Iceland
Credit Update

Republic of Iceland

Ratings

Security Class	Current Ratings
Foreign Currency	
Long-Term IDR	A+
Short-Term IDR	F1
Local Currency	
Long-Term IDR	AA+
Country Ceiling	AA-

Outlook

Sovereign Foreign Long-Term IDR	Negative
Sovereign Local Long-Term IDR	Negative

Financial Data

Iceland

	2007e	2008f
GDP (USDbn)	20	19.4
GDP per head (USD)	66,289	63,827
Real GDP, % change	3.8	0.6
Consumer prices, % change	5.1	9
Government debt, % GDP	28.6	26.4
Net external debt, % CXR	417.4	416.8
International liquidity ratio	77.2	63.4

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Rating Rationale

- On 1 April 2008, Fitch Ratings revised the Outlooks for the Republic of Iceland's Long-Term Foreign and Local Currency Issuer Default Ratings to Negative from Stable. The proximate cause of this sovereign rating action was the decision to put Iceland's three largest banks — Glitnir, Kaupthing and Landsbanki Islands — on Rating Watch Negative. However, in the current climate of intense global risk aversion, it also reflects Iceland's heightened vulnerability to market sentiment in the light of its large gross external financing need (mostly due to banks), its wide current account deficit and rising net external indebtedness.
- Iceland's sovereign credit fundamentals remain strong, underpinned by net general government debt of 7.6% of GDP, a succession of budget surpluses since 2004 and a low debt service burden. Nonetheless, the economy as a whole is highly leveraged: net external debt exceeds 250% of GDP, incomparably high for any Fitch-rated sovereign, while its net international investment position has deteriorated to around 125% of GDP in 2007 from 78% as recently as 2004, as accumulated net debt liabilities have steadily outstripped net equity assets.
- Banks have been the chief conduit of foreign borrowing either for on-lending to Icelandic corporates/households or to expand their own balance sheets, and their total assets have grown more than threefold since 2004 to 900% of GDP. Constrained by a narrow domestic deposit base, these banks have become increasingly dependent on securities issuance in international capital markets, short term credit lines and overseas deposits for funding.
- Turmoil in global credit markets has delivered a negative external shock to Iceland, raising the cost and restricting the access of Icelandic entities (and particularly banks) to foreign capital. Deteriorating investor sentiment, coupled with a continuing large current account deficit projected at over 13% of GDP in 2008, has precipitated a sharp fall in the exchange rate and the prospect of double digit inflation in H208. These factors, combined with further hikes in the policy rate to 15.5%, point to a steep contraction in domestic demand in 2008, exacerbating an already difficult operating environment for banks.

What Could Trigger a Downgrade?

- Heightened risks to macroeconomic stability and sovereign creditworthiness arising from distress in the banking system. The banks are currently sitting on a cushion of liquidity, while the authorities have made statements indicating that they will support them should it become necessary. However, the sheer size of the banks relative to GDP raises questions about the government's ability to deliver on this assurance, while the timing of any support would be critical.
- International reserves alone would be hard pressed to support the banking system through an external funding crisis — Iceland has the lowest international liquidity ratio of any 'A' rated sovereign — pointing to the need to marshal additional foreign exchange resources as a precautionary measure in the current climate of global financial uncertainty. The authorities are looking at a range of options including the issuance of sovereign foreign debt.
- Continued deterioration in the credit profiles of Iceland's major banks, leading to heightened perceptions of the need for sovereign support, could put downward pressure on Iceland's sovereign ratings. Conversely, timely and more concrete policy responses have the potential to restore confidence without severely imperilling sovereign creditworthiness.

