

Iceland
Special Report

Iceland and the Banks: Questions and Answers

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Peer Group

Rating	Country
A+	Iceland
	China
	Czech Republic
	Korea
	Malta
	Saudi Arabia
A	Taiwan
	Bahrain
	Chile
	Estonia
	Greece
	Israel
	Lithuania
A-	Slovakia
	Malaysia
	Poland

Rating History

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

Introduction

The Icelandic economy has been subject to heightened investor scrutiny since Fitch Ratings first put the sovereign rating on Negative Outlook in February 2006. Whereas the key drivers behind that rating action and the downgrade that followed were quite country specific, Iceland's current predicament stems from the onset of global financial-market turmoil since August 2007. This has raised many concerns about the rate of expansion of Icelandic banks, their ability to overcome limited market access and much less favourable investor sentiment, and the broader implications of a potential financial crisis for the economy and sovereign creditworthiness. This Special Report examines the background to Iceland's financial dilemma and seeks to answer many of the questions investors have posed to Fitch over the past few months.

How does the current situation differ from previous negative rating actions?

The revision of the Outlooks on Iceland's sovereign ratings to Negative from Stable in April 2008 marks the continuation of a trend that began in February 2006, when Iceland's ratings were placed on Negative Outlook prior to a downgrade of the Foreign and Local Currency Issuer Default Ratings (IDRs) from 'AA-'/ 'AAA' to 'A+'/'AA+' in March 2007.

The key rating drivers behind the 2006-2007 actions were very country specific. Rapid expansion of the economy both at home – chiefly the construction of a series of aluminium smelters – and abroad – a wave of overseas investment driven by banks and corporates – had generated unsustainable macroeconomic imbalances and soaring net external debt. While the rise in indebtedness was firmly rooted in the private sector and intermediated by the banks, Fitch perceived a potential and growing risk for the relatively debt-free sovereign, should the banks encounter external funding difficulties¹.

Icelandic banks treated the market volatility that ensued as a "wake-up call", taking this as their cue to stretch out maturities, broaden their investor/deposit bases and build liquidity. In this sense, Icelandic banks were much better prepared for the global credit squeeze that started to gather pace throughout H207 than they would have been a year earlier. Nonetheless, there was little diminution in Icelandic banks' appetite for overseas expansion, and their net external liabilities continued to rise to over 200% of GDP by end-2007, leaving them vulnerable to global risk aversion and higher interest rates.

Iceland's current predicament stems from the onset of global financial-market turmoil since August 2007, which has delivered a negative external shock to the economy as a whole and the banks in particular. The proximate cause of April's negative sovereign rating action was the decision to put Iceland's three largest banks – Glitnir Banki hf., Kaupthing Bank hf. and Landsbanki Islands hf. – on Rating Watch Negative. However, it also reflects Fitch's view that Iceland is poorly placed to ride out a prolonged bout of global risk aversion in the light of its large gross external financing need, its wide current account deficit and its rising net external indebtedness.

¹ Iceland's narrow deposit base has led banks to fund themselves mostly in the international capital markets. A gaping current account deficit, coupled with a distinct hump in redemptions in 2007, pointed to significant market and roll-over risk in Fitch's view.

Following last year's downgrade, is Iceland now viewed as an "emerging market"?

While it is true that the broad 'A' rating category (sovereigns rated 'A+', 'A' or 'A-') is heavily populated with emerging markets, it would be a mistake to assume that Iceland had been reclassified as an emerging market. Sovereign ratings are a synthesis of many factors, quantitative and qualitative. Strong public finances play to Iceland's advantage, but they are not remarkable in the 'A' context, whereas Iceland's net external debt undoubtedly is, marking it down as a rank outsider compared to 'A+'-rated peers like China, Korea and Saudi Arabia.

The single most tangible indicator that distinguishes Iceland from its emerging-market peers is its income per head: measured at market exchange rates (USD68,670 in 2007), it is among the highest in the OECD and three times higher than for Israel, the wealthiest emerging market in terms of income per head.

Qualitative factors – high standards of governance and transparency, robust institutions and a responsive policy framework – are defining features of a developed economy and work decisively in Iceland's favour. Likewise is its fully functioning market economy, well integrated into and aligned with the EU through the European Economic Area.

Has the wave of investment in the real economy done nothing to alleviate Iceland's external vulnerabilities?

