



Iceland's economic situation in autumn 2010

There are some indications that the recession has levelled out and recovery is under way. Positive signs are job growth in the second quarter of 2010 and an increase in investment goods imports in the first half of the year although energy-intensive industrial development projects have been delayed. Other factors are improved fiscal balance, ISK appreciation and a more stable economic environment. The fiscal deficit as a ratio of GDP of 9,3% in 2009 is estimated to decrease to 5,7% in 2010. The new proposal for the 2011 budget assumes that the fiscal deficit will be reduced to 2,1% of GDP.

The current economic strategy is based on four main pillars. Firstly, rebuilding a solid financial system, secondly to reinforce the financial position of the Treasury, thirdly to take steps in relaxing capital account controls and determining the outlines of long-term monetary policy and fourthly to restructure household and corporate debt. The verdict recently pronounced by the Supreme Court and proposed legislation concerning foreign-denominated debt will remove uncertainty and speed up debt restructuring.

Macroeconomic development

Iceland's recession in 2009 was milder than originally feared. The decline in real GDP was 6.8% compared to projected 10% a year ago. A return to growth is projected in 2011, but moderate, mostly due to low investment activity. In August 2010 the Central bank of Iceland estimated a 2.4% growth in GDP in 2011.

The adjustment of the economy has been striking. In 2009 the decrease in domestic demand was 21%, thereof private consumption declined by 16% and investments by 51%. The share of investments was 14% of GDP in 2009. This is the lowest share ever. In the past 60 years the share has been 25% and 21% in the past two decades. Recent indicators imply that general business investment is slowly recovering.

In 2009 exports rose by 7.4% and imports fell by 24%. The positive change in the balance of trade together with a smaller deficit in primary income from abroad, resulted in a current account deficit of 25 billion ISK or 1.6% of GDP. In 2008 the current account deficit was 324 billion ISK or 21.9% of GDP.

In 2010 domestic demand is expected to fall by 0.7% but rise by 3.7% in 2011. The current account deficit is expected to be 2.2% in 2010 and 3.7% in 2011. These current account figures are not relevant though as they include calculated interest payments of the collapsed banks, of which only a fraction will be paid to the creditors. When these calculated interest payments are subtracted the current account balance is positive.

Delays in energy-intensive investment projects dampen immediate prospects for growth but booming tourism partly compensates it. The impact of necessary fiscal restraint and possible emigration are other factors that might restrain growth. In the medium term the main contribution to growth will stem from expanding exports, import compression, rising investments, exploitation of improved competitiveness and ultimately recovering domestic demand.



Economic and monetary policy

Following the collapse of the three large Icelandic banks in early October 2008 access to international financial markets closed completely, an access which is vital for the functioning of the economy and to service sovereign and private debt. Under these circumstances the only solution available at the time was to seek assistance with the IMF which the ruling government at the time did on October 27, 2008.

On November 19, 2008 a Stand-By-Agreement was approved by the IMF, giving the Icelandic government access to loans equivalent to \$2.1 billion during a 24 month period. The Nordic countries and Poland also committed to provide \$2.75 billion to cover the financing gap under the program. These loans are subject to successful reviews of the program.

Now when The Executive Board of the IMF has agreed upon the third review of the Government-IMF economic recovery programme, the preconditions for capital account liberalization will be in place as regards the foreign exchange reserves and macroeconomic stability.

The Icelandic króna has appreciated by 11% so far in 2010. Nonetheless, in real terms it remains 22% below the average over the past 30 years. The capital controls, developments in the terms of trade and the current account and the interest rate differential with major currencies have supported the positive development of the exchange rate.

Inflation has fallen markedly in recent months. It fell from 7.5% in May to 3.7 in September and is now projected to reach 3% by end year. The major force behind lower inflation is the recent strengthening of the Icelandic króna which lost over half of its value in 2008 and 2009.

The Central bank's policy to support the króna has mainly consisted of tightening the administration of capital controls. Lower inflation and a stronger króna have provided the scope for a larger interest rate cuts. The monetary committee of the bank has cut the policy rate, currently at 6.25%, gradually from 13.0% in May 2009. Given the inflation outlook, the Central Bank's interest rates are still high and there is scope for further cuts.

Government finances

The Government's program for Treasury finances assumes surplus in the overall balance of the general government in 2013, and surplus in the primary balance (without consideration of interest payments or receipts) in 2011. The primary balance is expected to improve by 4¼ percent of GDP during 2010 and reach -2¾ percent of GDP. The adjustment is primarily delivered by the central government. The budget for 2010 met these objectives, mostly by tax increases in mid-year 2009 and 2010, which amounted to 4½% of GDP and cuts in government investments. Further adjustment is a major challenge as the main emphasis must be put on cuts in expenditures in 2011. Still the government has proposed additional tax rises for next year.

At end-2009 the general government debt stood at 105 percent of GDP which was about 15 percent of GDP lower than previously expected. Creditor acquisition of the government share in Arion and Islandsbanki has helped in that respect. The expected Ice-save obligation of the public sector, which is included in the debt estimate, is estimated to be between 15 and 20 percent of GDP.



Restructuring of the banking system

The three new commercial banks have now been recapitalized, with domestic assets and liabilities of the collapsed banks. The government is controlling party only in Landsbanki, after the creditors acquired their stake in the two other banks. Savings banks have all been taken into administration by the government, the largest two as late as in April 2010 when negotiations with creditors didn't succeed. The need to recapitalize the government owned and guaranteed Housing Financing Fund has become more acute, as operational losses reduced its capital significantly.

