Iceland

Full Rating Report

Ratings

Foreign Currency	
Long-Term IDR	BBB−
Short-Term IDR	F3
Local Currency	
Long-Term IDR	BBB+
Country Ceiling	BBB−

Outlooks

Foreign-Currency Long-Term IDR	Stable
Local-Currency Long-Term IDR	Stable

Financial Data

Iceland

(USDbn)	2011
GDP	14.1
GDP per head (USD 000)	42.1
Population (m)	0.3
International reserves	8.5
Net external debt (% GDP)	683.4
Central government total debt (% GDP)	81.1
CG foreign-currency debt	2.9
CG domestically issued debt (ISKbn)	1,327.2

Related Research

Global Economic Outlook (December 2011)
Sovereign Review and Outlook (December 2011)
Sovereign Data Comparator (December 2011)

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Key Rating Drivers

Investment Grade Rating Restored: The upgrade of Iceland's Long-Term Foreign Currency IDR to 'BBB−' from 'BB+' reflects the progress that has been made in restoring macroeconomic stability, restructuring the financial sector and rebuilding sovereign creditworthiness since the banking and currency crisis that befell Iceland in late 2008.

Ahead of the Pack: As the first country to suffer the full force of the global financial crisis, Iceland successfully completed a three-year IMF-supported rescue programme in August 2011. The programme has delivered renewed access to international capital markets and an encouraging rebound in economic growth to 3% in 2011, setting Iceland apart from some of its more troubled eurozone peers and near peers.

Track Record Reasserts Itself: Iceland developed a strong track record of fiscal consolidation prior to its banking and currency crisis. Post-crisis, Iceland has been among the frontrunners in advanced economies in terms of fiscal consolidation. It cut its primary deficit from 6.5% of GDP in 2009 to 0.5% in 2011 and the government appears to be on track to attain primary fiscal surpluses from 2012 and headline surpluses from 2014.

Favourable Public Debt Dynamics: With financial sector restructuring now largely complete and fiscal consolidation on track, Fitch believes that general government debt peaked at almost 100% of GDP in 2011. Barring further shocks, Iceland should see a sustained reduction in its public debt/GDP ratio from 2012. Net debt is significantly lower at 65% of GDP, while near-term fiscal financing risks are low. However, the risk of additional contingent liabilities migrating to the sovereign's balance sheet remains high.

Legacy Issues: Iceland's unorthodox crisis policy response has succeeded in preserving sovereign creditworthiness at a price; capital controls continue to block repatriation of USD3bn-4bn of non-resident investment in ISK instruments, while the protracted dispute over Icesave and the reimbursement of USD5bn of deposit insurance outlays to the UK/Netherlands is unresolved. Resolution of this dispute awaits an EFTA court ruling and could potentially add up to 13% of GDP to public debt, while an orderly unwinding of capital controls will take time.

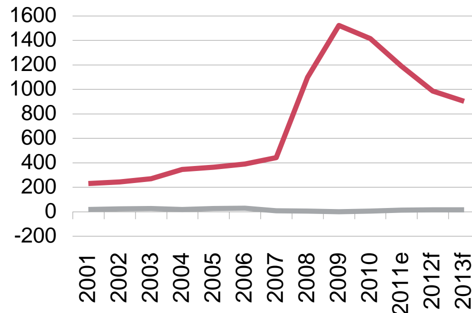
Keeping Contagion at Bay: So far, Iceland has been largely unaffected by the eurozone sovereign debt crisis and, although growth is expected to slow in 2012-2013, Fitch does not expect Iceland to slip back into recession. However, the private sector remains heavily indebted – household debt exceeds 200% of disposable income and corporate debt 210% of GDP – highlighting the need for further domestic debt restructuring, while the key export sector has been held back by capacity constraints and a lack of investment.

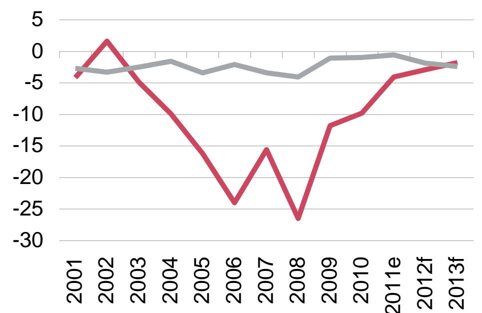
Underlying Rating Strengths: Measures of governance, Human Development and Ease of Doing Business are akin to 'AAA' levels, as is Iceland's income per head. Rich natural resources, a young population and robust pension assets are additional rating attributes.

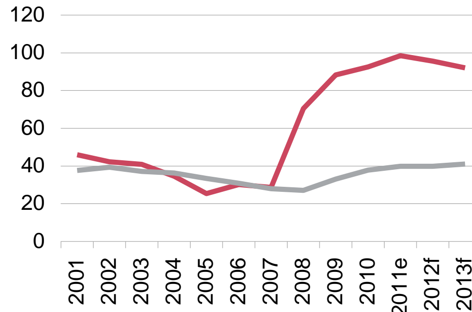
What Could Trigger a Rating Action

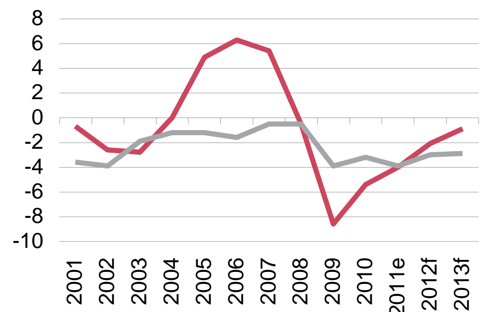
Work In Progress: Future sovereign rating actions will take a range of factors into account including economic recovery and fiscal consolidation and progress towards public and external debt reduction. Accelerated private sector domestic debt restructuring, a progressive unwinding of capital controls, normalisation of relations with external creditors and enduring monetary and exchange rate stability would advance Iceland's investment grade status.

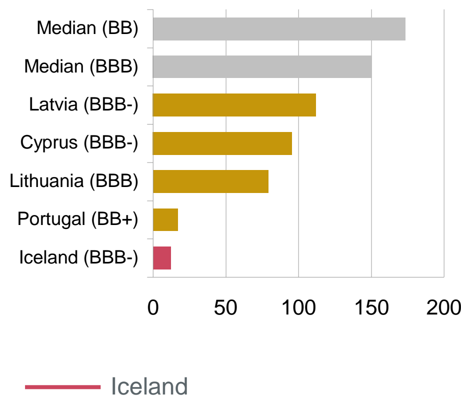
Peer Comparison

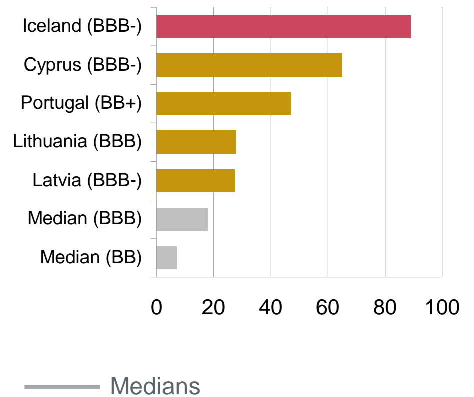












Iceland Medians

Related Criteria

Sovereign Rating Methodology (August 2011)

Rating Factors

Peer Group

Rating	Country
BBB	Aruba
	Bahrain
	Brazil
	Kazakhstan
	Lithuania
	Mexico
	Panama
	Peru
	Russia
	Thailand
BBB-	**Iceland**
	Azerbaijan
	Bulgaria
	Colombia
	Croatia
	Cyprus
	India
	Indonesia
	Latvia
	Morocco
	Namibia
	Romania
	Tunisia
BB+	Costa Rica
	Guatemala
	Hungary
	Macedonia
	Philippines
	Portugal
	Turkey
	Uruguay

