

# Republic of Iceland Debut EUR Benchmark



Central Bank of Iceland  
November 2006

## Presentation Outline

- Structural Features and Long-Term Trends in Iceland's Economy
- The Emergence of Imbalances and the Policy Response
- The Outlook: Grounds for Optimism



# Structural Features and Long-Term Trends

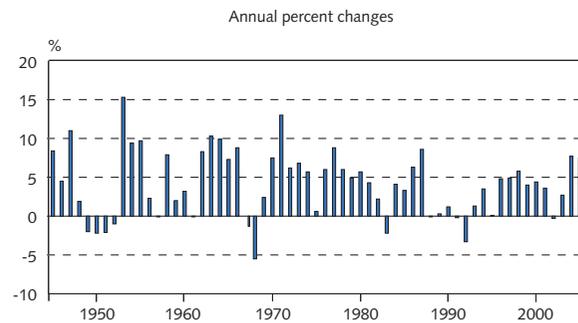
## Republic of Iceland



- Size: 103,000 km<sup>2</sup>
- Population: 300,000
- Settled in AD 874. Nordic/Celtic origin
- Main export industries:
  - Fishing, aluminium, services, tourism
- Average life expectancy:
  - Men: 79 years
  - Women: 83 years
- Member: EEA (EU + Iceland, Norway, Liechtenstein); NATO; Nordic Council; OECD; UN; WTO; IMF; WB

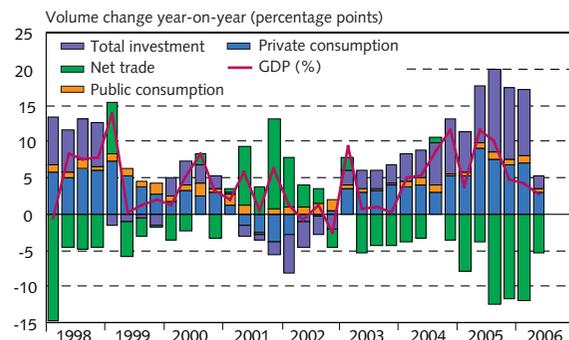
## GDP Growth Performance

Growth of GDP 1945-2005



Source: Statistics Iceland.

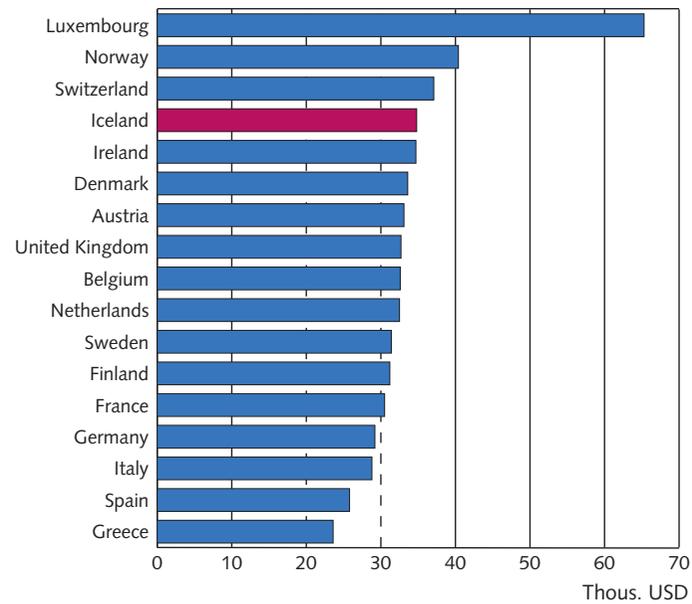
Contributions to GDP growth



- Iceland is no stranger to GDP growth volatility
- Has grown from being one of the poorest countries in Europe in the beginning of the 20th century to be among the wealthiest
- Average growth for the last 10 years around 5% p.a.
- Significant growth in the manufacturing and financial sectors as well as tourism
- Structural changes driving growth
  - Privatisation
  - Increased openness
  - Foreign investments

