Euler Hermes Economic Research

Country Report

Iceland

Improving but legacy risks remain

General Information

GDP	USD17.071bn (World ranking 114, World Bank 2014)
Population	0.33mn (World ranking 176, World Bank 2014)
Form of state	Constitutional Republic
Head of government	PM Sigmundur David GUNNLAUGSSON
Next elections	2016, presidential

Strengths

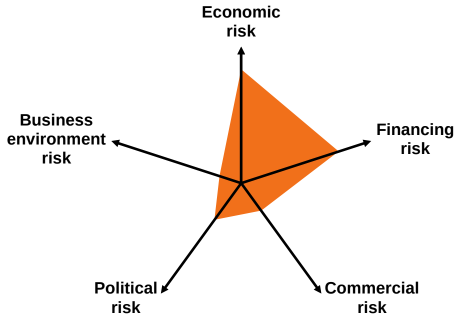
- Current account surpluses since 2013
- Adequate foreign exchange reserves
- Strong structural business environment

Weaknesses

- Unfavourable economic structure
- High public debt
- Exchange rate risk
- Vulnerable banking sector
- Very high external debt
- Capital account controls: liberalisation has gained momentum, but the process still carries risks. Sudden and large capital outflows may lead to short-term uncertainty and exchange rate volatility, putting pressure on the balance of payments

Country Rating

C3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
United Kingdom	13%	1	15%	Norway
Germany	13%	2	15%	Denmark
Netherlands	11%	3	8%	Germany
United States	7%	4	8%	United States
Russia	5%	5	7%	Netherlands

By product (% of total)

Exports		Rank		Imports
Meat	46%	1	12%	Refined Petroleum Products
Non Ferrous Metals	22%	2	8%	Non Ferrous Ores
Preserved Meat/Fish	9%	3	8%	Electrical Apparatus
Animal Food	3%	4	4%	Ships
Pharmaceuticals	3%	5	3%	Cars And Cycles

Source: Chelem (2013)

After surging in 2015, growth will likely slow but remain robust in 2016-2017

The moderate economic recovery that began in 2011 has been volatile. Following a sound +3.9% in 2013, real GDP growth slowed to +1.8% in 2014. Then it accelerated again to an average +4.5% y/y in Q1-Q3 2015, fuelled by soaring fixed investment (+15.8% y/y) and a contribution of +0.7pps by inventories – both in part thanks to increased FDI inflows – as well as strong private consumption (+4.4% y/y) on the back of large wage rises. Net exports made a negative contribution to Q1-Q3 growth as imports (+10.9% y/y) outpaced exports (+7.4% y/y). Euler Hermes expects full-year GDP to rise by +4.5% in 2015. Growth is likely to slow to around +3% in 2016 and 2017 on the back of some economic policy tightening and the wage hikes dampening employment expansion.

Capital control liberalisation gains momentum

Comprehensive capital controls were introduced in November 2008, following the collapse of Iceland's three major banks. While 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, restrictions on capital account transactions have remained in place to date. But in June 2015 the government announced an updated capital account liberalisation strategy, a three-staged approach.

In the first stage, the government is essentially asking creditors to take a haircut of about USD6.8bn on their claims against estates of the failed banks – either through negotiations or through a one-off 39% 'stability tax' on their assets by end-2015. In doing so, it attempts to avoid destabilising the krona (ISK), the country's currency, from a massive outflow of assets. Afterward, those creditors will then be able to move any money recovered out of Iceland. At the time of writing there were indications that all three estates were seeking a composition agreement, but negotiations were not concludes yet. The next two stages will address remaining offshore liquid ISK holdings – currently estimated at around 15% of GDP – using an auction format, and then resident flows.

The updated strategy has the backing of the IMF and triggered sovereign rating upgrades by all three major rating agencies in mid-2015 (Moody's to Baa2, S&P to BBB and Fitch to BBB+). If successfully implemented, the strategy will help speed up the pace of liberalisation and could even generate significant one-off fiscal revenues – the government has indicated that such windfall gains would be used to pay down debt – but full liberalisation remains distant at this stage. And even if the strategy is well thought out, the process still carries some risks. Sudden and large capital outflows may lead to short-term uncertainty and exchange rate volatility, putting pressure on import prices, and the balance of payments.