The level of leverage is high in the corporate sector. Companies with revenues in Icelandic króna and debt denominated in foreign currency have been severely hit by the depreciation of the króna. The level of non-performing loans is estimated at 50 percent for the corporate sector. Most holding companies, which borrowed in foreign currency and bought Icelandic shares, have already defaulted. The new commercial banks have during the past year been preparing solutions and methodology to address the problems of the corporate sectors' over-indebtedness and have recently started to offer viable companies permanent solutions. A swift restructuring of corporate debt is generally considered a precondition for recovery and increased activity in Iceland.

The household sector also suffers from the effects of the currency depreciation, mainly due to indexation of loans but partly due to loans denominated in foreign exchange, especially car-loans. Latest estimates of non-performing loans indicate that 30 percent of bank-loans and 15 percent of loans of the Housing Loan Fund are in default or under payment suspension. Only 9 percent of households have foreign currency mortgage debt, and foreign currency car-loans are a small portion of total indebtedness. Various targeted measures for debt restructuring of distressed households have been introduced but the issue is still subject to debate as many households risk bankruptcy and loss of their homes.

In June 2010 the Supreme Court ruled that foreign exchange indexation clauses in loan contracts are illegal, but left open the question of what constituted a foreign exchange indexed loan and whether the foreign-currency related interest rate stipulated in the loan contracts would remain valid. In September the Supreme Court ruled that the Central Bank's krona interest rate should be applied to recalculate some of the illegal foreign exchange indexed loans. The authorities are considering new legislation to eliminate the uncertainties resulting from these rulings.

Political considerations

The Icesave dispute between Icelandic government and governments of U.K. and Netherland have at times overwhelmed political discussions in the past year. An agreement, involving an Icelandic government guarantee of full recovery of deposit insurance claims, was reached during October 2009, and passed by Iceland's parliament with a small majority. However, it was rejected in a national referendum in March 2010 following the president's refusal of signing the law. Negotiations halted in the wake of the referendum and the elections both in UK and Netherlands, but it has been indicated that a new agreement is probable soon. Gross Icesave obligations amounts to about 40% of Iceland's GDP and are expected to be repaid over time mainly through asset recovery. In the past year or so many political commentators have doubted that the Government would be able to convince the Althingi to pass the bill for the 2011 budget. The proposed bill will put the cooperation of the ruling coalition to a test as the Government relies on a tiny majority and there are numerous unpopular cuts in the budget.



Energy and climate issues

There is demand for establishing new energy-intensive projects in Iceland. These involve new or extended aluminium and silicon plants, data storage facilities etc. In general the interested parties are looking for renewable energy, long term contracts and competitive energy prices. Most of these projects are progressing slowly at the moment due to currency restrictions, lack of political commitment and general uncertainty.

A framework plan for utilization or protection of certain areas in Iceland is being prepared. The plan is supposed to bridge the gap between energy utilization and nature conservation where conflicts may arise. It is expected that the plan will be finalized this year and given a legal status by the approval of the Parliament.

On climate change, the government is preparing an action plan covering most of the economy. The energy intensive industries will fall under the ETS-system from 2013. The government has presented a target of reducing emission by 15% by 2020 relative to 1990 values. This target must be seen in the light of Iceland's Kyoto commitment which allowed a 10% increase from 1990 to 2008-12.

Labour Market Developments

The unemployment rate has varied from 7-9% in 2009 and 2010 which was lower than was originally feared but major improvements are not to be expected unless growth picks up substantially. A worrying factor is that a third of the unemployed is long term unemployed, and the share is rising rapidly. Unemployment is highest among young people with the shortest education.

Employment increased by 1.2% in the 2nd quarter of 2010 compared with a year earlier, for the first time since 2007. Employed persons as a share of the population aged 16-74 rose by 1.6% and total hours worked rose by 1.1%.

According to CIE's estimates economic growth has to reach as high as 4-5% in the coming years in order to eliminate unemployment, but the official estimates of 2-2.5% growth will result in persistent unemployment. The current low real exchange rate is helpful in raising employment as labour intensive industries as the tourism industry flourish.

Collective agreements

Most of the collective agreements on the private and public labour markets expire in November or December this year. It is probable that negotiations will stretch out in time as there is a large gap between the public expectations of the results and businesses ability to bear additional costs. The Confederation of Icelandic Employers advocates a three year agreement, identical for all unions, with cost increases in line with collective agreements in neighbouring countries with the aim of price stability and a stronger exchange rate.

EU application

Althingi agreed to apply for EU membership in July 16 2009 with a tiny majority of 32 against 28. A formal approval of Iceland as a candidate country by the Council was accepted on June 17 2010. The European Commission has delivered its opinion on the application in a detailed report. Iceland is, according to the report, well prepared to become a member and fulfils the most important criteria.

The support for EU membership in Iceland has declined considerably since the application was submitted. The major reason for this change of mood is likely the difficult dispute with the UK and



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Netherlands concerning Icesave and EUs position in the dispute. Still there is a considerable majority of the population that wants to continue and conclude the negotiations and vote in a national referendum on the result.

Formal negotiations are expected to open in the second half of 2011 on some of the 35 chapters, after the screening process of the relevant chapters is finalized, with a duration of 1-2 years.