Key Indicators for Iceland

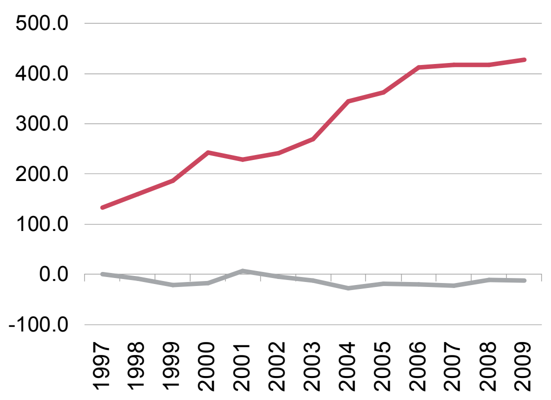
Population (2007e): 0.3m
Population Growth Rate (2002-2007e): 1.0% p.a.
GDP (2007e): USD20.0bn
GDP per Head at Market Exchange Rates (2007e): USD66,289
GNI Per Head at Purchasing Power Parity (2006): USD35,980 (= 81% of USA level)
Modern Sovereign Rescheduling History: None

	2003	2004	2005	2006	2007e	2008f	2009f
Domestic Economy and Finance							
Real GDP Growth (%)	2.4	7.7	7.1	4.2	3.8	0.6	-0.8
Unemployment (% of Labour Force)	3.3	3.1	2.1	1.3	1.1	1.7	2.5
Consumer Prices (Annual Average % Change)	2.1	2.8	4.2	6.7	5.1	9.0	4.5
Gross Domestic Savings (% of GDP)	16.7	17.8	15.9	16.9	17.1	17.5	19.7
Gross Domestic Investment (% of GDP)	19.8	23.4	28.3	34.8	27.7	24.3	23.3
Short-Term Interest Rate (%)(1)	5.4	6.1	9.4	12.5	13.3	14.5	12.0
Broad Money (% Change Dec to Dec)	22.4	13.5	29.3	60.1	9.6	9.9	4.2
ISK per USD (Annual Average)	76.71	70.19	62.98	70.20	64.1	72.5	70.0
REER (CPI, 2000=100)	98.9	101.6	114.6	106.8	112.8	104.8	110.9
REER: % Change (+ = Appreciation)	6.3	2.8	12.7	-6.8	5.6	-7.1	5.8
Public Finances							
General Government Balance (% of GDP)	-2.8	0.2	5.2	6.9	5.2	2.7	-1.1
General Government Debt (% of GDP)	40.8	34.5	25.4	30.2	28.6	26.4	26.4
General Government Debt Maturities (% of GDP)(2)	5.4	5.6	5.6	4.1	3.1	2.8	2.6
General Government Debt/Revenue (%)	95.5	77.9	53.6	62.1	59.3	57.8	61.1
Interest Payments/Revenue (%)	6.4	5.4	4.5	4.4	5.3	5.1	5.2
Balance of Payments							
Current Account Balance (USDbn)	-0.5	-1.3	-2.6	-4.2	-3.2	-2.6	-1.9
Current Account Balance (% of GDP)	-4.9	-10.0	-16.2	-25.5	-16.0	-13.6	-9.1
Current Account Balance plus Net FDI (USDbn)	-0.6	-3.1	-6.6	-5.5	-12.3	-4.1	-3.9
Current Account Balance plus Net FDI (% of GDP)	-5.3	-23.8	-40.7	-33.3	-61.4	-21.3	-18.7
Gross Financing Requirement (% of Official Reserves)(3)	465.6	381.1	584.5	716.9	562.2	353.0	586.5
Current External Receipts CXR (USDbn)	4.2	5.0	6.6	7.9	12.1	13.2	14.0
Current External Receipts CXR (Annual % Change)	12.3	20.4	32.3	19.5	52.5	9.8	5.9
Current External Payments CXP (USDbn)	4.7	6.3	9.3	12.1	15.2	15.9	15.9
Current External Payments CXP (Annual % Change)	31.9	34.8	46.6	31.1	25.6	4.1	0.4
External Assets and Liabilities							
Gross External Debt (USDbn)	16.2	26.9	45.6	71.7	112.3	108.3	116.7
Gross External Debt (% of GDP)	148.0	203.0	279.9	430.8	562.4	558.6	557.5
Gross External Debt (% of CXR)	391.1	537.3	689.5	906.5	931.3	818.3	831.8
Net External Debt (USDbn)	11.2	17.2	24.0	32.6	50.3	55.2	60.0
Net External Debt (% of GDP)	102.0	130.3	147.0	196.1	252.1	284.5	286.7
Net External Debt (% of CXR)	269.4	344.9	362.2	412.6	417.4	416.8	427.8
Public External Debt (USDbn)	3.1	3.5	2.4	3.4	3.9	3.5	3.3
Public External Debt (% of GDP)	28.4	26.3	14.9	20.5	19.7	18.1	15.9
Net Public External Debt (% of CXR)	55.2	48.1	20.8	13.5	10.8	6.6	4.9
Public FC Denominated & FC Indexed Debt (USDbn)	2.7	2.7	1.7	2.7	2.7	2.4	2.3
Short-Term External Debt (% of Gross External Debt)	21.4	18.1	15.5	16.6	36.7	34.8	34.9
External Debt Service (% of CXR)	47.9	45.9	69.5	73.0	120.6	92.1	137.1
External Interest Service (% of CXR)	9.2	10.1	14.7	30.0	37.9	42.1	40.4
Liquidity Ratio (%)(4)	22.9	40.5	39.9	71.2	77.2	63.4	50.8
Official International Reserves Including Gold (USDbn)	0.8	1.1	1.1	2.3	2.6	2.6	2.6
Official International Reserves in Months of CXP Cover	2.1	2.0	1.4	2.3	2.1	2.0	2.0
Official International Reserves (% of Broad Money)	12.0	12.0	9.5	14.8	13.1	13.5	13.0

