Euler Hermes Economic Research

Country Report

Iceland

Moderate recovery but legacy risks not overcome yet

General Information

GDP	USD13.657bn (World ranking 121, World Bank 2012)
Population	0.32 million (World ranking 176, World Bank 2012)
Form of state	Constitutional Republic
Head of government	PM Sigmundur David GUNNLAUGSSON
Next elections	2016, presidential

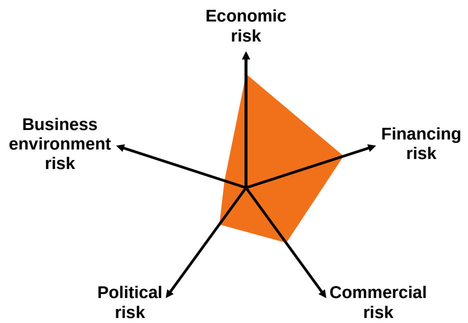
Strengths

- Current account has turned into surplus
- Adequate foreign exchange reserves
- Strong structural business environment

Weaknesses

- Unfavourable economic structure
- High public debt
- Exchange rate risk
- Vulnerable banking sector
- Very high external debt
- Limited progress in removing capital controls which will be retained for some time to ensure relative financial stability. Lifting the controls remains a key policy challenge and, if not done properly, could be followed by renewed financial turmoil

Country Rating C3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Netherlands	23%	1	16%	Norway
Germany	12%	2	13%	Denmark
United Kingdom	12%	3	10%	Algeria
United States	6%	4	8%	Germany
Russia	5%	5	6%	Netherlands

By product (% of total)

Exports		Rank		Imports
Meat	37%	1	11%	Refined Petroleum Products
Non Ferrous Metals	30%	2	10%	Natural Gas
Preserved Meat/Fish	8%	3	7%	Electrical Apparatus
Iron Steel	4%	4	7%	Non Ferrous Ores
Animal Food	3%	5	5%	Ships

Source: Chelem (2012)

Economic Overview

Unfavourable economic structure

The economic structure is somewhat paradoxical. Iceland (still) has one of the highest per capita incomes in the world, but the economy is quite volatile, with large cyclical upswings and downturns. Partly this can be attributed to the natural resource-based export sector which depends heavily on fishery products and aluminium (both sectors accounts for over 40% of exports each). The severe downturn in 2008-2010, however, was caused by the collapse of the banking sector which had become unsustainably oversized (equivalent to around 900% of GDP in 2008) during the decade prior to the crisis.

Recovery to continue at moderate pace

The moderate economic recovery that began in 2011 has been volatile. Following robust growth of +3.5% in 2013, real GDP contracted by -1.3% y/y in Q1 2014 – driven by a surge in imports (of equipment investment) and a cutback in inventories – and expanded by +2.4% y/y in Q2. Early indicators suggest that GDP has remained solid in Q3 and Euler Hermes expects full-year growth of +1.5% in 2014. This should be followed by about +2.5% in 2015, driven by private consumption, fixed investment and tourism, though overall net exports are likely to make a negative contribution to growth.

The downtrend in insolvencies is continuing: Following the +60% surge to a record 1579 cases in 2011, the number of business failures declined by -30% in 2012 (1112 cases), by -17% in 2013 (918 cases) and further by -15% y/y in the first nine months of 2014.

Fiscal consolidation continues, risks remain

The collapse and subsequent nationalisation of the banking sector in 2008 shifted the fiscal account from large surpluses in 2005-2007 to double-digit deficits in 2008-2010 while total public debt surged from about 30% of GDP in 2007 to 100% in 2011. But post-crisis fiscal consolidation has been impressive and, after a moderate fiscal deficit of -1.7% of GDP in 2013, a small surplus is expected in 2014, albeit thanks to a one-off dividend payment of a state-owned bank, followed by a modest deficit of about -1% of GDP in 2015. Public debt will remain high but should decline gradually as a percentage of GDP. Risks to this central forecast include a number of contingent liabilities that could still materialise.

