STANDARD & POOR'S

CREDIT RESEARCH REPORT

Iceland (Republic of)

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Rating history

Outlook revised to negative from stable, foreign currency 'AA-/A-1+', local currency 'AA+/A-1+' ratings affirmed…...June 2006

Long-term foreign currency rating raised to 'AA-' from 'A+'......February 2005

Short-term local currency rating of 'A-1+' assigned......May 1998

Long-term local currency rating of 'AA+' assigned; foreign currency ratings raised to 'A+/A-1+'......March 1996

Foreign currency ratings of 'A/A-1' assigned......February 1989

Default history since 1975

None

Year

2006

Population

0.31 million

Per capita GDP

$50,023

Current government

Prime Minister Geir H. Haarde heads a center-right coalition composed of the Independence Party and the Progressive Party. President Olafur Ragnar Grimsson is head of state.

Election schedule

General elections

Last......May 2003

Next......May 2007

Presidential elections

Last......June 2004

Next......June 2008

Major Rating Factors

Strengths:

- Stable and mature political institutions
- Very high per capita income and strong long-term growth prospect
- Healthy public finances and a rapidly declining public debt burden

Weaknesses:

- Inadequate fiscal and monetary policy mix in management of macroeconomic imbalances
- Significant contingent fiscal risks from high level of external debt and weak external liquidity
- Small, relatively undiversified economy

Rationale

The ratings on Iceland are supported by its stable and flexible political institutions, high level of prosperity, and strong long-term economic growth prospects. In the near term, however, the Icelandic economy faces a period of stagnation and the potential risk of a hard landing, as the macroeconomic imbalances built up in the credit and investment boom in the past two years unwind.

Fiscal surpluses could not completely offset excessive domestic demand during the period of large-scale investment projects and rapidly expanding bank credit in 2003-2006. Accelerating wage growth and other inflationary pressures have prompted the Central Bank of Iceland to hike interest rates, to their current level of 14.00%. Although the economy is showing signs of cooling, the possible depreciation of the Icelandic krona represents a further inflationary pressure. This could lead to additional increases in interest rates, risking an adjustment process that is more painful and more disruptive to the economy.

The Icelandic economy is likely to stagnate in 2007, but to recover gradually to an annual growth of about 3% by 2010. Iceland will enter this period of a weakening economy with a low general government debt burden of 24% of GDP in 2006, one-half the level of five years earlier. The possibility of a significant economic contraction remains real, however. In this case, there will be increasing pressure on both budget balances and contingent liabilities for the government, such as those posed by the guaranteed debt of Ibudalanasjodur (Housing Finance Fund, HFF; foreign currency AA-/Negative/A-1+; local currency AA-/Stable/A-1+), or stemming from the financial sector.

Icelandic banks' very high external leverage, their dependency on wholesale funding, and the risk of a deterioration of credit quality in the country remain a major source of concern. This is somewhat balanced by the increasing resilience of Iceland's financial sector as a result of improved regulation and supervision, as well as local banks' international diversification, good profitability, and entry into the mortgage market.

Iceland's external financing needs are among the highest of any rated sovereign, driven by very high levels of external debt throughout the economy and by large current account deficits (which are expected to decline to 11% of GDP in 2007 and 3% of GDP in 2010, from 18% of GDP in 2006), exacerbated by foreign direct investment (FDI) and portfolio equity outflows. Consequently, levels of narrow net external debt are set to remain at more than 400% of current account receipts (CARs) until the end of the current decade, notwithstanding surging export performance in 2007-2008 as new aluminum production capacity becomes available.

Outlook

The negative outlook reflects the risk posed by the large imbalances in the economy. High and rising interest rates increase the risk of a disorderly unwinding of these imbalances, and might have an adverse impact on private sector, and consequently public sector, balance sheets. If measures taken to contain domestic demand and inflation do not prove effective, and if the above scenario of a pronounced economic contraction and worsening balance sheets unfolds, the result would be a downward revision of the ratings. Conversely, if economic imbalances unwind in an orderly fashion and the risks are contained, the outlook would be revised back to stable.

Table 1

Republic of Iceland Selected Indicators

	2010f	2009f	2008f	2007f	2006f	2005	2004	2003	'AA' Median 2006f
GDP per capita ($)	56,926	54,999	53,180	51,772	50,023	53,678	44,459	37,274	35,805
Real GDP (% change)	3.0	2.9	1.9	(0.3)	4.6	7.5	7.7	2.7	3.2
Real GDP per capita (% change)	1.5	1.4	0.5	(1.3)	2.0	5.3	6.7	1.9	2.5
General government balance (% of GDP)	0.1	(0.2)	(1.3)	(0.6)	3.9	5.5	0.5	(2.0)	(0.3)
General government debt (% of GDP)	22.3	23.4	24.2	23.8	23.8	36.5	35.0	40.5	29.7
Net general government debt (% of GDP)	16.7	17.7	18.4	17.8	17.7	29.9	33.1	37.7	21.7
General government interest expenditures (% of revenues)	4.6	4.7	4.8	4.8	4.9	5.0	6.1	7.0	4.9
Domestic credit to private sector and NFPEs* (% of GDP)	277.7	277.8	277.7	275.8	270.8	250.0	168.3	132.6	150.4
Consumer price index (average; % change)	2.5	2.5	3.1	4.0	7.0	4.2	2.8	2.1	3.0
Gross external financing needs (% of CARs and usable reserves)	483.0	473.0	488.4	511.8	450.1	297.6	250.1	219.8	261.5
Current account balance (% of GDP)	(3.3)	(4.1)	(5.5)	(11.5)	(18.4)	(16.2)	(10.0)	(4.8)	3.0
Narrow net external debt (% of CARs)	443.2	441.9	441.0	451.0	462.7	396.8	363.2	282.8	2.6

*Standard & Poor's estimates that, in a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 15-30% of bank credit; see table 5 in "Banking Industry Country Risk: These Are The Good Old Days," published on June 6, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis. NFPE—Nonfinancial public enterprise. CARs—Current account receipts. f—Forecast. e—Estimate. Narrow net external debt is defined as total external debt minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending.

