FITCH: ICELAND EXCHANGE RATE STABILITY KEY TO IMF PROGRAMME

Fitch Ratings-London-20 November 2008: Fitch Ratings says yesterday's IMF Executive Board approval of a two-year USD2.1bn stand-by arrangement (SBA) for Iceland ('BBB-'((BBB minus))/Rating Watch Negative) with immediate disbursement of USD827m, will provide the authorities with much needed financial support to restore confidence in the ISK, restructure the financial system and stabilise the economy.

"This keenly anticipated financial rescue programme comes at a critical juncture for Iceland: the collapse of the banking system has inflicted severe dislocation on the economy and the conduct of international trade. It is imperative that the authorities move quickly to stabilise the currency and lay the foundations for economic recovery and a normalisation of financial flows," said Paul Rawkins, Senior Director in Fitch's Sovereign Ratings Group.

While the need to restore a fully functioning banking system is paramount, the government recognises that its first objective must be to stabilise the currency in a sustainable manner. Given the elevated degree of leverage throughout the economy and the high concentration of foreign exchange and inflation indexed debt, a further steep fall in the ISK would inflict severe financial distress on households and corporates. While the current account is set to swing into surplus in 2009, Fitch cautions that the stance of non-resident investors who hold some ISK400bn (USD2.3bn equivalent at current exchange rates) of liquid domestic assets will be key in the near term. Potential pressures to close these positions and repatriate foreign exchange point to the temporary maintenance of capital controls, tight liquidity and continuing high policy rates, currently at 18%.

Fitch notes that financial crises of the magnitude that Iceland has experienced are invariably accompanied by sharp contractions in output and deteriorating public finances. The Icelandic authorities are forecasting a 10% fall in real GDP in 2009, accompanied by a spike in inflation to some 23% in Q109 and a rise in unemployment to 10% by end-2009. Iceland's economy has exhibited an impressive ability to respond to external shocks in the past. However, Fitch emphasises that tight monetary policy, coupled with the indebtedness of the household and corporate sectors, and the prospect of steep falls in asset prices, all point to a difficult period of adjustment, further complicated by the adverse global economic outlook.

Robust public finances have been a sovereign rating strength for Iceland and maintenance of investment grade status reflects the authorities stated commitment to prioritise sovereign debt service in the face of significant financial sector distress. Nonetheless, Iceland's sovereign ratings remain on Rating Watch Negative. Preliminary IMF estimates put the combined fiscal cost of recapitalising the banking system and honouring deposit insurance obligations at 80% of GDP, taking general government debt/GDP to 109% by end-2008, up from 29% in 2007. Higher debt service and declining revenues will contribute to a much increased general government deficit of 13.5% of GDP in 2009, compared to a surplus of 5.5% in 2007. Increased uptake of government paper by Icelandic asset-rich pension funds should limit funding pressures on domestic financial markets, while the IMF programme should address external funding needs. However, this prognosis is obviously not risk free, while early pursuit of an aggressive medium-term fiscal consolidation programme will be essential to rebuild sovereign creditworthiness.

Gross external public debt is also set to rise as Iceland draws down almost USD5bn of IMF and associated bilateral funding (mainly from its Nordic neighbours) to bolster its reserves and stabilise the currency. Net external public debt outcomes will be determined by the foreign exchange cost of meeting as yet unquantified deposit insurance obligations and the extent to which the Central Bank finds it necessary to support the currency. Such uncertainties speak to the unusually high degree of execution risk that will be uppermost in the early stages of the IMF programme. That said, however, Fitch acknowledges the authorities' clear determination to see the programme through, while simultaneously preserving the sovereign's financial integrity.

A short commentary on Iceland will be available to subscribers on the Fitch website, ww.fitchresearch.com, on Friday, 21 November.

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