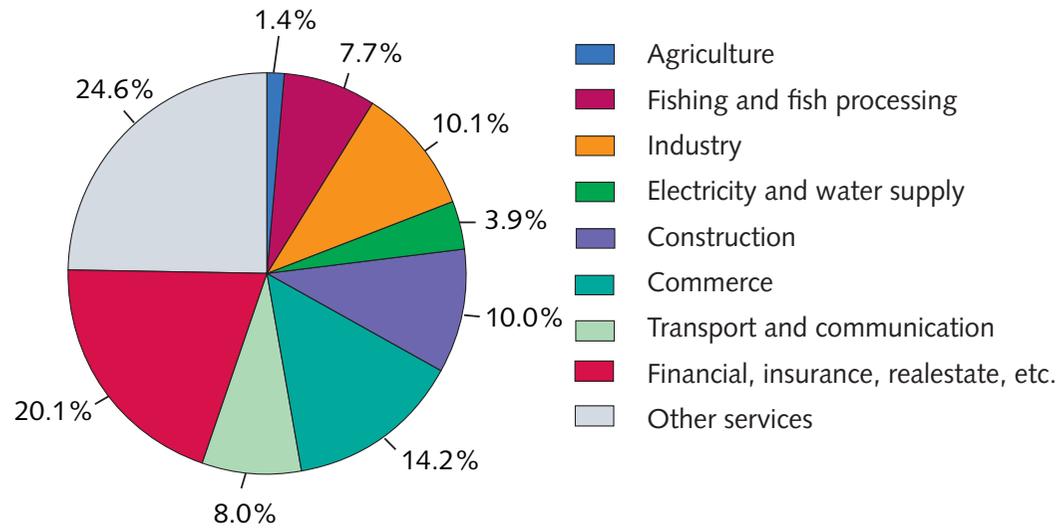
## Iceland: High Ranking for European Per Capita Income

Gross national income per capita in 2005<sup>1</sup>



1. Based on PPP.  
Source: World Bank.

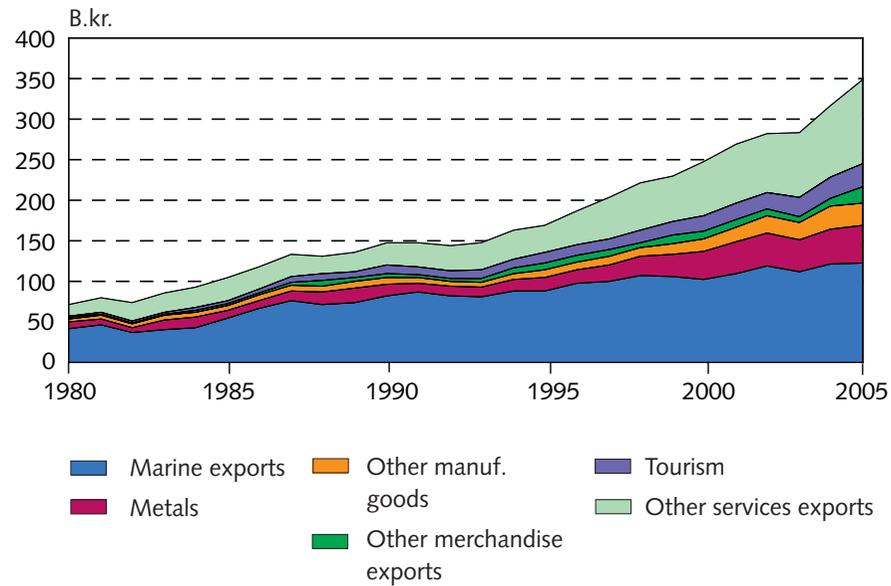
## Breakdown of GDP by sector 2005



Source: Statistics Iceland.