Comparative Analysis

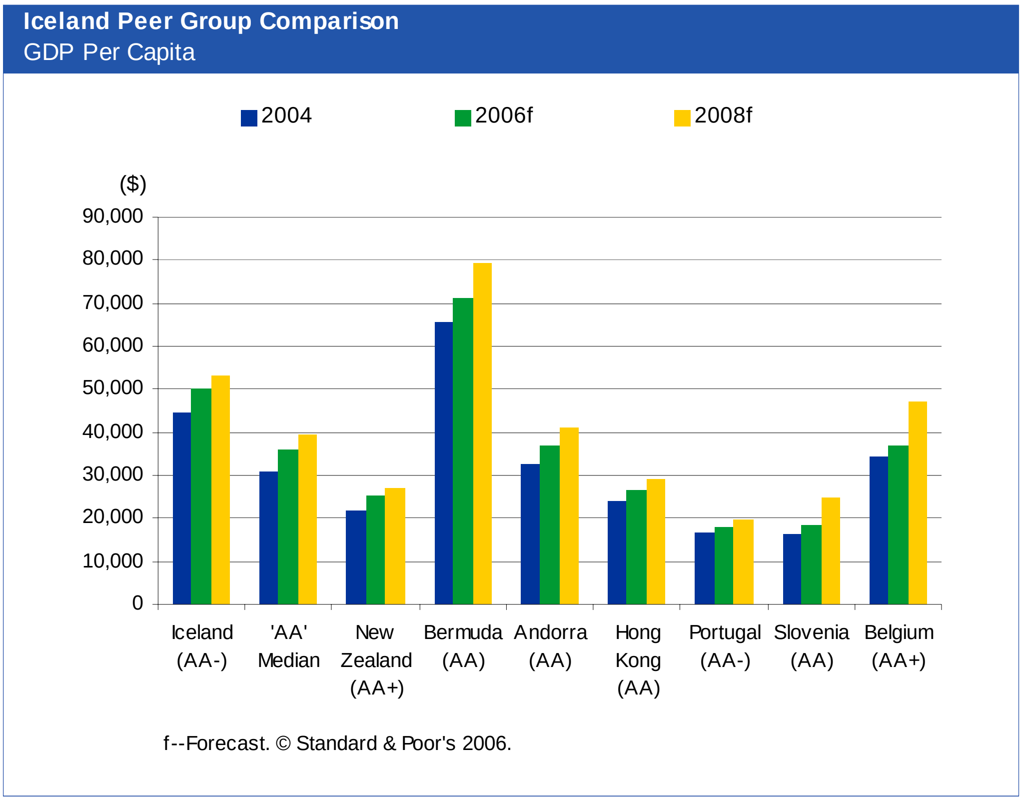
- The Icelandic economy is prosperous and flexible, with per capita incomes substantially higher than in most peers.
- The country has strong economic growth potential with large year-to-year fluctuations.
- Iceland's fiscal stance and declining general government debt levels compare favorably with its peers, but it has the highest contingent liabilities in the group.
- Iceland compares unfavorably with virtually all its peers in terms of external exposure.

Iceland's economic structure and export base remain relatively narrow, depending largely on an array of marine products, aluminum—whose export share is set to increase markedly in the coming years—and tourism. As a small, open, and relatively undiversified but wealthy economy, Iceland's peers include New Zealand (rated foreign currency AA+/Stable/A-1+; all references to ratings hereafter are to foreign currency sovereign credit ratings), which is also an insular economy with a dependence on agriculture. In addition, Bermuda and the Principality of Andorra (both AA/Stable/A-1+) are both small and undiversified but wealthy economies. The Hong Kong Special Administrative Region and the Republic of Slovenia (both AA/Stable/A-1+), together with the Republic of Portugal (AA-/Stable/A-1+), and the Kingdom of Belgium (AA+/Stable/A-1+) also provide useful comparisons. That said, Belgium and Portugal are far more diversified economies, and as members of EMU, are not affected by the external pressures that are Iceland's major weakness.

Iceland is wealthier than peers

Iceland is substantially wealthier than almost all its peers, with GDP per capita forecast to reach $50,000 in 2006, compared with the 'AA' median of $33,900 (see chart 1). Iceland's level of wealth is only exceeded by that of Bermuda, at a staggering $71,267, which is supported by the Caribbean island's status as an offshore financial and international business center, as well as by its extensive tourism industry. The level of Icelandic GDP per capita reflects the high productivity and flexibility of the country's labor force and the economy as a whole. This has kept unemployment (1.5% of the workforce in 2006) lower than in any of Iceland's peers, and endows the country with a solid ability to digest external shocks.

