

Strong growth as capital controls have been mostly lifted

General Information



GDP	USD16.6bn (World ranking 113, World Bank 2015)
Population	0.33mn (World ranking 176, World Bank 2015)
Form of state	Parliamentary Republic
Head of government	Sigurdur Ingi JOHANNSSON (acting PM as of Dec 2016)
Next elections	2020, presidential and legislative



Strengths

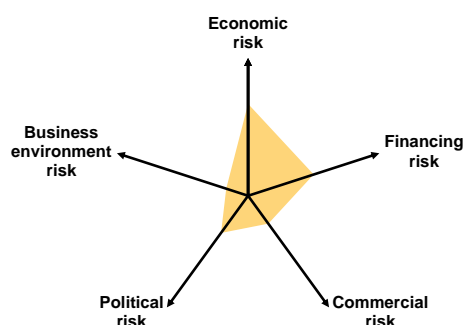
- Current account surpluses since 2013
- Adequate foreign exchange reserves
- Strong structural business environment

Weaknesses

- Government instability
- Unfavourable economic structure
- Vulnerable banking sector
- High external debt
- Capital account liberalisation largely completed, but the process still carries some tail risks: sudden and large capital outflows could lead to renewed exchange rate volatility

Country Rating

B2



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports	Rank	Imports
Netherlands	21% 1	16% Norway
United Kingdom	13% 2	15% Denmark
Germany	10% 3	8% Netherlands
Russia	7% 4	7% Germany
United States	6% 5	6% China

By product (% of total)

Exports	Rank	Imports
Meat	41% 1	11% Refined Petroleum Products
Non Ferrous Metals	28% 2	8% Non Ferrous Ores
Preserved Meat/Fish	8% 3	8% Electrical Apparatus
Ships	3% 4	5% Ships
Animal Food	2% 5	4% Cars And Cycles

Source: Chelem (2014)

After surging in 2015-2016, slower but still robust growth forecast in 2017-2018

Real GDP continued to surge from +4.1% in 2015 to an average +6.1% y/y in Q1-Q3 2016, fuelled by soaring fixed investment (+27.4% y/y) and continued strong private consumption (+6.7% y/y) on the back of large wage rises. Government consumption expanded by a more modest +1.1% y/y. Net exports made a negative contribution to Q1-Q3 growth as imports (+16.6% y/y) outpaced exports (+9.5% y/y). As growth was particularly strong in Q3 2016 (+10.2% y/y) in part due to calendar effects, Euler Hermes expects a slowdown in Q4 and full-year GDP to rise by about +5.2% in 2016.

Against the background of surging wages (+8% in 2016 according to EU estimates) with a low unemployment rate at around 3.4%, the main challenge for Iceland is now perhaps to avoid a possible overheating of the economy. Euler Hermes expects some economic policy tightening and forecasts GDP growth to slow to around +3.5% in 2017 and +3% in 2018.

Capital controls mostly lifted

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 remained in place until 2015.

Since end-2015, however, much progress has been made regarding capital account liberalization. After negotiations, creditors accepted a substantial haircut on their claims against estates of the failed banks and, in exchange, capital controls on the estates were lifted so that non-resident creditors have been able to move any money recovered out of Iceland.

The settling of remaining offshore liquid ISK holdings – estimated at around 13% of GDP in mid-2016 – through an auction in June has been partially successful. The assets of holdouts remained blocked at the Central Bank of Iceland (CBI). Capital controls for resident have been significantly eased.

So far the capital account liberalization process appears to be successful. Some tail risks remain, though. On the one hand, sudden and large capital outflows could still lead to short-term uncertainty and exchange rate volatility, putting pressure on import prices, and the balance of payments. On the other hand, persistent capital inflows could result in upward pressure on the ISK and erode the country's international price competitiveness. However, recently adopted legislation includes safety clause that should prevent sudden swings in capital flows.

