International
Credit Analysis

Republic of Iceland

Ratings

Foreign Currency
Long-Term IDR* .... AA-
Short-Term IDR* .... F1+
Outlook .... Negative

Local Currency
Long-Term IDR* .... AAA
Rating Outlook .... Negative

Country Ceiling .... AA

* IDR – Issuer Default Rating

Peer Group

AA	Japan Portugal San Marino Slovenia
AA-	**Iceland** Hong Kong Italy Kuwait
A+	Cyprus Korea Saudi Arabia Taiwan

Ratings History

Date	LTFC	LTLC
3 Feb 2000	AA-	AAA

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■ Ratings Affirmed, Outlook Remains Negative

Fitch Ratings has affirmed Iceland's foreign and local currency Issuer Default Ratings ("IDRs") of 'AA–' and 'AAA' respectively, both with Negative Outlooks. Iceland is a highly leveraged economy that has yet to address some of the key concerns highlighted in Fitch's negative rating action in February 2006. Icelandic banks treated this sovereign credit event as a wake-up call that obliged them to re-examine their overseas expansion aspirations and secure longer-term external funding to cover a bunching of maturities in 2007. With the successful conclusion of the latter, a substantial source of near-term uncertainty has been addressed. However, serious macroeconomic imbalances remain that could take much longer to work themselves out.

A sharp fall in the krona in H106 triggered higher inflation of 8%, prompting the Central Bank of Iceland ("CBI") to raise interest rates to 14%, while the general government turned in a surplus of 5.5% of GDP in 2005. Nonetheless, a rebalancing of the economy still looks some way off, as the authorities contend with strong aggregate demand and a renewed strengthening of the krona on the back of short-term capital inflows, attracted by a wide interest differential with the rest of the world. With private consumption and investment responding only slowly to policy tightening, the current account deficit will breach 20% of GDP this year, driving gross external debt up to 370% of GDP.

■ Credit Outlook

Net external debt ratios are lower on account of a rapid build-up of financial assets abroad; but, at 357% of current external receipts in 2005, Iceland remains the most heavily indebted of any Fitch-rated sovereign. This constraint, coupled with the current size of Iceland's macroeconomic imbalances, leaves it vulnerable to external shocks such as global monetary tightening and/or a sudden deterioration in investor sentiment. Such developments and the likely policy responses that would follow could tip Iceland into a much deeper recession than the short sharp adjustment that occurred in 2002, with adverse consequences for households, corporates and banks, all of which are much more indebted now.

Fitch recognises that a wave of structural reforms since the 1990s has made Iceland more resilient to shocks, but argues that it has yet to forge a convincing track record of managing volatility in highly indebted circumstances. The Outlook remains Negative.

■ Strengths

- Sustainable public finances, including fully funded pensions
- Floating exchange rate; high-quality institutions
- Significant growth potential in energy-intensive industries

■ Weaknesses

- Heavily indebted, wholesale-funded banks
- Unsustainable current account deficit
- Very high net external indebtedness

14 November 2006

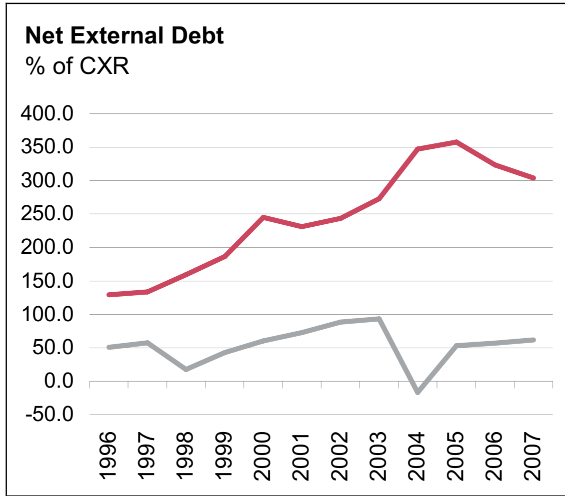
Key Indicators for Iceland

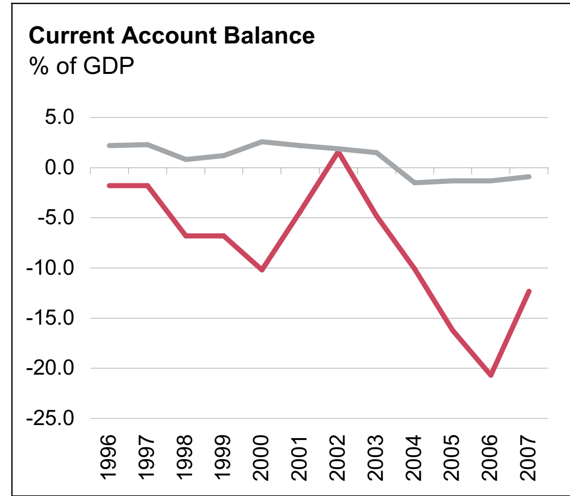
Population (2005): 0.3m **Population Growth Rate (2000-2005):** 0.9% p.a.
GDP (2006): USD16.1bn **GDP per Head at Market Exchange Rates (2005):** USD54,560
GNI Per Head at Purchasing Power Parity (2005): USD32,370 (= 81% of USA level)
Modern Sovereign Rescheduling History: None

