Fitch Rates Republic of Iceland's EUR Benchmark Bond 'AA-'

Fitch Ratings-London-21 November 2006: Fitch Ratings today assigned the Republic of Iceland's debut EUR1 billion benchmark bond a Long-term rating of 'AA-' (AA minus). This rating is in line with Iceland's foreign currency Issuer Default rating, which was affirmed earlier this month with a Negative Outlook.

Fitch says this sovereign bond issue comes at a critical juncture for Iceland. On the one hand, the country boasts sound public finances and general government debt levels that are closely aligned with the 'AA' median. But, on the other, the authorities are struggling to contain broader macroeconomic imbalances that have manifested themselves in an unsustainable current account deficit and rising net external debt. Fitch adheres to the view that countries with sound public finances cannot afford to be indifferent to severe private sector imbalances. This concern was signalled to investors on 22 February 2006 when Fitch changed the Outlook on Iceland's sovereign ratings to Negative from Stable.

Fitch notes that mounting Treasury deposits at the Central Bank of Iceland ("CBI") mean that general government net debt has fallen sharply to 11% of GDP in 2005 from 23% in 2004, aided by a general government surplus of 5.5% of GDP and half the proceeds (ISK67bn) from the privatisation of Iceland Telecom. The remaining half was used to pay down external debt and net public external debt dropped to 24% of current external receipts ("CXR") in 2005 from 70% in 2002. Government-guaranteed debt amounts to a higher 50% of GDP, on account of the state-owned Housing Finance Fund and the national power company.

Fitch says public sector rectitude stands in stark contrast to the private sector. Iceland is in the midst of a supply side-driven expansion entailing huge investment in the aluminium and associated energy sectors. Over the medium term these projects are expected to broaden the export base, boost foreign exchange earnings and enhance external debt sustainability. In the short term, they have posed a considerable challenge to macroeconomic stability, exacerbated by a restructuring of the housing market and the rapid expansion of Icelandic banks and corporates abroad, funded by heavy international borrowing. Banks account for over 90% of net external debt. Much of this has been contracted at relatively short maturities, posing a roll-over risk that the banks have only recently addressed.

Despite the latter, Fitch says a broader rebalancing of the economy still looks some way off, as the authorities contend with strong aggregate demand and a renewed strengthening of the exchange rate on the back of short-term capital inflows attracted by a wide interest rate differential with the rest of the world. A sharp depreciation of the krona in H106 triggered higher inflation of 7%-8%, prompting the CBI to raise interest rates to 14%. Yet, private consumption and investment have been slow to respond to policy tightening and the current account deficit will breach 20% of GDP this year, while net external debt of well over 300% of CXR will remain the highest of any Fitch-rated sovereign.

Fitch acknowledges that Iceland's high income per head (USD55,000 at market exchange rates in 2005) implies an appreciable ability to sustain high levels of debt, while the private sector has been borrowing to invest in real and financial assets abroad. Nonetheless, Fitch reiterates that Iceland remains a highly leveraged economy with some severe macroeconomic imbalances that could yet impair the country's sovereign rating, should these imbalances ultimately work themselves out in a disorderly manner.

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