Yes and no. 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, helping to narrow the trade and current account deficits.

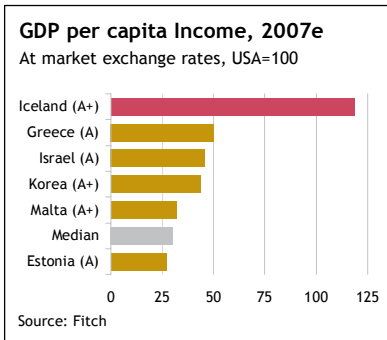
Had Iceland's growth aspirations been limited to domestic expansion, the chances are that the economy would have been little more leveraged now than it was in 2001-2002, since inward foreign direct investment broadly matched larger current account deficits in 2003-2007. However, the authorities reckoned 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 tenfold 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. Moreover, despite a 53% increase in current external receipts (CXR) in 2007, Iceland's net external debt ratios continued to rise to 417% of CXR and 253% of GDP (among the highest of any Fitch-rated sovereign), raising concerns about external debt sustainability over the medium term.

How has the global credit crunch affected the macroeconomic outlook for Iceland?

Iceland was always going to be vulnerable to a less benign global credit environment, given the magnitude of its external imbalances and its growing dependence on short-term capital inflows.

At 350% of official reserves, gross external financing needs – current account deficit plus medium- and long-term amortisation payments – are still among the highest of any developed country outside the EU (much higher ratios are not



Net external debt ratios remain high, despite a 53% increase in current external receipts in 2007

Gross external financing needs remain high

unusual within the euro area). Short-term liabilities as a share of gross external debt also jumped to 37% in 2007 from 17% in 2006, as short-term inter-bank lines and non-resident deposits (including overseas retail deposits) rose sharply.

Year on year, the ISK has depreciated by more than 20% against the EUR, with the sharp lurch downwards in March precipitating the highest policy interest rates in Europe (15.5%) and double-digit inflation of 11.8% in April. These developments have hastened the probability of a “hard landing” as households and corporates adjust to a much harsher economic environment.

The private sector is highly leveraged: household and corporate debt combined more than doubled from 184% of GDP in 2004 to over 400% at the end of 2007, high by any standard. Most household debt is long term and index linked, and lags behind changing credit conditions, as higher debt service costs are spread over long periods. However, foreign-currency lending to households has been growing rapidly and accounted for 23% of total household debt to banks by the end of March 2008, almost all of which is unhedged.

Households and corporates are highly leveraged

Over 60% of commercial bank lending in Iceland is to the corporate sector; of this, almost 70% is denominated in foreign currency. Some sectors, like fisheries, are almost perfectly hedged by virtue of their foreign-currency earnings, but many of the fastest-growing sectors – holding companies, services, retail and construction – are less well positioned. Q108 results indicate that some Icelandic companies have sustained significant exchange-rate-related losses at a time when their domestic cost base is also rising sharply, raising some concerns about future bank asset quality.

A prolonged credit squeeze and rising risk premia could trigger a pronounced downturn in the housing market. Iceland has witnessed some of the steepest increases in house prices among developed countries and residential investment rose to 7% of GDP in 2007. The Central Bank of Iceland’s (CBI) forecasts of a 30%-40% fall in house prices in real terms in 2008-2010, should they materialise, would rival the reversals experienced by some Nordic countries in the early 1990s.

Asset prices look set to fall further

Equity prices have shadowed the ISK: the OMXI15 index dropped by 50% between July 2007 and March 2008, depressed by the financial sector, which accounts for almost 80% of the index. Icelandic banks hold a high proportion of equities on their balance sheets, much of it as collateral for forward security sales transactions for customers, while related-party interests between banks and Icelandic corporates and investment companies further magnify their vulnerability to stock market volatility².

So where does this leave the banks?

Fitch downgraded the Foreign Currency IDRs of two of Iceland’s three major banks – Glitnir and Kaupthing – from ‘A’ to ‘A-’ on 9 May 2008, while leaving the third, Landsbanki, unchanged at ‘A’. All three banks have also had their Foreign Currency IDRs placed on Negative Outlook. A deteriorating business environment and ongoing funding challenges in wholesale markets were key factors behind these actions.

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 foreign operations, 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 debt issuance in international capital markets (50% of total funding), short-term credit lines and overseas deposits for funding.

