability to changing market sentiment and the potential implications for the sovereign. State injection of EUR600m of new capital into Glitnir will be reflected in a drawdown of international reserves. While this drawdown will be mitigated by EUR300m of sovereign borrowing from European banks, the costs of supporting the banking system are now starting to crystallise on the sovereign's balance sheet.
- The rating action also takes into account renewed deterioration in Iceland's macroeconomic imbalances. Although there has been a significant improvement in the trade balance this year, a sharp deterioration in the balance on net income threatens to widen the current account deficit to 20% of GDP in 2008, at a time when sources of external financing have become increasingly strained. Meanwhile, the combined impact of this year's steep fall in the exchange rate (45% against the USD since end-2007) and double-digit inflation could push the stock of private-sector credit beyond 500% of GDP by year-end, exacerbating the risk of a hard landing for the Icelandic economy in 2009.
- Iceland's sovereign credit fundamentals remain underpinned by low general government debt (28% of GDP), high GDP per capita, robust institutions and high standards of governance and transparency. The authorities can point to a favourable external debt service profile and liquid foreign-currency resources of almost USD6bn, bolstered by recent sovereign borrowing and a EUR1.5bn swap arrangement with Nordic central banks. Such credit attributes mean that the sovereign still has some room for manoeuvre in its quest to manage the pressures emanating from the financial sector.

## What Could Trigger a Downgrade?

- Heightened risks to macroeconomic stability and sovereign creditworthiness arising from further potential distress in the banking system could trigger a downgrade. Given the banks' high degree of external leverage – net external indebtedness exceeds 370% of current external receipts or 220% of GDP – and rising funding needs, Fitch believes Iceland will remain vulnerable to global financial developments. Official intervention to support Glitnir has affirmed earlier official statements to support the banks, where necessary. However, the sheer size of the banks relative to GDP (900%) and the scale of their near-term external funding requirements underscore the need for a timely and credible policy response to stem any further loss of confidence in the financial system.

## Key Indicators for Iceland

Population (2007<sup>e</sup>): 0.3m  
 GDP (2007<sup>e</sup>): USD20.2n  
 GNI Per Head at Purchasing Power Parity (2006): USD35,980 (= 81% of USA level)  
 Modern Sovereign Rescheduling History: None

Population Growth Rate (2002-2007<sup>e</sup>): 1.0% p.a.  
 GDP per Head at Market Exchange Rates (2007<sup>e</sup>): USD67,004