Rating History

Date	Long-Term Foreign Currency	Long-Term Local Currency
17 Feb 12	BBB−	BBB+
05 Jan 10	BB+	BBB+
08 Oct 08	BBB−	A−
30 Sep 08	A−	AA
15 Mar 07	A+	AA+
03 Feb 00	AA−	AAA

Summary: Strengths and Weaknesses

Rating factor	Macroeconomic	Public finances	External finances	Structural issues
Status	Weakness	Weakness	Weakness	Strength
Trend	Stable	Positive	Stable	Stable

Note: Relative to 'BBB' category/sovereigns rated 'BBB', 'BBB−' and 'BBB+'.
Source: Fitch

Strengths

- In qualitative terms – measures of governance, Human Development, and Ease of Doing Business – Iceland is more akin to an 'AAA' than a 'BBB−' rated sovereign.
- Iceland's superior income per head is indicative of a greater level of 'debt tolerance' than poorer rating peers which, together with its robust tax base and well-endowed pension funds, supports sovereign creditworthiness.
- An established track record of public debt reduction prior to the financial crisis has reasserted itself: a medium-term fiscal consolidation programme aims to deliver fiscal balance by 2014 and a reduction in debt/GDP from a peak of 98% in 2011 to 60% by 2020.
- Flexible labour and product markets, coupled with a floating exchange rate and a penchant for national unity in the face of adversity have helped Iceland to graduate from its IMF programme and post growth of 3% in 2011, following a deep recession in 2009-2010.
- Fitch views Iceland as less at risk of slipping back into recession than some troubled eurozone countries, given the depth of its financial sector reforms, the robustness of its fiscal austerity programme and the elimination of serious macroeconomic imbalances.
- Iceland maintained sovereign debt service in the face of unprecedented financial sector distress, albeit with the help of capital controls, and regained market access in mid-2011.

Weaknesses

- Iceland has yet to normalise relations with external creditors. Extensive capital controls are still in place, blocking non-resident repatriation of a captive USD3bn-4bn of ISK-denominated assets, while a protracted dispute over Icesave, an offshore internet branch of Landsbanki, still overshadows sovereign creditworthiness and the public finances.
- Monetary and exchange rate policy are in an unstable equilibrium, pending the dismantling of exchange controls. The challenge for the authorities is to dismantle these in a sufficiently timely manner that avoids damaging the outlook for investment and growth, yet is not so hasty as to trigger renewed funding strains and macro-economic instability.
- Gross/net general government debt is markedly higher than peer group medians, driven upwards by the direct and indirect costs of the financial sector crisis in 2008-09. Public external debt has also risen sharply, but net sovereign external debt remains at low levels, reflecting record levels of international reserves (USD8.5bn at end-2011).
- High levels of private debt/GDP, much of it foreign exchange or inflation indexed, pose a risk to financial stability and economic recovery. Externally, Iceland remains a stand-out on measures of gross and external debt pending resolution of failed banks' external assets and liabilities.

Local Currency Rating

The two-notch differential between the Long-Term Foreign ('BBB−') and Local-Currency IDRs ('BBB+') reflects the comparative sophistication and depth of the domestic ISK market.

Country Ceiling

The Country Ceiling is aligned with the sovereign's Long-Term Foreign Currency IDR, reflecting the imposition of capital controls since November 2008, which ring-fenced sovereign debt service but trapped USD3bn-4bn of non-resident investment in local currency debt instruments.

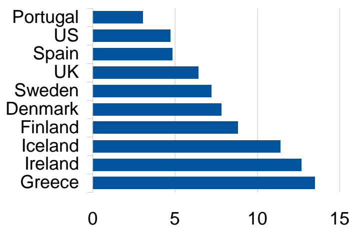
Outlook and Key Issues

The restoration of Iceland's Long-Term Foreign Currency rating to investment grade reflects the progress that has been made in restoring macroeconomic stability, addressing structural reform, rebuilding sovereign creditworthiness and regaining capital market access since the 2008 banking and currency crisis. A promising economic recovery is underway, financial sector restructuring is well advanced, while public debt/GDP may have peaked in 2011 on the back of a robust fiscal consolidation programme. These developments build upon structural factors that are more akin to 'AAA' levels than the lowest rung of investment grade.

Figure 1

Output Losses in Financial Crisis

% of GDP peak to trough as at Q311



Source: CBI

Macroeconomic Developments

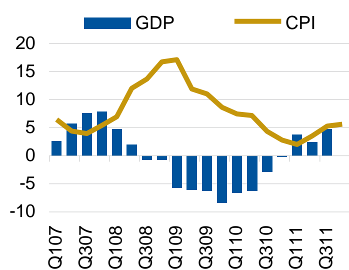
The banking and currency crisis that befell Iceland in 2008 cost the country almost 12% in lost output measured from peak to trough, on a par with Ireland and significantly less than the Baltics. In contrast to eurozone member-state Ireland, Iceland avoided the onset of deflation, as a steep fall in the exchange rate fed through to double digit inflation. However, widespread indexation to prices and the exchange rate meant that the financial standing of households and corporates suffered a heavy blow, precipitating steep falls in private consumption, down 22%, and investment down 68%. The severity of these falls was accentuated by the economy clearly overheating in 2006-2007.

Quarter-on-quarter GDP figures indicate that economic recovery began in mid-2010 and the economy recorded year-on-year growth of 3.7% in the first nine months of 2011, helped by a strong third quarter. Growth was driven by a strong rebound in private consumption and, to a lesser extent, investment. Household debt restructuring, generous real wage increases (nominal wages rose 9% yoy in 2011, more than double consumer price inflation of 4%), third-pillar pension payouts and rising house prices (up 10% nationally) all contributed to this outturn.

Figure 2

Output and Prices

% change year-on-year



Source: Statistics Iceland, CBI

One of the more disappointing aspects of Iceland's recovery has been the negative contribution of net exports, even though the real exchange rate is now more than 20% below its long-run average whether measured on a consumer price or unit labour cost basis. A narrowing of the current account deficit from 26.5% in 2008 to 4% of GDP in 2011 was mostly attributable to a collapse in demand for imports of goods and services.

Merchandise exports have been slow to respond to the steep fall in the Icelandic krona chiefly because of capacity constraints in the marine and aluminium smelting sectors and a precipitous decline in investment. There are some signs of a pick up in investment in the energy sector and tourism has exhibited strong growth, but rising real wages threaten to erode post-crisis gains in international competitiveness, while capital controls remain an obstacle to foreign investment.

Figure 3

Growth Forecasts (%)

Institution	2012	2013
Central Bank of Iceland	2.5	2.5
Statistics Iceland	2.4	2.5
Fitch	2.3	2.5
Federation of Labour	1.5	2.0

Source: Fitch

Prospects for Recovery

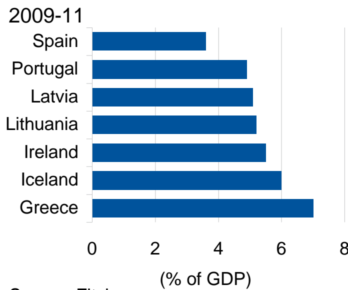
The strength and durability of the recovery will be key to the restoration of sovereign creditworthiness. The economy needs to rebalance away from the financial sector, which generated severe macroeconomic imbalances in 2004-2008 that were Iceland's undoing. While fishing, tourism and energy-related industries promise to be the mainstay of future prosperity, most sectors of the economy have emerged from the crisis with much higher debt levels. Household debt exceeds 200% of disposable income; corporate debt (210% of GDP) is among the highest in the industrialised world; and public debt is almost 100% of GDP.

The outlook is dominated by the global economic environment. Given its close links to Europe, Iceland remains vulnerable to a further escalation in the eurozone banking and sovereign debt crisis. With 60% of Icelandic exports destined for the eurozone, contagion is expected to come mainly through trade channels. In the short term, capital controls should act as an effective buffer against financial contagion; in the long term, further delays in their relaxation would act as a drag on recovery, as would any moderation in the pace of domestic debt restructuring. Fitch looks for growth of 2%-2.5% in 2012-2013, down from an estimated 3% in 2011.