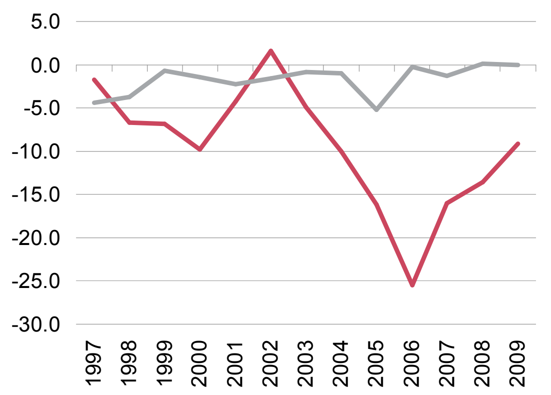
(1) Central Bank policy interest rate (annual average).
(2) Maturities of medium and long-term debt during year plus short-term debt outstanding at the beginning of the year.
(3) Current account balance plus amortization of medium and long-term debt, over official international reserves.
(4) Official reserves incl. gold plus banks' foreign assets/ Debt service plus liquid external liabilities.

Peer Comparison

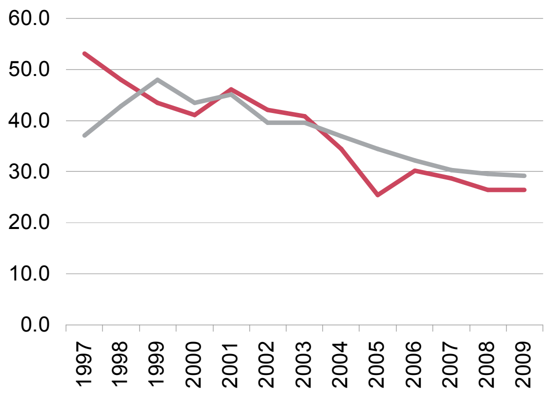
Net External Debt
% of CXR



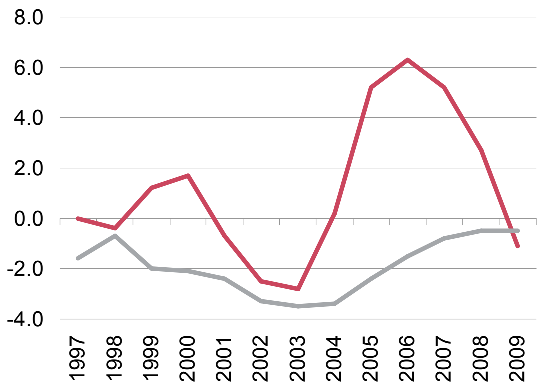
Current Account Balance
% of GDP



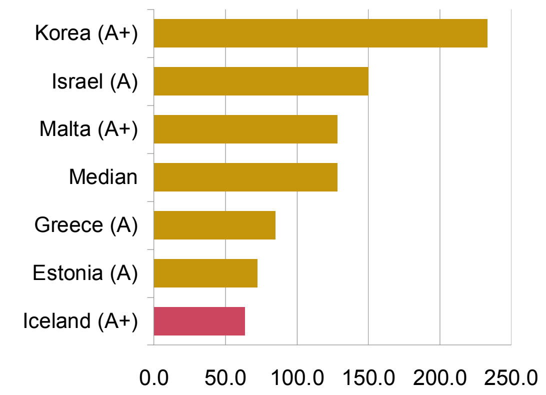
General Government Debt
% of GDP



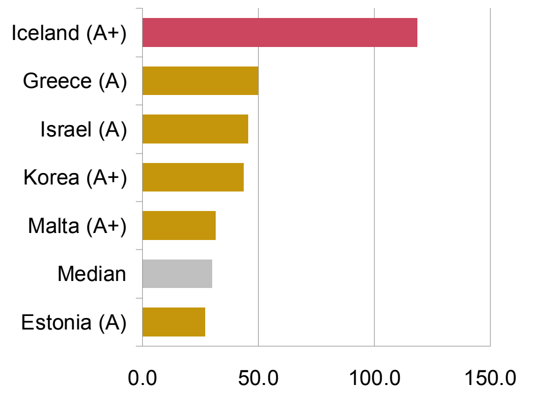
General Government Balance
% of GDP



International Liquidity Ratio, 2007
%



GDP per capita Income, 2007[e]
At market exchange rates, USA=100



Iceland

A Median

Peer Group

Rating	Country
AA-	Cyprus
	Italy
	Kuwait
A+	**Iceland**
	China
	Czech Republic
	Korea
	Malta
	Saudi Arabia
	Taiwan
A	Bahrain
	Chile
	Estonia
	Greece
	Israel
	Lithuania
	Slovakia

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
3 Feb 2000	AA-	AAA
15 Mar 2007	A+	AA+

Iceland is currently paying the price for a five-year borrowing spree that has left the country highly leveraged and poorly positioned to surmount a prolonged bout of global risk aversion. The initial reasoning behind more rapid economic expansion was well-grounded in a series of aluminium smelters, designed to capitalise on the economy's low cost renewable energy sources and diversify the export base away from marine products. Following a surge in investment, leading in part to a record current account deficit of 26% of GDP in 2006, these projects are now coming on stream providing a significant boost to export receipts which has started to narrow the trade and current account deficits.

Had Iceland's growth aspirations been limited to domestic expansion, the chances are that the economy would have been little more leveraged now than it was in 2001-2002, since inward foreign direct investment broadly matched larger current account deficits in 2003-2007. However, the authorities reckoned without the unbridled overseas expansion of