## Changing Structure of Exports of Goods and Services 1980-2005

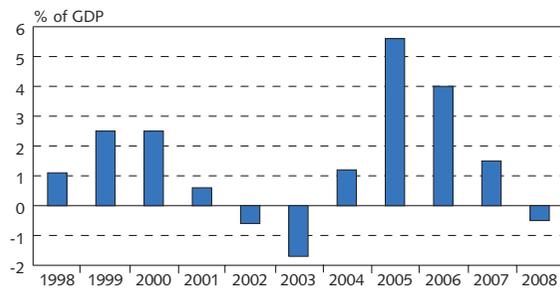
At constant average exchange rates,  
based on a trade-weighted basket of currencies



Sources: Statistics Iceland, Central Bank of Iceland.

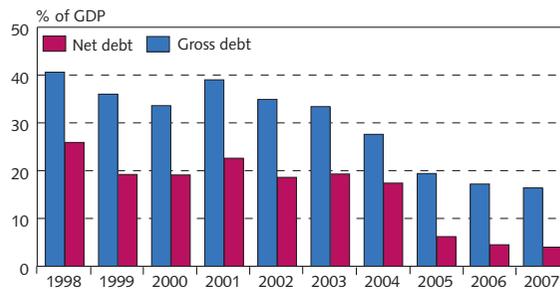
## Strong Government Finances

Treasury balance 1998-2008<sup>1</sup>



1. Estimated for 2006-2007.  
Source: Statistics Iceland, MOF forecast.

Treasury debt 1998-2007<sup>1</sup>

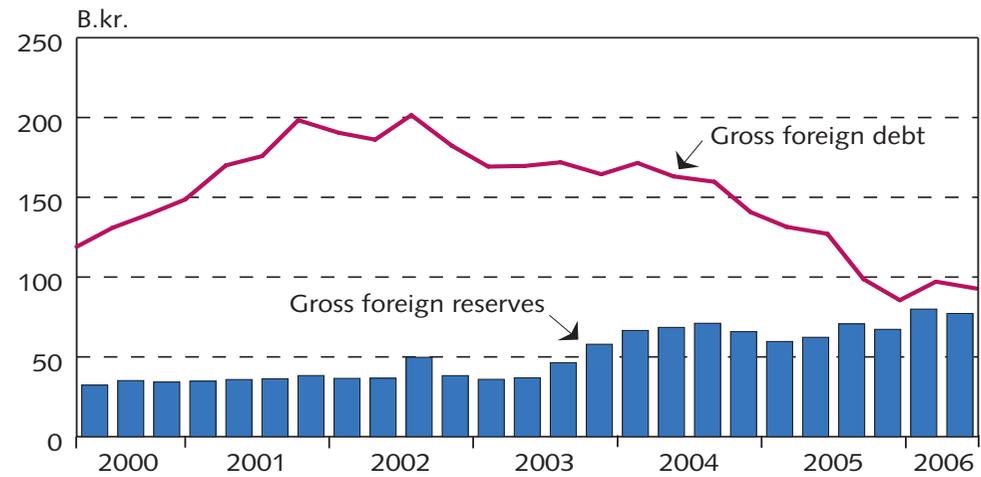


1. Estimated for 2006-2007.

- Treasury surplus for eight out of last nine years
- Treasury debt among the lowest within the OECD
- Current reserves almost cover domestic and foreign treasury debt
- Privatisation proceeds used to pay debt and cover public sector pension obligations
- Reduced surplus as the economy cools down
- New EUR issue increases gross debt to 25% of GDP but will not increase net debt

