

New era of financial stability amid concerns of an overheating economy



General Information

GDP	USD20.0bn (World ranking 105, World Bank 2016)
Population	0.33mn (World ranking 175, World Bank 2016)
Form of state	Parliamentary Republic
Head of government	Katrin JAKOBSDOTTIR (Prime Minister)
Next elections	2020, presidential



Strengths

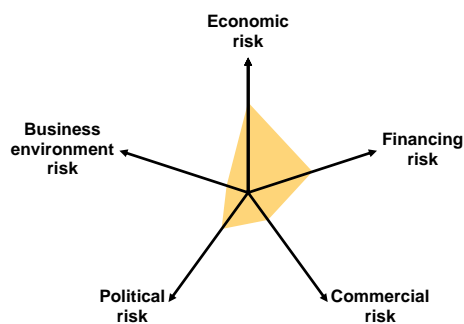
- Prudent macroeconomic policies
- Sufficient foreign exchange reserves
- Strong structural business environment
- New growth potential (tourism, innovation)

Weaknesses

- Government instability
- Unfavorable economic structure; export concentration in fish and aluminum
- Vulnerability to economic overheating
- Still elevated level of external debt
- High vulnerability to large financial shocks

Country Rating

B2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports	Rank	Imports
Netherlands	26% 1	10% Germany
United Kingdom	11% 2	10% United States
Spain	10% 3	9% Norway
United States	8% 4	7% Netherlands
Germany	7% 5	7% China

By product (% of total)

Exports	Rank	Imports
Fish	40% 1	11% Road vehicles
Non-ferrous metals	36% 2	10% Petroleum products
Iron and steel	3% 3	9% Electrical machinery
Feedstuff for animals	3% 4	8% Metalliferous ores
Animal oils and fats	2% 5	5% Transport equipment

Source: UNCTAD (2016)

Economic Overview

Growth momentum fueled by tourism activity

Real GDP rose by +7.4% in 2016, fueled by surging investment (+22.8%) and strong private consumption (+7.1%) on the back of large wage rises (+8%). The latter combined with low unemployment (3% in 2016) has raised concerns of an overheating of the economy. So far, the +16% appreciation of the króna (ISK) against the EUR in 2016 (followed by stabilization in 2017), strong terms of trade and profit margin compression have lowered the pass-through from wages to consumer prices. But headline inflation is expected to exceed the Central Bank of Iceland's (CBI) 2.5% inflation target in 2018.

But other signs of overheating – such as high credit growth, large current account deficits, and rising fiscal deficits – are not evident. Our core scenario is a soft landing of the economy with GDP growth moderating to +4% in 2017 and +3.3% in 2018.

Macroeconomic policies remain fairly prudent

The fiscal balance is forecast to narrow from a surplus of +12.4% of GDP in 2016 to +1.7% in 2017 and to remain in surplus in 2018-2019. Fiscal policy is firmly committed to debt reduction. Public debt fell to 54% of GDP in 2016 and is projected to decline to a comfortable level of less than 40% by 2019.

Monetary policy is focused on maintaining price stability. The CBI's interventionist FX policy should help build up reserves in the run-up to full capital account liberalization, while limiting the short-term volatility of the ISK. Current FX reserves of USD6.4 bn (Sept. 2017) provide for ample policy buffers.

Iceland ushers in a new era of financial openness amid diminishing external risks

Capital controls imposed during the 2009 global financial crisis have been gradually removed in recent years and are now almost abolished. This has likely helped to moderate the appreciation of the ISK in 2017. The last barriers that are designed to prevent speculative currency trading may be lifted in 2018, as the government declared that financial stability was restored in early 2017.

While the trade balance has deteriorated in recent years due to falling exports and rising imports, surging tourism earnings have boosted the services balance and resulted in current account surpluses of +7.9% of GDP in 2016 and +5.5% in 2017 (estimate). The surplus is set to narrow to 4% in 2018, mainly driven by the drag of the stronger ISK on tourism activity and rising goods imports.

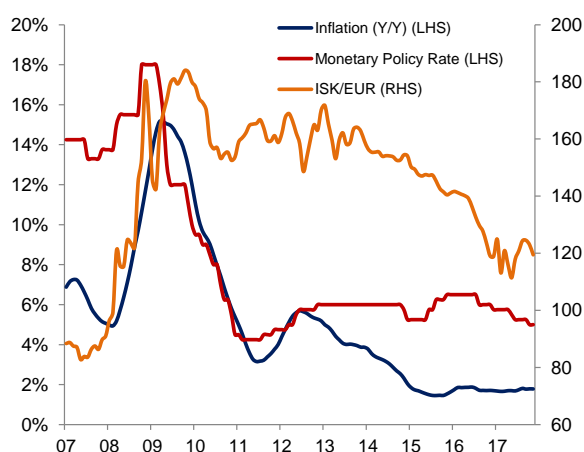
The external debt-to-GDP ratio has been brought down from its peak of 960% during the 2009 financial crisis to 95% or so in 2017 thanks to the wind-ups of banks estates and write-offs of remaining bank debt. Financial sector oversight has also been strengthened.

Key economic forecasts

	2016	2017e	2018f	2019f
GDP growth (% change)	7.4	4.0	3.3	3.0
Inflation (% , yearly average)	1.7	1.8	2.7	2.8
Fiscal balance (% of GDP)	12.4	1.7	1.2	1.0
Public debt (% of GDP)	54.0	45.0	40.0	35.0
Current account (% of GDP)	7.9	5.5	4.0	3.8
External debt (% of GDP)	117.9	95.0	92.0	90.0

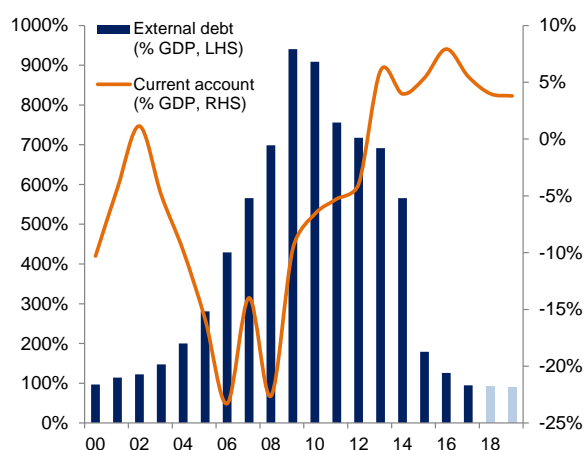
Sources: National statistics, IHS, Euler Hermes

Inflation (%), Policy Rate (%), Exchange Rate



Sources: National Statistics, IHS, Euler Hermes

Current Account and External Debt (% of GDP)



Sources: National Statistics, IHS, Euler Hermes

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