Exchange rate and inflation risk have declined but not vanished

The official target of the Central Bank of Iceland (CBI) is price stability, but monetary policy has primarily focused on exchange rate stabilisation since the severe financial crisis in 2008-2010. Meanwhile, relative exchange rate stability has been achieved through a pragmatic combination of interest rate policy, foreign exchange (FX) interventions, liquidity provision and, in particular, capital controls. Inflation has also retreated to an average 2.3% in the first 10 months of 2014 and should stay moderate until end-2015. However, uncertainty related to exchange rate developments remains a source of inflation risk, as the link from depreciation to inflation works very rapidly in Iceland.

Capital account controls will remain in place for some time

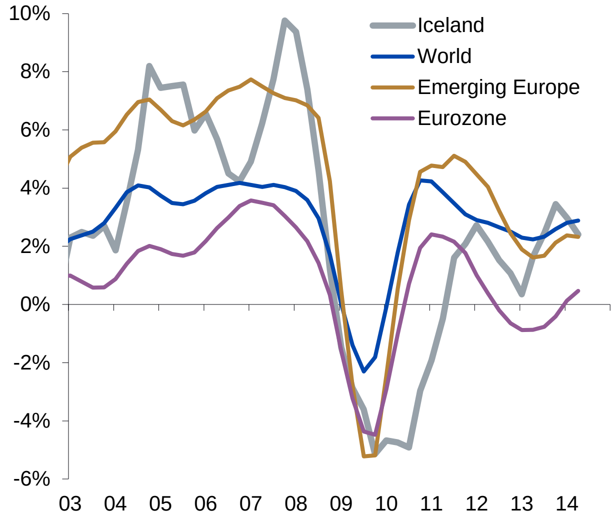
Lifting capital controls remains a key policy challenge for Iceland. Liquid offshore ISK holdings have remained large, at around 18% of GDP at end-2013. The IMF and the Icelandic authorities agree that capital account liberalisation needs to be gradual, cautious and based on domestic

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	1.1	3.5	1.5	2.5
Inflation (%, end-year)	4.2	4.2	2.0	2.5
Fiscal balance (% of GDP)	-3.8	-1.7	0.3	-1.0
Public debt (% of GDP)	96.9	89.9	87.0	86.0
Current account (% of GDP)	-5.3	3.9	0.5	0.2
External debt (% of GDP)	745.8	663.2	627.9	610.0

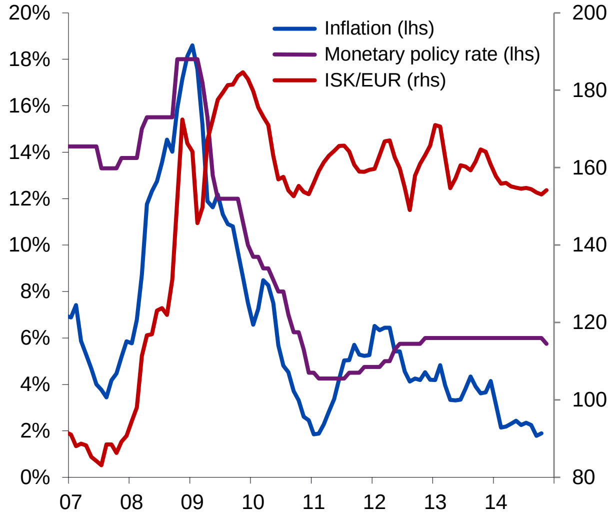
Sources: National sources, IHS, Euler Hermes

GDP growth (%)



Sources: National sources, IHS, Euler Hermes

Monetary policy interest rate (%), inflation rate (y/y, %), and exchange rate



Sources: National sources, IHS, Euler Hermes and external conditions, as such action should not lead to destabilisation of the progress so far made. A disorderly unwinding of capital controls could weaken the ISK, lead to capital flight with adverse effects on the balance of payments, lower FX reserves, and jeopardise market confidence and growth. Accordingly, Euler Hermes believes that capital controls will remain in place in the short to medium term, although it is possible that some limited phasing out may be undertaken. Note, however, that payments linked to current account transactions and inward foreign direct investment (FDI) were already released after a short period of time, reducing risks related to external trade with short payment periods.