² SPRON, the largest savings bank in Iceland, suffered extensive losses on its shareholdings in Exista in Q108, leading it to enter merger discussions with Kaupthing.

Banks' External Assets and Liabilities

(USDbn)	2006	2007
Assets		
Portfolio equity	3.0	4.6
Debt securities	3.1	6.7
Loans	23.6	33.8
Currency + deposits	5.8	11.1
Liabilities		
Portfolio equity	2.2	3.4
Debt securities	44.4	47.5
Loans	9.8	28.4
o/w: Short term	5.2	18.1
Currency + deposits	5.1	20.8

Source: IMF

External Debt Service

(USDbn)	2008	2009
Amortisation*		
General government	0.2	0.2
Financial institutions	5.7	11.4
Other private	0.7	2.0
Interest payments		
	5.6	5.7
Short-term debt	41.2	37.7

* Medium- and long-term debt
Source: CBI, Fitch

Non-resident deposits have increased significantly since mid-2006 and now account for well over half of all deposits. On the one hand, banks have heeded investors' concerns and diversified their funding mix³; on the other, access to longer-term funding has become increasingly restricted. International investment position data indicate that Icelandic banks' dependence on short-term external funding increased significantly in 2007. Admittedly, some of this build-up was attributable to the banks' drive for overseas retail deposits (particularly in the UK). Nonetheless, the mobility of deposits in a mature market like the UK should not be underestimated and the banks' vulnerability to sudden shifts in investor sentiment remains high.

The banks survived significant market stress in 2006, prompting them to secure longer-term funding and build external liquidity. All three major banks maintain that they can afford to stay out of international capital markets for the remainder of 2008 if they have to. Credit default swap spreads have tightened markedly in recent weeks (albeit from extremely high and unsustainable levels); still, global perceptions have played a large part in this and the spreads remain four to five multiples above other similarly rated banks, implying limited market access at very elevated interest rates.

The longer the global credit squeeze endures, the less adequate banks' liquidity will appear. Refinancing needs appear manageable this year, but lack of market access could become more problematic in 2009 as refinancing needs rise to USD11.4bn. Moreover, even in a climate of improving credit conditions, it could take time for investors to become more comfortable with Icelandic bank risk.

Banks' liquidity risk promises to be accompanied by heightened credit risk, reflecting the impact of higher interest rates, the depreciation of the ISK and the possibility of a hard economic landing domestically and slower growth overseas. Icelandic banks are soundly capitalised (with low non-performing loans and very little exposure to sub-prime lending) and have diversified their portfolios geographically⁴. Nevertheless, sharp contemporaneous economic slowdowns in Iceland and the UK – which together account for more than 50% of banks' assets – could have a highly negative impact on asset quality.

Allied to these risks are nagging concerns about the banks' reliance on potentially vulnerable revenue streams from investment banking and capital markets, which could be adversely affected by ongoing market dislocation and more challenging operating conditions⁵.

How would the sovereign be implicated?

In a worst-case scenario, where banks continue to encounter limited access to external funding beyond 2008, against a backdrop of domestic recession and global slowdown, sovereign support could become necessary.

The authorities have stated that they will support the banks if necessary. However, the sheer size of the potential funding challenge relative to the limited resources of the sovereign raises concerns about the extent to which any deterioration in the banks' credit ratings would ultimately tarnish the superior creditworthiness of the sovereign.

³ Loan/deposit ratios for the three major banks fell from 336% at the end of 2006 to 230% in Q108. Even so, these remain among the highest of any banks rated by Fitch.

⁴ 90% of banks' assets are located in Iceland (39%), other Nordic countries (33%) and the UK (18%).

⁵ For further details, see recent Credit Analyses on Glitnir bank hf., Kaupthing Bank hf., and Landsbanki Islands, published in May 2008 and available to subscribers of the Fitch website.

Fiscal Costs of Bank Crises (% of GDP)

Country	Crisis Period	Gross Outlay
Chile	1981-1983	52.7
Finland	1991-1993	12.8
Indonesia	1997-2003	56.8
Korea	1997-2000	31.2
Norway	1987-1989	2.5
Sweden	1991-1993	4.4
Thailand	1997-2000	43.8
Turkey	2000-2003	29.7
USA	1984-1991	3.7
Venezuela	1994-1995	15.0

Source: IMF

Given the size of the Icelandic banks relative to GDP (900%) and the lack of foreign parents with deep pockets⁶, it is hard to imagine that the authorities could distance themselves from a systemic crisis, particularly because of banks' huge net external liabilities (200% of GDP). Few countries boast banking systems so large in relation to the size of their economies: those that do – Ireland and Luxembourg⁷ would be the nearest comparators – are international financial centres with robust net external creditor positions. Ireland and Luxembourg are also members of the euro area, with access to the European Central Bank's large pool of foreign-exchange reserves.