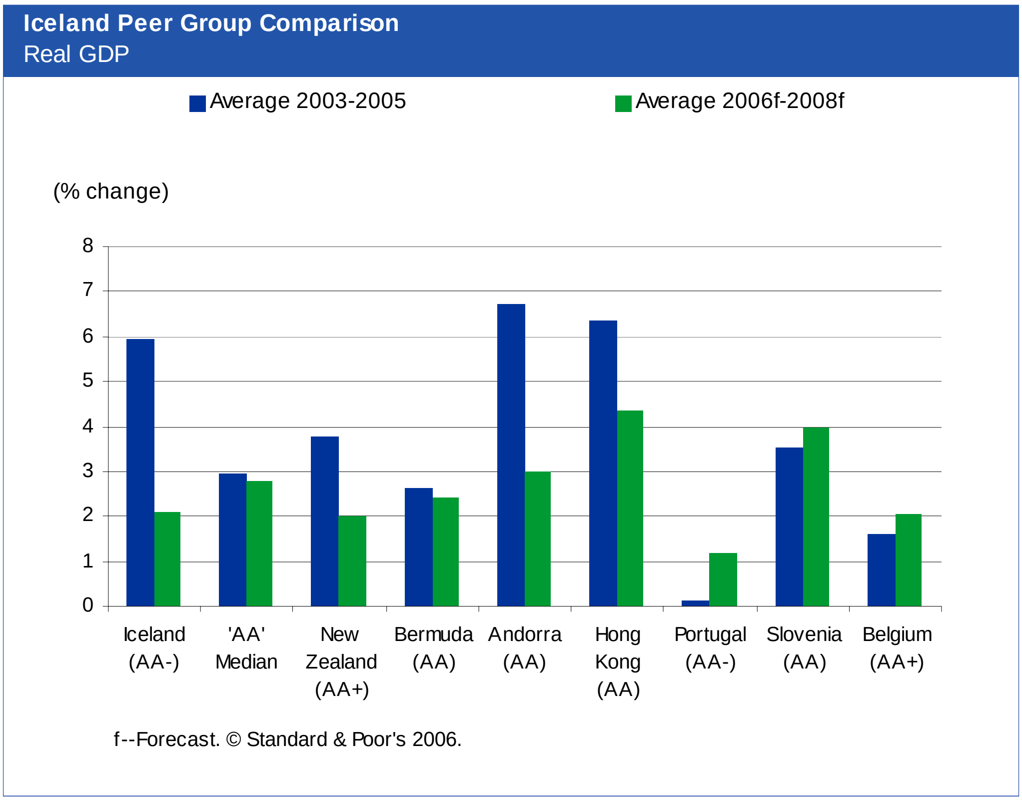
Chart 1



Growth is strong but volatile

Despite its relative affluence, Iceland's growth performance exceeds that of most of its peers. Following a contraction in 2002, average growth of 6.0% per annum was recorded in the boom period of 2003-2005, far exceeding the 'AA' median of 2.9%. Economic growth is already decelerating in 2006 and a period of economic stagnation is expected in 2007. The investments in energy-intensive industrial projects are expected to improve the diversification and productivity of the Icelandic economy, however, with its long-term potential growth estimated to be around 3%. The small but flexible and resilient economy is expected to return to its growth potential within a few years. Therefore, the average growth rates in the 2006-2008 period are expected to be only slightly below the 'AA' median of 2.8%. Growth in Iceland is more volatile than in most peers, as the economy swings from boom to bust and back. The small and relatively undiversified Icelandic economy has one of the most volatile growth rates among peers. Between 2003-2008, the standard deviation of real GDP growth in Iceland is 3.2, compared with the next most volatile Andorra and Hong Kong, which recorded standard deviations of 2.3 and 2.1, respectively.

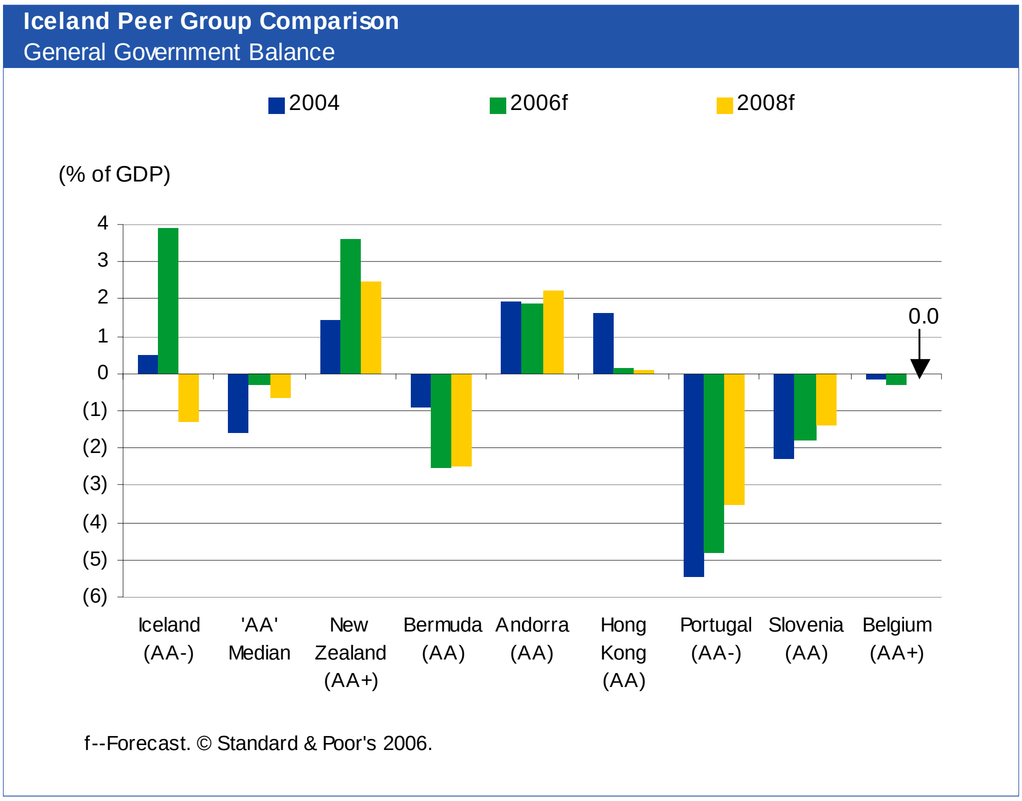
Chart 2



Fiscal consolidation compares favorably with peers

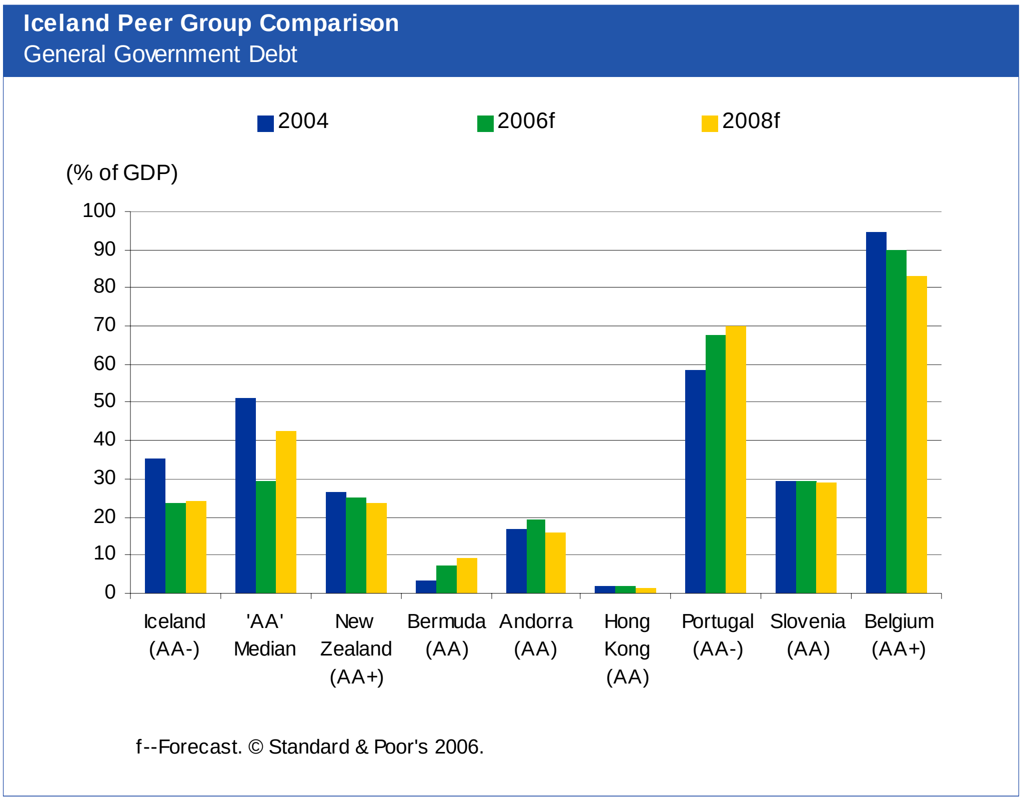
Iceland's government has made good progress in consolidating its fiscal accounts, on the back of broad-based support for prudent macroeconomic policies following the economic turmoil of the 1980s. Sizable budget surpluses in 2005 and 2006 have been achieved by the postponement of certain government investments and by strong revenue growth, as the economy experiences a boom partly fueled by the ongoing investment projects. In the medium term, despite a readjusting economy, only moderate general government deficits of around 1% of GDP are expected, Iceland's fiscal stance still compares well with that of its peers, particularly Portugal and Hong Kong, but also Slovenia, which continue to run moderate to sizable general government deficits (see chart 3). Once the economy returns to its potential, however, the budget is forecast to achieve close to balanced positions.