Figure 4

Change in Primary Balances

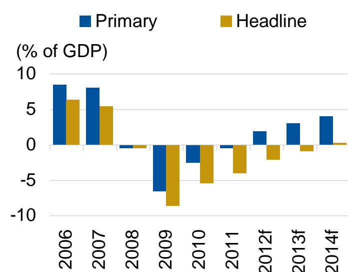
2009-11



Source: Fitch

Figure 5

General Government Balances



Source: Fitch, IMF

Figure 6

Fiscal Reversals in Primary Balances: Selected Countries

(% of GDP)	Cumulative adjustment	Duration
Finland	15.0	1993-02
Denmark	14.7	1982-86
Sweden	14.2	1993-99
Iceland	11.3	2009-16
UK	9.6	2009-15
Ireland	8.5	1986-93
Latvia	7.5	2009-13

Source: CBI, IMF, EC

Public Finances

Prior to the banking and currency crisis, Iceland developed a strong track record of fiscal consolidation; in 1995-2005 general government debt/GDP fell from 59% to 25% and primary surpluses of 7%-8% of GDP were recorded in 2005-2007. In this sense, Iceland entered the financial crisis with a strong sovereign balance sheet. Under the twin pressures of recession and financial sector collapse, the primary balance abruptly reversed, deteriorating by the equivalent of 14.5% of GDP in 2007-2009, while gross general government debt (GGD) had risen more than threefold to almost 100% of GDP by end-2011.

Among advanced economies, post-crisis fiscal consolidation in Iceland has been second only to Greece, which faltered badly in 2011. The Icelandic authorities demonstrated a strong commitment to fiscal adjustment from the outset. Front-loaded revenue and expenditure measures equivalent to 10% of GDP, mostly of a permanent nature, cut the primary deficit from 6.5% of GDP in 2009 to 0.5% of GDP in 2011, effectively clawing back 40% of the deterioration that occurred in 2007-2009.

Robust revenues, lower-than-expected costs of financial sector stabilisation and the judgement that public debt probably peaked in 2011 allowed the government to accommodate some expenditure slippage in 2011 and modify the pace of fiscal consolidation from 2012. The re-emergence of spending pressures in H211 owed much to higher public sector wage awards and wage-related social benefits, exchange rate depreciation and the cost of natural disasters (eg, volcanoes). Nonetheless, Fitch expects Iceland to attain primary surpluses from 2012 and headline general government surpluses from 2014 (one year later than planned).

Assuming fiscal consolidation remains on track, the IMF estimates that Iceland should realise cumulative primary fiscal adjustment of 11%-12% of GDP by 2016 and structural adjustment of over 10%. This degree of adjustment would be close to some of the successful Nordic fiscal adjustment programmes of the 1990s. A combination of higher taxation – environmental, resources and financial sector – administrative reforms and extensive reforms in local government (a perennial source of weakness in the past) will be key to this outcome.

Fiscal Financing

Financial markets have remained weak following the banking crisis, leaving government and government guaranteed bonds as the most active capital markets. The sovereign's overriding priority in the wake of the crisis was to preserve its own debt-servicing capacity. The imposition of capital controls in November 2008 denied domestic and non-resident investors the opportunity of exchanging their capital into foreign exchange, trapping USD3.8bn of non-resident investment in Icelandic krona-denominated financial instruments.

Public Finances: Sources and Uses (% GDP)

	2010	2011e	2012f	2013f
Uses	**23.7**	**14.9**	**7.1**	**5.0**
Budget balance	8.0	2.9	1.2	0.1
Amortisation (by place of issue)	15.7	12.0	5.9	4.9
Domestic	8.7	4.7	3.7	4.6
Foreign	7.0	7.3	2.2	0.4
Sources	**23.7**	**14.9**	**7.1**	**5.0**
Gross borrowing (by place of issue)	26.5	16.4	6.6	5.0
Domestic	12.6	7.8	4.3	3.3
Foreign	14.0	8.5	2.3	1.7
Privatisation/equity sales	3.8	0.0	0.0	0.0
Short-term, net	-0.7	0.0	0.0	0.0
Change in deposits (- = Increase)	-6.0	-1.5	0.6	0.0

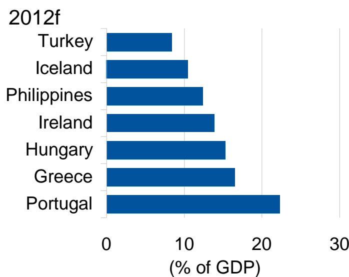
Source: Fitch

From a fiscal financing viewpoint, this pool of capital has served as a captive market for the central government; non-residents hold 50% (ISK29bn) of the stock of T-bills and are the largest owners by far (ISK142.5bn) of short and medium-term Treasury bonds (RB1223, RB13

Figure 7

Gross Fiscal Financing Need

2012f



Source: IMF Fiscal Monitor

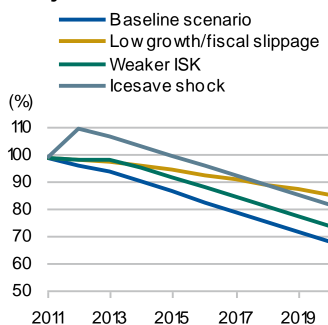
and RB16). Well-funded Icelandic pension funds dominate the opposite end of the spectrum, holding almost 40% of RIK19 and 65% of bonds maturing in 2022 or later. Lengthening the maturity profile of Treasury debt – the average duration of Treasury bonds has risen from three to seven years – is viewed as a prerequisite to lifting capital controls.

The sovereign is highly liquid. Aside from financing larger budget deficits and financial sector restructuring, the government's debt management strategy has concentrated on building up sufficient cash buffers – domestic and foreign currency – to secure debt service and meet the eventual challenge of lifting capital controls.

Domestically, the Treasury has accumulated sufficient deposits at the Central Bank of Iceland (CBI) to cover 12 months of domestic debt service. Externally, the government has contracted USD5.1bn of IMF/bilateral official loans since 2008, to rebuild international reserves and meet external debt service. The Republic of Iceland also successfully regained access to the international capital markets in mid-2011, raising USD1bn over five years at 4.875%. A significant proportion of these loans have been routed through the general government before being deposited at the CBI.

Figure 8

General Government Debt Projections



Source: Fitch

Favourable Public Debt Dynamics

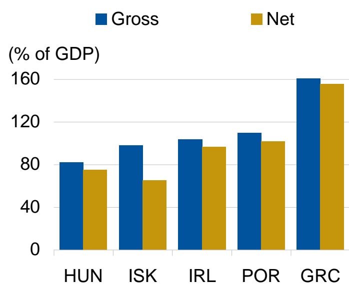
Iceland's sovereign debt profile has been materially weakened by its financial crisis. General government debt has risen rapidly since 2007, as the general government balance swung into deficit and the authorities were obliged to contract additional liabilities to recapitalise the domestic financial sector (25% of GDP) and strengthen the foreign currency reserves (18% of GDP)[1]. With the bulk of financial sector restructuring now complete, IMF/bilateral loans fully disbursed and fiscal consolidation on track, Fitch estimates that GGD may have peaked at 98% of GDP in 2011 (excluding the potential impact of Icesave – see below)[2].

Iceland's public debt dynamics look more favourable than for Ireland or Portugal, where debt has yet to peak at higher levels of 119% and 116% respectively in 2013. In contrast to the eurozone peripheral economies, Iceland has been able to devalue its currency, rather than subjecting its economy to a challenging internal devaluation (and the associated debt/deflation risks) that both Ireland and Portugal have gone through.

Under Fitch's baseline scenario – a primary surplus of 4% of GDP (in line with the average for 1998-2007), average nominal GDP growth of 5.4% and average nominal interest rates of 4.8% – GGD peaks at 98% in 2011 and declines to 68% of GDP by 2020.