	2004	2005	2006	2007	2008 <sup>f</sup>	2009 <sup>f</sup>	2010 <sup>f</sup>
<b>Domestic Economy and Finance</b>							
Real GDP Growth (%)	7.7	7.4	4.4	4.9	1.7	-1.2	1.0
Unemployment (% of Labour Force)	3.1	2.1	1.3	1.1	1.7	2.5	3.0
Consumer Prices (Annual Average % Change)	2.8	4.2	6.7	5.1	12.0	7.0	3.0
Gross Domestic Savings (% of GDP)	17.8	15.9	16.9	17.6	17.9	19.5	19.8
Gross Domestic Investment (% of GDP)	23.4	28.3	34.8	28.1	23.7	22.5	19.8
Short-Term Interest Rate (%) <sup>(1)</sup>	6.1	9.4	12.5	13.3	14.5	12.0	8.0
Broad Money (% Change Dec to Dec)	13.5	29.3	60.1	10.7	12.8	6.2	5.9
ISK per USD (Annual Average)	70.2	63.0	70.2	64.1	85.0	107.5	90.0
REER (CPI, 2000=100)	101.6	114.6	106.8	112.8	91.8	75.8	91.7
REER: % Change (+ = Appreciation)	2.8	12.7	-6.8	5.6	-18.6	-17.4	20.9
<b>Public Finances</b>							
General Government Balance (% of GDP)	0.2	5.2	6.3	5.5	1.8	-1.4	-2.4
General Government Debt (% of GDP)	34.5	25.4	30.1	28.3	36.1	35.4	33.3
General Government Debt Maturities (% of GDP) <sup>(2)</sup>	5.6	5.6	4.1	3.1	2.9	2.7	1.9
General Government Debt/Revenue (%)	77.9	53.6	62.9	58.7	81.5	86.6	82.7
Interest Payments/Revenue (%)	5.4	4.5	4.5	5.4	7.5	6.3	7.6
<b>Balance of Payments</b>							
Current Account Balance (USDbn)	-1.3	-2.6	-4.2	-3.2	-3.4	-2.5	-2.3
Current Account Balance (% of GDP)	-9.9	-16.2	-25.4	-15.8	-19.8	-17.6	-12.7
Current Account Balance plus Net FDI (USDbn)	-3.1	-6.6	-5.5	-12.3	-4.9	-3.5	-4.3
Current Account Balance plus Net FDI (% of GDP)	-23.8	-40.7	-33.3	-60.8	-28.5	-24.5	-23.7
Gross Financing Requirement (% of Official Reserves) <sup>(3)</sup>	381.1	584.5	716.9	562.2	438.6	725.3	477.9
Current External Receipts CXR (USDbn)	5.0	6.6	7.9	12.1	10.7	11.7	12.8
Current External Receipts CXR (Annual % Change)	20.4	32.3	19.5	52.5	-11.0	8.9	9.7
Current External Payments CXP (USDbn)	6.3	9.3	12.1	15.2	14.1	14.2	15.1
Current External Payments CXP (Annual % Change)	34.8	46.6	31.1	25.6	-7.4	0.7	6.5
<b>External Assets and Liabilities</b>							
Gross External Debt (USDbn)	26.9	45.6	71.7	113.9	117.5	122.6	128.1
Gross External Debt (% of GDP)	203.0	279.9	430.7	564.7	684.9	850.8	702.5
Gross External Debt (% of CXR)	537.3	689.5	906.5	945.1	1095.6	1049.9	999.6
Net External Debt (USDbn)	17.2	24.0	32.6	52.9	58.4	63.3	68.7
Net External Debt (% of GDP)	130.3	147.0	196.0	262.0	340.6	439.2	377.1
Net External Debt (% of CXR)	344.9	362.2	412.6	438.5	544.9	541.9	536.5
Public External Debt (USDbn)	3.5	2.4	3.4	3.9	4.2	5.3	5.3
Public External Debt (% of GDP)	26.3	14.9	20.5	19.5	24.6	36.9	28.9
Net Public External Debt (% of CXR)	48.1	20.8	13.5	10.8	14.8	12.4	10.9
Public FC Denominated & FC Indexed Debt (USDbn)	2.7	1.7	2.7	2.8	3.0	3.7	3.7
Short-Term External Debt (% of Gross External Debt)	18.1	15.5	16.6	35.7	38.3	37.8	37.8
External Debt Service (% of CXR)	45.9	69.5	73.0	119.2	123.5	189.1	172.9
External Interest Service (% of CXR)	10.1	14.7	30.0	36.5	47.8	47.0	46.1
Liquidity Ratio (%) <sup>(4)</sup>	40.5	39.9	71.2	77.7	39.6	31.2	31.8
Official International Reserves Including Gold (USDbn)	1.1	1.1	2.3	2.6	2.6	3.9	3.9
Official International Reserves in Months of CXP Cover	2.0	1.4	2.3	2.1	2.2	3.3	3.1
Official International Reserves (% of Broad Money)	12.0	9.5	14.8	12.9	22.4	24.5	20.7

