

COUNTRY REVIEW

Iceland Update



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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

LATEST OUTLOOK

Politics & International Relations: Following street demonstrations, popular protest at deteriorating economic and social conditions and the worst riots in 60 years, the coalition government of PM Geir Haarde's centre-right Independence Party (IP) resigned in January. General elections were held on 25 April and resulted in a significant swing to the left, with a new coalition government forged by the Social Democratic Alliance (SDA) and the Left-Green movement, which together now hold 34 out of 63 seats in the Althingi (parliament). The conservative IP, which had been in power for almost 18 years, was swept aside, with only 16 seats. The new government is headed by PM Johanna Sigurdardottir and she is attempting to steer the country towards EU membership, although the Left-Green movement does not (fully) support this policy as it has the potential to threaten the health of the important local fishing sector. Moreover, it is now unclear whether the population will endorse application for EU membership if put to a national referendum, even though parliament narrowly approved in July a formal application process. The latest polls indicate that only 33% of the population now supports EU application, compared with around 80% in mid-crisis, and 50% is against membership. Nevertheless, while the policy focus remains ST economic stabilisation, a possible route to EU membership may at least begin to be mapped out during 2010.

The new government has also managed to negotiate a compensation deal with the governments of the UK and the Netherlands in relation to insured depositors with Icesave, the online service of former bank Landsbanki. This agreement is important in relation to release of further IMF assistance (see below). An additional concern of the government is ensuring that investigations into "suspicions of criminal activity" in the banking sector prior to the collapse are (a) dealt with effectively through legal channels and (b) do not reflect negatively on the current administration.

The new government is far from stable, with internal divisions over EU membership, the Icesave agreement and speed with which the banking crisis is investigated. The Health Minister has already resigned. Outside government, there is resentment that ordinary citizens are now paying the penalty for the perceived excesses of bankers and corporate dealers. As austerity measures begin to bite there is likely to be further street protest by those not able to leave the country – a recent poll revealed that 50% of those aged 18-24 years are considering emigration.

GDP Growth: The economy fell deeper into recession in Q2 2009, with seasonally-adjusted GDP contracting by 6.5% yr/yr, the fourth consecutive quarterly fall. In Q1, GDP contracted by 4.5% yr/yr. The deterioration in Q2 stemmed largely from a worsening in external trade, with the export sector particularly badly affected. However, revisions to the 2008 data now show that GDP expanded by 1.3% yr/yr, compared with initial estimates of only 0.3%. With strong erosion in domestic purchasing power, household consumption continues to suffer very badly, as does gross fixed capital formation, reflecting severe credit conditions and weak demand prospects. In 2009, average real disposable wages will be around 15% down on 2008 and most employees have had to accept cuts in nominal earnings. Moreover, this is taking place as unemployment increases and inflationary pressures remain stubbornly high (see below). For calendar 2009, it is likely that household spending will fall by around 20% and fixed investment by almost 50%. Overall, we forecast recessionary conditions to continue into 2010, with real GDP contracting by around 10% yr/yr in 2009 and 1-2% in 2010. Against this background, business and trading conditions will remain challenging.

The Icelandic equity market has fallen 94% since it peaked in July 2007 and market capitalisation is now under USD2bn.

Inflation: The annual rate of inflation fell to 10.9% in August, having started the year at 18.6% (January). However, the weak krona prevents the rate of inflation from declining more quickly. As a result, inflation may fall only to 9% by end-2009 and around 5% by end-2010. We thereby forecast that inflation will remain much higher than the central bank forecast that it will be close to 2% by early 2010. A key risk here would be if further rapid depreciation of the krona introduced a return of high imported inflationary pressures.

Policy: The central bank has cut its key policy interest rate, although the IMF has opposed interest rate reductions, at this stage. Even so, the key rate at 12% remains relatively high compared with other European economies. The IMF facility approved for Iceland in October 2008, amounting to USD2.1bn with USD800mn for immediate disbursement (part of an overall USD10bn rescue package), was contingent on the central bank not taking drastic interest rate action. Nevertheless, the Fund appears broadly satisfied with progress and is scheduled to review its loan arrangement on 28

October. It is likely that the review will enable a second tranche (of USD167.4mn) to be released from the overall facility. There should not be a hold up to this funding as parliamentary approval was given at the end of August to seek agreement with the UK and the Netherlands on repayment of money lost (around €3.8bn) by foreign savers when Iceland's banks collapsed last year. If finally ratified, the Icesave deal paves the way for bilateral aid, particularly from Poland and the Nordic countries, as well as the IMF.

The policy imperatives remain to stabilise the economy and restore confidence in the banking system, in the currency and in government's management credentials. Access to an IMF emergency facility and assistance from other Scandinavian countries has necessitated austerity measures (fiscal and monetary) as part of an overall reform strategy. Currency stabilisation is being pursued partly through use of capital controls, which are unlikely to be repealed in full by end-2010. The controls have slowed, but not stopped, the depreciation of the currency. In relation to the banking system, an attempt must also be made to value the banks' assets (foreign assets are likely to be sold gradually), the banks must be recapitalised (under a USD2.1bn programme) and a new regulatory structure has to be put in place. Although new banks are being created free from the toxicity of the failed organisations, financial restructuring will take some considerable time yet.

In 2008, the krona lost nearly one-half of its value against the euro and more against the USD. Since then it has been more stable but much of this improvement could be because of the foreign-exchange controls adopted. Even so, between mid-March and end-June, the krona depreciated by a further 21%, perhaps because exporters were finding loopholes in the controls. The krona has been more stable since June, particularly reflecting IMF and other support. Exchange controls will not be lifted fully in 2010 but they may be relaxed in a staged schedule, thereby allowing the krona to weaken moderately. However, risks are weighted on the negative side, with potential further rapid krona depreciation leading to higher inflation.

External Sector: Lower import prices in 2009 as significantly weaker oil prices cut the import bill will be partly offset by declining prices for aluminium, a key export, as global demand softens. However, the strength and extent of the collapse in import demand resulted in a merchandise trade surplus in H1 2009. Despite a continuing deficit in the balance on investment income, we now forecast an improvement in the current account balance, with perhaps a deficit equivalent to around 5% of GDP this year and 1-2% in 2010, compared with a deficit of almost 40% of GDP in 2008.

SUMMARY & CONCLUSION

Iceland's home-grown, foreign-funded boom in recent years led to macro-economic imbalances, overstretched private sector balance sheets and a high dependence on foreign financing. Significant deterioration in economic indicators included a current account deficit equivalent to 15% of GDP, inflation above its target range, krona overvaluation, rapid expansion in domestic credit aggregates and ratios, a financial sector equivalent to 900% of the country's GDP and gross external indebtedness of 550% of GDP at end-2007. As the global financial crisis spread, Iceland's banking sector collapsed as credit dried up. Even before the advent of the banking crisis a hard-landing and possible recession were expected. With access to credit markets virtually closed and severe liquidity constraints, the government nationalised the bulk of the banking sector and appealed to the international community for financial assistance. An IMF emergency facility is now in place and that resulted in other funding from the other IFIs and bilateral donors. With the financial bail-out, however, came the need for implementation of corrective (austerity) economic policies and a full recession is now in progress.

A high concentration and interlocking shareholding structure in Iceland's corporate sector has resulted in problems for leading companies and investment vehicles. Moreover, with recession in 2009, small- to medium-sized companies have also faced severe difficulties and business failures and the number of insolvencies have risen. We expect the economy to contract by 10% this year, with a further fall of around 2% in 2010. Capital controls are still in place.

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