## Forex Reserves almost Equal to Central Government Foreign Debt

Gross reserves and gross central government foreign debt

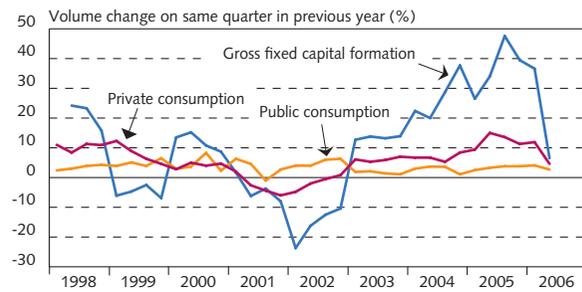




# The Emergence of Recent Imbalances and the Policy Response

## Surge in Investment

Consumption and gross fixed capital formation

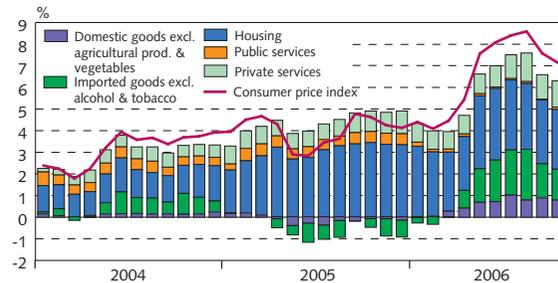


- Huge swings in investments due to aluminum and power plant investments
- Private consumption also a contributing factor
- Aluminum and services a growing part of GDP

## Inflation Rose Above CB Target...

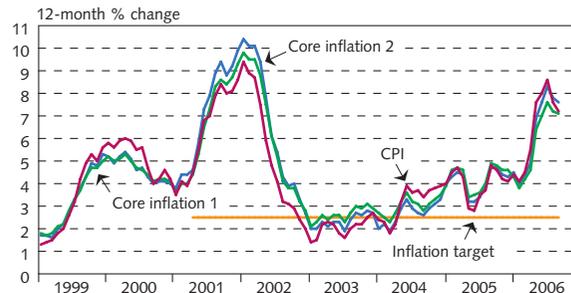
### Components of CPI inflation

Contribution to inflation in past 12 months



### Consumer price inflation and core inflation

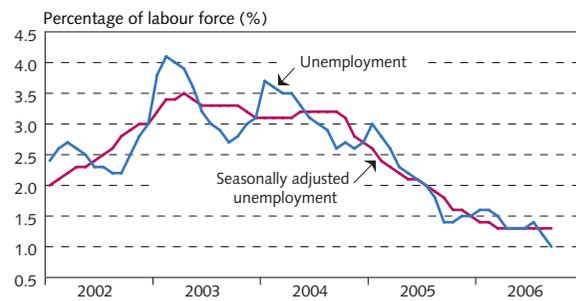
Core inflation 1: CPI less agricultural products, vegetables, fruit petrol and petrol  
Core inflation 2: Core inflation 1 less public services



- Inflation peaked in August 2006
- Housing prices a significant contributor to inflation
- Housing inflation slowing down
- Other sources of inflation picked up after ISK depreciation
- Inflation still well above CB official target but subsiding
- ISK exchange rate important for future developments
- The 3-month increase in CPI Aug. – Nov. is 0.8%, which is equivalent to 3.2% annualised

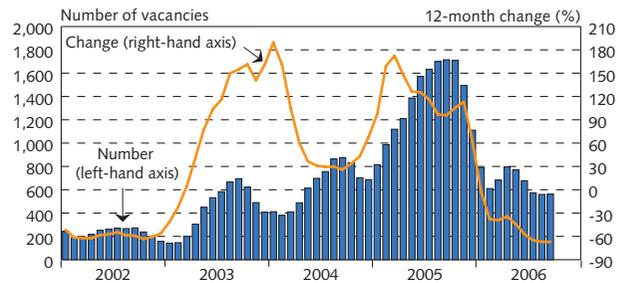
## ..and Labour Markets Tightened

Unemployment



- Unemployment at historic lows (1%)
- Output gap
- Labour shortages
- Inflow of foreign workers did help but not fully offset labour market pressures

Listed vacancies with employment agencies  
3-month moving averages



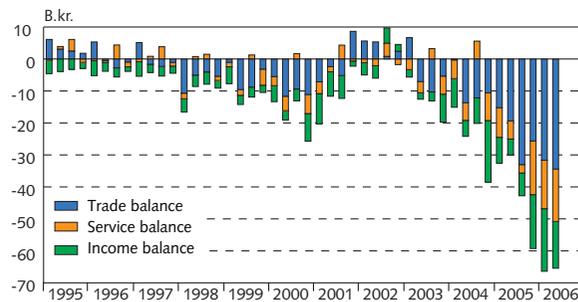
## Financial Sector Changes also Fed Rapid Economic Growth