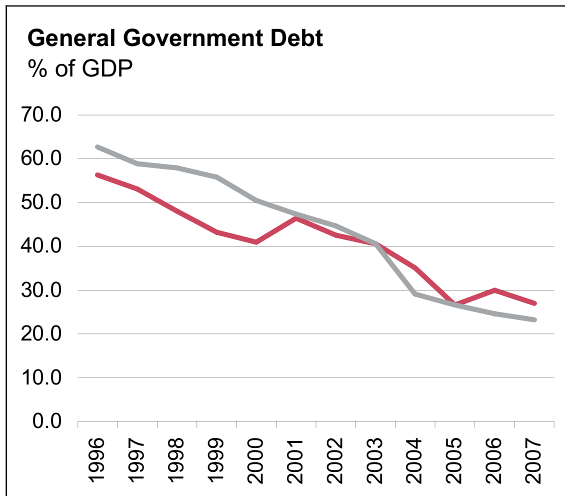
	2002	2003	2004	2005	2006[f]	2007[f]	2008[f]
Domestic Economy and Finance							
Real GDP Growth (%)	-1.3	3.6	6.2	7.5	3.7	-0.1	2.6
Unemployment (% of Labour Force)	2.5	3.3	3.1	2.1	1.6	2.5	3.0
Consumer Prices (Annual Average % Change)	5.2	2.1	2.8	4.2	7.5	5.0	2.5
Gross Domestic Savings (% of GDP)	19.0	16.6	17.5	15.9	13.6	16.9	17.5
Gross Domestic Investment (% of GDP)	17.4	19.7	23.2	28.4	30.9	23.4	17.9
Short-Term Interest Rate (%)[(1)]	8.4	5.4	6.1	9.4	12.5	12.0	9.5
Broad Money (% Change Dec to Dec)	5.0	27.8	34.1	59.8	22.4	5.9	12.5
ISK per USD (Annual Average)	91.7	76.7	70.2	63.0	69.0	77.5	82.5
REER (CPI, 2000=100)	6.2	6.3	2.8	12.8	-8.4	-1.0	-1.0
REER: % Change (+ = Appreciation)	-1.3	3.6	6.2	7.5	3.7	-0.1	2.6
Public Finances							
General Government Balance (% of GDP)	-0.8	-2.0	0.5	5.5	3.9	0.7	-1.3
General Government Debt (% of GDP)	42.6	40.6	35.1	26.6	30.0	27.0	27.0
General Government Debt Maturities (% of GDP)[(2)]	6.0	5.5	5.6	5.7	4.3	3.4	3.5
General Government Debt/Revenue (%)	97.2	91.2	76.3	54.7	63.5	61.8	63.6
Interest Payments/Revenue (%)	6.7	6.4	5.6	4.5	4.9	5.8	6.1
Balance of Payments							
Current Account Balance (USDbn)	0.1	-0.5	-1.3	-2.6	-3.3	-1.9	-1.0
Current Account Balance (% of GDP)	1.6	-4.8	-10.1	-16.2	-20.7	-12.3	-6.5
Current Account Balance plus Net FDI (USDbn)	-0.1	-0.6	-3.1	-7.1	-5.1	-2.9	-2.5
Current Account Balance plus Net FDI (% of GDP)	-1.2	-5.3	-24.0	-44.4	-31.6	-18.7	-16.3
Gross Financing Requirement (% of Official Reserves)[(3)]	336.0	461.1	379.3	580.0	626.9	633.0	345.5
Current External Receipts CXR (USDbn)	3.7	4.1	5.0	6.6	8.0	9.3	10.2
Current External Receipts CXR (Annual % Change)	12.8	13.1	20.4	31.8	21.3	16.5	9.9
Current External Payments CXP (USDbn)	3.5	4.7	6.3	9.2	11.3	11.2	11.2
Current External Payments CXP (Annual % Change)	-1.9	32.3	35.1	45.7	22.8	-0.8	0.1
External Assets and Liabilities							
Gross External Debt (USDbn)	11.1	16.4	26.9	45.2	59.2	66.2	71.6
Gross External Debt (% of GDP)	127.7	151.6	206.8	281.5	370.7	428.8	470.3
Gross External Debt (% of CXR)	303.9	395.0	540.0	688.2	742.8	712.7	701.0
Net External Debt (USDbn)	8.9	11.3	17.3	23.5	25.8	28.2	30.1
Net External Debt (% of GDP)	102.4	104.8	132.9	146.4	161.4	182.7	197.8
Net External Debt (% of CXR)	243.7	273.1	347.1	357.9	323.4	303.7	294.8
Public External Debt (USDbn)	3.0	3.1	3.5	2.7	2.8	2.4	2.2
Public External Debt (% of GDP)	34.7	28.8	26.7	16.6	17.5	15.8	14.2
Net Public External Debt (% of CXR)	69.9	55.3	48.3	24.4	11.8	6.2	2.9
Public FC Denominated & FC Indexed Debt (USDbn)	2.4	2.5	2.5	1.5	2.0	1.8	1.6
Short-Term External Debt (% of Gross External Debt)	21.3	21.2	18.1	15.5	22.7	22.8	22.8
External Debt Service (% of CXR)	46.5	48.0	46.0	69.8	61.3	129.9	76.6
External Interest Service (% of CXR)	10.2	9.3	10.1	14.7	18.7	22.6	22.9
Liquidity Ratio (%)[(4)]	20.6	22.9	40.6	39.9	75.8	55.4	68.8
Official International Reserves Including Gold (USDbn)	0.5	0.8	1.1	1.1	1.9	1.9	1.9
Official International Reserves in Months of CXP Cover	1.6	2.1	2.0	1.4	2.0	2.0	2.0
Official International Reserves (% of Broad Money)	9.4	12.1	12.0	11.0	20.8	20.2	20.1

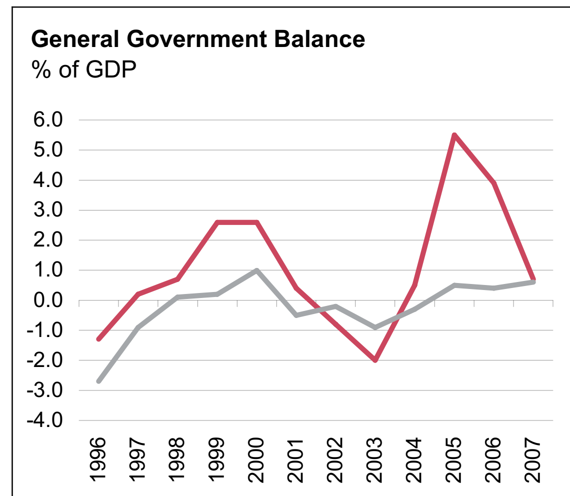
(1) Central bank policy interest rate (annual average).
(2) Maturities of medium and long-term debt during year plus short-term debt outstanding at the beginning of the year.
(3) Current account balance plus amortization of medium and long-term debt, over official international reserves.
(4) Official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

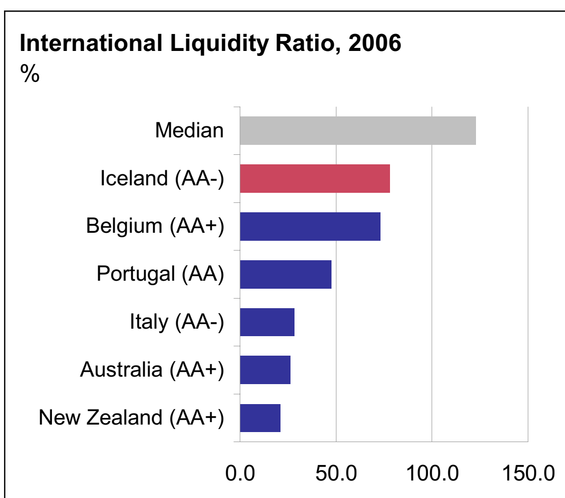
Peer Comparison

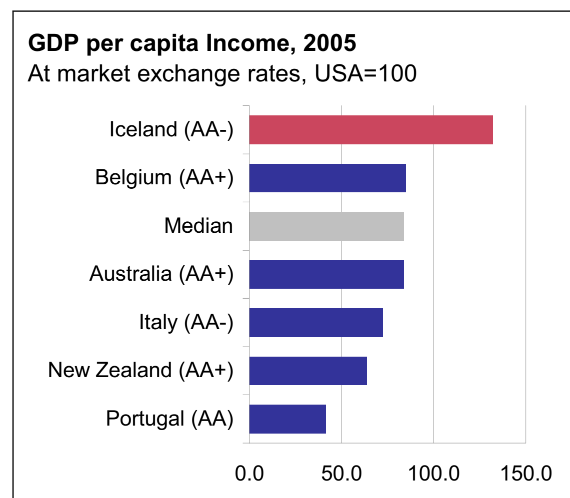












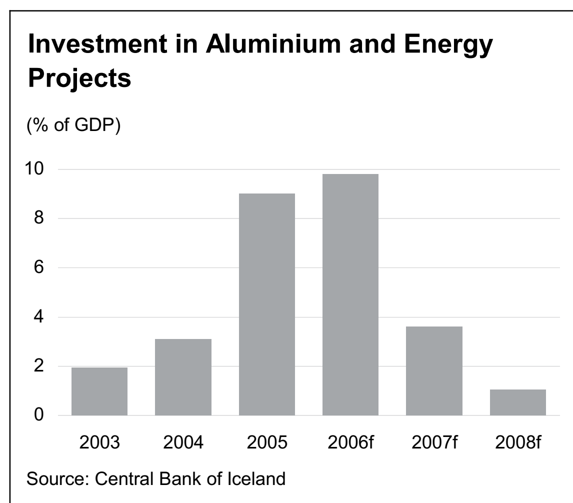
Iceland AA Median

Source: Fitch Sovereign Comparator

Rationale

Fitch has affirmed Iceland's foreign and local currency IDRs of 'AA–' and 'AAA' respectively, both with Negative Outlooks. Iceland is a highly leveraged economy that has yet to address some of the key concerns highlighted in the negative rating action Fitch took on 22 February 2006[1]. Icelandic banks treated this sovereign credit event as a wake-up call that obliged them to re-examine their overseas expansion aspirations and secure longer-term external funding to cover a bunching of maturities in 2007. With the successful conclusion of the latter, a substantial source of near-term uncertainty has been addressed. However, serious macroeconomic imbalances remain that could take much longer to work themselves out.

