



# NEWS RELEASE

Nov 11, 2011

## R&I Affirms BB+, Changes Outlook to Stable: Republic of Iceland

Rating and Investment Information, Inc. (R&I) has announced the following:

**ISSUER:** Republic of Iceland  
**Foreign Currency Issuer Rating:** BB+, Affirmed  
**Rating Outlook:** Stable, Changed from Negative

### RATIONALE:

The Icelandic economy was forced to contract significantly following the collapse of its banking sector in the aftermath of the fall 2008 global financial crisis, but has entered into a phase of gradual recovery in 2011. The country's response measures with bank reconstruction efforts that emphasized continued domestic financing and introduction of capital controls to stabilize exchange rates and inflation have proven to be effective. Public finance has embarked on a consolidation trajectory. On the other hand, the after-effect of the collapse of banking system is perceptible, global economic and financial environment remains severe, and a full economic recovery will likely take a long time. In view of these, R&I has affirmed the country's Foreign Currency Issuer Rating at BB+, but changed its Rating Outlook from Negative to Stable.

Iceland's economy bottomed from 4Q 2010 and has been improving, however gradually, since 2011 and is expected to come in at 3.1% this year. The unemployment rate has improved to 6.7% from a peak of 9.8% and real wages have risen. Household debt relief has been granted and that helped support a recovery in consumer sentiment. The IMF's Stand-by Arrangement, which Iceland accepted immediately after the financial crisis, was completed in August 2011, as the country emerged from crisis conditions. However, debt restructuring, particularly among large companies, still lags; hence, downward pressure on the economy persists from further unwinding of assets and debts. The money supply and bank credit are not expected to start to increase for some time, and the economy's resilience remains weak.

Iceland has managed to shrink its fiscal deficit -- which hit 13.5% of GDP in 2008 -- by raising taxes and cutting spending, and the country is expected to achieve a primary surplus in 2012 and an overall balance by 2014. Government debt is not light at 86% of GDP as of end-August 2011, but is projected to trend down soon. The issue of compensations to the governments of the UK and the Netherlands, which covered the deposits of their own citizens at failed Icelandic banks, has not been resolved yet. Even if those are to be made, concerns that this would lead to a huge increase in government net debt have diminished. However, the banking sector still holds a large amount of non-performing loans, and the risk of a growing fiscal burden from further capital injections into financial institutions persists.

The country's sizeable trade deficit has also turned positive. Because unpaid interest by failed private sector banks will eventually disappear from payment obligations as the bank settlement process moves on, Iceland's current balance is positive in effect. International reserves as of the end of September stood at an all-time high of US\$8.0 billion, sufficient to cover external government debt payments through 2015. There are few concerns about Iceland's external liquidity. However, with capital controls being eased or lifted in future, there is a risk that non-residents' holdings of Icelandic sovereign bonds held captive could be sold and capital outflows result. This point bears watching.

External debt defaulted by failed banks amounted over six times of GDP. The Icelandic government decision of not bailing out the bank debt has evidently helped avoid a catastrophic fiscal crisis, but it has certainly alienated foreign investors. To restore confidence and lure back foreign investment will hold a key to a strong economic recovery and the improvement in the country's sovereign creditworthiness. R&I will pay attention to the government efforts in these respects.

The primary rating methodology applied to this rating is provided at "R&I's Analytical Approach to

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Sovereigns". The methodology is available at the web site listed below, together with other rating methodologies that are taken into consideration when assigning the rating.

<http://www.r-i.co.jp/eng/cfp/about/methodology/index.html>

## R&I RATINGS:

<b>ISSUER:</b>	<b>Republic of Iceland</b>
	<b>Foreign Currency Issuer Rating</b>
<b>RATING:</b>	<b>BB+, Affirmed</b>
<b>RATING OUTLOOK:</b>	<b>Stable, Changed from Negative</b>

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