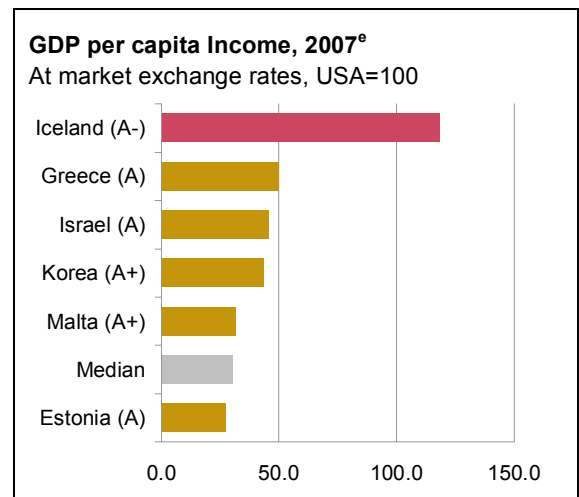
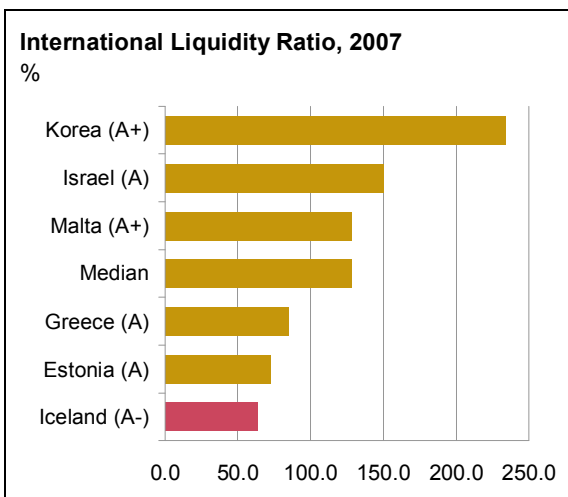
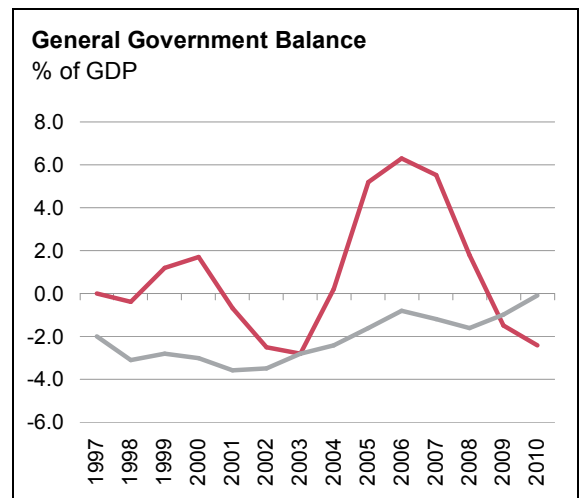
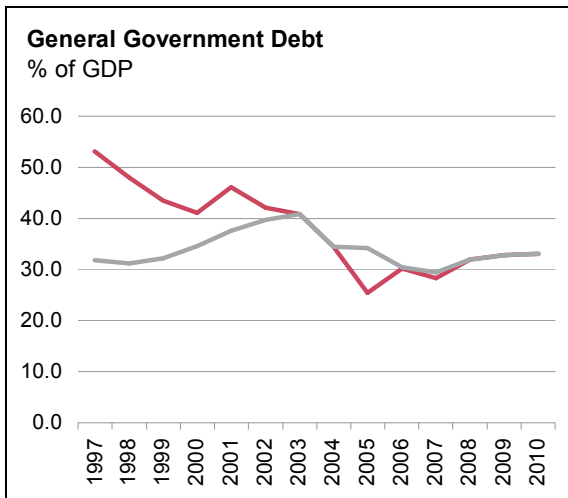
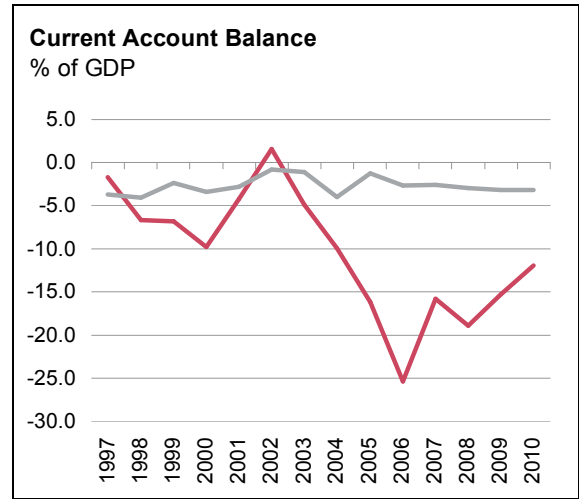
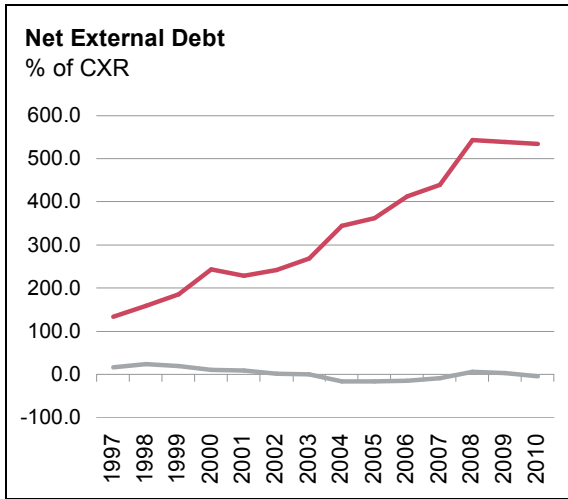
<sup>(1)</sup> Central Bank policy interest rate (annual average).

<sup>(2)</sup> Maturities of medium- and long-term debt during year plus short-term debt outstanding at the beginning of the year.

<sup>(3)</sup> Current account balance plus amortisation of medium- and long-term debt, over official international reserves.

<sup>(4)</sup> Official reserves incl. gold plus banks' foreign assets/debt service plus liquid external liabilities.

**Peer Comparison**



— Iceland

— A Median

**Peer Group**

Rating	Country
A	Bahrain
	Chile
	Estonia
	Greece
	Israel
	Lithuania
	Ras Al Khaimah
A-	Iceland
	Malaysia
	Poland
BBB+	Hungary
	Latvia
	Mexico
	Russia
	South Africa
	Thailand

**Rating History**

Date	Long-Term Foreign Currency	Long-Term Local Currency
3 Feb 2000	AA-	AAA
15 Mar 2007	A+	AA+
30 Sep 2008	A-	AA

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