Iceland's economy is in the midst of a supply-side-driven expansion entailing huge investment in the aluminium and associated energy sectors[2]. 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 poorly timed move to liberalise households' access to residential mortgages and the breakneck expansion of Icelandic banks and corporates abroad.



Source: Central Bank of Iceland

As a small, very open economy with a relatively narrow export base[3], Iceland is not unaccustomed to output volatility, economic overheating and the sharp corrective policy actions that often follow. An earlier wave of investment in the aluminium/power industries in the late 1990s engendered rapid growth and outsize current account deficits, followed by a shallow recession in 2002. However, the scale of the investment boom is only beginning to be appreciated: annual average increases of 26% in gross domestic fixed capital formation over 2003-2005 constitute the largest expansion Iceland has known in the post-war era.

This investment has been accompanied by buoyant investment in other sectors, notably the financial sector, and soaring increases in private consumption on the back of over-full employment and rapid domestic credit growth. The authorities' handle on investment has not been perfect, leading to frequent revisions to the national accounts data – at 7.5% in 2005 growth again surprised on the upside – and a sense that policy tightening may have been "behind the curve". Externally, the current account deficit mushroomed to 16% of GDP in 2005 from 10% in 2004, reflecting an unprecedented deterioration in the domestic savings-investment balance. Meantime, net external debt rose to 358% of current external receipts – the highest of any Fitch-rated sovereign – from 244% at the end of the last boom in 2002.

The market response to Fitch's rating action in February was swift, with both the exchange rate and the stock market plunging by more than 20% in the ensuing months as international investors liquidated their positions. Spreads on credit default swaps ("CDSs") for the major Icelandic banks also rose sharply, spiking up beyond 100 basis points compared to around 20bp in October 2005. Faced with the prospect of a rapid pass-through to inflation, the CBI responded with a fresh round of rate hikes, taking the repo rate from an already high 10.75% to 14% at the time of writing.

Systemic Financial Concerns

Icelandic banks have been expanding at an unprecedented rate, both at home and abroad. Domestic credit growth was running at over 60% in 2005; asset prices were shooting up, further flattering banks' balance sheets by virtue of their extensive equity holdings; and the banks were borrowing heavily on international capital markets, both for onlending to Icelandic corporates and to fund their overseas expansion aspirations. The mix of this external financing had become increasingly short term, with an alarming hump in repayments in 2007 raising concerns of a sudden shift in investor sentiment and the risk of collateral damage for the sovereign, should a broader financial crisis ensue.

As 2006 draws to a close, all three major banks – Kaupthing Bank, Glitnir Banki and Landsbanki

[1] See "*Iceland – Macro Imbalances Trigger Negative Outlook*" published on 22 February 2006 and available on www.fitchratings.com.

[2] Subscribers are referred to the August 2005 sovereign report for a detailed account for these projects.

[3] Marine products accounted for 57% of merchandise exports in 2005, down from 77% in 1970.

Islands, all rated ‘A’/Stable – can confirm that they have secured sufficient funding at longer-term maturities to meet their 2007 obligations, albeit at higher cost. This has addressed a substantial source of near-term uncertainty, not just for the banks themselves but also the broader economy and the balance payments. Nonetheless, the banks will remain heavily indebted and highly reliant on wholesale funding in the international market to fuel their operations.

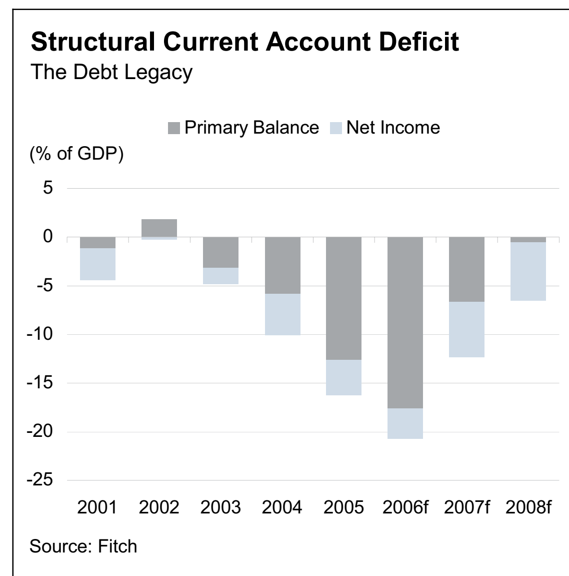
Macroeconomic Imbalances

There is a widespread divergence of views between the public and private sectors as to where the economy is headed. The depreciation of the ISK delivered an inflation shock which peaked at 8.6% in August. Some, like the Employers Federation, are critical about monetary policy and worry that the CBI will lower rates too slowly; but with unemployment down to barely 1%, nominal wage increases of over 10% are far from consistent with the CBI’s inflation target of 2.5%. Meanwhile, private consumption and investment have been slow to respond to policy tightening and the current account deficit has breached 20% of GDP, implying further increases in external indebtedness.

Reining in the current account deficit has been complicated by the limited efficacy of monetary policy due to widespread indexation domestically and the widening differential between Icelandic and international interest rates since the collapse of the ISK. Indeed, renewed inflows of short-term capital have reversed the depreciation of the ISK since June, reinforcing CBI concerns that the ISK no longer responds to economic fundamentals. The risk here is that a sudden change of investor sentiment driven by shifting international interest rate expectations results in a further sharp correction of the ISK, necessitating further policy tightening, which could ultimately tip the economy into recession. So, in Fitch’s opinion, the risk of a “hard landing” remains.

Looking ahead, investment in the major projects peaks this year and they should be 80% complete by end-2006. Thereafter, aluminium production for export should rise by 73% in 2007 and half as much again in 2008, boosting exports and potentially eliminating the trade deficit by 2008. However, Fitch is less sanguine than some about the rate of improvement of the current account deficit and counsels against any repetition of 2001-2002, when Iceland quickly regained a surplus.

The latest round of economic expansion has left a legacy of high external indebtedness. Admittedly, Iceland’s net external debt ratios look as though they may have peaked in 2005, while the international liquidity position has strengthened markedly. It is also true that the country’s net international investment position has deteriorated less rapidly over time, as Iceland has accumulated net equity abroad. Nonetheless, Iceland’s balance on net income looks set to widen significantly under the combined weight of higher interest payments and outflows of profits and dividends in 2007-2008. Consequently, Fitch believes that Iceland may be left with a structural current account deficit of 5%-6% of GDP, partially diluting the rationale for the major projects.



Allied to this is the risk that Iceland could embark on a further round of aluminium projects after 2008, before the current imbalances have worked themselves out. Arguably, this is what happened in 2003-2004, when the economy recovered strongly from the short, sharp downturn of 2002. Global demand for aluminium remains strong and there is no shortage of investor interest in further projects. However, officials are quick to point out that Iceland needs a period of introspection to reflect carefully on the strains current projects have put on the economy, while environmental concerns become ever more pressing. In any event, no decisions are likely to be taken before the 2007 general election.

Sovereign Considerations

Fiscal consolidation has set general government debt on a declining trend since the mid-1990s, aided by substantial windfalls from high-profile privatisations like Iceland Telecom in 2005. Consequently, the public debt/GDP ratio ended the year at 27% – almost exactly in line with the ‘AA’ median – and net debt halved to just 11% of GDP. Externally, the Treasury has been prepaying debt and net public external debt dropped to 24% of current external

receipts in 2005 from 70% as recently as 2002. In short, the public sector's solvency is not in doubt.

That said, one of the most important lessons to come out of the Asia crisis was that countries with seemingly sound public finances ignore private-sector imbalances at their peril. Clearly, there are limits to how far this parallel can be taken: Iceland is a much wealthier country than say Korea, the financial system is much stronger and transparency is infinitely greater. Nonetheless, there is a sense that the government has been content to let monetary policy take the strain in ironing out the current macro imbalances, while fiscal policy has conveyed a less insistent message.

