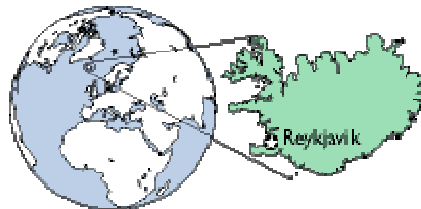


COUNTRY REVIEW

Iceland



8 June 2011

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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.

Strengths

- Long history of political stability and relative ease of transition between governments, although there is a tendency for coalition administrations that sometimes require careful management
- High per capita incomes
- High GDP growth rates in years up to 2008
- Natural resource base includes gas reserves, lessening the need to import fuels
- In its time of need in 2008-10, financial support was forthcoming from Nordic central banks and then from the IMF, suggesting that further support, if needed, will be made available, as long as the government remains committed to reform policies and other adjustments

Weaknesses

- Dependence on fishing and aluminium sectors for merchandise trade
- Large current account deficits
- Very high foreign debt ratios (Note: this should not be compared prima facie with analysis of foreign debt in emerging markets)
- Low import cover (Note: this should not be compared prima facie with emerging markets)
- Exchange rate subject to volatility because of international market fluctuations and speculative forces

Key Risks

- Failure to reach a compensation deal with the UK and Netherlands relating to lost Icesave deposits complicates progress towards EU membership, ability to raise international capital and to lift self-imposed capital controls, thereby threatening the putative economic recovery and ability to implement reforms and restructuring

Country Risk Assessment

Ratings	Iceland	Median	Argentina	Peers	Latvia
	Latest	Grade D		Ukraine	
Systemic Political Risk:	P2+	P3-	P2-	P3-	P2+
Systemic Economic Risk:	E6	E6	E6	E6	E5
ME rating:	ME6	ME6	ME6	ME6	ME5
<i>Structure</i>	3.3	6.0	6.0	5.0	4.0
<i>Policy</i>	6.0	5.6	3.8	6.0	5.6
<i>Solvency</i>	5.9	4.3	5.1	6.0	5.9
<i>External Liquidity</i>	5.2	4.3	2.3	3.2	3.8
SBE rating:	SBE1	SBE6	SBE4	SBE5	SBE2
COUNTRY GRADE:	D	D	D	D	C
Nomenclature: Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk). Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk). ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk). The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst). SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst). Source: Euler Hermes Country Risk Unit					

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Reykjavik
Population:	0.32 mn (2009)
GDP:	USD 12093 mn (2009)
Currency:	Krona (ISK)
Form of state:	Republic
Head of government:	PM Johanna Sigurdardottir
Next elections:	Parliamentary by April 2013

Major Industries (% of GDP at market prices, 2010)	Global Assumptions	2010	2011f
Fishing	5.3%	World GDP (% yr/yr)	4.1
Manufacturing	16.5%	Dated Brent (USD/b)	110.0
Wholesale & retail trade	9.1%		
Transport & communication	7.3%		

Main Exports (% of total, 2010)		Main Imports (% of total, 2010)	
Marine products	39.3%	Industrial supplies	33.0%
Cod	12.9%	Capital goods	22.6%
Manufacturing	55.4%		
Aluminium	39.6%		
Lead Export Markets (% of total exports, 2010)		Lead Import Markets (% of total imports, 2010)	
Netherlands	34.0%	Norway	9.1%
Germany	14.0%	Brazil	8.7%
UK	10.1%	Netherlands	8.5%
Spain	4.7%	US	7.9%

Basic indicators

Selected economic indicators	2007	2008	2009	2010e	2011f
Nominal GDP (USD mn)	20,426	16,863	12,094	12,594	14,522
Population (mn)	0.31	0.32	0.32	0.32	0.32
GDP per capita (USD)	65,892	52,698	37,794	39,357	45,380
Real GDP growth (% yr/yr)	5.9	1.4	-6.9	-3.4	2.0
Inflation (% average)	5.1	12.7	12.0	5.4	4.0
Fiscal balance (% of GDP)	5.5	-8.4	-7.4	-5.9	-3.0
Current account balance (% of GDP)	-15.6	-26.5	-10.4	-7.7	-4.5
External debt/GDP (%)	567.9	889.5	992.2	952.8	826.3
External debt/Exports of goods & services (%)	1,005.3	1,682.2	1,900.8	1,710.9	1,500.0
Debt-service ratio (%)	80.6	72.9	72.9	59.9	55.0
Foreign exchange reserves (USD mn)	2,549	3,486	3,639	5,557	5,250
Import cover (months)	2.1	3.3	5.8	8.4	7.5
Exchange rate assumption, ISK:USD (av)	64.1	88.0	123.6	122.2	115.0
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Background and EH Position