Chart 3



As a result of conservative fiscal policies and sizable privatization proceeds, as well as the high nominal GDP growth, the Icelandic general government debt-to-GDP ratio declined more rapidly than those of any peers in the past few years. The debt burden was reduced to an estimated 24% in 2006 from more than 40% in 2003. The pace of decline is expected to slow in the medium term, but it remains well below the 'AA' median, which is forecast at 43% by year-end 2008 (see chart 4). By 2008, Iceland's general government debt levels are forecast to almost close the gap with New Zealand, while Bermuda and Hong Kong should remain virtually debt-free. In contrast, debt levels in Belgium are the highest among Iceland's peers, at 90% in 2006, but keep on falling, thanks to sustained general government surpluses. Debt levels in Portugal are comparatively high, as well, and this remains the only sovereign among Iceland's peers where debt levels have kept trending upward. The importance of debt levels as a constraining factor on the ratings of Portugal and Belgium is further compounded by their Eurozone membership. Adoption of the euro requires increased fiscal prudence, as monetary and exchange rate policies are no longer available to the government to complement the policy mix.

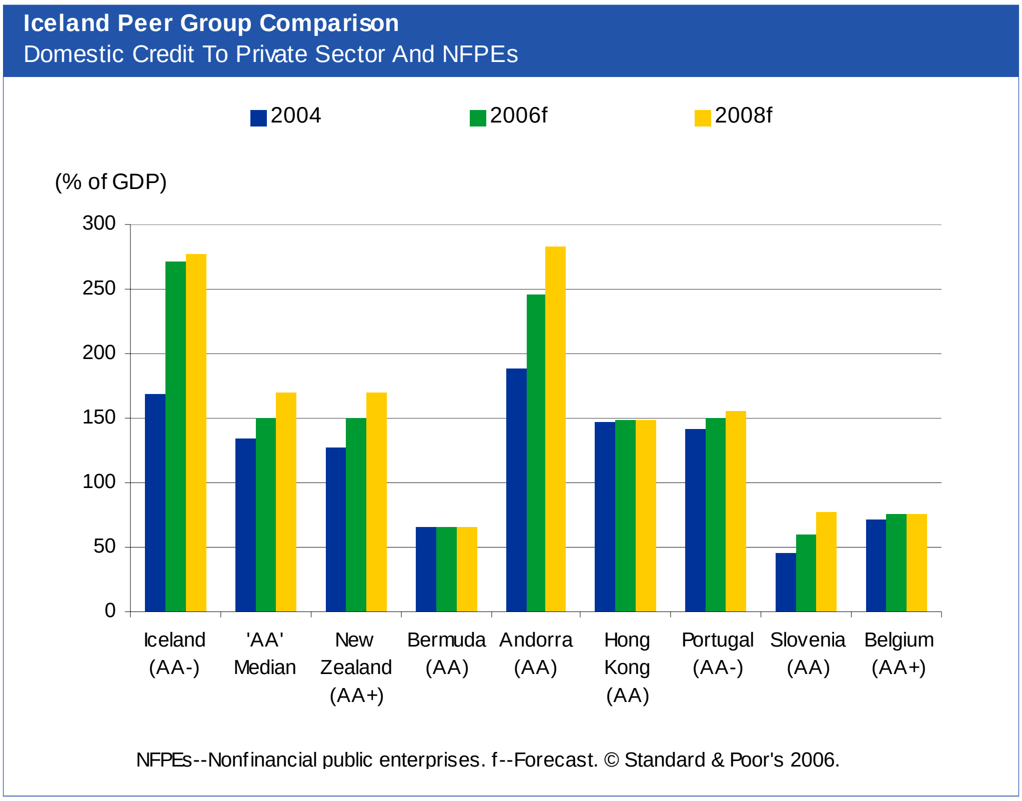
Chart 4



Iceland has the highest contingent liabilities among all peers

The recent credit boom in Iceland has created a high level of contingent liabilities from the financial sector. In a reasonable worst-case scenario, combining Standard & Poor's Ratings Services estimate of gross problematic assets in the financial system and the high level of domestic credit, the contingent liability for the government from the financial sector reaches more than 80% of GDP in 2006, more than twice the 'AA' medium of 30% (see chart 5). Most peers have a domestic credit-to-GDP ratio less than half of Iceland's, which is more than 270%; the exception is Andorra, where domestic credit also exceeds 240% of GDP, but the banking sector has a lower risk profile in general. Moreover, government guaranteed debt exceeds 50% of GDP in 2006 in Iceland, compared with 0%-5% for its peers.