Exchange rate and inflation risks have eased but caution remains appropriate

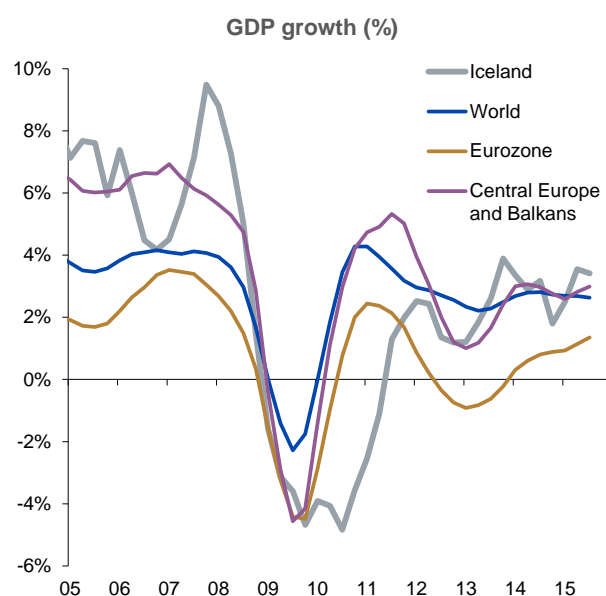
The official target of the CBI is price stability – its inflation target is 2.5% - but monetary policy has primarily focused on exchange rate stabilisation for most of the time after the severe financial crisis in 2008-2010.

Meanwhile, relative exchange rate stability has been achieved and the ISK has even appreciated by +14% against the USD over the past year, despite the large-scale capital account liberalization. Moreover, inflation has been below the CBI's target

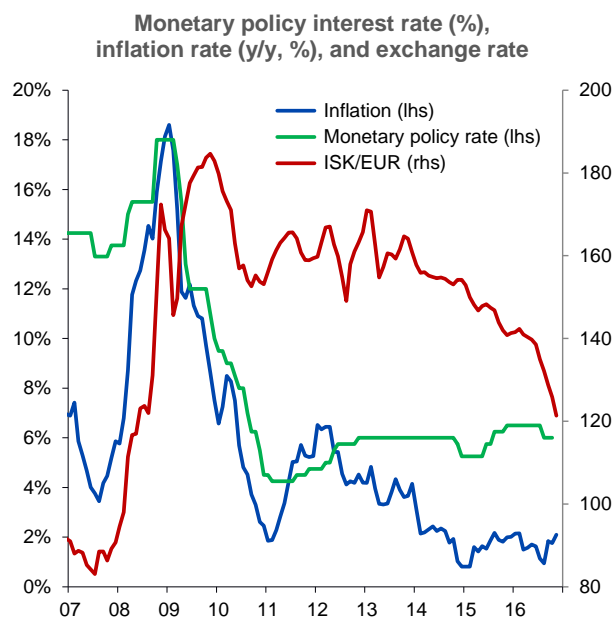
Key economic forecasts

	2015	2016e	2017f	2018f
GDP growth (% change)	4.1	5.2	3.5	3.0
Inflation (% end-year)	2.0	2.0	3.0	3.5
Fiscal balance (% of GDP)	-0.5	14.5	0.5	0.0
Public debt (% of GDP)	67.6	55.0	53.0	49.0
Current account (% of GDP)	4.2	6.0	2.5	2.0
External debt (% of GDP)	185	137	120	115

Sources: National sources, IHS, Euler Hermes



Sources: National sources, IHS, Euler Hermes



Sources: National sources, IHS, Euler Hermes

for almost three years now. As a consequence, the CBI lowered its policy interest rate by 50bps to 6% in August 2016.

However, inflation has recently picked up from a low of 0.9% in August to 2.1% in November and may accelerate further against the background of surging wages (see above). Euler Hermes expects the CBI to be ready to tighten monetary policy should consumer prices rise further.

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 2014-2015, near-balanced budgets were achieved and public debt fell to 68% of GDP.

In 2016, the settlement of the failed bank estates has had large positive knock-on effects on public finances as the estates have assigned most of their ISK assets to the state (worth about 16 of GDP). The government has indicated that these windfall gains will be used to pay down debt.

As a result, Euler Hermes expects a large one-off fiscal surplus of 14.5% of GDP in 2016, followed by near-balanced budgets in 2017-2018. Public debt is forecast to fall further to below 50% of GDP by 2018.