Figure 9

General Government Debt



Source: Fitch

There are a range of alternative scenarios that could derail this outcome, not least an unfavourable ruling on Icesave that required Iceland to reimburse the UK/Dutch governments for the residual amounts of both insured and uninsured deposits plus financing costs after asset recoveries (see below). Such an outcome could potentially add over 13% of GDP to the public debt stock, taking GGD to almost 110% of GDP, assuming that asset recoveries evolve as the authorities expect and conceivably much more if recoveries fall short of expectations.

Growth is typically (ex-post) the most important contributor to large declines in public debt. In a worst case scenario where lower growth and sub-optimal fiscal outcomes persist over the long term, a public debt/GDP ratio of 85% by 2020 suggests that public debt sustainability would still be within Iceland's grasp, barring a highly adverse outcome to the resolution of Icesave.

[1] Some of the funds to strengthen the international reserves were channelled through the general government; the remainder were contracted by the CBI.

[2] In addition, outstanding government guarantees equated to 82% of GDP at end-November 2011. Of this, 70% represented state backing for residential mortgages through the Housing Finance Fund (recapitalised in 2010) and 26% related to Landsvirkjun, the national power company.

Figure 10

Size of the Financial Sector: Pre and Post Crisis (% of GDP)

Institution	Assets end-2007	Assets end-2010
Banks	**985**	**193**
Commercial	937	189
Glitnir/ Islandsbanki	225	57
Kaupthing/ Arion	409	53
Landsbanki/ Landkinn	234	76
Others	69	3
Savings banks	48	4
SPRON	17	-
Old Byr	14	-
Sp Kef	7	-
Others	10	4
Non-banks	82	73
Housing finance fund	46	54
Others	36	19
Total	**1,086**	**266**
Memo		
No. of institutions	37	23
Banks	23	14
Non-banks	14	9

Source: FME, IMF

The distinction between gross and net public indebtedness further distinguishes Iceland from some of its peers. Factoring in central government deposits at the CBI of ISK469bn (29% of GDP) at end-2011 reduces net debt to 65% of GDP, well below Portugal, Ireland and Hungary.

Financial Sector

Although Iceland chose to impose losses on its failed banks' external creditors, the gross fiscal costs of *domestic* financial sector support and restructuring at 44% of GDP[3] was not dissimilar to Ireland (40%) that explicitly guaranteed all banks' external liabilities. Part of the explanation for this is that Iceland suffered one of the most complete examples of a financial sector meltdown in modern times; measured by assets, an estimated 97% of the system collapsed between October 2008 and March 2009. Unlike Iceland, Ireland has also funded significant financial sector support through off-balance sheet special purpose vehicles.

Restructuring and recapitalisation of the Icelandic financial system is now virtually complete and is not expected to make further demands on the state. Significant consolidation has taken place, with smaller institutions merged into larger units. The system has shrunk to one-fifth of its pre-crisis size, foreign exchange imbalances have fallen substantially and the focus is almost entirely on domestic activities. Capital adequacy ratios of the three largest commercial banks stood at 24% at end-September, well ahead of the minimum regulatory requirement of 16%.

Appreciable capital adequacy and liquidity ratios reflect the high degree of uncertainty surrounding banks' asset quality – approximately one-third of banks' loan portfolios have been restructured, while close to one-quarter are still non-performing – and the potential erosion of deposits once capital controls are lifted.

Domestic debt restructuring accelerated throughout 2011, but progress is slow and 19% of household and 25% of corporate lending remained in default as at end-September. On the funding side, with virtually no access to foreign funding, banks remain highly dependent on deposits, 9% of which are owned by non-residents and 'locked in' by capital controls. Cognisant of the risks of high deposit outflows, the largest banks held secure liquid assets equivalent to 41% of their deposits at end-October.

Icesave: Protracted Resolution

Fitch regards the resolution of Icesave – an offshore branch of failed Landsbanki that accepted online deposits in foreign currencies from foreign depositors in the UK (EUR4.5bn) and the Netherlands (EUR1.7bn) – as an important step towards full restoration of sovereign creditworthiness and the normalisation of relations with international creditors.

Risks posed by the Icesave dispute have diminished in relation to external funding from official creditors and broader economic recovery. However, reimbursement of the UK and Dutch governments up to (and potentially beyond) the Icelandic deposit insurance scheme amount of EUR20,000 per depositor, and associated debt service costs, remains a material contingent liability for the state (see public debt dynamics above).

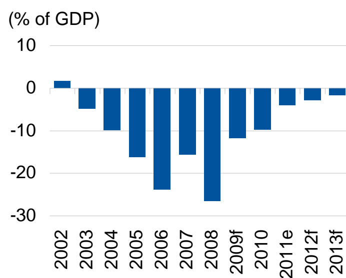
Following popular rejection in a second national referendum of a negotiated solution in early 2011, the dispute was referred to the EFTA Surveillance Authority. EFTA upheld the Deposit Guarantee Directive compelling Iceland to pay minimum compensation of EUR20,000 per depositor and announced on 14 December 2011 that it would be pursuing the matter through the EFTA Court. If the court ruling should go against Iceland, the authorities will be required to take immediate action to comply with the court's judgement and the UK and the Netherlands could pursue the government for the associated debt service costs.

[3] The IMF estimates net fiscal costs of bank support and restructuring at 20% of GDP, in recognition of assets equivalent to 24% of GDP the government acquired as a result of recapitalising the CBI and the 'new' commercial banks.

The Icelandic authorities are committed to resolving the Icesave dispute in an orderly manner. In the meantime, they are confident that asset recoveries from the failed Landsbanki estate should be sufficient to cover 90%-100% of deposit liabilities. A first instalment of EUR900m was paid out to the UK and Dutch governments in December 2011 and the authorities expect deposit claims to be paid out in full by the end of 2013. If insured deposits were accorded super-priority status, they could conceivably be fully reimbursed by end-2012. In that event, should the EFTA Court ruling go against Iceland, the government could potentially be liable for financing costs of 6%-13% of GDP.

Figure 11

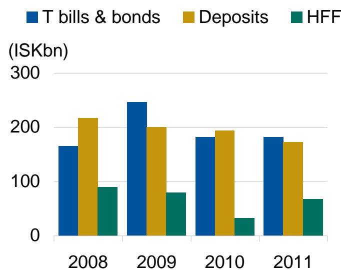
Current Account Balance



Source: Fitch

Figure 12

Non-Resident Holdings of ISK Assets



Source: CBI

External Finances

Iceland's current account deficit has undergone a marked reversal since 2008 when it peaked at 26.5% of GDP. Even so, a significant discrepancy remains between cash and accruals; the current account balance is flattered by the failed financial sector's cessation of interest payments to external creditors, while Iceland's international investment position (IIP) is heavily encumbered by 'old (failed) banks' disproportionate assets and liabilities.

Iceland graduated from its IMF programme in August 2011. Borrowing from official creditors was key to rebuilding international reserves to a record USD8.5bn (60% of GDP) at end-2011. Recovery of 'old banks' assets from abroad also made an important contribution, while the issue of a USD1bn sovereign bond in mid-2011 marked an important milestone along the road to rebuilding sovereign creditworthiness. Two further developments would help to complete this process: resolution of the Icesave dispute (see above) and the unwinding of capital controls.

Capital Controls Dilemma

The imposition of capital controls in November 2008 was central to preserving economic and financial stability and ring-fencing sovereign creditworthiness. They have, however, damaged the investment climate and locked in USD3.4bn of non-resident offshore ISK holdings.

At this stage, capital controls are supporting the exchange rate and shielding Iceland from the worst of the fall-out from the eurozone crisis. The authorities face a dilemma. Indiscriminate unwinding of capital controls would probably expose Iceland to damaging capital flight (resident and non-resident), a collapse of the exchange rate, soaring inflation and renewed financial sector instability[4]. However, the longer controls remain in place, the more detrimental they will become to investor sentiment and broader economic recovery.

In March 2011, the CBI announced a gradual timetable for lifting controls. Three preconditions were highlighted: restoration of macroeconomic stability; an adequate level of international reserves; and a sound financial system. Significant progress has been made on all three, yet the steps taken towards liberalisation in 2011 were fewer and smaller than originally intended.