Chart 5



External solvency and liquidity compare unfavorably

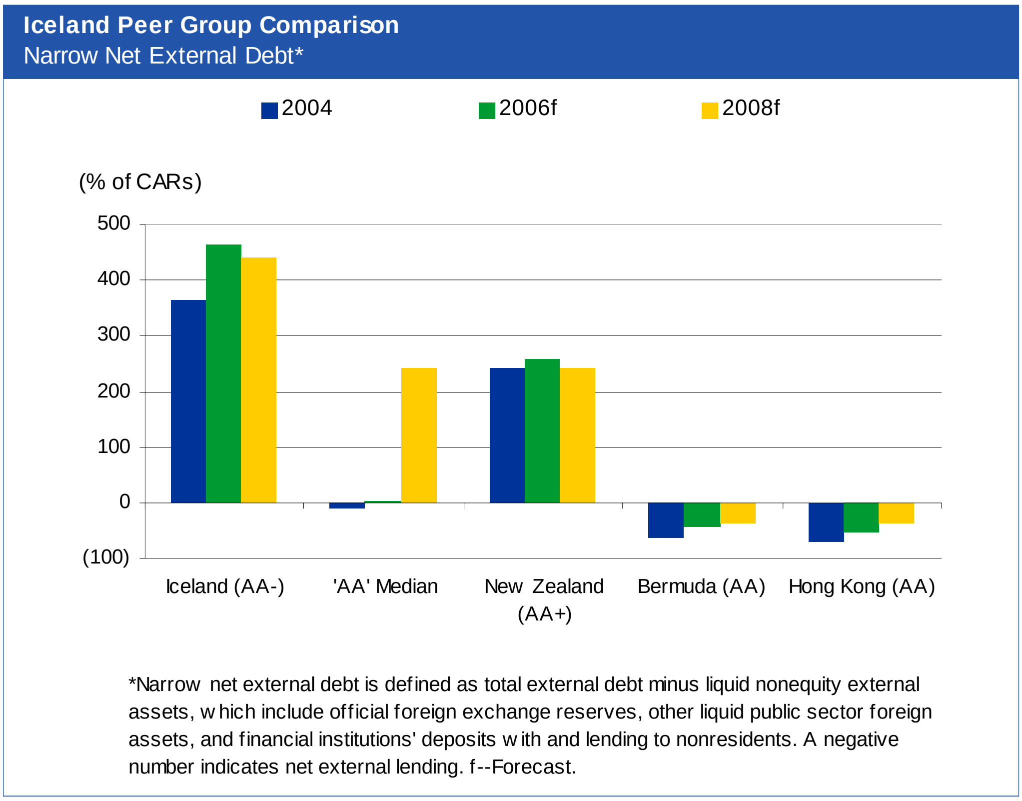
The four European sovereigns among Iceland's peers, namely Belgium, Portugal, Andorra, and Slovenia (which will join EMU in 2007) all benefit from the common currency euro, which effectively shields them from balance-of-payments pressures, and instead allows them to enjoy the very strong external balance sheet of the Eurozone as a whole. Most similarly to New Zealand, Iceland's small and narrow economy means that it is highly dependent on imported goods to satisfy domestic demand. Its current account therefore fluctuates widely with the GDP growth rate. The Icelandic economy's impressive adaptability has been demonstrated in particular by the unwinding of imbalances in the previous boom and bust cycle in the late-1990s. The current account deficit returned to a slight surplus in 2002, from a 10% of GDP deficit in 2000, without major economic disruption.

Since 2002, however, the current account has worsened again on the back of another investment and credit boom, as the deficit is expected to peak at 18.5% in 2006, double the current account deficit in New Zealand and in contrast to the surplus position in almost all the other peers. Part of the deficit reflects the high volume of imported capital goods that are related to the energy-intensive industrial projects, which are expected to lead to a surge in the export of aluminum in the next few years. This is similar to the structure of imports in New Zealand, where capital goods and consumption goods are about equal. The readjustment of economic imbalances is expected to reduce the Icelandic current account deficit to 5.5% in 2008, below the 7.1% projected for New Zealand.

The financing of current account deficits is mainly from the increasing leverage of the private sector, particularly in the financial sector. Net narrow external debt levels continue to rise in

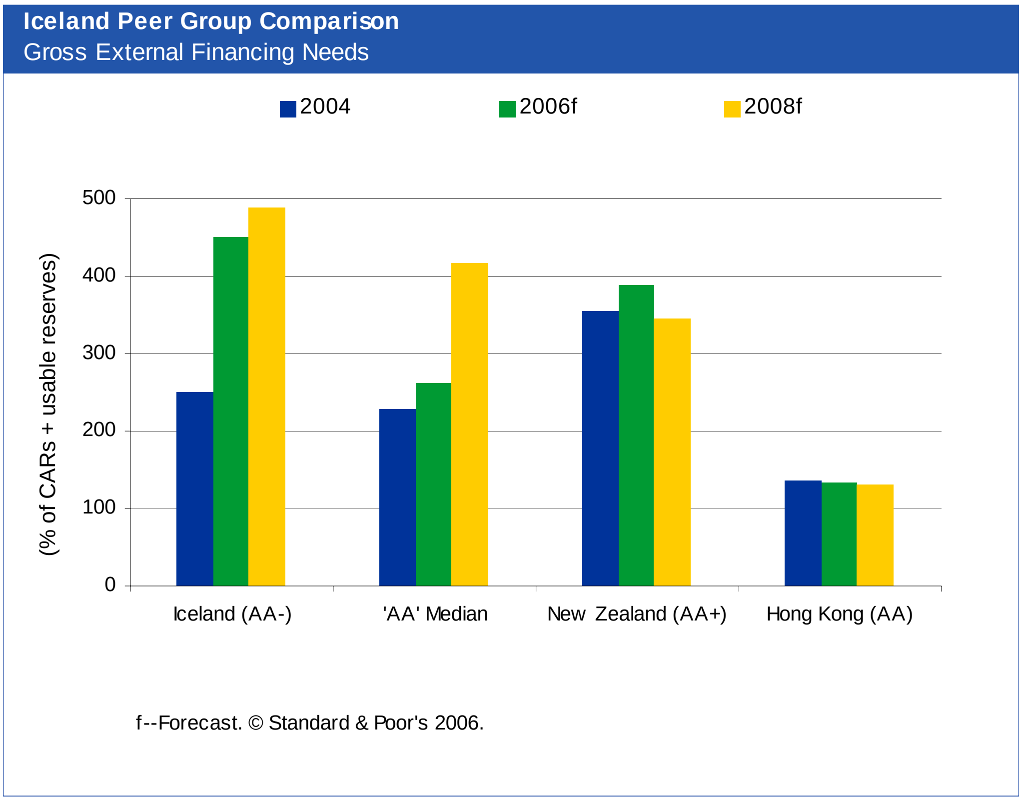
Iceland, reaching 464% of CARs in 2006, nearly twice the level of New Zealand. This also compares unfavorably with the creditor position in all other non-Eurozone peers (see chart 6).

Chart 6



Iceland's gross external financing needs (current account payments plus external debt with a residual maturity of up to one year) as a share of CARs plus usable reserves continue to grow, on the back of widening current account deficits and external leverage (see chart 7). Among all rated sovereigns, only the U.K. (AAA/Stable/A-1+), the U.S. (AAA/stable/A-1+), and New Zealand have similarly high financing needs, with all three benefiting from internationally more liquid currencies (the British pound sterling, the U.S. dollar, and the New Zealand dollar, respectively).

Chart 7



Political Environment: Stability And Flexibility

- Iceland's political institutions enjoy broad public backing and provide the flexibility to respond quickly to changing economic circumstances.
- The May 2007 election outcome is unlikely to change major policy priorities.
- The issue of EU membership is debated intermittently, but Iceland is highly unlikely to apply to join in the foreseeable future.