Icelandic corporates and banks. Huge outflows of foreign investment (direct and portfolio equity) and net lending abroad since 2003, amounting to 164% of GDP in 2007, have been financed by a 10-fold increase in gross external debt. Banks have accounted for over 90% of this debt build up either for use on their own account or for onlending to Icelandic corporates. Admittedly these investments are now yielding sizeable returns, but it is notable that close to 50% of the current account deficit in 2008 will be accounted for by net outflows of profits, dividends and interest payments compared to virtually zero in 2002.

Iceland is a small, high income, open economy and this wave of overseas investment has been undertaken on rational grounds by the private sector; nonetheless, the scale and the pace of it have been breathtaking, while the risks to the sovereign are non-negligible. The macroeconomic consequences have been clear in terms of heightened volatility of the ISK, interest rates and inflation, while the economy as a whole has become much more vulnerable to external shocks. Thus, a prolonged reversal in investor sentiment could precipitate a steep domestic downturn and growing concerns about the stability of the banking system, should access to international capital markets remain limited. Given the size of the banks relative to GDP, it is hard to imagine that the authorities could distance themselves from a systemic crisis given the dislocation that would be likely to follow.

Fitch continues to attach a very low probability to sovereign default: the government has a very low debt service burden and retains considerable capacity to raise funds in ISK and foreign currency. The banks survived a significant market stress test in 2006, prompting them to secure longer term funding and build external liquidity. Nonetheless, external funding uncertainties remain and the longer the global credit squeeze endures, the less adequate Icelandic banks' reserves will appear, amplifying the potential need for sovereign support. Timely concrete precautionary measures to crystallize support for the banks could help to restore confidence and minimise the future fall-out for sovereign creditworthiness.