Fitch views the resumption of modest foreign currency auctions starting in February 2012 as an encouraging step forward. However, Iceland's exit from capital controls promises to be lengthy, given the underlying risks to macroeconomic stability, fiscal financing and the newly restructured commercial banks' deposit base.

Public External Finances

Prior to the crisis, Iceland's public external debt was low at around 19% of GDP in 2007; post crisis, it now stands at 67% of GDP, reflecting borrowing from the IMF and bilateral creditors. The sovereign, defined in this instance as the CBI and the central government, is, therefore, significantly more exposed to foreign exchange risk than before. However, because foreign borrowing has been used almost exclusively to rebuild international reserves, sovereign net external debt measures are little changed from 2007 and not dissimilar to peers. Conversely, although international reserves stand at a record USD8.5bn, they are almost fully leveraged.

[4] Fitch estimates that predetermined drains on the reserves, including 'locked in' offshore ISK holdings could amount to USD4.5bn (60% of reserves), if controls were lifted with immediate effect.

With little market debt falling due in the next few years – barely EUR500m in 2012-2014 – sovereign external debt service (general government and the monetary authorities) will be dominated by repayments to official creditors. IMF loans will amortise in 2012-2016 and Nordic and other bilateral loans in 2014-2021. In addition, non-resident holdings of ISK public debt instruments equate to a potential claim of USD1.9bn on the reserves at current exchange rates. The government is intending to build on its renewed access to international capital markets to refinance non-market debt over time.

'Old Banks' Distort External Assets and Liabilities

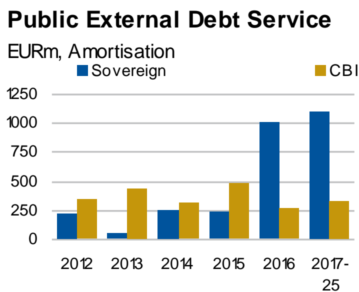
Iceland's net international investment and external debt service metrics are distorted by the winding up of 'old banks' assets and liabilities. 'Old banks' are recovering assets from abroad and repayments to external creditors have begun, most notably EUR900m in December 2011 from Landsbanki in respect of Icesave liabilities. This process has some way to go. However, with liabilities outweighing assets by a factor of 5:1, unsecured creditors (as opposed to depositors) can expect to sustain significant losses. Conversion of 'old banks' external liabilities into equity stakes in 'new banks' should reduce the debt overhang.

Resolution of 'old banks' assets and liabilities should bring Iceland's gross external debt down to around 200% of GDP and net debt to 140% of GDP. While still significantly higher than 'BB' and 'BBB' medians, these metrics would be on a par with Latvia ('BBB−') and Hungary ('BB+') and better than Portugal ('BB+'). Depending upon the extent to which debt-equity swaps were employed to resolve 'old banks' liabilities, the IIP could contract to between negative 52% and negative 130% of GDP compared to negative 600% of GDP at present.

Figure 13

Public External Debt Service

EURm, Amortisation



Source: CBI

Forecast Summary

	2007	2008	2009	2010	2011e	2012f	2013f
Macroeconomic indicators and policy							
Real GDP growth (%)	6.0	1.3	-6.7	-4.0	3.0	2.3	2.5
Unemployment (%)	1.0	1.6	8.0	8.1	7.0	6.0	4.5
Consumer prices (annual average % change)	3.6	12.8	12.0	5.4	4.0	4.0	3.0
Short-term interest rate (%)[a]	13.3	16.5	11.0	7.7	5.0	6.0	4.5
General government balance (% of GDP)	5.4	-0.5	-8.6	-5.4	-4.0	-2.1	-0.9
General government debt (% of GDP)	28.6	70.3	88.2	92.4	98.4	95.5	91.9
ISK per USD (annual average)	64.1	87.9	123.6	122.2	116.1	124.6	125.0
Real effective exchange rate (2000 = 100)	113.2	88.9	71.7	75.4	82.4	80.1	82.2
External finance							
Current account balance (USDbn)	-3.2	-4.5	-1.4	-1.2	-0.6	-0.4	-0.3
Current account balance (% of GDP)	-15.6	-26.5	-11.8	-9.8	-4.1	-2.9	-1.8
Current account balance plus net FDI (% of GDP)	-32.0	3.1	-29.9	29.5	0.2	2.8	3.6
Net external debt (USDbn)	51.0	98.1	96.3	95.2	96.3	85.6	88.9
Net external debt (% of GDP)	249.8	582.5	795.1	757.3	683.4	613.5	592.7
Net external debt (% of CXR)	441.7	1,098.2	1,522.8	1,413.9	1,188.0	986.0	900.7
Official international reserves including gold (USDbn)	2.6	3.6	3.9	5.8	8.5	6.7	4.5
Official international reserves (months of CXP cover)	2.1	3.2	6.0	8.7	11.7	8.9	5.4
External interest service (% of CXR)	38.0	66.0	38.5	26.7	9.9	13.8	13.2
Gross external financing requirement (% int. reserves)	562.0	412.2	115.2	111.6	101.5	59.1	26.2
Memo: Global forecast summary							
Real GDP growth (%)							
US	1.9	-0.3	-3.5	3.0	1.7	1.8	2.6
Japan	2.3	-1.2	-6.3	4.0	-0.3	2.2	1.4
Euro area	3.0	0.4	-4.2	1.8	1.6	0.4	1.2
World	4.3	1.5	-2.4	3.9	2.7	2.4	3.0
Commodities							
Oil (USD/barrel)	72.7	97.7	61.9	79.6	110.0	100.0	100.0

[a] Central bank policy interest rate (annual average)
Source: Fitch

Comparative Analysis: Macroeconomic Performance and Policies

Iceland

	2011						
	Ireland 'BBB+'	Cyprus 'BBB–'	Iceland 'BBB–'	Latvia 'BBB–'	Portugal 'BB+'	'BBB' median	'BB' median
Real GDP (5yr average % change)	-1.1	1.7	-0.1	-1.6	-0.2	3.0	3.5
Volatility of GDP (10yr rolling SD)	4.8	2.1	4.7	9.2	1.6	3.1	2.5
Consumer prices (5yr average)	0.8	2.6	7.6	6.3	1.8	5.1	7.1
Volatility of CPI (10yr rolling SD)	2.1	1.2	4.0	4.6	1.3	2.6	2.9
Years since double-digit inflation	28.0	30.0	2.0	3.0	20.0	n.a.	n.a.
Unemployment rate	14.3	7.2	7.0	15.0	12.5	7.7	10.0
Type of exchange rate regime	Euro peg	Euro peg	Floating	Euro peg	Euro peg	n.a.	n.a.
Dollarisation ratio	-	-	-	-	-	43.9	70.0
REER volatility (10yr rolling SD)	7.2	3.5	11.9	11.6	1.8	5.5	5.9

Source: Fitch

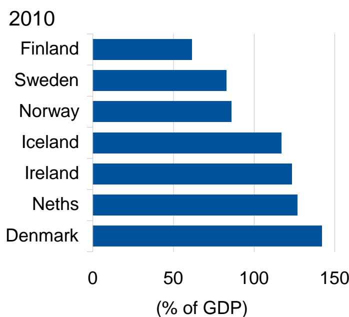
Strengths

- Despite the policy failures leading up to the financial crisis, policy-making institutions remain intact and the authorities are committed to honouring their sovereign obligations and restoring confidence in their solvency.
- As the first country to suffer the full force of the global financial crisis, Iceland successfully completed a three-year IMF-supported rescue programme in August 2011. The programme has delivered renewed access to international capital markets, while fiscal consolidation has been second only to Greece, helping to restore confidence.
- In the past, the economy has displayed an impressive track record of adjusting to external shocks, reflecting flexible labour and product markets and a penchant for national unity in the face of adversity. Despite the depth of the recession, unemployment remains in line with the 'BBB' median, while there have been few signs of overt social unrest.