Iceland's creditworthiness faces no appreciable political risks. The country enjoys well-established, stable, and predictable institutions, and both internal and external security risks are negligible. The ruling coalition, consisting of Prime Minister Geir H. Haarde's Independence Party (IP) and its junior coalition partner Progressive Party (PP), holds a majority of five seats in the 63-member parliament. The diminishing support for PP led to the resignation of former chairman Halldor Asgrimsson as Prime Minister in June 2006. Although the support for IP remains strong, whether the current centre-right coalition can regain a majority in the May 2007 election will largely depend on the PP's ability to recover its support in time.

The center-left Alliance is the largest opposition party, led by Ingibjorg Solrun Gisladottir, who is expected to be the candidate for the next prime minister for Iceland for the Alliance. Support for the Alliance, however, remains stable, in contrast to the other main opposition, Left-Green Movement (LGM), which has been steadily gaining support due to voters' concerns over the large scale of the energy-intensive industrial projects and their impact on the environment and character of the island. With the support of the small Liberal Party, there is reasonable probability of a center-left lead coalition after the election.

The election outcome is unlikely to affect macroeconomic policy, however. All mainstream political parties share a commitment to responsible macroeconomic policies, as memories of the economic turmoil that followed populist excesses in the 1970s and 1980s remain fresh. The agreement to control wage growth reached in mid-2006 also demonstrated strong co-operative spirit between the government and the social partners representing the employers and employees t.

The prospect of EU and Eurozone membership is debated intermittently and remains a divisive topic. The possibility of adopting the euro was debated especially during the sharp weakening of the Icelandic currency in the first half of 2006. That said, further EU integration remains highly unlikely as long as membership of the EU would also entail adopting the EU's Common Fisheries Policy. Iceland is part of the European Economic Area (EEA), however, together with the Kingdom of Norway and the Principality of Liechtenstein (both AAA/Stable/A-1+). This grants the country many of the benefits of EU membership, particularly free trade and free movement of capital and labor.

Economic Prospects: Temporary Slowdown

- Iceland's economy is one of the wealthiest in the world, dominated by the fisheries and energy sectors.
- Net exports are expected to replace domestic demand as the main driver for growth after large-scale investment projects in aluminum smelting and power generation come onstream in 2007.
- Real GDP growth, which reached more than 7% in 2004 and 2005, is likely to slow to 4.6% in 2006 and to stagnate in 2007.

Table 2

Republic of Iceland Economic and Financial Indicators

	2010f	2009f	2008f	2007f	2006f	2005	2004	2003
Nominal GDP (bil. ISK)	1,328	1,264	1,205	1,156	1,121	1,012	915	831
Nominal GDP (bil. $)	18.4	17.6	16.7	16.0	15.4	16.1	13.0	10.8
GDP per capita ($000s)	56.9	55.0	53.2	51.8	50.0	53.7	44.5	37.3
Real GDP (% change)	3.0	2.9	1.9	(0.3)	4.6	7.5	7.7	2.7
Real GDP per capita (% change)	1.5	1.4	0.5	(1.3)	2.0	5.3	6.7	1.9
Real investment (% change)	3.4	3.4	(20.0)	(19.0)	6.7	37.6	27.4	13.4
Gross domestic investment (% of GDP)	19.8	19.7	19.6	24.8	30.7	28.4	23.2	19.6
Gross domestic savings (% of GDP)	16.5	15.6	14.0	13.4	12.3	12.2	13.2	14.8
Real exports (% change)	4.0	4.0	9.8	11.5	3.5	7.1	8.4	1.6
Unemployment rate (average claimant count; %)	3.0	3.0	3.0	2.5	1.5	1.3	3.1	3.4
Consumer price index (% change)	2.5	2.5	3.1	4.0	7.0	4.2	2.8	2.1
Domestic credit to private sector and NFPEs (% change)	5.0	5.0	5.0	5.0	19.9	64.3	39.9	27.0
Domestic credit to private sector and NFPEs (% of GDP)	277.7	277.8	277.7	275.8	270.8	250.0	168.3	132.6
Short-term interest rate: 3-month REIBOR (%)	N/A	N/A	N/A	N/A	13.5*	10.2	8.6	5.1
Ten-year government bond yield (%)	N/A	N/A	N/A	N/A	7.8*	7.8	7.4	7.9
Real exchange rate index (1980=100)	N/A	N/A	N/A	N/A	100.9*	107.1	97.2	94.1
ICEX15 share index	N/A	N/A	N/A	N/A	6473.5*	5,534.4	3,359.6	2,114.3

*At Oct. 27, 2006. ISK—Icelandic krona. NFPE—Nonfinancial public enterprise. f—Forecast. N/A—Not applicable.

Economic structure

Iceland's population is among the richest in the world, with an estimated per capita income of $50,000 in 2006. Despite its geographical isolation, Iceland will export about 33% of its GDP in 2006. Fishing and fish-processing remain important to the Icelandic economy, but their significance both to GDP (10.9% of GDP in 2005, down from 18.5% in 1995) and exports (56% of merchandise exports in 2005, down from 72% in 1995) continues to decline.

Large-scale investment projects in aluminum smelters, along with the necessary expansion of energy generation, continue to have a marked effect on the Icelandic economy. Business investment is expected to peak at 21.7% of GDP in 2006, compared with 11.8% in 2003. Such investments will almost triple aluminum production in Iceland, contributing to the diversification of the economy. By the end of 2008, aluminum exports are expected to contribute 26% of exports of goods and services, similar to the contribution of marine product exports. Three more projects aiming to expand production further are under discussion for the period after 2008, which could lead to another surge of investment and further boost the export of aluminum. These projects are more politically controversial compared with the previous project, due to the rising concerns about their impact on the economy and the environment of the island. Standard & Poor's does not expect all the projects to start on schedule.

Icelandic companies, particularly in the financial sector, are generally profitable and, due to the limited size of the domestic market, have increasingly sought to diversify abroad. This is expected to provide a more stable source of income for Icelandic companies and to improve their profitability in the long run. In the process, however, as the companies take on increasing (especially external) leverage, these Icelandic firms are also increasingly exposed to external financing risks and to global credit market sentiment.

Economic growth

The economy is in the process of readjusting the macroeconomic imbalances built up during the investment and credit boom in the past few years. Real GDP growth, which reached over 7% in 2004 and 2005, are likely to slow to 4.6% in 2006 and to stagnate in 2007.

The economic boom, driven both by large-scale investment and by a surge in consumption due to fast-expanding credit and the (previously) strong Icelandic krona, has fueled macroeconomic imbalances, as evidenced by a current account deficit of more than 16% of GDP in 2005, rapidly increasing external leverage, strong asset price inflation, and high and rising short-term interest rates. Since March 2006, a downward correction of the currency and asset prices and further increases in short-term interest rates have prompted changes in consumer behavior, pointing to the start of the expected unwinding process.