Iceland's severe downgrade from AA to D (by December 2008) resulted from significant deterioration in macro-economic indicators, particularly the current account deficit, inflationary pressures and increase in foreign debt, as well as a systemic collapse in the banking system. 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 was put 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 an outright recession resulted in 2009 and 2010.**

A high concentration and interlocking shareholding structure in Iceland's corporate sector resulted in problems for high profile companies and investment vehicles. Moreover, small- to medium-sized companies also faced severe difficulties and **business failures and the number of insolvencies increased.**

Policy adjustments appear to have stabilised the economy and moderate GDP growth is now forecast for 2011. However, the recession was severe and recovery will be prolonged process, including **continuation in the short term of exchange restrictions (capital controls).**

Political Stability

General elections were held on 25 April 2009 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 current 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 2009 a formal application process. Accession negotiations are scheduled to start in late-2011, with a referendum perhaps late-2012 and, potentially, quick-route membership in 2013. However, the result of the referendum is in balance as polls have indicated that around 30% of the population now supports EU application, compared with around 80% in mid-crisis. Moreover, problems within the EU, including sovereign debt default risks, may extend the length of the process and colour perceptions of Icelanders prior to the referendum. For now, **the policy focus remains ST economic stabilisation**, but a possible route to EU membership is mapped out and is in progress.

The government has also tried 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. A second compensation deal (April 2011) was rejected by a national referendum, even though it had been approved by parliament, and the UK and Netherlands are taking Iceland to court (via the EFTA Surveillance Authority) for resolution. The Icesave issue provides a further potential hold-up to EU membership and to further international and bilateral financial assistance.

Although the basic political system is stable, **the current government** has had to endure what are effectively votes of confidence in its policies and leadership and it **is not guaranteed to survive its full term.** However, government collapse would probably necessitate formation of another coalition and is unlikely to prove destabilising to the system. Internal divisions are evident in relation to implementation of austerity measures, as well as over EU membership, the Icesave agreement and speed with which the banking system can be re-invigorated. Outside government, there is resentment that ordinary citizens are now paying the penalty for the perceived excesses of bankers and corporate dealers. Austerity measures have impacted negatively on job availability and personal consumption. Nevertheless, we do not envisage excessive civil disorder and the commercial climate and business effectiveness are unlikely to be impaired.

Economic Stability

In early June 2011, the IMF concluded its fifth review under a Stand-by Arrangement (SBA), with a broad assessment that Iceland is continuing to **emerge from crisis and that economic growth will be moderately positive in 2011, after two consecutive years of outright contraction.** The Fund noted that marked progress has been made in implementing policies, particularly in relation to control of public finances, exchange rate stabilisation and control of inflationary pressures. Nonetheless, some **significant challenges remain, including an orderly lifting of current capital controls,**

reduction of unemployment (8%), further private sector debt restructuring and continuation of reforms to the supervision and regulation of the financial sector. The USD2.1bn IMF-supported financial package and associated reform programme expire in August, although further assistance would probably be made available at the request of the Icelandic authorities. The latter may feel they do not require further multilateral support.

Real GDP growth was 2% qtr/qtr and 2.2% yr/yr in Q1 2011, following 0.1% yr/yr in Q4 2010. Before the latter, GDP had been contracting since Q3 2008, on an annual base. **Latest data therefore suggest that economic recovery is now in place**, although key contributions to the more rapid Q1 growth came from inventory accumulation and from import compression and an accompanying boost from net exports. Both consumption and investment remain lacklustre. Moreover, the **size of the economy is still 11% below its peak in 2007.**

Capital controls are a negative influence on foreign investor perceptions and on limitations of movement of domestic investment. The fact that controls were considered at all as a policy option indicates the size of the economic shock associated with the crisis and the scale for potential capital flight of both foreign- and locally-controlled money. Given the potential impact of capital flight on the balance of payments, even the IMF acknowledged the appropriateness of controls. The Fund believes **capital restrictions should be lifted as quickly as possible**, but such action should not lead to destabilisation of the progress so far made. Accordingly, we believe the Icelandic authorities will maintain a cautious approach and that controls will remain in place in the ST, although it is possible that some limited phasing out may be undertaken.

To contemplate lifting capital controls, the Icelandic authorities will require sufficient international reserves to meet any outflows and to provide other support. In this regard, Treasury access to the international capital markets will be a key indicator of the timing of potential control easing. With **FX reserves of over USD5bn (providing an import cover of 7-8 months)** short-term debt obligations do not pose a significant threat. In addition, reserves and other support may be boosted through an approach to the capital markets and a **USD1bn bond issue is currently being contemplated** (the cost of insuring against sovereign credit default is at its lowest since the crisis and is better than for several Euro states.) Even so, further financial sector stability is needed to ensure that banks are sufficiently liquid to withstand potential deposit withdrawals and **controls are therefore likely to remain in place in the ST.**

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Charts