- Incorporation of public investment funds
- Privatisation of state owned banks
  - Landsbanki, Bunadarbanki and FBA
- Mergers within the banking system
  - Kaupthing and Bunadarbanki (KB Bank)
  - FBA and Islandsbanki (Glitnir Bank)
- Expansion of domestic banks into other markets, i.e. Scandinavia and UK
- Favourable market circumstances used to fund rapid growth
- Record profits every year since 2002

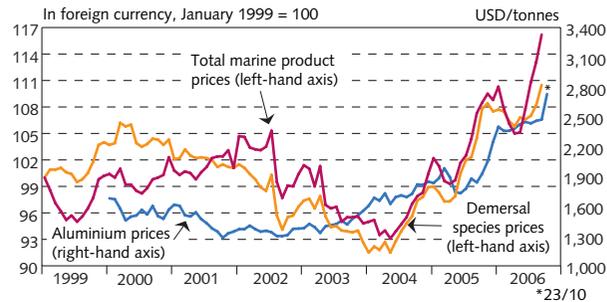
## Developments in the External Accounts

### Quarterly current account

(Net current transfer is included in factor income)



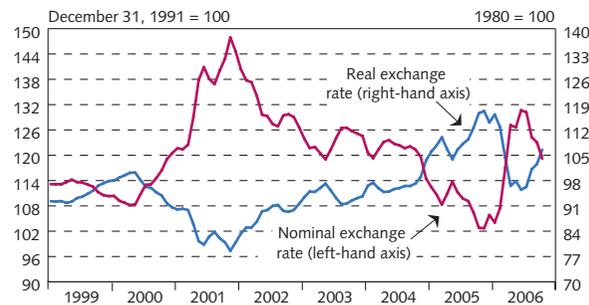
### Prices of marine exports and aluminium



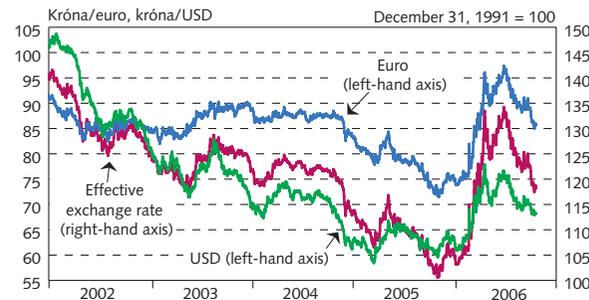
- Trade deficit largely driven by investments in energy and aluminium
- Smelters coming on stream in 2007 led to build up of reserves of imported raw materials
- Higher disposable income and strength of ISK fuelled consumption growth
- Structural changes in the mortgage market
- The CA deficit is forecast to peak in 2006 and fall significantly in 2007 and 2008

## Exchange Rate Developments

Nominal and real effective exchange rate of the króna  
Monthly averages, later October 20, 2006



Exchange rate of króna



- ISK depreciation early this year triggered by Fitch Ratings change in outlook
- ISK strength was at historic high in 2005
- Foreign parties issuing ISK bonds (Glacier bonds)
- International investors building up ISK positions
- Temporary concerns earlier this year about banks' ability to refinance
- ISK has regained part of its strength – close to long-term equilibrium

## Economic Developments Had Mixed Impact on Iceland's Ratings

### Ratings for Icelandic Treasury bonds 2005

	<i>Affirmed</i>	<i>Foreign currency</i>		<i>Domestic currency</i>		<i>Outlook</i>
		<i>Long-term</i>	<i>Short-term</i>	<i>Long-term</i>	<i>Short-term</i>	
Moody's	Aug. 2006	Aaa	P-1	Aaa	P-1	Stable
Standard & Poor's	Oct. 2006	AA-	A-1+	AA+	A-1+	Negative
Fitch	Nov. 2006	AA-	F1+	AAA		Negative