Banking sector remains vulnerable

Considerable progress has been made in restructuring the banking system which was significantly downsized and now holds assets of about 200% of GDP, down from 900% before the crisis. The recapitalization of the three core banks has been completed, two of which are now under majority private ownership. The banking sector as a whole is now profitable and liquid. However, legacy risks remain as households, companies and the government are still highly leveraged. Nonperforming loans have remained high, at 12.5% of total loans at end-2013, albeit this was down from 40% at end-2010. Further financial sector stability will be needed to ensure that banks are sufficiently liquid to withstand potential deposit withdrawals once capital controls are lifted.

Current account has shifted into surplus

The current account balance turned into a surplus of +3.9% of GDP in 2013. The deficit on the net income balance, which is largely accounted for by banks in winding up proceedings, improved substantially while the balance of trade and services, already in surplus since 2009, also improved. Euler Hermes expects the current account to narrow to smaller surpluses in 2014-2015 as strong domestic demand will boost imports of goods and shift the trade balance into a deficit.

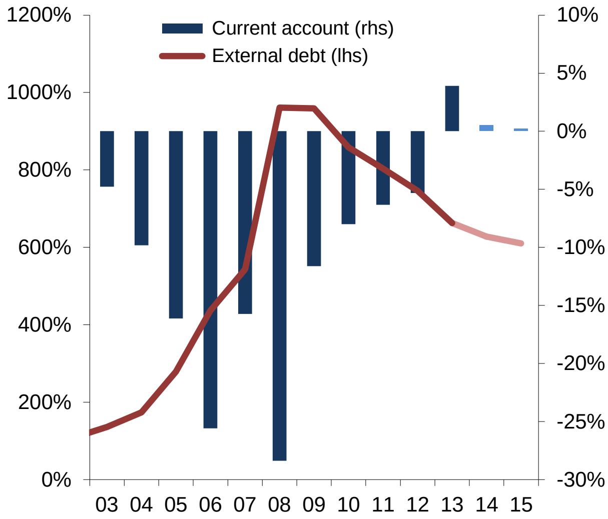
External debt remains very high

Gross external debt has fallen from USD123 bn at end-2008 to USD108 bn in mid-2014, but remains very high in relation to GDP (about 628%) – a legacy from the previously oversized banking sector.

Foreign exchange reserves are adequate

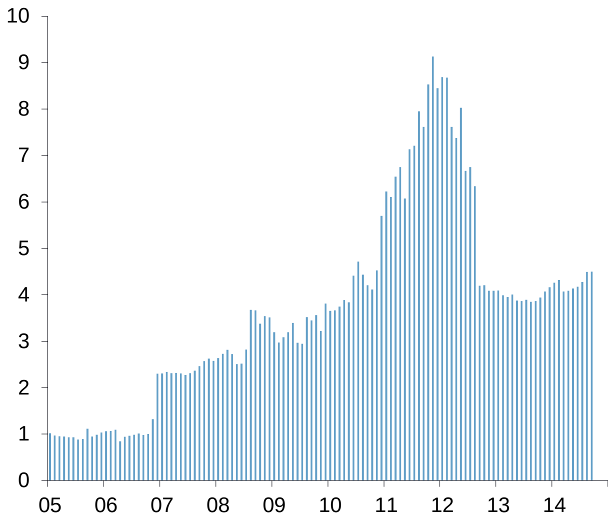
Official FX reserves increased markedly to USD7.7bn at end-2011, but have declined after early debt repayments in 2012 and stood at USD4.5 bn in September 2014. As this level still provides an import cover of almost seven months, short-term debt obligations do not pose a significant threat.

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves (USD billion)



Sources: National sources, IHS, Euler Hermes

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