Exchange rate and inflation risk have moderated but not vanished

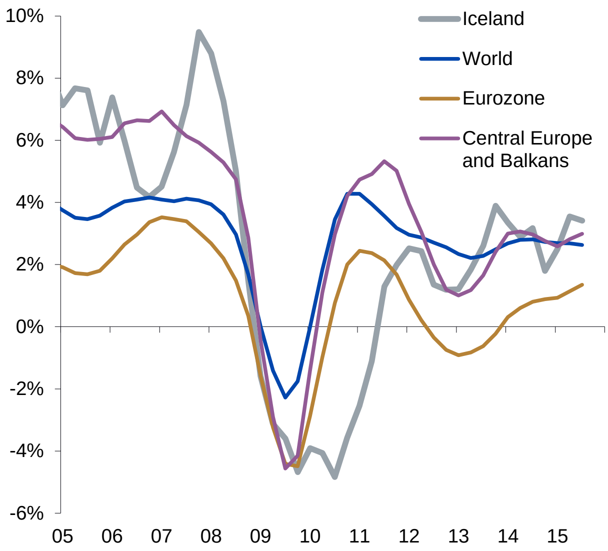
The official target of the Central Bank of Iceland (CBI) is price stability, but monetary policy has primarily focused on exchange rate stabilisation since the severe financial crisis in 2008-2010. Meanwhile, relative exchange rate stability has been achieved through a pragmatic combination of

Key economic forecasts

	2014	2015f	2016f	2017f
GDP growth (% change)	1.8	4.5	3.0	3.0
Inflation (%, end-year)	0.8	2.7	3.3	3.0
Fiscal balance (% of GDP)	-0.1	-0.5	-0.1	-1.0
Public debt (% of GDP)	82.5	78.0	75.0	72.0
Current account (% of GDP)	3.4	4.3	3.0	2.5
External debt (% of GDP)	624	543	470	450

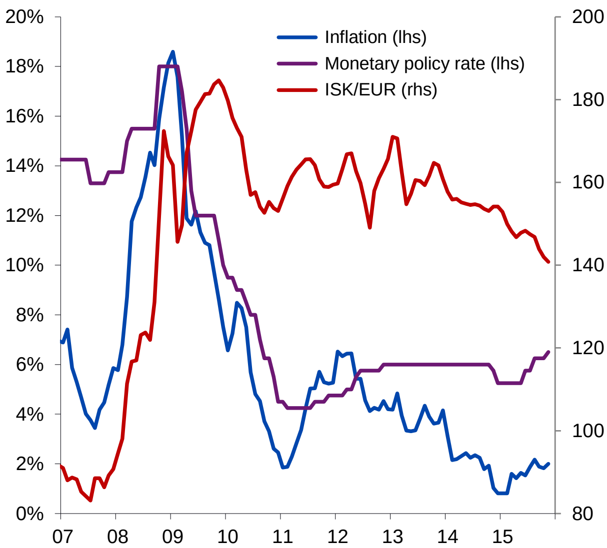
Sources: National sources, IHS, Euler Hermes

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 interest rate policy, foreign exchange interventions, liquidity provision and, in particular, capital controls. Inflation has also retreated to an average 1.6% in the first 11 months of 2015, benefitting from low energy prices and some ISK appreciation. However, inflation expectations and inflation have begun to rise, responding to a nominal wage rise by around 7% in 2015 and wage settlements indicating cumulative increases of more than 20% through 2018. Moreover, uncertainty related to exchange rate developments in the wake of capital control liberalisation (see above) remains another source of inflation risk, as the link from depreciation to inflation works very rapidly in Iceland. As a consequence, the CBI began to tighten monetary policy in June, lifting the key 7-day rate on lending against collateral in three steps by a cumulative 125bps to 6.5% in November, even though inflation has remained below its target of 2.5% so far. Headline inflation stood at 2% y/y in November 2015, up from a low of 0.8% y/y at the start of the year.