Current account to remain in surplus

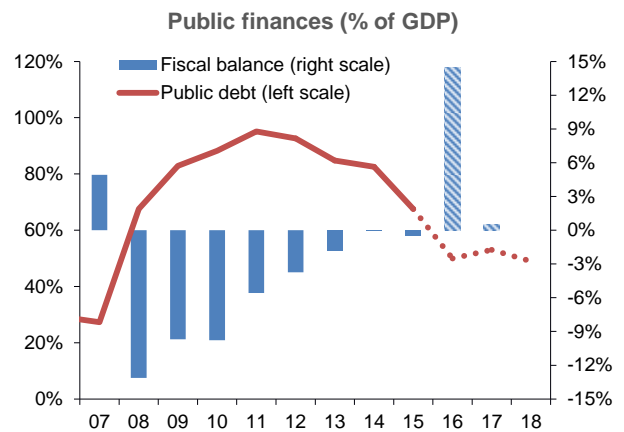
The current account balance has posted large surpluses since 2013, and Euler Hermes expects the surplus to rise to about 6% of GDP in 2016 before gradually narrowing in 2017-2018 as strengthening domestic demand is likely to boost imports of goods and raise the trade deficit.

External debt has much improved

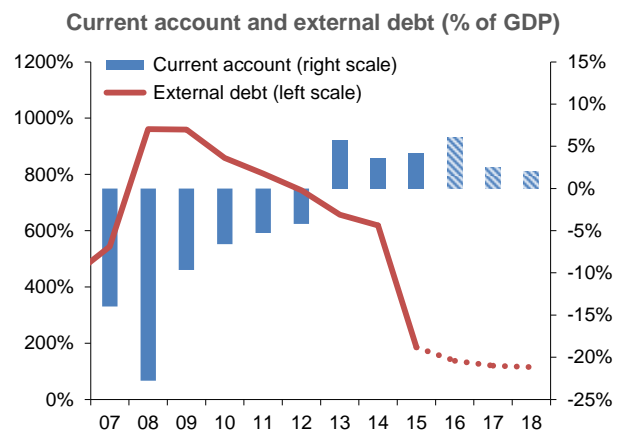
Gross external debt has also substantially benefitted from the settlement of the failed bank estates – it fell from USD91bn (550% of GDP) in Q3 2015 to USD26bn (132% of GDP) in Q3 2016, a reasonable ratio for advanced economies.

Foreign exchange reserves are favorable

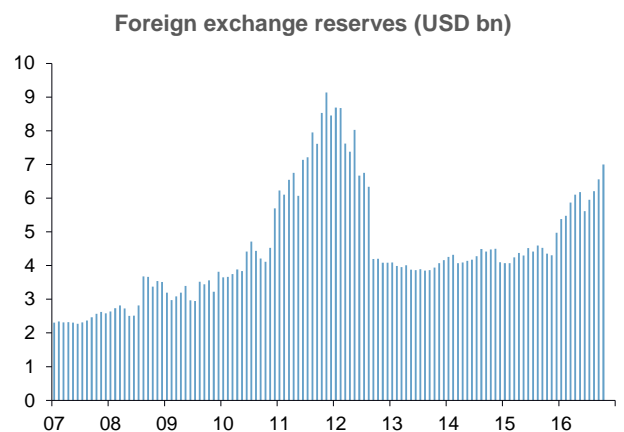
Official foreign exchange reserves increased markedly to USD9.1bn at end-2011, but declined thereafter due to early debt repayments in 2012 and stabilised in the range of 4.0-4.6 bn USD until end-2015. In the course of 2016, reserves rose to USD7bn in October and now provide about 10 months of import cover. Hence, short-term debt obligations do currently not pose a significant threat.



Sources: IMF, Euler Hermes



Sources: National sources, IHS, Euler Hermes



Sources: IMF, Euler Hermes

DISCLAIMER

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

This material is published by Euler Hermes SA, a Company of Allianz, for information purposes only and should not be regarded as providing any specific advice. Recipients should make their own independent evaluation of this information and no action should be taken, solely relying on it. This material should not be reproduced or disclosed without our consent. It is not intended for distribution in any jurisdiction in which this would be prohibited. Whilst this information is believed to be reliable, it has not been independently verified by Euler Hermes and Euler Hermes makes no representation or warranty (express or implied) of any kind, as regards the accuracy or completeness of this information, nor does it accept any responsibility or liability for any loss or damage arising in any way from any use made of or reliance placed on, this information. Unless otherwise stated, any views, forecasts, or estimates are solely those of the Euler Hermes Economics Department, as of this date and are subject to change without notice. Euler Hermes SA is authorised and regulated by the Financial Markets Authority of France.

© Copyright 2016 Euler Hermes. All rights reserved.