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Fitch Revises Iceland's Outlook to Negative on Widening Macro Imbalances

Fitch Ratings

FITCH REVISES ICELAND'S OUTLOOK TO NEGATIVE ON WIDENING MACRO IMBALANCES

Fitch Ratings-London-21 February 2006: Fitch Ratings has today revised the Outlooks on the Republic of Iceland's foreign and local currency Issuer Default Ratings ("IDRs") to Negative from Stable. The Long term foreign and local currency IDRs are affirmed at 'AA-(AA minus)' and 'AAA' respectively. The Country Ceiling is also affirmed at 'AA' and the Short-term foreign currency rating at 'F1+'.

"The Negative Outlook has been triggered by a material deterioration in Iceland's macro-prudential risk indicators, accompanied by an unsustainable current account deficit and soaring net external indebtedness," said Paul Rawkins, Senior Director in Fitch's Sovereign team in London.

Fitch says that while all the signs of economic overheating - rising inflation, rapid credit growth, buoyant asset prices, a steep current account deficit and escalating external indebtedness - have been evident for a while, the rate at which some of these indicators has deteriorated has exceeded the agency's expectations. Thus, credit growth of over 30% per annum continues unabated, the current account deficit expanded to 15% of GDP in 2005 and net external debt has climbed to well over 400% of current external receipts.

"In the absence of a more balanced policy response, Fitch believes that the risks of a hard landing have increased, raising concerns about how well the broader financial system would cope in such a scenario and the likely implications for the sovereign," said Fitch's Rawkins.

The agency recognises that a wave of structural reforms since the 1990s, including the adoption of a floating exchange rate in 2001 and better financial supervision, have made Iceland's economy more resilient to shocks. Moreover, the public finances continue to go from strength to strength - general government debt is forecast to fall to 25% of GDP in 2006 – underpinning the sovereign ratings. However, the rest of the economy is significantly indebted now: credit to the private sector – much of it price or exchange rate linked - stood at an estimated 218% of GDP at end-2005, having doubled in three years. Yet Icelandic banks and corporates continue to pursue ambitious expansion plans abroad, accumulating external debt at an unprecedented rate in the process.

Fitch is critical of the current policy framework, arguing that monetary policy has been left to take the strain, while fiscal policy has been a silent partner. Because households enjoy easy access to long-term housing credit, 12 successive increases in interest rates since May 2004 have succeeded only in driving up the real exchange rate and further worsening the current account deficit. Fiscal inaction stems from the government's view that the current imbalances are private sector driven and will be self-correcting over time. As such, it continues to budget for small surpluses over the course of the economic cycle and remains committed to its campaign promise of tax cuts through 2006-07.

Iceland's public debt ratios are in line with 'AA' medians and net public external debt has come down to less than half its 2002 peak of 70% of current external receipts. Nonetheless, Fitch says that one of the most important lessons to come out of the Asia crisis was that countries with seemingly sound public finances ignore private sector imbalances at their peril. Iceland's net external debt is higher than virtually any other Fitch rated sovereign, while its external liquidity ratio - liquid external assets as a share of liquid external liabilities - is among the weakest, particularly if banks' foreign assets are excluded. Fitch acknowledges that Icelandic banks' foreign assets have expanded considerably, but cautions that the banks remain heavily dependent on foreign funding and could ill afford to be shut out of international capital markets for any length of time.

Fitch avers that other highly rated countries like Australia and New Zealand display similar, albeit less extreme external financial constraints to Iceland, but the agency argues that the structure and hedging characteristics of these countries external indebtedness is much better documented than in Iceland. Moreover, whereas Australia and New Zealand's economies have been successfully stress tested over a long period of time, Iceland has yet to establish a similar track record in more indebted circumstances. Such uncertainty accounts in large measure for the agency's decision to revise the outlook on Iceland's sovereign rating to Negative from Stable.

A special comment will be available on the Fitch website later today and Fitch will hold a teleconference tomorrow, Wednesday 22 February at 14.30 GMT to discuss the agency's views.

Contact: Paul Rawkins, London, Tel: +44 (0)20 7417 4239; Brian

Coulton, +44 (0)20 7417 4097; Alexandre Birry (Financial

Institutions Group), +44 (0)20 7862 4150.

Media Relations: Jon Laycock, London, Tel: +44 20 7417 4327.

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