Rating Action: **MOODY'S REPORTS: NARROWING OF MACRO IMBALANCES HELPS SUSTAIN STABLE OUTLOOK ON ICELAND'S Aa3 FOREIGN CURRENCY COUNTRY CEILINGS**

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In its new annual report, Moody's Investors Service outlines several factors that support the stable outlook on Iceland's Aa3 foreign currency ceilings and the Aaa rating on the króna-denominated debt issued by the Republic of Iceland, including the island nation's advanced development, its high and even per capita income, and its consensual politics. The structural economic reforms undertaken during the 1990s resulted in economic diversification away from the fishing sector, fast growth, monetary stabilization, and a meaningful reduction in public sector debt.

Moody's concerns about large macroeconomic imbalances that had emerged after years of heady economic growth have been partly allayed by the significant corrections that have taken place over the past year, warranting the continuation of the stable outlook. The external current account deficit was more than halved in response to the steep devaluation of the exchange rate and the completion of large capital-intensive foreign projects. Although the deficit in the net international investment position continued to climb rapidly in 2001, further narrowing of the current account deficit and recent appreciation of the currency are expected to start reducing the country's net external debt ratios as early as this year.

The rating agency also explains in its report that the economic landing has been surprisingly soft thus far, with growth holding up to 3% in spite of fast-climbing inflation and early signs of a pickup in unemployment. The central bank's adoption of inflation targeting one year ago has had a rocky start, however, with inflation consistently underestimated. The government's debt and debt service situation remains favorable, although the devaluation inflated the foreign currency portion of the debt and the general government surplus will likely disappear this year with growth expected to turn negative.

Moody's emphasized that a number of uncertainties linger, especially regarding the inflation outlook since union wage agreements could be reopened in May. The country's high foreign indebtedness magnifies the importance of achieving an appropriate blend of fiscal, monetary, and incomes policies in order to achieve a sustainable pace of growth over the medium term. For example, should the exchange rate continue to strengthen, growth fare better than anticipated, or new large investment projects be started, further improvement in the current account may not materialize. This situation would raise worries of a deeper and more painful correction going forward. Additional concerns relate to the banking system, where the external exposure expanded rapidly during the boom years and asset quality subsequently weakened, necessitating significant provisioning, although the major rated banks continue to be profitable.

On balance, however, Moody's believes that Iceland's proven policy adaptability should serve the country well during this potentially difficult phase. The healthy public finances and access to external liquidity still provide adequate room to maneuver in spite of the acknowledged risks.

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