The Icelandic economy demonstrated remarkable flexibility in unwinding the macroeconomic imbalances without major economic repercussions in its previous boom-bust cycle, which ended in only a minor recession in 2002. Since then, the economy has become more flexible and robust, thanks to comprehensive structural reforms, the introduction of a flexible exchange rate, and the privatization and restructuring of the financial sector. On the other hand, the very high external leverage of the economy, particularly of the financial sector, combined with the very high short-term interest rates, increases risk of a rapid deterioration of private sector balance sheet and therefore disruptive readjustment of the current imbalances.

Domestic demand is expected to contract in 2007 as the unwinding process reduces consumption and the investment projects come to a close. A recession is avoidable, as net exports become the main drive for economic growth in the next two years, when the new aluminum smelters start their production. Real GDP growth is expected to reach its strong potential rate of around 3% by 2010, not taking into account the aforementioned three further industrial projects, which would again drive the economy into another investment boom.

Fiscal Flexibility: Strong Balances, But High Contingent Risk

- The general government balances are expected to return to deficit in the medium term after reaching sizable surpluses in 2004-2006.
- Debt continues to trend downward at a slower pace, to reach 22% of GDP in 2010.
- Contingent liabilities remain the major fiscal risk.

Table 3

Republic of Iceland Fiscal Indicators

(% of GDP)	2010f	2009f	2008f	2007f	2006f	2005	2004	2003
General government revenues	43.6	43.3	43.7	44.0	46.6	48.7	45.9	44.4
Of which central government	32.5	32.2	31.5	31.0	36.0	36.9	34.4	33.0
General government expenditures	43.5	43.5	45.0	44.6	42.7	43.2	45.4	46.4
Of which central government	32.2	32.2	32.5	31.5	31.8	31.3	33.1	34.7
General government balance	0.1	(0.2)	(1.3)	(0.6)	3.9	5.5	0.5	(2.0)
Of which central government	0.3	0.0	(1.0)	(0.5)	4.2	5.6	1.3	(1.7)
Of which local authorities	(0.3)	(0.3)	(0.4)	(0.2)	(0.4)	(0.4)	(0.9)	(0.4)
General government primary balance	2.1	1.9	0.8	1.5	6.2	7.9	3.3	1.1
Central government primary balance	2.0	1.7	0.8	1.3	6.1	7.8	3.8	1.1
General government balance (% of revenues)	0.2	(0.5)	(3.0)	(1.4)	8.4	11.3	1.1	(4.5)
General government interest payments (% of revenues)	4.6	4.7	4.8	4.8	4.9	5.0	6.1	7.0
Central government interest payments (% of revenues)	5.2	5.4	5.5	5.7	5.4	5.9	7.3	8.4
Public sector gross debt	82.1	84.9	87.2	87.7	87.2	92.2	106.7	111.8
Of which general government debt	22.3	23.4	24.2	23.8	23.8	36.5	35.0	40.5
Of which central government debt	15.5	16.0	16.4	16.7	17.0	19.4	27.6	33.4
Public sector net debt	74.4	77.0	78.2	78.4	79.0	82.2	101.2	105.4
Of which general government net debt	16.7	17.7	18.4	17.8	17.7	29.9	33.1	37.7
Of which central government net debt	11.0	11.2	11.5	11.5	11.6	13.5	25.7	30.6

f—Forecast.

Revenue, expenditure, and balance performance

Although the government recognized the critical importance of tightening fiscal policy to accommodate the macroeconomic effects of the ongoing major investment projects and had outlined clear measures in its medium-term fiscal framework, the fiscal surpluses achieved in 2004-2006 were not sufficient to absorb the excessive domestic demand. In the face of very strong growth in domestic demand and relatively high inflation (including housing prices) despite tight monetary policy, there have repeatedly been calls on the government to further tighten fiscal policy. The surpluses mainly result from revenue outperformance due to higher-than-expected domestic demand, whereas the government made little effort to reduce expenditures that exceeded its medium-term plans. In particular, cuts in personal income tax and abolishing the tax on net wealth in 2006 are further fueling domestic demand. The fiscal coordination between central and local government also undermines the macroeconomic stability. In 2006, facing a tight labor market, the City of Reykjavik announced an increase of up to 20% of low-skilled public sector wages, leading to knock-on effects in the wages of care workers and welfare spending.

As signs of decelerating demand surface and the election looms, the 2007 fiscal plan is expected to be on the expansionary side. The planned 1% tax cut, combined with recently announced VAT rate cuts on food and resumed public investment worth 0.9% of GDP which was previously postponed, will lead to a small deficit of 0.6% of GDP. Fiscal balances are expected to stay in deficit until 2008, but to return to near-balance afterward.

Government debt and interest burden

Debt levels continue on a downward path, helped by moderate deficits or surpluses and strong GDP growth. Sizable privatization proceeds of Icelandic krona (ISK) 67 billion ($1.1 billion, or 6.7% of 2005 GDP) from the sale of national telecoms operator Siminn have been used for debt reduction, especially to pay down debt dominated in foreign currency. General government debt is forecast to continue falling, reaching 22% of GDP in 2010, less than one-half the 46% recorded in 2001. About 4.9% of general government revenues will be spent on interest payments in 2006, down from 8.7% in 2001.

Off-budget and contingent liabilities

Off-budget and contingent liabilities of the government stemming from the banking sector have increased substantially in volume, because of fast-expanding domestic credit and the increased leverage of Icelandic banks. In a reasonable worst-case scenario, Standard & Poor's estimates gross problematic assets in the financial system at 15%-30% of domestic credit to the private sector and nonfinancial public enterprises (NFPEs), bringing the contingent liability for the sovereign to 40.6%-81.3% of GDP in 2006, compared with the 20%-40% recorded in 2003. On the other hand, the financial sector has undergone significant restructuring, following privatization of the last two government-controlled banks in 2002 and 2003. They have moved into the mortgage market to improve their risk profiles and have greatly expanded their operations abroad, significantly reducing their reliance on the Icelandic economy. Their improving but still extant cross-holding ownership structure, dependency on wholesale foreign currency funding, and high external leverage expansion policy, however, constrain their creditworthiness and pose contingent risk to the government.

The stock of debt guaranteed by the government is high, amounting to an estimated 61% of GDP in 2005. More than three-quarters of the government guarantees are on the debt of HFF, whose debt is secured by real estate, but which has highly concentrated exposure to house prices in Iceland and the credit risk of Icelandic households.