There is no denying that fiscal policy was tight in 2005: the automatic stabilisers kicked in delivering a general government surplus of 5.5% of GDP, far in excess of budget. However, fiscal outturns tend to be very erratic in Iceland in contrast to New Zealand, for example, where a more consistent countercyclical fiscal stance has played a key role in dampening down economic volatility. Moreover, Iceland's fiscal policy stance going forward implies some easing at a time when current imbalances continue to deteriorate and with them the associated risks of a "hard landing". There are, too, substantial government guaranteed debts equivalent to over 50% of GDP. These are chiefly embedded in the state-owned Housing Finance Fund ("HFF") and could come home to roost in the event of a prolonged fall in house prices.

Institutional Strengths

Iceland is an advanced country with strong, transparent institutions, a long tradition of stable coalition politics and enduring membership of many international institutions. The current government, a coalition of the Progressive and Independence parties, was elected for a third successive term in 2003 and, in common with most previous administrations, is expected to serve out its full term until 2007.

Allied to these deep-seated attributes, a wave of structural reforms since the 1990s and the adoption of a floating exchange rate in 2001 have made the economy more resilient to shocks and responsive to change. Nor should it be forgotten that Iceland's extraordinarily high income per head – USD55,000 at market exchange rates in 2005 – itself implies an appreciable ability to sustain high levels of debt. Such factors provide important underpinnings for the sovereign rating. However, in contrast to near rating peer New Zealand, for example, Iceland has yet to forge a convincing track record of managing economic volatility in highly indebted circumstances.

■ Financial Sector

Sovereign concerns about financial sector trends came to a head in early 2006, when the semi-annual Fitch Bank Systemic Risk Report [4] highlighted Iceland as the most extreme example of a country where certain macro-prudential indicators ("MPIs") were running far above long-run trends. Studies have shown that calibrated divergences from trend in private-sector credit to GDP, real asset prices (ie property/equity values) and/or the real effective exchange rate can signal a heightened risk of potential financial sector distress. Thus, on a scale of 1 (least risky) to 3 (most risky), Iceland scored and continues to score 3. Moreover, such empirical analysis rests in no small part on a number of Scandinavian banking crises that occurred in the wake of financial liberalisation in the 1990s.

Iceland's financial system is not intrinsically weak: on a scale of A-E the system ranks B, while the three largest banks – Kaupthing, Glitnir and Landsbanki – all enjoy Long-term foreign currency ratings of 'A', underpinned by high profitability and strong capitalisation. However, the sheer size of these banks relative to the size of the economy and the manner in which their growth and expansion has been funded raise issues of potential sovereign support in a crisis. Moreover, in the absence of any foreign banking presence in Iceland, the authorities could not rely on foreign ownership to mitigate the scale of bailing out any bank(s).

Key Facts: Banking System 2005

M2 (% GDP)	60.6
NPL Ratio	0.7
Capital Adequacy Ratio	12.6
Public Ownership (% of Assets)	0.0
Foreign Ownership (% of Assets)	0.0
Macro Prudential Indicator*	3
Banking System Indicator*	B

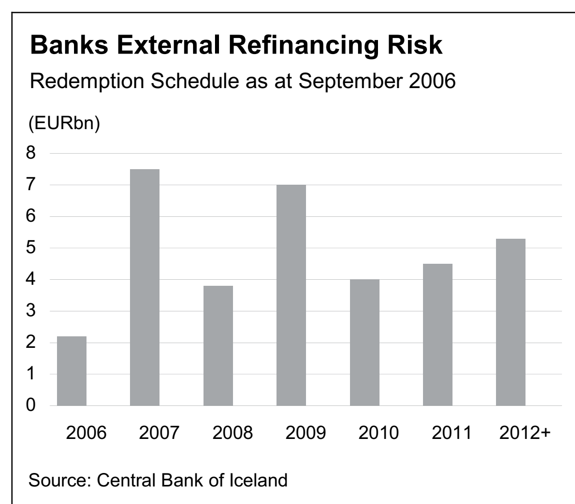
* See "*Assessing Bank Systemic Risk*" of July 2005 and "*Bank Systemic Risk Report*" of February 2006
Source: CBI and Fitch estimates

Following the depreciation of the krona earlier this year, the combined assets of the big three banks now amount to more than seven times nominal GDP, a multiple evoking the "too big to fail" argument. Compounding this concern is the fact that because their deposit base is relatively narrow, funding just 20%-25% of total assets, these banks are heavily dependent on wholesale funding, chiefly from international investors. Admittedly, overseas expansion has reduced Icelandic banks' dependence on their home market, but their vulnerability to shocks has been accentuated by an unprecedented

[4] "*Bank Systemic Risk Report*" published in February and September 2006, available on www.fitchratings.com.

rise in net external liabilities in the context of soaring domestic credit growth and asset prices.

Banks External Refinancing Risk
Redemption Schedule as at September 2006



Source: Central Bank of Iceland

One of Fitch's chief concerns, highlighted in the February 2006 rating review, was that in the event of a shift in market sentiment, Icelandic banks could encounter restricted access to external funding and/or a sharp rise in the cost of funding. With almost 40% of banks' external liabilities falling due in 2006-2007 and a growing shift towards short-term borrowing in Q405-Q106, the risks were clear. In the event, the switch in Iceland's sovereign rating Outlook to Negative coincided with the imminent demise of Japan's zero-interest-rate policy, spooking international investors and sending banks' CDS spreads skywards.

All three major banks have courted international investors assiduously this summer and point out that they have now either fully funded or almost fully funded the hump in maturities in 2007, while simultaneously shoring up their liquidity positions. Traditionally supportive European investors have been largely unreceptive to primary new issues, but significant sums have been placed with US and Asian institutions, thereby diversifying the investor base. Funding costs have remained high, with indicative CDS spreads still hovering around 40bp, but average maturities have been extended out from three to four or five years, with some paper being placed for up to 10 years. In sum, banks' external liabilities remain high, but more immediate concerns about market access and roll-over risk have been assuaged.

Heightened market volatility has also been a salutary experience for the Financial Supervisory Authority ("FME") and the CBI. Nonetheless, both institutions maintain that their financial sector stress tests continue to be appropriate and remain confident that the banking system is fundamentally sound. However, both also concede that banks have become more introspective about their future overseas expansion plans and could face a more challenging domestic environment, particularly if the economy should encounter a lengthy "hard landing".

Banks are well capitalised, while non-performing loan ratios are at historic lows, although the latter have been flattered by strong credit growth. However, there is no denying that banks' cost of funding has risen, both domestically and externally, while higher inflation and interest rates will ultimately feed through to asset quality. Moreover, households and corporates are heavily indebted[5] by any standard, leaving them vulnerable to sharp drops in income, employment, output and asset prices.

Household/Corporate Exposure

Banks' share of household debt has more than doubled to 56% from 27% in late 2004, when they started to compete in the state-dominated mortgage market. Much household debt is fixed rate index-linked, with inflation-adjusted increments being added to principal and spread over long repayment periods, thus insulating households from the immediate impact of higher inflation. Debt service actually declined to 27% of disposable income in 2005 from a peak of 35% in 2002. However, more persistent inflation as a result of extended weakness of the ISK could be expected to reverse this trend over time. Household borrowing in foreign currency still only accounts for 5% of total debt, but it has been rising sharply since the ISK depreciated.

Despite the rapid growth of household credit, corporate lending still accounts for the bulk of banks' loan portfolios. Most of this lending is in foreign currency, raising concerns about exchange rate-related credit risk. Banks maintain that most of their corporate clients are hedged with income streams from abroad, and this is clearly so for such sectors as fisheries. That said, though, Fitch does not rule out the risk that companies in other sectors may have sustained substantial exchange rate losses this year, with adverse consequences for profitability.