Figure 14

Household Debt

2010



Source: CBI

Weaknesses

- Iceland is a stand-out on measures of GDP/CPI/REER volatility. Rising inflation expectations and the protracted timetable for the removal of capital controls underline the challenge the authorities face in restoring domestic price and exchange rate stability.
- Severe macroeconomic imbalances built up in 2004-2007 – mounting corporate and household debt, soaring private consumption, rising real estate prices, over-extended bank balance sheets and an unsustainable current account deficit – have taken time to unwind, constraining economic recovery from financial sector meltdown.
- As a small, open economy, weakened by the collapse of its financial system and the rise in public debt, Iceland remains vulnerable to external shocks

Commentary

As the first country to encounter the full impact of the global financial crisis, Iceland is ahead of the curve for economic recovery. Growth in Q111-Q311 was 3.7% yoy, comfortably ahead of other crisis-affected countries like Ireland, driven by a rebound in domestic demand following the deep recession of 2008-2009. Iceland remains vulnerable to external shocks, most notably developments in the eurozone, which takes 60% of its exports. Even so, growth of 2%-2.5% in 2012-2013 looks plausible, given progress to date with macro-economic stabilisation.

With inflation set to peak at 6% in Q112, interest rates have been on hold since November 2011, following a series of hikes from August, but the risks of a wage-price spiral developing have risen significantly over recent months and the tone of monetary policy has become more hawkish. Household/corporate debt restructuring will continue to constrain growth; however, consumption has been boosted by improved employment prospects, higher wage awards and the temporary provision for savings withdrawals from the third pillar pension scheme.

Comparative Analysis: Structural Features

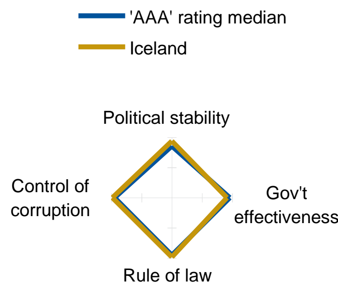
Iceland

	2011						
	Ireland ‘BBB+’	Cyprus ‘BBB–‘	Iceland ‘BBB–‘	Latvia ‘BBB–‘	Portugal ‘BB+’	‘BBB’ median	‘BB’ median
GNI per capita PPP (USD, latest)	32,740	30,160	28,630	16,360	24,710	13,075	5,910
GDP per capita (USD, mkt exchange rates)	47,792	30,767	42,087	12,313	22,296	8,608	4,245
Human Development Index (percentile, latest)	97.6	83.8	93.0	76.8	76.1	65.5	51.1
Ease of Doing Business (percentile, latest)	95.7	78.6	95.7	89.1	83.6	73.7	45.1
Trade openness (CXR and CXP % GDP)	126.1	75.8	59.6	58.6	44.8	49.9	47.4
Gross domestic savings (% GDP)	33.1	11.4	22.5	21.6	14.0	22.7	14.7
Gross national savings (% GNP)	14.0	11.3	10.6	23.0	11.2	22.5	16.0
Gross domestic investment (% GDP)	9.9	17.8	13.3	23.0	18.3	23.9	21.0
Private credit (% GDP)	197.8	292.7	94.0	92.6	188.1	62.8	33.3
BSR indicators	E2	D3	n.a	E1	C2	n.a.	n.a.
Bank system CAR	10.1	12.9	24.0	17.2	10.3	15.0	16.3
Foreign bank ownership (% assets)	63.0	44.5	34.0	60.0	12.0	30.0	60.9
Public bank ownership (% assets)	7.0	1.2	66.0	18.0	30.0	17.5	38.8
Default record (year cured)	-	-	-	-	-	n.a.	n.a.

Source: Fitch and World Bank

Figure 15

Governance Indicators



Source: World Bank, Fitch

Strengths

- On measures of governance, Human Development and Ease of Doing Business, Iceland is far superior to ‘BBB’ medians and exactly aligned with ‘AAA’ medians. A recent European Union (EU) progress report on Iceland’s application for EU membership concluded that Iceland satisfied all the political and economic conditions for membership.
- Iceland’s income per capita is a clear stand-out in the ‘BBB’ range; whether measured at market prices or on a PPP basis, it is more akin to the ‘AAA’ median. Taken together with a young population, a low average old-age dependency ratio (18% in 2010 compared to 26% in the EU25) and net pension fund assets of almost 130% of GDP (end-2011), Iceland is better placed than most OECD countries to meet the challenge of ageing populations.
- Iceland’s rich natural resource endowment – marine products and abundant renewable energy resources – coupled with good quality human capital resources, should lay the foundations for a sustainable economic recovery.

Weaknesses

- The financial system has shrunk to one-fifth (200% of GDP) of its former size and is well capitalised for the most part with core Tier One ratios of 20%. Nonetheless, significant balance sheet risks remain: asset quality is poor; access to international financial markets is limited; and the lifting of capital controls could create new funding challenges.
- The economy’s weak supply side response to a much depreciated (and hence more competitive) real exchange rate has highlighted capacity constraints in some areas (marine products) and lack of investment in others (energy). Gross domestic investment has fallen from a cyclical peak of 35% of GDP in 2006 to 13% in 2011 (66% of the ‘BBB’ median).
- High levels of private debt/GDP, much of it foreign exchange or inflation indexed, pose a risk to financial stability and economic recovery. Household and corporate debt restructuring has accelerated, but the stock of debt is unlikely to diminish significantly and banks’ capacity for new lending is likely to remain limited.

Commentary

Iceland suffered one of the most complete examples of a financial sector meltdown in modern times. Measured by assets, an estimated 97% of the system collapsed between October 2008 and March 2009, and required extensive public support. Rebalancing the economy away from the flawed business model of 2000s presents significant challenges, but the economy’s underlying fundamentals remain strong.

Comparative Analysis: External Finances

Iceland

	2011					Last 10 years	
	Ireland ‘BBB+’	Cyprus ‘BBB–‘	Iceland ‘BBB–‘	Latvia ‘BBB–‘	Portugal ‘BB+’	‘BBB’ median	‘BB’ median
GXD (% CXR)	250.3	612.6	1,472.1	249.9	548.4	91.9	99.5
GXD (% GDP)	317.1	441.7	846.9	146.0	225.0	44.6	39.9
NXD (% CXR)	65.8	16.6	1,188.0	91.8	192.4	13.5	12.3
NXD (% GDP)	83.4	12.0	683.4	53.6	78.9	6.1	5.1
GSXD (% GXD)	44.8	9.0	7.9	25.5	40.2	33.5	52.5
NSXD (% CXR)	102.4	22.5	12.8	22.5	161.1	-12.7	7.7
NSXD (% GDP)	130.4	16.2	7.4	13.1	66.1	-6.2	3.4
SNFA (USDbn)	-276.4	-4.1	-1.0	-3.6	-155.0	4.5	-0.5
SNFA (% GDP)	-126.0	-16.2	-7.1	-13.1	-66.0	7.3	-3.1
Ext. debt service ratio (% CXR)	29.8	14.1	75.2	38.7	76.4	14.2	11.9
Ext. interest service ratio (% CXR)	7.5	12.4	9.9	6.5	16.5	3.9	3.6
Liquidity ratio (latest)	11.1	95.7	12.2	112.0	17.1	143.0	168.2
Current account balance (% GDP)	1.2	-7.3	-4.1	-0.3	-7.6	-2.3	-2.1
CAB plus net FDI (% GDP)	-2.5	-2.2	0.2	2.8	-6.4	0.7	1.5
Commodity dependence (% CXR, latest)	5.4	5.7	58.4	24.1	14.5	22.5	27.1
Sovereign net FX debt (% GDP)	-1.0	-5.7	-2.6	37.0	-1.2	-5.3	1.5

Source: Fitch

Strengths

- The narrowing in Iceland’s current account balance from a record deficit of 26.5% of GDP in 2008 to an estimated 4% of GDP in 2011 has been remarkable.
- International reserves now stand at a record high of USD8.5bn or 12 months of current external payments (compared to a ‘BBB’ median of six months), bolstered by IMF and associated bilateral funding and renewed access to international capital markets.