## The Policy Response: Fiscal policy

- Treasury continues to show a surplus
- Surpluses intended for 2006 and 2007
- Favourable tax regime
- Tax cuts should fuel growth in the long run
- Net deposits of the Treasury at the Central Bank amount to 70-100 billion ISK, equivalent to 7-10% of GDP (fluctuates from month to month)

## The Policy Response: Monetary Policy

- Current policy rate at 14%
- Monetary policy to stay tight until clear signs of improving inflation prospects
- Additional interest rate decision on December 21
- Interest rate differential with abroad is still wide

## The Policy Response: Tighter Bank Supervision

- FSA has been significantly strengthened in recent years
- Stress tests conducted by FSA enhanced
- CB monitors the banks' liquidity management closely
- CB also conducts independent stress tests
- Thorough analysis of financial stability published annually
- Banks also closely monitored by the rating agencies

## The Policy Response: Build-Up of Central Bank Reserves

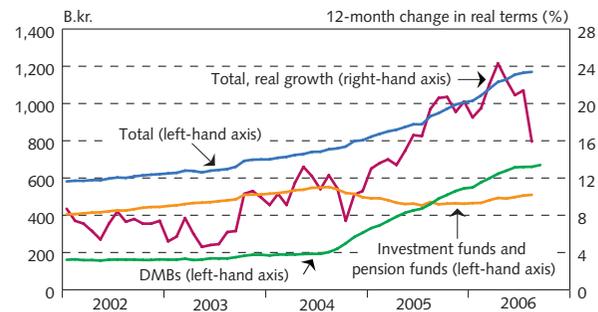
- Larger domestic financial system
- Increased involvement of foreign account in ISK products
- Signal of strength for the Republic and the financial system
- Strong government finances create a perfect opportunity
- Favourable market circumstances
- Create a benchmark in the EUR market
- Proceeds used to build a liquid immunisation portfolio in line with current guidelines
- Rating agencies often refer to relatively low international liquidity



## The Outlook: Grounds for Optimism

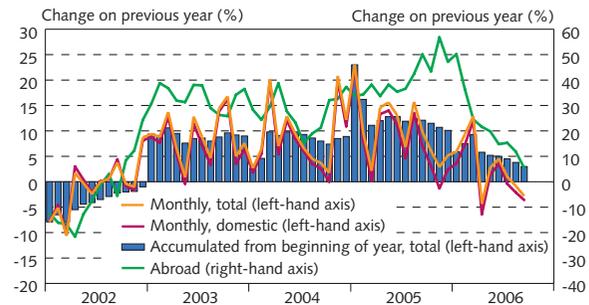
## Signs of Cooling in the Economy

Household debt with main credit institutions



Credit card and debit card turnover

Change on same period in previous year, deflated using the CPI for domestic turnover and the exchange rate for turnover abroad



- Real growth of credit has slowed significantly
- Private consumption is becoming more balanced
- Significant drop in car imports
- Inflation has been on a downward trend since it peaked in August
- Output gap will shrink once the investments in the power and aluminum sectors come to an end next year