In a small economy such as Iceland's, the risks associated with corporate lending are magnified by banks' relatively large exposure to the Icelandic stock market – equity holdings are double the EU average – and related-party lending. The Icex-15 rose by an annual average rate of 60% in 2002-2005, bolstering banks' profitability, but a 20% drop in the index in H106 highlighted the risks of such dependence. Cognisant of investor concerns, banks

[5] In 2005 household debt/disposable income stood at 215%, while corporate debt/GDP stood at 220%.

have started to unwind some of their cross-shareholdings. High-profile examples this year have been Glitnir and Straumur, and Kaupthing and Exista; but this process still has far to go.

Housing Finance Fund

The Icelandic government is unusual among OECD nations in retaining a direct stake in the financial system through its outright ownership of the HFF, the fourth-largest financial institution. Prior to 2004 the HFF dominated the home loan market, funding itself through government-guaranteed, inflation-indexed bonds. However, an untimely liberalisation of the HFF's lending criteria in August 2004 unleashed fierce competition with the banks, simultaneously boosting domestic credit growth and house prices and undermining the effectiveness of monetary policy.

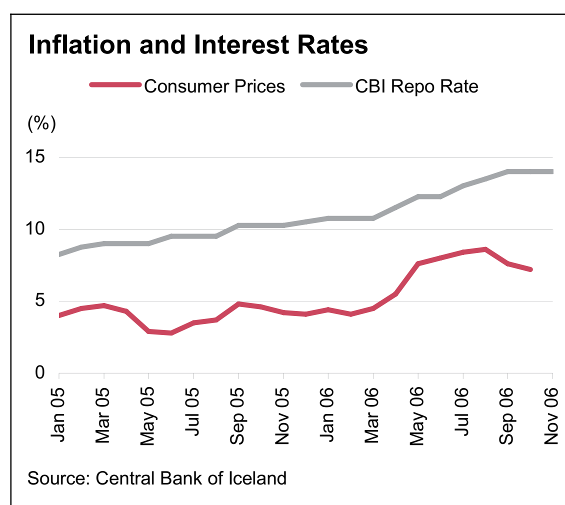
Having initially lost market share, the HFF has since redressed some of the balance, but an uneasy equilibrium prevails pending a more thorough-going reform of the HFF. There is a deep and liquid market for HFF bonds, the stock of which amounts to almost 40% of GDP, and they are widely held by domestic and foreign investors as a proxy for sovereign debt. As such, the government remains indirectly exposed to any prolonged fall in asset prices, were such an event to undermine the financial standing of the HFF.

■ Monetary and Exchange Rate Policy

The conduct of monetary policy in a small national domain like Iceland's is inevitably subject to complex challenges[6]. Thus, in 2001 the authorities conceded that a nominal exchange rate target was no longer appropriate and switched to an inflation targeting regime allied to greater CBI independence. While it can be argued that the mid-point target of 2.5% is relatively high compared to other advanced economies, while the tolerance band (+/–1.5%) is quite wide, these parameters need to be viewed in the context of an economy that is very susceptible to external shocks. Even so, Iceland's experience with inflation targeting has been very mixed to date and the regime lacks the credibility of the more deep-seated regimes in comparable rating peers like Australia and New Zealand.

Looking at the policy framework in the context of the current policy cycle, the overriding impression is that monetary policy has been left to take the strain, while fiscal policy has been the silent partner (an issue discussed further in *Public Finance* below). Prior to the sharp exchange rate correction that occurred in late February, the CBI had already raised its policy rate 12 times since May 2004, to 10.75% from 5.3%. Even so, inflation had climbed above the upper bound of the CBI's target range (4%), notwithstanding a very strong real appreciation of the ISK.

Part of the explanation for this inflation inertia lay in soaring housing prices, which form a weighty component of the consumer price index, set in train by the aforementioned structural change in the residential mortgage market. In the ensuing climate of easy access to long-term housing credit at low interest rates, tighter monetary policy had little impact on the real economy. Consequently, the impact of higher policy rates was confined almost exclusively to the short end of the yield curve, mainly affecting the money markets and the exchange rate which ascended to ever greater heights.



Source: Central Bank of Iceland

The sharp fall in the ISK in February/March delivered an inflation shock to the economy that saw annual average headline CPI more than double to 8.6% by August 2006. With few other tools at its disposal, the CBI was obliged to raise policy rates further to 14%, inviting the dubious accolade of the highest interest rates in the developed world. Yet private consumption and investment have remained strong and the current account deficit breached 20% of GDP in H106. Still, the ISK has rebounded from its earlier nominal and real lows in recent months.

Herein lays the policy dilemma for the authorities: high interest rates in a world of increasingly mobile capital flows mean that the ISK has ceased to respond to domestic fundamentals as hedge funds and "carry traders" return to the fray. Thus, the real effective exchange rate has appreciated by 8% since June, although it is still 11% lower than the

[6] As Mishkin and Herbertsson point out in their 2006 report "Financial Stability in Iceland", Iceland is the smallest economy in the world to have its own currency and a flexible exchange rate.

beginning of 2006. Yet the continued deterioration in the current account deficit ultimately holds out the risk of a further sharp correction in the exchange rate in coming months.

Empirical analysis suggests that approximately 50% of the impact of any movement in the ISK feeds through to prices within six months and inflation has indeed abated since August. Other factors have also been at work, including a moderation in credit growth and house price inflation and the aforementioned renewed appreciation of the real exchange rate. Such developments have raised market expectations that interest rates may have peaked, holding out the prospect of aggressive step reductions in 2007. However, while the CBI side-stepped any rate change at its November meeting, it has not ruled out further hikes in coming months.

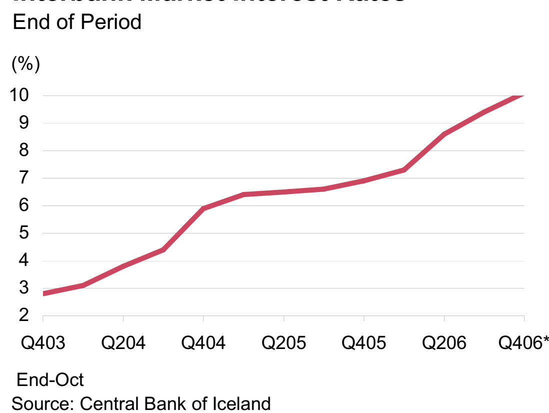
The CBI remains characteristically cautious that current monetary policy settings will be sufficient to bring inflation down to its mid-point target of 2.5% by end-2007. Among the factors most likely to influence future meetings of the monetary policy committee will be the tight labour market and the abiding risk of wage drift, shifting perceptions of the output gap and the uncertain course of the exchange rate. Weighing in the balance will be proposed cuts in indirect taxes, which could shave up to 2.7% points off the CPI in 2007, sending a potentially misleading message on the appropriate stance of monetary policy.

"Carry Trade" Concerns

A key determinant of the exchange rate will be future trends in international interest rates, particularly in Europe and Japan and their implications for the influential "carry trade". International investors have continued to lap up new issues of "glacier bonds" (ISK-denominated eurobonds issued by foreign counterparties) and the outstanding stock has risen to ISK294bn (26% of GDP). However, while recent maturities have been more than offset by new issues, nullifying the impact on the ISK, much larger quantities fall due in 2007 (ISK80bn in September alone). Non-residents also hold over 40% of Treasury notes, most probably as an exchange rate hedge to the glacier bonds.