Fiscal consolidation on track

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 27% of GDP in 2007 to 95% in 2011. But post-crisis fiscal consolidation has been impressive and, in 2014, a near-balanced budget was achieved. Euler Hermes expects small annual fiscal deficits in 2015-2017 and a further reduction of public debt, which has fallen to 82% of GDP in 2014. A successful implementation of the capital account liberalisation would speed up the fiscal consolidation process.

Current account to remain in surplus

The current account balance turned into a surplus of +5.7% of GDP in 2013, followed by +3.4% in 2014. Euler Hermes expects the current account surplus to rise to about 4.3% of GDP in 2015 before gradually narrowing in 2016-2017 as strengthening domestic demand is likely to boost imports of goods and shift the trade balance into a deficit.

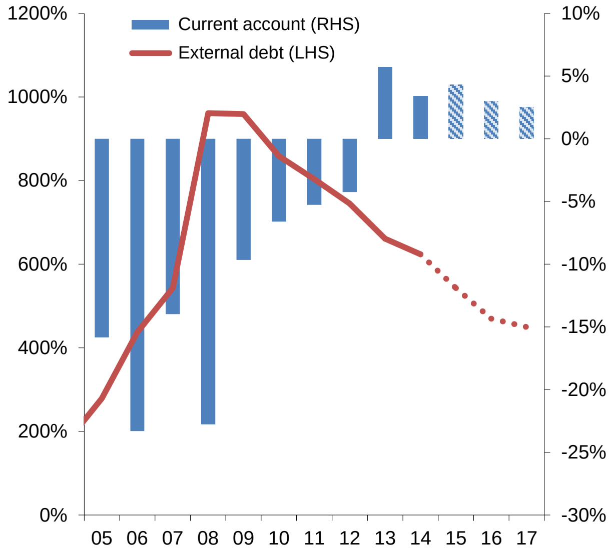
External debt remains very high

Gross external debt has fallen from USD123bn at end-2008 to USD91bn in Q2 2015, but remains very high in relation to GDP (about 550%) – a legacy from the previously oversized banking sector.

Foreign exchange reserves are adequate

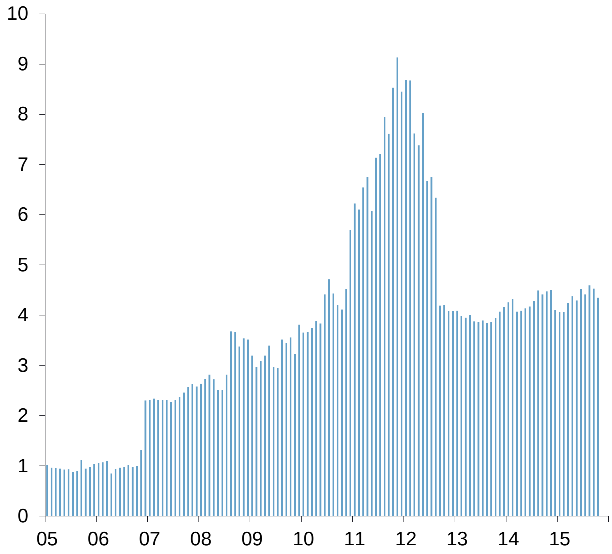
Official FX reserves increased markedly to USD9.1bn at end-2011, but have declined after early debt repayments in 2012 and have stabilised in the range of 4.0-4.6 bn USD since early 2014. As this level still provides an import cover of more than six months, short-term debt obligations do not pose a significant threat.

Current account and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves (USD bn)



Sources: IMF, Euler Hermes

DISCLAIMER
These assessments are, as always, subject to the disclaimer provided below.

Contact Euler Hermes Economic Research Team
research@eulerhermes.com

Last review: 2015-12-07
Country Risk Analyst:
Manfred Stamer
manfred.stamer@eulerhermes.com