ICELAND'S SOVEREIGN RATINGS AFFIRMED:OUTLOOK NOW STABLE

Fitch Ratings-London-31 March 2003: Fitch Ratings, the international rating agency, has 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 rating at 'F1+'. The Outlooks on the Long-term ratings were revised to Stable from Negative.

The agency explained that Iceland has been through a rather difficult period but appears to be emerging stronger from it. Following six years of fast but ultimately unsustainable growth, the floating of the kr・a in 2001 marked the start of a rapid and successful restoration of macro-economic balance. The credit boom came to an abrupt end, partly as domestic borrowers came to appreciate the risks of borrowing in foreign currency. Domestic demand weakened but export growth was sustained and the current account moved from a deficit of 10% of GDP in 2000 into a tiny surplus last year. Inflation has dropped to 2%, while unemployment has risen to only 3.5%.

Despite the slowdown, the budget remains close to balance and, thanks to receipts from bank privatisation, gross general government debt should drop below 40% of GDP this year. But the earlier fall in the ratio of government expenditure to GDP has been reversed and some tough decisions on public spending may be needed following the election to be held in May.

The erstwhile credit boom has inevitably left banks with bad debts but these are being identified and provisioned and banks' average capital ratios are back over 12%. Concerns expressed earlier by the IMF about the adequacy of financial supervision have also been addressed.

Provided spending can be restrained, the longer-term fiscal position looks easily sustainable as future generations are not burdened with state pension commitments. Demographics are favourable with a youthful population growing at over 1% pa and small state pensions payable only at age 67.

It makes sense that a country with good demographics and able to offer good investment returns should build up a negative international investment position. But in relation to the size of its economy Iceland has gone even further in this direction than comparable economies like Australia and New Zealand. And unlike those two countries, Iceland has added further to its net external debt by, in national terms, building up debt to finance equity assets. This is the main constraint on the rating. Net external debt ratios should fall, and the ratings could improve, more quickly if Icelandic pension funds curbed their appetite for foreign equities.

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