Weaknesses

- Iceland is a clear stand-out on (unadjusted for ‘failed banks’) measures of gross and net external debt that far exceed ‘BBB’ medians and distort its external debt service and international liquidity ratios. Resolution of Iceland’s ‘failed banks’ external assets and liabilities should reduce these ratios significantly, but they will remain high relative to peers.
- Iceland’s sovereign external balance sheet has deteriorated relative to peer group medians as the public sector has contracted additional foreign currency liabilities to restore economic and financial stability and rebuild international reserves.
- Commodity dependence is much higher than the ‘BBB’ median reflecting Iceland’s narrow export base: three aluminium smelters and the marine products sector together account for over 80% of merchandise exports.

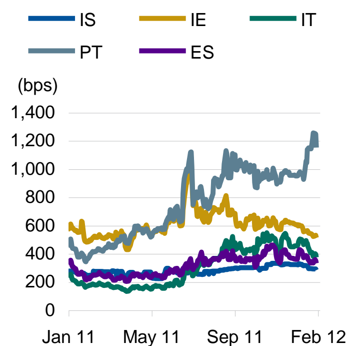
Commentary

Renewed access to international capital markets in mid-2011 was an important milestone along the road to rebuilding sovereign creditworthiness. The perception that Iceland would sustain insurmountable reputational damage by failing to support its beleaguered financial sector has proved unfounded for the most part. However, this strategy has not been without it drawbacks: capital controls remain in place; the dispute over Icesave continues; and ‘old banks’ still have some way to go in unwinding their pre-crisis assets and liabilities.

Nonetheless, for the moment capital controls and Iceland’s limited financial links with the rest of the world are shielding Iceland from the worst of the fallout from the eurozone sovereign debt crisis. Ten-year sovereign CDS spreads have remained stable over the past year at around 300bp and below Greece, Portugal, Ireland, Spain and Italy.

Figure 16

10yr CDS Spreads



Source: Thomson Datastream

Comparative Analysis: Public Finances

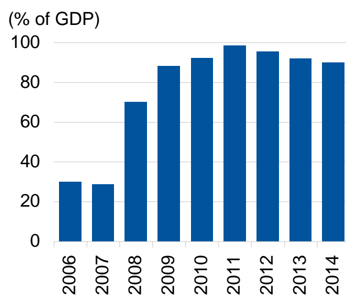
Iceland

	2011					Last 10 years	
	Ireland 'BBB+'	Cyprus 'BBB−'	Iceland 'BBB−'	Latvia 'BBB−'	Portugal 'BB+'	'BBB' median	'BB' median
Budget balance (% GDP)	-10.1	-6.8	-4.0	-4.5	-5.9	-2.6	-2.3
Primary balance (% GDP)	-6.6	-4.4	-0.5	-3.1	-2.3	-0.2	0.1
Revenues and grants (% GDP)	32.7	42.3	41.0	39.9	42.1	32.9	26.0
Volatility of revenues/GDP ratio	4.9	6.8	6.1	5.5	2.1	6.2	6.2
Interest payments (% revenue)	10.4	5.7	12.2	3.6	8.5	7.2	10.4
Debt (% revenue)	321.7	153.5	240.1	112.8	261.1	117.8	163.1
Debt (% GDP)	105.3	64.9	98.4	45.0	109.9	35.6	40.3
Net debt (% GDP)	98.5	58.4	65.2	37.8	102.3	29.5	34.6
FC debt (% total debt)	0.0	0.0	58.4	82.6	7.9	39.9	63.5
CG debt maturities (% GDP)	6.6	9.7	11.7	4.5	18.3	5.4	4.8
Average duration of CG debt (years)	-	-	6.6	-	4.0	5.1	3.4

[a] GG if not otherwise specified
Source: Fitch

Figure 17

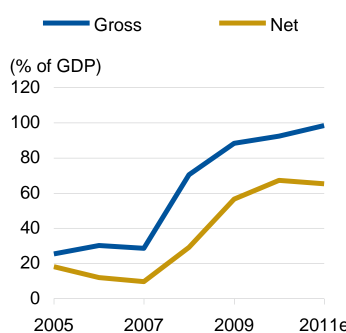
General Government Debt



Source: Fitch

Figure 18

General Government Debt



Source: Fitch

Strengths

- Iceland is no stranger to fiscal consolidation; by 2007 public debt had been brought down to 28% of GDP, well below current 'BBB' medians, from a peak of 59% in 1995, while public foreign currency assets and liabilities were evenly matched. In this sense, Iceland's fiscal pedigree was similar to Ireland and markedly better than Portugal.
- Fiscal consolidation since 2009 has been second only to Greece, holding out the realistic prospect of primary balance and declining public debt /GDP from 2012.
- Revenue/GDP is markedly superior to 'BBB' medians reflecting a wealthy economy with a broad and sophisticated tax base.
- Iceland has a well developed government debt market relative to peers that benefits from regular auctions and a clear medium-term financing strategy.
- Iceland maintained sovereign debt service in the face of unprecedented financial sector distress, albeit with the help of capital controls, and regained market access in mid-2011.

Weaknesses

- Gross and net general government debt are markedly higher than peer group medians reflecting the direct and indirect costs of the financial sector crisis in 2008-2009, which materially damaged sovereign creditworthiness.
- Public debt service is high relative to peers and vulnerable to exchange rate fluctuations reflecting a high share of foreign-currency denominated debt.
- Capital controls have denied non-resident investors in ISK-denominated government debt instruments unfettered access to their principal (but not interest) since 2008.
- The risk of additional contingent liabilities migrating to the government's balance sheet remains high; direct support for the financial sector is drawing to a close, but concerns remain over asset quality, while the longstanding dispute over Icesave remains unresolved.

Commentary

Despite its alternative approach to handling its failed banks, private sector liabilities have migrated to the public sector's balance sheet and Iceland's public debt has risen exponentially to almost 100% of GDP. However, the sovereign's past track record of fiscal consolidation has worked to its advantage, while a stronger economic recovery should set Iceland's public debt dynamics apart from its peers. That said, capital controls have played an important part in this process by delivering the government a captive investor base. Any setbacks to fiscal consolidation would delay the unwinding of capital controls and undermine investor confidence in Iceland's recovery, as would the crystallisation of additional contingent liabilities.

Figure 19

Fiscal Accounts Summary

(% of GDP)	2008	2009	2010	2011e	2012f	2013f
General government						
Revenue	**44.1**	**41.1**	**42.3**	**41.0**	**41.3**	**41.3**
Expenditure	**44.6**	**49.7**	**47.7**	**45.0**	**43.4**	**42.2**
O/w interest payments	3.3	5.2	5.1	5.0	5.5	5.5
Primary balance	-0.5	-6.5	-2.5	-0.5	1.9	3.0
Overall balance	**-0.5**	**-8.6**	**-5.4**	**-4.0**	**-2.1**	**-0.9**
General government debt	**70.3**	**88.2**	**92.4**	**98.4**	**95.5**	**91.9**
% of general government revenue	159.4	214.6	218.4	240.1	231.3	222.4
General government deposits	22.2	30.8	31.1	26.8	27.1	25.2
Net general government debt	29.1	56.5	67.1	65.2	68.2	66.7
Central government						
Revenue	**31.9**	**29.3**	**31.1**	**29.5**		
O/w grants	0.1	0.1	0.1	0.1		
Expenditure and net lending	**32.6**	**38.6**	**39.2**	**32.1**		
O/w current expenditure and transfers						
- Interest	2.7	5.6	4.4	4.1		
O/w capital expenditure						
Current balance						
Primary balance	2.0	-3.7	-3.6	1.5		
Overall balance	**-0.7**	**-9.3**	**-8.0**	**-2.6**		
Central government debt	62.8	78.6	83.6	84.7		
% of central government revenues	197.0	267.7	268.5	287.2		
Central government debt (ISKbn)	**931.3**	**1,176.4**	**1,285.1**	**1,386.5**		
By residency of holder						
Domestic	367.3	588.0	763.0	757.5		
Foreign	564.0	588.0	522.0	629.0		
By place of issue						
Domestic	613.8	819.9	943.9	1,022.5		
Foreign	317.5	356.6	341.1	364.0		
By currency denomination						
Local currency	613.3	819.8	943.9	1,022.5		
Foreign currency	318.0	356.6	341.1	364.0		
In USD equivalent (eop exchange rate)	2.6	2.9	3.0	2.9		
By maturity						
Less than 12 months (residual maturity)	133.4	179.0	212.5	191.6		
Average maturity (years)						
Average duration (years)						
Memo (% GDP)						
Non-financial public-sector balance						
Net non-financial public-sector debt						
Nominal GDP (ISKbn)	1,481.9	1,497.6	1,537.1	1,636.1	1,738.0	1,874.8