Monetary Policy: Inflation Above Target, Despite Tight Policy

- Inflation is expected to exceed central bank's upper tolerance limit until 2007.
- Potential depreciation of the krona leads to uncertainties regarding future monetary policy.
- Structural changes in the mortgage market temporarily weakened the transmission mechanism of monetary policy.

The Central Bank Law of March 2001 reflects international best practice. The central bank's track record of independent monetary policy remains short, but dominated by considerable challenges. In the previous boom and bust cycle, the central bank successfully brought down record inflation levels of about 10% in 2002. After a period of loose monetary policy, it is again combating the inflation rates far exceeding its target band.

Strong growth in aggregate demand, a tight labor market, the ample availability of credit and the rapid depreciation of the Icelandic krona in the second quarter 2006 have led to mounting inflation (which, according to the definition used by the central bank, includes housing prices). Despite a rapid tightening of monetary policy, inflation exceeded 8% in August 2006, more than twice the central bank's inflation target tolerance limit, which is 2.5% with a band of plus or minus 1.5

percentage points. As a result of this surge in price pressures, the central bank has increased the repo rate to 14.00% in September 2006 from 5.30% in May 2004. Despite signs of a cooling economy, there is still a possibility that the central bank will raise rates further, as exchange rates have a strong pass through effect on the domestic price level and a potential fresh depreciation of the krona could create further inflation pressure. The issuance of "glacier bonds" (foreign issuance of bonds denominated in krona), with nearly ISK300 billion outstanding as of September 2006, helps to deepen the krona market, but their lumpy maturity structure could increase volatility in the exchange rate.

In 2004 and 2005, the peak of the economic boom, the transmission mechanism of monetary policy was weakened by the unfortunately timed structural changes in the mortgage market. When commercial banks entered the market, previously dominated by HFF, and offered attractive mortgage rates, the competition led to sustained low long-term interest rates and fast credit growth exceeding 60% in 2005, despite the high and rising central bank policy rate. As a result, monetary policy had limited effect on buoyant domestic demand, but led to further appreciation of the krona, which spurred strong consumption of foreign goods. This situation started to improve in 2006 after market concerns prompted a correction of krona. The government tightened the lending policy of HFF and commercial banks are more systematically passing on the repo rate increases to their mortgage rates.

External Finances

- External financing needs remain dominated by very high levels of external debt and large current account deficits.
- Central government net external debt is falling rapidly, as the government repays external debt.
- The very high external leverage of the financial sector continues to increase.

Table 4

Republic of Iceland External Indicators

	2010f	2009f	2008f	2007f	2006f	2005	2004	2003
(% of GDP)								
Current account balance	(3.3)	(4.1)	(5.5)	(11.5)	(18.4)	(16.2)	(10.0)	(4.8)
Trade balance	1.5	0.7	(0.5)	(5.0)	(10.7)	(9.2)	(4.0)	(1.9)
Net foreign direct investment	(2.7)	(2.8)	(2.5)	(1.2)	(5.0)	(28.9)	(14.2)	(0.4)
(% of CARs)								
Current account balance	(6.4)	(7.9)	(10.9)	(23.8)	(40.8)	(39.5)	(26.2)	(12.7)
Net external liabilities	204.1	209.4	214.8	224.4	228.7	200.3	219.3	190.6
Total external debt	916.4	884.2	850.1	828.6	806.1	682.7	530.4	389.0
General government external debt	33.0	32.0	37.7	36.9	42.3	40.8	69.9	75.4
Narrow net external debt	443.2	441.9	441.0	451.0	462.7	396.8	363.2	282.8
Net public sector external debt	54.1	54.4	63.1	64.8	71.7	73.2	113.9	112.9
Net nonbank private sector external debt	26.5	27.0	20.7	23.2	25.0	18.2	8.5	21.0
Net banking sector external debt	290.8	299.3	306.9	322.8	335.6	283.6	226.1	136.7
Reserves/CAPs (months)	1.9	1.8	1.8	1.6	1.3	1.4	1.6	1.2
Gross external financing needs (% of CARs and usable reserves)	483.0	473.0	488.4	511.8	450.1	297.6	250.1	219.8

CARs—Current account receipts. CAPs—Current account payments. f—Forecast. Narrow net external debt is defined as total external debt minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending.

External liquidity low, despite a strong increase in reserves

Gross external financing needs (current account payments plus short-term debt by residual maturity) in Iceland are among the highest of all rated sovereigns, at a forecast 450% of CARs plus usable reserves in 2006. Financing needs remain driven by large current account deficits and high levels of external debt, of which a high proportion are short-term by residual maturity. After a slight current account surplus in 2002 (at 1.5% of GDP), the current account has run massive deficits averaging 17.3% over 2005-2006, as the industrial investment projects and buoyant domestic demand (to roughly a equal extent in 2005) boost imports. From 2007 on, deficits should decline rapidly again, however, to reach 3.3% in 2010, as domestic demand contracts and exports rise as a result of the completion of the investment projects.

Levels of gross external debt, at 800% of GDP in 2006 compared with less than 100% prior to 2000, continue to grow, as domestic real interest rates and current account deficits remain high, and Icelandic companies continue their leveraged acquisitions abroad. Not all the external debt is in foreign currency, however, as foreign investors remain holders of local currency bonds, predominantly housing bonds. Net foreign direct investment (FDI) is not alleviating the external financing pressure, despite inflows related to the investment projects. Subsiding investment project-related inflows and expansion abroad by Icelandic companies are expected contribute to the net outflow of FDI in the medium term.

Narrow net external debt

Iceland has a significant narrow net external debtor position, at 463% of CARs in 2006 (assets considered in this definition are private and public sector nonequity external obligations minus reserves, public sector liquid external assets, and financial institutions' external assets). This is a substantial build-up from 283% in 2003, driven by the sustained high current account deficits and net FDI outflows.

The financial sector is the main external debtor of the economy, accounting for 82% of Iceland's net external debt. Its net external debt is forecast to peak at 336% of CARs in 2006, up from 137% in 2003. Banks continue to borrow heavily abroad, and have financed a series of domestic corporate takeovers by external borrowings in past years. In contrast to the lending boom that preceded the 2001 bust phase, however, financial regulation and supervision have improved significantly, and the banks' structure of financing has shifted from interbank loans to capital market funding, with plans to expand deposit funding through foreign subsidiaries.

The share of foreign liabilities in central government debt is forecast to decline to an estimated 41% in 2006, from a peak of 67% in 2001. As a result, the public sector net debt position is expected to improve.