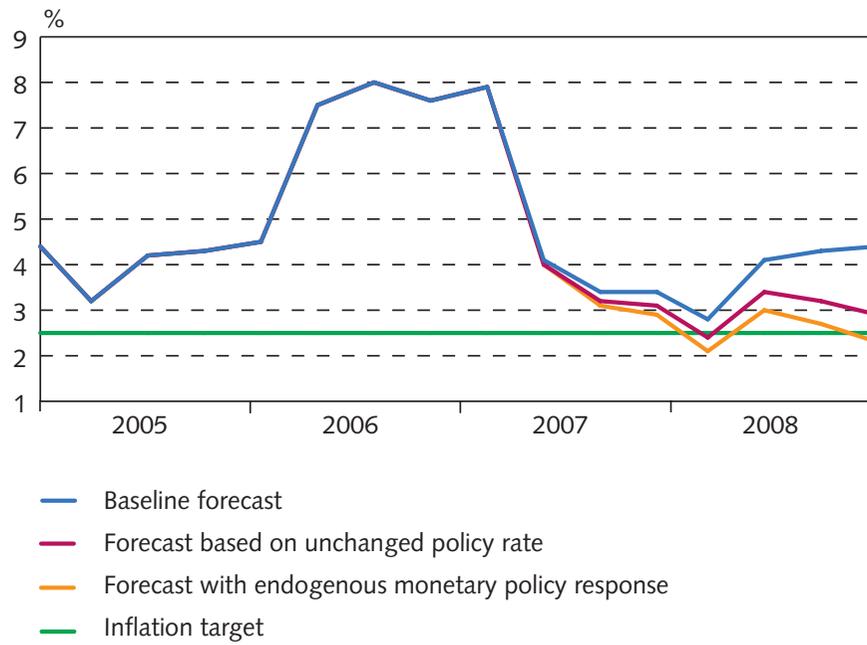
## Macroeconomic and Inflation Forecast with Endogenous Mon. Policy Response

<i>GDP and its main components<sup>1</sup></i>	<i>Current forecast</i>			
	2005	2006	2007	2008
Private consumption	12.3	5.9	-2.3	-12.1
Public consumption	3.3	2.2	3.0	2.7
Gross fixed capital formation	37.6	9.1	-30.1	-15.1
Business sector investment	60.5	7.8	-41.3	-27.0
Residential construction	11.9	13.8	-5.4	-10.3
Public works and buildings	-13.1	3.1	4.2	30.0
National expenditure	15.9	6.1	-8.7	-9.6
Exports of goods and services	7.1	-2.9	13.3	13.6
Imports of goods and services	28.9	4.6	-12.1	-7.4
Gross domestic product	7.5	3.9	0.1	-1.7
<i>Other key aggregates</i>				
Gross domestic product at current prices (b.kr.)	1,012	1,134	1,199	1,188
Current account balance (% of GDP)	-16.2	-20.8	-10.7	-4.0
Unit labour cost (change between annual averages in %)	4.8	8.2	7.3	1.9
Unemployment (% of labour force)	2.1	1.4	2.0	3.8
<i>Policy rate and exchange rate</i>				
Central Bank policy interest rate (%)	9.4	12.7	15.4	14.1
Foreign exchange index (Dec. 31. 1991 = 100)	108.7	122.5	124.8	121.3
<i>Change year on year</i>		<i>Inflation forecast</i>		
2005				4.0
2006				6.9
2007				4.4
2008				2.5