Source: Ministry of Finance and Fitch estimates and forecasts

Figure 20

External Debt and Assets

(USDbn)	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011e
Gross external debt	**11.1**	**16.2**	**26.9**	**45.6**	**71.3**	**115.5**	**118.4**	**116.8**	**117.6**	**119.4**
% of GDP	124.9	148.1	203.0	279.8	428.5	565.2	702.6	964.1	935.5	846.9
% of CXR	300.7	391.1	537.3	690.0	897.4	999.2	1,324.5	1,846.5	1,746.6	1,472.1
By maturity										
Medium- and long-term	8.7	12.8	22.0	38.5	59.5	74.7	74.3	78.9	79.5	81.0
Short-term	2.4	3.5	4.9	7.1	11.9	40.7	44.1	37.9	38.1	38.3
% of total debt	21.4	21.4	18.1	15.5	16.7	35.3	37.2	32.4	32.4	32.1
By debtor										
Monetary authorities	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**2.4**	**1.5**	**2.1**	**3.2**
General government	**3.0**	**3.1**	**3.5**	**2.4**	**3.4**	**3.9**	**6.8**	**6.6**	**6.4**	**9.5**
O/w central government	2.3	2.5	2.9	1.8	3.1	3.6	1.8	1.8	1.8	0.0
Banks	**5.6**	**10.2**	**20.0**	**37.9**	**59.3**	**96.1**	**5.6**	**2.4**	**1.8**	**0.4**
Other sectors	**2.5**	**2.9**	**3.4**	**5.3**	**8.6**	**15.4**	**105.9**	**107.7**	**109.5**	**109.5**
Gross external assets (non-equity)	**2.2**	**5.1**	**9.6**	**21.6**	**40.4**	**64.4**	**20.2**	**20.5**	**22.4**	**23.0**
International reserves, incl. gold	0.5	0.8	1.1	1.1	2.3	2.6	3.6	3.9	5.8	8.5
Other sovereign assets nes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit money banks' foreign assets	0.6	1.6	2.9	8.5	18.6	76.3	0.0	0.0	0.0	0.0
Other sector foreign assets	0.6	0.7	1.3	2.9	5.5	4.4	13.0	14.6	14.6	13.6
Net external debt	**8.9**	**11.2**	**17.2**	**24.0**	**31.0**	**51.0**	**98.1**	**96.3**	**95.2**	**96.3**
% of GDP	100.1	102.0	130.3	147.1	186.0	249.8	582.5	795.1	757.3	683.4
% of CXR	241.1	269.4	344.9	362.8	389.5	441.7	1,098.2	1,522.8	1,413.9	1,188.0
Net sovereign external debt	2.6	2.3	2.4	1.4	1.1	1.3	3.3	2.7	0.6	1.0
% of GDP	28.8	20.9	18.2	8.4	6.4	6.4	19.5	22.7	4.7	7.4
Net bank external debt	4.5	6.6	12.7	20.2	26.8	38.7	2.0	0.4	-0.3	-0.6
Net other external debt	1.9	2.3	2.1	2.4	3.1	11.1	92.9	93.2	94.9	95.9
Net international investment position	**-7.0**	**-7.4**	**-10.3**	**-13.7**	**-16.7**	**-23.6**	**-84.6**	**-84.6**	**-84.7**	**-84.4**
% of GDP	-78.3	-67.6	-77.6	-84.0	-100.5	-115.3	-502.1	-698.3	-673.5	-598.7
Sovereign net foreign assets	**-2.6**	**-2.3**	**-2.4**	**-1.4**	**-1.0**	**-1.3**	**-3.3**	**-2.7**	**-0.6**	**-1.0**
% of GDP	-28.7	-20.8	-18.1	-8.4	-6.3	-6.2	-19.3	-22.5	-4.5	-7.1
Debt service (principal & interest)	**1.7**	**2.0**	**2.3**	**4.6**	**5.8**	**14.4**	**12.3**	**5.1**	**4.9**	**6.1**
Debt service (% of CXR)	46.1	47.9	45.9	69.6	72.6	124.3	137.4	81.0	72.8	75.2
Interest (% of CXR)	10.1	9.2	10.1	14.7	29.9	38.0	66.0	38.5	26.7	9.9
Liquidity ratio (%)	19.6	22.9	40.6	39.9	71.2	77.7	145.8	7.0	8.6	12.2
Net sovereign FX debt (% of GDP)	26.3	17.3	12.5	3.8	2.4	0.9	11.2	7.3	-3.3	-2.6
Memo										
Nominal GDP	8.9	11.0	13.2	16.3	16.7	20.4	16.8	12.1	12.6	14.1
Gross sovereign external debt										
Inter-company loans	0.1	0.3	0.5	0.9	1.7	5.7	7.0	7.7	10.3	10.3

Source: NBP, IMF, World Bank and Fitch estimates and forecasts

Figure 21

Balance of Payments

(USDbn)	2008	2009	2010	2011e	2012f	2013f
Current account balance	**-4.5**	**-1.4**	**-1.2**	**-0.6**	**-0.4**	**-0.3**
% of GDP	-26.5	-11.8	-9.8	-4.1	-2.9	-1.8
% of CXR	-50.0	-22.5	-18.3	-7.1	-4.7	-2.7
Trade balance	**-0.3**	**0.7**	**1.0**	**0.9**	**0.7**	**0.8**
Exports, fob	5.4	4.1	4.6	5.0	5.3	6.0
Imports, fob	5.7	3.3	3.6	4.1	4.6	5.2
Services, net	**-0.3**	**0.3**	**0.4**	**0.4**	**0.3**	**0.3**
Services, credit	2.2	2.3	2.5	2.8	3.0	3.4
Services, debit	2.5	2.0	2.2	2.4	2.7	3.1
Income, net	**-3.8**	**-2.4**	**-2.5**	**-1.8**	**-1.3**	**-1.3**
Income, credit	1.3	-0.1	-0.4	0.3	0.4	0.5
Income, debit	5.1	2.3	2.1	2.1	1.7	1.8
O/w: Interest payments	5.9	2.4	1.8	0.8	1.2	1.3
Current transfers, net	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Memo						
Non-debt-creating inflows (net)	2.8	-1.9	2.3	0.7	11.7[a]	-2.8
O/w equity FDI	2.4	-2.8	1.7	0.6	0.8	0.8
O/w portfolio equity	2.4	-2.8	1.7	0.6	0.8	0.8
O/w other	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (-= increase)	1.1	0.2	1.9	2.7	-1.7	-2.2
Gross external financing requirement	10.8	4.1	4.3	5.9	5.0	1.8
Stock of international reserves, incl. gold	3.6	3.9	5.8	8.5	6.7	4.5

[a] This is the counterpart of a notional debt-equity swap assumed to be conducted on behalf of the shareholders of Iceland’s ‘old’ banks that reduces Iceland’s external debt and increases its equity obligations. The overall impact on the balances of payments is assumed to be zero
Sources: IMF and Fitch estimates and forecasts

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