

## FITCH AFFIRMS ICELAND AT 'AA-'/ 'AAA'; OUTLOOK STABLE

Fitch Ratings-London-04 August 2005: Fitch Ratings, the international rating agency, has today affirmed the Republic of Iceland's Long-term foreign and local currency ratings at 'AA-' (AA minus) and 'AAA' respectively with Stable Outlook. The Short-term foreign currency rating is affirmed at 'F1+'.

"These ratings balance the near-term concerns of the overheating domestic economy, escalating asset prices and growing net external indebtedness against the longer term benefits that should accrue from the huge investments underway in the aluminium and power-related sectors of the economy," says Paul Rawkins, Senior Director in Fitch's Sovereign Ratings Group in London.

Since it embraced financial and market reforms in the early 1990s, Iceland has enjoyed a comparatively long run of respectable economic growth. Its income per capita is now among the highest in the OECD and the economy is much more resilient to shocks. These achievements owe much to a more robust policy framework - inflation targeting and a floating exchange rate have been important advances. At the same time, fiscal consolidation has brought Iceland's general government debt/GDP ratio in line with the 'AA' rating median.

However, because of the small size of the economy and its narrow production base, output volatility remains high and with it a history of overheating requiring sharp corrective policy action. Revised macroeconomic data for the period 2002-04 indicate that the economy suffered a much harder landing in 2002 than had previously been thought. By the same token, recovery from that recession has been unexpectedly strong, reinforced by a new wave of investment in the aluminium and associated power industries and further financial sector rationalisation.

Fitch notes that the scale of the investment programme is immense, amounting to at least 30% of a single year's GDP. The current programme is spread over the period 2004-07 and will be followed by a further phase of expansion in 2007-08. Assuming that all of these investments materialise, the production capacity of Iceland's aluminium smelting industry will increase almost threefold. In the long term, this should raise Iceland's real GDP by up to 2%, broaden the export base, boost foreignexchange earnings and enhance external debt sustainability. However, in the short term, these investments pose a considerable challenge to macroeconomic stability, coming at a time of rapid expansion of bank lending to the residential sector, which has fuelled higher consumption and house price inflation.

Fitch takes comfort from the high quality of Iceland's institutions and their ability to adapt to policy challenges. Nonetheless, Iceland's experience with a floating exchange rate and inflation targeting is still a fairly short one, while the risk of a 'hard landing' has increased, given the nature of the economic imbalances. Growth is set to exceed 6% this year, accompanied by rising inflation, soaring asset prices and a current account deficit in the region of 12% of GDP.

In Fitch's opinion, Iceland's public finances are well-placed to withstand the impact of a hard landing: general government debt declined to 38% of GDP in 2004 and should fall sharply this year, aided by some of the proceeds from the sale of Iceland Telecom. These strengths, coupled with a well funded pension system, underpin Iceland's sovereign ratings. However, Fitch notes that it is less clear how

well the rest of the economy would fare in less propitious times: households and companies are heavily indebted by international standards, while intensive borrowing by the banks has driven net external debt up to levels far in excess of Iceland's rating peers, leaving it much more susceptible to shocks. Such factors continue to constrain the sovereign ratings and moderate the Outlook, which remains Stable.

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Fitch's rating definitions are available on the agency's public site, [www.fitchratings.com](http://www.fitchratings.com). Published ratings, criteria and methodologies and relevant policies and procedures are also available from this site, at all times. This document will remain on the public site for seven days.

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