The traditional role of the sovereign in a banking crisis is to provide sufficient liquidity to arrest depositor and creditor runs and stabilise banks' liabilities. Should liquidity support fail and/or asset quality deteriorate, solvency support (ie recapitalisation) could also become necessary. This is to overstate the dilemma currently facing Icelandic banks: deposits (domestic and foreign) continue to grow and the banks are sitting on significant cushions of liquidity. Nonetheless, the sovereign may have to stand ready to lend external support if investors continue to shy away from medium-term Icelandic bank refinancing risk. Although 2008 is a light refinancing year for the banks, refinancing needs will rise to 60% of GDP in 2009.

Assessing the cost of financial crises is always difficult: the worst crises have cost over 50% of GDP. In general, the gross fiscal outlay has been less in industrial countries than in emerging markets, while the net cost is invariably lower as governments recover their initial outlay over time. In the case of Sweden, for example, the final cost was zero. The latest edition of the CBI's Financial Stability Report employs some stylised assumptions based on World Bank data to arrive at a potential clean-up cost in the Icelandic case of 30%-40% of GDP, split evenly between the fiscal impact and lost output⁸.

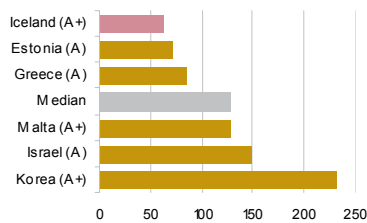
Does the sovereign have the financial firepower to support the banks?

While there is no denying the authorities' willingness to support the banks, there has been a question mark over their ability to deliver foreign-currency support. International reserves amount to just 13% of GDP and would be ill-matched to the task of supporting the banking system through an external funding crisis. This shortcoming is underlined by the fact that Iceland has the lowest international liquidity ratio (63%) – liquid external assets as a percentage of liquid external liabilities – of any country in the 'A' category.

Iceland's strong sovereign credit fundamentals represent its trump card. Sustained general government surpluses of 5%-7% of GDP since 2005 have reduced public debt to 28.6% of GDP in 2007, which is at the low end of the broad 'A' spectrum. Externally, public foreign-currency assets and liabilities are evenly matched. As such, the government enjoys a very low debt service burden and retains considerable capacity to raise new debt in both ISK and foreign currency. Indeed, were its funding needs dictated solely by budgetary considerations, it would have no need to issue new debt in 2008.

On 16 May 2008 the CBI announced that it had concluded bilateral swap arrangements with the central banks of Denmark, Norway and Sweden, giving it access to EUR1.5bn of foreign currency. Although this sum is modest in relation to the size of the banks' liquid external liabilities, it sends a key message to investors

International Liquidity Ratio, 2007
Liquid assets % liquid liabilities



Source: Fitch

⁶ In 'AA+'-rated New Zealand, for example, where banks also have very high net external liabilities and rely heavily on funding from global capital markets, the banking system is almost 100% owned by foreign parents domiciled in a still stronger national financial jurisdiction (Australia).

⁷ Banks' assets as a % of GDP stood at 619% in Ireland and 2,432% in Luxembourg at the end of 2006.

⁸ See CBI Financial Stability Report 2008, 'The importance of averting a financial crisis' page 38.

that the authorities are serious about mounting a timely and credible defence of the banking system, should it become necessary. As such, it builds confidence – both the ISK and the stock market rallied on the day of the announcement and banks’ CDS spreads tightened further – and could hasten the banks’ access to longer-term funding.

Drawdown of these swap facilities would effectively double Iceland’s international reserves to almost USD6bn. Further measures are underway to bolster the central bank’s international liquidity.

How would public-sector-funded external support for the banks affect the sovereign rating?

Fitch continues to attach a very low probability to sovereign default in Iceland. Nonetheless, were the government obliged to borrow say USD5bn-10bn (25%-50% of GDP) in the international capital markets to support the banks, it could materially weaken the sovereign’s balance sheet, placing downward pressure on the sovereign rating, depending on how it was applied.