The CBI is keenly aware that at this stage in the economic cycle Iceland's unsustainable current account deficit makes it acutely vulnerable to any marked narrowing in the differential between domestic and international interest rates[7]. Such a development could again unnerve investors and trigger a much more abrupt adjustment to Iceland's macroeconomic imbalances, hastening the onset of a potentially prolonged "hard landing". As such, this risk continues to hang over the sovereign rating.

Spreads Between Domestic and Foreign Interbank Market Interest Rates
End of Period



End-Oct
Source: Central Bank of Iceland

The authorities are under no illusions about their ability to intervene in the foreign exchange market to support the ISK and have made no attempt to do so since October 2001. However, mindful of the rapid expansion of the financial sector and Iceland's greater vulnerability to external shocks, steps are being taken to strengthen the CBI's balance sheet with an external bond issue that could double international reserves by end year. This exercise is being presented as a precautionary measure, unrelated to banks' funding needs in 2007, which have now been fully remunerated.

■ Public Finance

Sound public finances have been a key factor underpinning Iceland's sovereign ratings. Fiscal consolidation in the 1990s served to put the national exchequer on a more sustainable path and general government debt has come down from a peak of over 59% in 1995 to 27% in 2005, in line with the 'AA' median. Low unemployment, a young population and a nearly fully funded pension system mean that demographic demands on the public finances are well contained.

That said, though, general government revenue and expenditure are high by OECD standards and fiscal outcomes relative to budget tend to display greater variability than rating peers Australia and New Zealand, for example. Thus, whereas New Zealand has pursued a consistently more countercyclical fiscal policy[8], thereby helping to better damp down

[7] In October 2006 the differential between three-month domestic and foreign inter-bank interest rates stood at an historical high of over 10%.

[8] New Zealand has consistently run the highest general government surpluses (5%-6% of GDP) of any OECD economy over the past five years.

volatility, Iceland has opted to give comparatively free reign to the automatic stabilisers. However, these tend to be less powerful in Iceland than other OECD countries, while central and local government finances have displayed little correlation, with the latter tending towards a pro-cyclical stance.

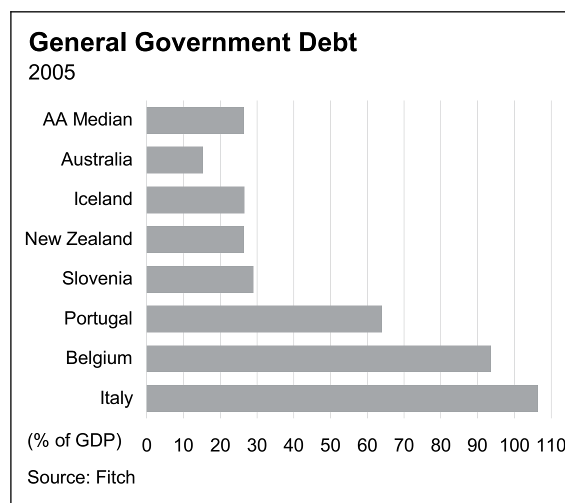
The Icelandic authorities remain of the opinion that discretionary measures to control aggregate demand tend to be counterproductive in an economy as volatile as Iceland's and are better applied to the supply side and to enhance structural change. Even so, the timing of the relaxation of lending parameters at the HFF in 2004 and personal income and wealth tax cuts dating back to 2005 was hardly ideal, adding to economic overheating and, in the case of the HFF, unwittingly undermining the efficacy of monetary policy.

The unexpectedly strong growth of the economy in 2005 delivered a general government surplus of 5.5% of GDP, up from just 0.5% in 2004 and far in excess of original budget estimates of 1% of GDP. Buoyant direct and indirect taxes played a key role in this outcome, but so, too, did greater restraint on the expenditure side compared to the recent past, when slippages were in danger of becoming the norm.

The 2007 budget handed down in October accordingly strikes a more upbeat note, with significant revisions to fiscal outcomes for 2006-2008. Official forecasts, based on macroeconomic assumptions somewhat more optimistic than Fitch's, foresee higher general government surpluses of almost 4% in 2006 and 1.5% in 2007, before reverting to a small deficit of 0.5% in 2008, one year later than previously budgeted.

Prima facie, these forecasts paint a picture of a still tight fiscal stance; yet the issue remains as to whether they are sufficiently supportive of the broader macroeconomic policy stance at this stage of the economic cycle. Indeed, relative to 2005, prospective outcomes for 2006 represent a fiscal easing at a time when the current account deficit continues to deteriorate. Moreover, although the government has backed away from multi-year personal income tax cuts, it intends to reduce some indirect taxes sharply in 2007, an election year. Relaxation of a previously announced freeze on public investment, albeit modest, also points in the direction of a premature easing of fiscal policy.

General government surpluses have fed a sharp reduction in public debt and, like New Zealand, Iceland's public debt ratios are closely aligned to 'AA' medians. Mounting Treasury deposits at the CBI mean that general government net debt has also fallen sharply to 11% of GDP in 2005 from 23% in 2004, helped in no small part by half the proceeds (ISK67bn) from last year's privatisation of Iceland Telecom. The remaining half was used to pay down external debt, delivering an equally impressive improvement in the net public external debt ratios.



The ratio of general government debt to GDP will undergo a brief reversal in 2006, reflecting the CBI's mandate to borrow in the international markets on behalf of the Ministry of Finance to strengthen the international reserves. Fitch is assuming that this bond could raise up to EUR1bn, which would boost general government debt to 30% of GDP, 5% of GDP higher than it would otherwise have been. Thereafter, general government debt is forecast to revert to its previous path, stabilising at around 27% of GDP in 2007-2008.

Broader public debt is significantly higher on account of substantial contingent liabilities in the form of government guaranteed debts. The authorities do not consider that these present an undue risk. Nevertheless, they amount to over 50% of GDP. Chief among them are the bonds issued by the state-owned HFF, the stock of which amounts to about 40% of GDP, a significant proportion (15%) of which are held by non-residents. The national power company Landsvirkjun has also accumulated government guaranteed external debts in excess of 10% of GDP on the back of the large power projects underway in the aluminium sector.

■ External Finance

Balance of payments developments in 2005 turned out much worse than expected, with the current account deficit ballooning to 16.2% of GDP from 10.1% in 2004. Worse still, the current account balance continued to deteriorate in H106, rising to 23% of GDP, as strong domestic demand fed higher imports, while the poor performance of the marine sector dragged down merchandise exports. Net

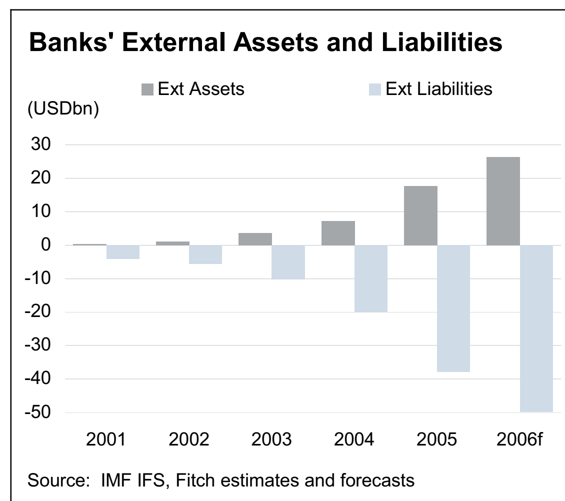
outflows on income (ie profits and dividends and interest payments) also rose sharply, primarily reflecting higher external debt and rising international interest rates. Based on these trends, Fitch is forecasting a current account deficit of 21% of GDP for 2006, in line with the forecasts in the CBI's latest Monetary Bulletin.

As the Icelandic authorities themselves point out, deficits of this magnitude are unparalleled among OECD countries and one has to look back to the 1970s and 1980s for current account imbalances remotely resembling Iceland's[9]. A larger current account deficit was always in prospect once the construction phase of the major projects began. However, the boom in consumption – which accounts for more than 50% of the deficit – was not anticipated and raises questions about the extent to which the deficit will be self-correcting once the investment boom starts to unwind.

