

## **Fitch Downgrades Iceland to 'A+'/'AA+'; Outlook Stable**

Fitch Ratings-London-15 March 2007: Fitch Ratings has today downgraded Iceland's foreign and local currency Issuer Default ratings ("IDRs") to 'A+' and 'AA+' from 'AA-' (AA minus) and 'AAA' respectively. The Outlook on both ratings is Stable. The Short-term foreign currency rating is also downgraded to 'F1' from 'F1+' and the Country Ceiling is lowered to 'AA-' from 'AA'.

"The downgrade reflects new data on the balance of payments and the international investment position that points to a material deterioration in Iceland's external balance sheet, amplifying concerns about external debt sustainability" says Paul Rawkins, Senior Director in Fitch's Sovereign team in London. Significantly higher net investment income outflows – primarily external interest payments – contributed to an unprecedented current account deficit of 27% of GDP in 2006, up from 16.3% in 2005, while net external debt rose to over 200% of GDP and 429% of current account receipts ("CXR"), compared to Fitch's previous end-2006 forecasts of 161% and 323% respectively.

"Such elevated ratios depict a highly leveraged economy poorly positioned to surmount a prolonged bout of global risk aversion and/or higher international interest rates" says Mr Rawkins. "Moreover, with the current account deficit having continued to deteriorate during the course of 2006, it is becoming increasingly hard to conceive of a smooth unwinding of Iceland's macroeconomic imbalances". A macroeconomic policy mix which exhibits little appetite for fiscal tightening in an election year – the general government surplus is set to decline to 1.1% of GDP in 2007 from 5.3% in 2006 – leaves monetary policy to shoulder most of the burden of policy adjustment in the guise of ever higher interest rates. Set against this background, Fitch believes that the risks of a 'hard landing' – entailing a severe contraction of private sector demand over a sustained period – have increased.

Fitch says that with interest payments now accounting for more than half the current account deficit, the magnitude of external adjustment – a swing of some 15% of GDP in the primary (non-interest) balance – required to stabilise the net external debt/CXR ratio would exceed anything that Iceland has experienced in the past. Few countries have attained this degree of adjustment without sustaining a period of low or negative growth and the agency expects Iceland's current account deficit to remain in double digits for some time to come. Meanwhile, Iceland's negative net international investment position of 119% of GDP in 2006 (up from 84% in 2005) now ranks among the highest of any sovereign in the 'AA'/'AAA' rating ranges. The rising cost of servicing external liabilities relative to the return on external assets also intensifies concerns about the sustainability of higher external borrowing, chiefly by Icelandic banks, to fund investments abroad.

Despite a prospective loosening of fiscal policy, Fitch says Iceland's superior public finance credentials remain firmly intact, justifying the maintenance of a three-notch differential between the local and foreign currency IDRs. However, the agency cautions that countries with seemingly sound public finances cannot afford to be indifferent to private sector-driven macroeconomic imbalances and spiralling net external indebtedness, particularly when banks are the main obligor. Fitch takes comfort from the fact that Icelandic banks have addressed concerns about a bunching of foreign debts maturing in 2007, but points out that their net external liabilities remain high at 168% of GDP, while their domestic operating environment could become more difficult, should a 'hard landing' materialise.

Fitch recognises that Iceland possesses certain strengths that clearly set it apart from other 'single A' category sovereigns: these include per capita income of USD52000, very high standards of governance and strong, transparent institutions. These continue to provide important underpinnings for the sovereign rating. For the moment, however, Fitch argues that these rating attributes are outweighed by Iceland's macroeconomic imbalances and their broader credit implications. The manner in which these imbalances are resolved will hold the key to future rating actions.

A copy of the credit update will be available to subscribers on the Fitch website and Fitch will hold a teleconference on Friday, 16<sup>th</sup> March at 15.00 GMT to discuss the agency's views. Teleconference details will be published separately.

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