In a renewed stress scenario in 2009 – where banks suffered say a 10% haircut on non-resident deposits, a 90% roll-over on short-term debt and an opening stock of liquid assets USD3bn down on 2008 – Fitch believes Icelandic banks could be looking at a funding shortfall of some USD7bn (35% of GDP) in 2009. Compared to the fx resources currently being marshalled by the CBI, this begins to look like a “manageable” scenario. While the authorities could not risk running international reserves down to zero, being able to point to sovereign liquidity of this magnitude would help to restore confidence.

If the CBI were to borrow USD5bn-10bn, boosting the international reserves by an identical amount as an outward demonstration of its much enhanced financial firepower, net public debt would remain unchanged and the pressure on the sovereign rating would accordingly be much less. However, as soon as it actively employed these funds to support the banks, Iceland’s public-debt dynamics would start to change.

If all the funds so raised were used to support banks, gross general government debt would rise to between 50% and 75% of GDP. Iceland would not be alone in the ‘A’ range in carrying such a high public debt load: Malta (‘A+’) has a public debt/GDP ratio of 61% and Israel (‘A’) and Greece (‘A’) have higher ratios. However, Malta and Israel are net external creditors, while Greece’s net external debt ratios are significantly lower than Iceland’s and enjoy the added comfort of euro membership, which eliminates fx risk. Thus, such an uplift in Iceland’s public debt would imply some diminution in sovereign creditworthiness.

Were the government to take the alternative route of guaranteeing banks’ debt issuance for refinancing purposes, the direct impact on the government’s balance sheet would be minimal (unless the guarantees were called). However, it is worth recalling that government-guaranteed debt is already high in Iceland, standing at some 60% of GDP at end-2006, over 80% of which is accounted for by the Housing Finance Fund. Providing additional guarantees to the banks could lift the government’s indirect exposure to the financial system to as much as 100% of GDP and potentially much higher if a blanket guarantee proved necessary to stabilise domestic deposits (39% of GDP).

Material financial support to the banks would also carry broader policy implications. Significantly higher debt service costs would feed through to the government’s “bottom line” at a time when the authorities are already signalling a slide into deficit by 2009. Such a development could precipitate a far-reaching review of tax and expenditure policies to address medium-term fiscal sustainability concerns.

Selected Debt Ratios (% of GDP) 2007

Country	General govern't debt	Net external debt
Iceland (A+)	28.6	252.1
Korea (A+)	39.3	0.0
Malta (A+)	61.1	-48.1
Greece (A)	91.3	63.3
Israel (A)	80.8	-25.9
Malaysia (A-)	42.4	-38.6
Poland (A-)	46.7	16.0

Source: Fitch Comparator

A key point to note in the scenario being painted here is that Iceland's overall net external debt ratios would remain unchanged (although they might rise as a percentage of GDP if there was a further fall in the ISK). However, the distribution of external debt between obligors would change, as public external borrowing was substituted for banks' capital market exposure. Moreover, sovereign creditworthiness would have been impaired, as the government acquired potentially significant net new external liabilities. That said, though, it would be reasonable to expect the sovereign to recover its investment in the banks over time; some bank bail-outs have ultimately cost the sovereign involved very little.

What is the risk of capital controls being imposed?

Remote. Iceland's Country Ceiling of 'AA-' is one notch above the sovereign. This reflects the extreme openness of the economy – Icelandic entities have become increasingly international in character – and high levels of governance and institutional strength that militate against arbitrary economic policy decisions.

Barring an acute speculative attack on the ISK, the chances of Iceland imposing capital controls are remote

Restrictions on capital flows in advanced economies have been virtually eliminated and the capacity of governments in countries with complex free market and open economies to impose capital controls has greatly decreased. Iceland is no exception: membership of such organisations as the OECD and the European Economic Area actively discourages the imposition of capital controls, an undertaking that Fitch believes Iceland would be highly unlikely to breach.

Nonetheless, in a small economy like Iceland's, where the currency is the key reference price and international reserves are very limited, it is possible to conceive of a situation, however remote, where the currency comes under acute speculative attack, forcing the authorities to take some form of pre-emptive action. In that event, it would not be surprising if the authorities also extended a blanket guarantee to domestic deposits and were obliged to provide entity-specific or liability-specific support.

