ICELAND'S SOVEREIGN RATINGS AFFIRMED; OUTLOOK REVISED TO NEGATIVE

Fitch Ratings-London-15 February 2002: Fitch Ratings, the international rating agency, today affirmed the Long-term foreign and local currency ratings of the Republic of Iceland at 'AA-' (AA minus) and 'AAA' respectively and the Short-term foreign currency at 'F1+'. The Outlook on the Long-term ratings was revised to Negative from Stable.

Iceland's economy has slowed significantly over the past year and, following the move to a floating exchange rate regime in March, the krona has fallen sharply. Real GDP growth fell to an estimated 2.2% in 2001 and the economy is likely to contract in 2002. Against this background, the fiscal balance and general government debt indicators have deteriorated. Fitch notes, however, that the adjustment in growth was necessary to bring the external accounts into better balance and that, after peaking at 10% of GDP in 2000, the current account deficit fell to an estimated 6.6% of GDP in 2001 and is forecast to fall below 5% this year. Nonetheless, the agency is concerned that the adjustment now underway could prove to be more painful than is currently expected.

Iceland's good record on fiscal consolidation and structural reforms during the 1990s, combined with its favourable business environment, puts it in a good position to weather the recession. Despite the 2001 deterioration, the fiscal position and the general government debt-to-GDP ratio still compare relatively well with Iceland's rating peers. However, the public sector's net external debt rose in 2001 due to new borrowing to replenish the Central Bank of Iceland's external reserves and, relative to current account receipts, it is higher than the peer group average. If several privatisations go ahead as planned, then the general government debt-to-GDP ratio could resume its downward trend over the coming period but progress could fall short of the authorities' ambitious goals and a more prolonged recession would have further negative implications for public finances. Such a scenario could also have implications for the banking system. Nonetheless, the sector is starting from a relatively healthy position with a comfortable capital base and low non-performing loans. Moreover, private sector balance sheet difficulties stemming from the devaluation should be limited by the fact that a significant share of foreign currency denominated loans is accounted for by export-oriented companies that have benefited from the currency adjustment. Thus, Fitch does not expect the banking sector to need any official support.

Over the longer term, the adjustment to the current account points to a containment of Iceland's heavy debt burden. The new monetary policy regime of inflation targeting and a market determined exchange rate will reinforce this trend, as well as give the economy greater flexibility to adjust to future external shocks. Even so, the external debt burden will remain a constraint on the rating for some time. Net external debt has risen sharply since the 'AA-' (AA minus) rating was assigned in February 2000 and, at the equivalent of 266% of current account receipts, the ratio is one of the highest of all of the countries that Fitch rates.

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