1. Volume change on previous year (%).

## Central Bank Forecast: Falling Inflation

Different inflation paths

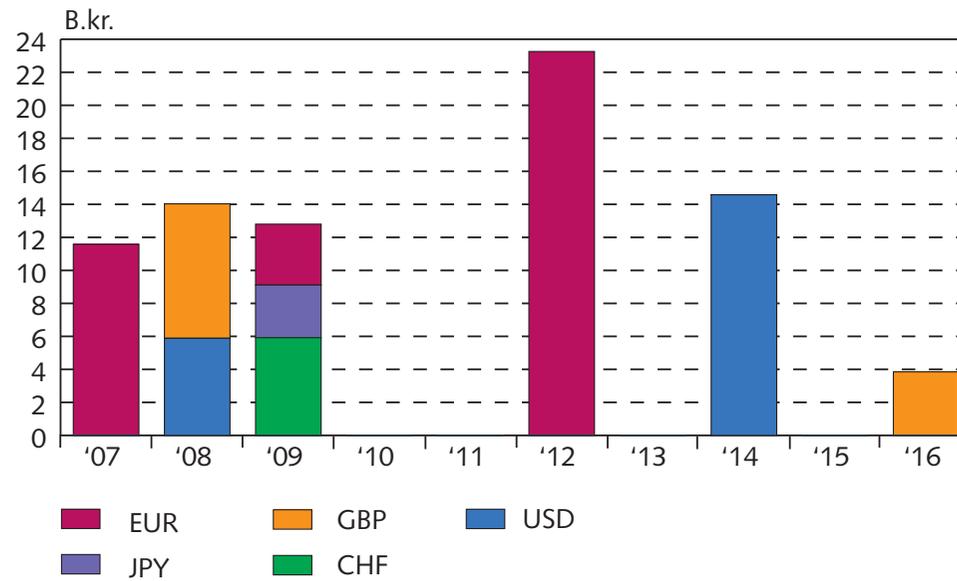


## Banking System in Sound Condition

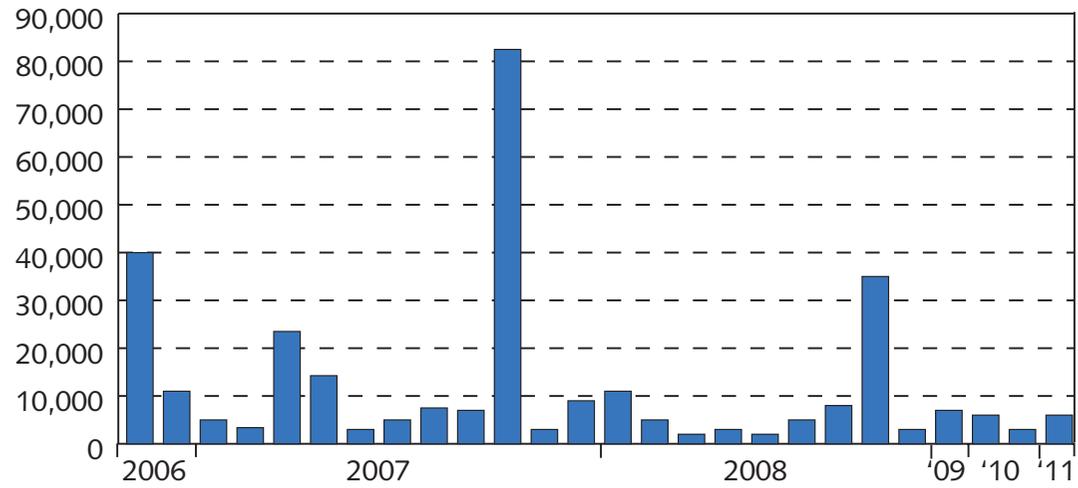
- Banks still showing record profits
- Well diversified assets in stable markets
- Increased transparency and communication with the market (media and investors)
- Unwinding of cross-ownership holdings
- Loan losses at historic lows
- Well equipped to withstand substantial shocks
  - Well capitalised (CAD 12% -14%)
  - Extended funding profile, 2007 covered
  - Prudent risk management
  - Increased funding from deposits
  - Geographically diverse operating base

## Government Finances Remain Healthy, Borrowing Needs Modest

Maturity profile of Treasury external long-term debt



## Maturity Profile of Glacier Bonds in billions of ISK



## Qualitative Factors Supporting Iceland's Sovereign Risk Profile

- Flexible exchange rate facilitates the adjustment process
- Structural changes and a massive investment boom at the root of the imbalances – calmer waters ahead
- Increased diversification in the economy
- Outlook of prices for main export products very favourable
- Well developed institutional framework including the FSA and the Central Bank
- Stable political situation and strong political support for an adjustment programme
- Well educated labour force
- Flexible labour market
- Well funded pension system
- Young population
- Strong government finances

## Further information

- Central Bank of Iceland:  
<http://www.sedlabanki.is/>
- Ministry of Finance:  
<http://www.ministryoffinance.is>
- Financial Supervisory Authority:  
<http://www.fme.is>
- Statistics Iceland:  
<http://www.statice.is/>