Higher aluminium exports have already started to come on stream and will build up rapidly through 2007-2008, by which time they should account for 40% of merchandise exports, putting them approximately on a par with marine exports. With imports also scaling down in line with the slower growth of the economy, the trade balance could swing back into small surplus by 2008 for the first time since 2002. However, Fitch is less optimistic about the current account deficit and believes that the deficit on net income will remain a significant drag (5%-6% of GDP) on the balance of payments, raising lingering concerns about external debt sustainability.

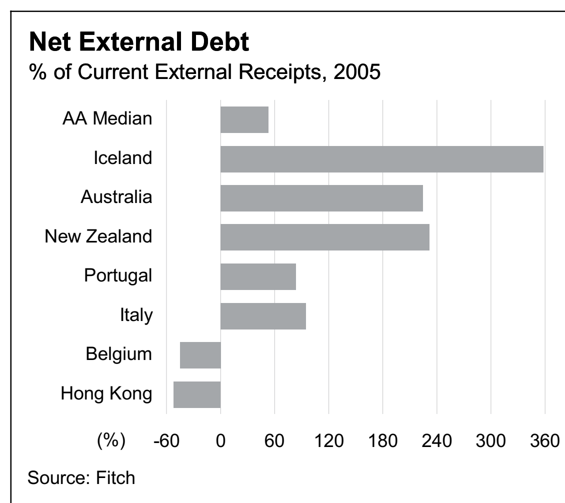
Large though the swings in the current account balance have been, they have been dwarfed by developments on the capital account, reflecting the unprecedented scale of international financial intermediation that has occurred in Iceland since the beginning of 2004. Net outflows of foreign direct and portfolio equity investment peaked at close to 50% of GDP in 2005, while net lending abroad more than quadrupled from 2004 to 86% of GDP in 2005. These outflows were funded by net external borrowing to the tune of USD23bn or 145% of GDP.

Unbridled expansion of Icelandic banks and corporates abroad lay behind these figures, with the banks playing the role of chief intermediary, raising funds mostly through the issue of medium term euro notes of two to three years' duration, either for their own use or for onlending to their corporate clients. By early 2006 three developments were apparent: (i) the current account deficit was becoming ever larger; (ii) the banks were borrowing increasingly short term; and (iii) the appreciable interest rate differential between Iceland and the rest of the world was attracting the growing attention of hedge funds and "carry traders".



Source: IMF IFS, Fitch estimates and forecasts

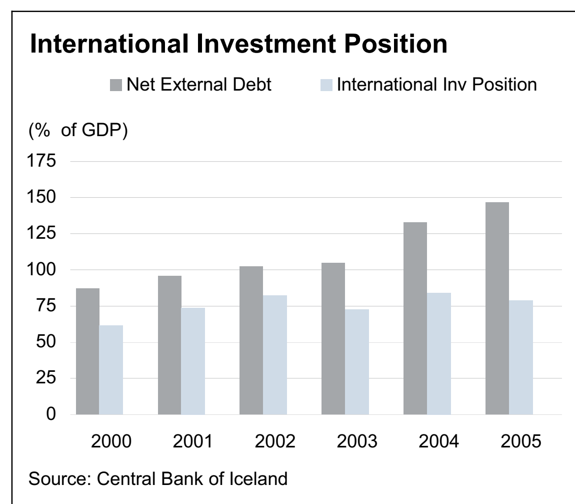
Ever more volatile funding of the current account deficit, mounting external indebtedness and a looming refinancing risk for the banks were key factors behind the revision of Iceland's sovereign rating Outlook to Negative from Stable in February 2006. By end-2005, Iceland's net external debt had climbed to 357% of current external receipts ("CXR"), putting it ahead of all other Fitch-rated sovereigns, including other 'AA' outliers like Australia and New Zealand. Admittedly, the public sector is the least externally indebted of all sectors. However, one of the chief lessons to come out of the Asia crisis was that sovereign creditworthiness cannot be indifferent to broader external financial concerns emanating from other sectors of the economy, particularly banks.



Source: Fitch

[9] Portugal incurred a current account deficit of 15% of GDP in 1982, Ireland 13% in 1981 and Norway 12% in 1977.

In Iceland's case, banks now account for 90% of net external debt, while over 20% of banks' external liabilities fall due for repayment in 2007. The impact of this bunching on the balance of payments is best exemplified by the external debt service ratio, which soars to 130% of current external receipts in 2007 from 61% in 2006. Debt service demands of this magnitude, coupled with an outsized current account deficit, highlight Iceland's continuing vulnerability to higher international interest rates and shifting investor sentiment.



Although external debt will continue to rise in nominal terms, Fitch believes that Iceland's external debt ratios may be at or close to their peak. However, the agency doubts that the net external debt ratio will fall much below 300% of CXR by 2008, notwithstanding more robust export growth and a narrowing current account deficit. That said, the fact that Iceland's net international investment position – net holdings of equity and debt combined – has deteriorated less rapidly than the net debt position underlines the point that the private sector is borrowing to invest in real and financial assets abroad. The return on these investments will be an important determinant of the future course of the current account deficit and external debt sustainability.

External liquidity has never been one of Iceland's strongest suits and, as in the case of Australia and New Zealand, Fitch's preferred measure of this ratio has traditionally languished well below the 'AA' median. This is changing now. Official international reserves have remained steady at around USD1bn this year, notwithstanding heightened exchange rate volatility. However, a three-fold increase in banks' liquid foreign assets in 2005 has almost doubled the broader international liquidity ratio to 76%, putting it ahead of many countries in the 'AA' rating category.

Banks' foreign assets have continued to rise sharply this year, as the banks have pre-funded 2007 obligations, placing the proceeds offshore. As aforementioned, the authorities are also in the process of raising up to EUR1bn in the market to strengthen international reserves. These additional financial resources will help to cushion the impact of the escalation of external debt service in 2007. Without them it is likely that the international liquidity ratio would have been more than halved to around 35%. Even so, gross external financing will remain high at over 600% of international reserves.

Fiscal Accounts Summary*

(% of GDP)	2002	2003	2004	2005	2006f	2007f	2008f
Total Revenue (Incl. Grants & Excl. Priv'n)	**43.8**	**44.5**	**45.9**	**48.7**	**47.3**	**43.7**	**42.5**
Tax Burden	36.3	37.8	39.1	41.6	40.6	37.1	36.1
Other Current Revenue	7.5	6.7	6.8	7.1	6.7	6.6	6.4
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Expenditure	**44.6**	**46.5**	**45.4**	**43.2**	**43.4**	**43.0**	**43.7**
Current Expenditure	41.9	44.0	42.5	41.2	42.1	41.7	41.7
o/w Wages and Salaries	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Transfers and Subsidies	2.9	2.9	2.6	2.2	2.3	2.5	2.6
Interest Payments	2.9	2.9	2.6	2.2	2.3	2.5	2.6
Capital Expenditure	2.7	2.5	2.9	2.0	1.3	1.3	2.1
Primary Balance (i.e. excl. Interest Payments)	-0.3	-0.8	1.5	6.5	4.7	1.6	-0.1
Overall Balance	**-0.8**	**-2.0**	**0.5**	**5.5**	**3.9**	**0.7**	**-1.3**
Financing	**0.8**	**2.0**	**-0.5**	**-5.5**	**-3.9**	**-0.7**	**1.3**
Borrowing Net	-2.4	-3.7	-1.7	-2.1	-3.9	-0.7	1.3
Privatisation Proceeds	0.6	3.1	0.0	6.8	0.0	0.0	0.0
Other	3.2	5.7	1.2	-3.4	0.0	0.0	0.0
Public Debt*	**42.6**	**40.6**	**35.1**	**26.6**	**30.0**	**27.0**	**27.0**
Owed to Residents	18.3	19.3	18.4	17.1	16.7	15.0	16.2
Owed to Non-Residents	24.3	21.3	16.7	9.5	13.3	12.0	10.8
Public Debt (% of Revenue)	97.2	91.2	76.3	54.7	63.5	61.8	63.6
Memo							
Interest Service (% of Revenue)	6.7	6.4	5.6	4.5	4.9	5.8	6.1