Was the mini crisis in March-April a case of the banks scrambling to raise foreign currency to pay foreign debts?

No, the steep fall in the ISK was due to market failure as the rising cost of borrowing abroad for the banks virtually eliminated the interest rate differential that they could offer on foreign-exchange swap agreements. As a result, the swap market seized up at the end of March, leaving companies with domestic foreign-currency obligations scrambling to buy foreign exchange to hedge their positions (a service normally performed by banks).

Had the authorities done nothing to address domestic investors' lack of foreign-currency liquidity, the impact on monetary policy and the financial system could have been more severe. In the event, the CBI took steps to inject fresh liquidity into the market by issuing fully transferable certificates of deposit and lightening the reserve requirements of banks with foreign branches, thereby freeing up additional foreign liquidity.

These measures, coupled with higher policy rates and the recent announcement of new swap facilities with Nordic central banks, have helped to stabilise the exchange rate and the ISK has recovered some lost ground against the EUR and the USD since the dark days of March.

Iceland is being penalised for its banks' overseas ambitions. Supposing the three major banks relocated their head offices abroad, wouldn't this alter the balance?

Not really. This supposition assumes that Iceland is no more than an offshore financial centre with few linkages to the domestic economy. It is true that banks' foreign borrowing has been used to fund Icelandic corporates' purchases of foreign

assets (including equity stakes in the UK retail sector, for example). However, if this were the whole story, then the overall external balance sheet for Iceland plc, including debt and equity, would not have deteriorated to the extent that it has. As it is, Iceland's international investment position is among the weakest of any country in the upper strata of investment grade.

Even if Icelandic banks relocated abroad, they would still be heavily exposed to the Icelandic economy: between one-third and half of their deposit base is rooted in Iceland, while up to half of their revenues originate in Iceland. Less well understood is the impact relocation would have on the banks' domestic loan book (350% of GDP), which would effectively become non-bank private-sector external liabilities, greatly diluting the perceived advantages of relocation on Iceland's debt ratios.

For the banks themselves, their underlying fundamentals would remain unchanged, while the issue of support could become more problematic, given that the overseas jurisdiction would have little incentive to render assistance in a crisis. In light of their strong Icelandic ties, they could therefore remain a potential contingent liability of the Icelandic authorities, regardless of their geographical location.

Following this spate of macroeconomic and financial instability, what policy lessons are there to be learned?

Iceland is a developed market economy and the banks are essentially free to make their own decisions without government interference. That said, and in retrospect, it is legitimate to ask whether the financial regulator should have exercised greater scrutiny over the banks' business model, their rate of expansion and their reliance on wholesale funding.

The effectiveness of monetary policy leaves much to be desired. Double-digit policy rates have had little impact on the real economy, yet at 11.8% yoy in April inflation remains as far removed as ever from the CBI's target of 2.5%. The shortcomings of the transmission mechanism are due in no small part to pervasive indexation. Meanwhile, the exchange rate remains a key reference price, which is unusual in an economy as developed as Iceland's.

The role of the state-controlled Housing Finance Fund (HFF) also remains poorly defined and has at times actively undermined the effectiveness of monetary policy, exacerbating Iceland's macroeconomic imbalances. Recent policy statements on the restructuring and reform of the HFF are encouraging in this respect.

Ex-post, Iceland has run substantial budget surpluses since 2005; ex-ante, fiscal policy has not always appeared consistent with the need to rein in Iceland's macroeconomic imbalances. Thus, the government has remained wedded to tax cuts, even as domestic demand was expanding at double digits and the current account deficit was running at record levels. Better co-ordinated monetary and fiscal policies could help dampen macroeconomic volatility.

Fiscal prudence remains the watchword of government policy. However, should the government ultimately be called upon to make good on its commitment to support the banks, new challenges could arise in relation to medium-term fiscal sustainability.

Recent events have inevitably reopened the debate about the merits of joining the euro area: euro membership would render Iceland's external imbalances less dominant, eliminate currency risk and allow Iceland's fiscal policy strengths to better assert themselves. However, the prospects of Iceland converging to euro area rates of inflation and interest rates in the near term are remote.

Redomiciling Icelandic banks abroad would not automatically transform Iceland's external balance sheet

Economic and financial volatility has exposed policy shortcomings

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