* All figures refer to the consolidated general government
Source: Ministry of Finance, Fitch estimates and forecasts

Balance of Payments

(USDm)	2002	2003	2004	2005	2006f	2007f	2008f
Current Account Balance	**137**	**-523**	**-1,315**	**-2,607**	**-3,304**	**-1,894**	**-988**
% of GDP	1.6	-4.8	-10.1	-16.2	-20.7	-12.3	-6.5
% of CXR	3.7	-12.6	-26.4	-39.7	-41.4	-20.4	-9.7
Trade Balance	**154**	**-207**	**-538**	**-1,501**	**-2,011**	**-684**	**170**
Exports, fob	2,229	2,380	2,883	3,086	3,225	3,574	3,988
o/w: Marine Products	1,403	1,482	1,734	1,749	1,812	1,774	1,758
o/w: Aluminium	421	447	520	572	870	1,161	1,600
Imports, fob	2,075	2,587	3,421	4,587	5,236	4,258	3,818
Services, Net	**-8**	**-119**	**-206**	**-497**	**-764**	**-310**	**-230**
Services, Credit	1,104	1,377	1,623	2,043	2,135	2,206	2,255
Services, Debit	1,112	1,497	1,828	2,540	2,899	2,516	2,485
Income, Net	**-22**	**-181**	**-554**	**-582**	**-500**	**-872**	**-904**
Income, Credit	295	374	468	1,432	2,598	3,494	3,955
Income, Debit	317	556	1,023	2,014	3,098	4,366	4,859
o/w: Interest Payments	374	384	505	969	1,491	2,101	2,339
Current Transfers, Net	**13**	**-15**	**-17**	**-27**	**-29**	**-28**	**-23**
Capital Account, Net	**-1**	**-5**	**-3**	**-27**	**-6**	**-5**	**-5**
Non-Debt Creating Flows, Net	-504	-1,194	-3,204	-7,676	-2,750	-2,000	-2,500
Equity Direct Investment, Net	-294	-591	-1,890	-4,657	-1,750	-1,000	-1,500
Portfolio Equity Investment, Net	-211	-603	-1,314	-3,019	-1,000	-1,000	-1,000
External Borrowing, Net	**784**	**3,596**	**8,542**	**23,509**	**20,676**	**10,000**	**8,500**
General Govt/Mon Authorities	89	-282	-51	-123	363	-279	-211
Banks	296	-37	668	3,487	3,067	1,483	1,261
Other Non-Bank Private	-14	252	-190	1,692	2,396	1,613	1,345
Portfolio Debt Securities	413	3,663	8,115	16,884	14,849	7,182	6,105
Net Lending Abroad	**-311**	**-1,798**	**-3,217**	**-14,027**	**-13,930**	**-6,000**	**-5,000**
o/w: Banks	-320	-2,080	-3,076	-10,381	-10,309	-4,440	-3,700
Net Errors and Omissions	**-42**	**229**	**-600**	**903**	**114**	**-101**	**-7**
Increase in Reserves (+)	**62**	**305**	**203**	**75**	**800**	**0**	**0**
Memo							
Gross Borrowing (incl. Short-Term)	2,115	5,201	10,332	27,132	24,072	19,968	13,977
Gross External Financing Requirement	-1,194	-2,128	-3,105	-6,230	-6,700	-11,861	-6,465
Stock of International Reserves, Excl. Gold	440	792	1,046	1,036	1,836	1,836	1,836

Source: Central Bank of Iceland, Fitch estimates and forecasts

Amortisation Schedule on Medium- and Long-Term Debt

(ISKbn)	2006	2007	2008	2009	2010	2011	2012
General Government	**30.1**	**21.6**	**17.4**	**15.6**	**4.7**	**4.8**	**26.5**
Central	24.2	17.8	13.6	12.1	0.0	0.0	22.2
Local	6.0	3.8	3.8	3.5	4.7	4.8	4.3
Financial Institutions	**187.1**	**672.7**	**355.2**	**629.3**	**360.1**	**403.2**	**93.8**
o/w: Banks	184.8	669.0	335.6	621.5	358.3	403.0	93.6
Other	**23.2**	**11.4**	**15.2**	**15.3**	**109.1**	**35.9**	**26.5**
Total	**240.4**	**705.7**	**387.8**	**660.2**	**473.9**	**443.9**	**146.8**
Memo							
USDbn Equivalent	3.4	10.0	5.5	9.3	6.7	6.3	2.1
o/w: Banks	2.6	9.4	4.7	8.8	5.1	5.7	1.3

Source: Central Bank of Iceland

External Debt and Liquidity

(USDm)	2002	2003	2004	2005	2006f	2007f	2008f
Gross External Debt	**11,135**	**16,366**	**26,934**	**45,247**	**59,216**	**66,194**	**71,573**
% of GDP	127.7	151.6	206.8	281.5	370.7	428.8	470.3
% of CXR	303.9	395.0	540.0	688.2	742.8	712.7	701.0
By Maturity							
Medium- and Long-Term	8,760	12,891	2,2070	38,234	45746	51,114	55,259
Short-Term	2,375	3,475	4863	7,012	13,469	15,080	16,314
% Total Debt	21.3	21.2	18.1	15.5	22.7	22.8	22.8
By Debtor							
Public Sector (incl. Publicly Guaranteed)	3,025	3,113	3482	2,664	2,799	2,437	2,157
Non-Bank Private Sector	2,485	3,060	3463	4,686	6,611	7,992	9,083
Banks	5,625	10,193	19,989	37,897	49,806	55,765	60,333
By Creditor							
Gross External Assets	**2,204**	**5,049**	**9,621**	**21,721**	**33,444**	**37,998**	**41,487**
International Reserves, incl. Gold	462	819	1,074	1,069	1,874	1,871	1,870
Deposit Money Banks' Foreign Assets	1,135	3,556	7,239	17,627	26,351	29,962	32,665
Non-Bank Private Sector's Foreign Assets	608	675	1,308	3,026	5,220	6,164	6,952
Net External Debt	**8929**	**11,315**	**17,312**	**23,534**	**25,785**	**28,207**	**30,095**
% of GDP	102.4	104.8	132.9	146.4	161.4	182.7	197.8
% of CXR	243.7	273.1	347.1	357.9	323.4	303.7	294.8
Debt Service (Principal & Interest)	**1,705**	**1,989**	**2,296**	**4,592**	**4,887**	**12,069**	**7,816**
Debt Service (% of CXR)	46.5	48.0	46.0	69.8	61.3	129.9	76.6
Interest Service (% of CXR)	10.2	9.3	10.1	14.7	18.7	22.6	22.9
Liquidity Ratio (%)*	**20.6**	**22.9**	**40.6**	**39.9**	**75.8**	**55.4**	**68.8**
Excl. Banks' Foreign Assets	10.8	10.3	13.8	10.9	8.5	7.1	7.9
Memo							
Public Foreign Currency & FC Indexed Debt	2,415.3	2,482.7	2,499.0	1,531.2	1,961.5	1,793.9	1,588.1
Net International Inv Position (% of GDP)	-82.5	-72.8	-84.2	-78.8			
o/w: Equity	19.9	32.0	48.7	67.7			

* Liquid external assets/liquid external liabilities (ie: international reserves inc gold + banks' liquid foreign assets/total debt service + short term debt)
Source: Central Bank of Iceland, Fitch estimates and forecasts

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