

ICELAND



Summary

Economic activity in Iceland continued to fall in 2010. However, in 2011 the economy may slowly begin to recover. The current account is likely to turn into a small surplus, and in the course of the year Iceland may start to ease the capital controls. However, the rejection by Iceland's electorate of the repayment deal made by the government with the UK and the Netherlands has resulted in renewed uncertainty. The governments of the UK and the Netherlands are now likely to sue Iceland's government for the billions of euros they paid to the depositors of Icelandic banks, which creates risk for the fiscal and external position. Meanwhile, the government narrowly survived a vote of no-confidence. Despite a rise in foreign reserves the net foreign asset position remains strongly negative.

Things to watch:

- Legal action by UK and the Netherlands following the rejection of the repayment deal.
- Political situation, as the coalition government is under strong pressure.

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Iceland			
National facts		Social and governance indicators	
Type of government	Constitutional republic	Human Development Index (rank)	rank / total 17 / 169
Capital	Reykjavik	Ease of doing business (rank)	15 / 183
Surface area (thousand sq km)	103	Economic freedom index (rank)	44 / 179
Population (millions)	0.3	Corruption perceptions index (rank)	11 / 178
Main languages	Icelandic	Press freedom index (rank)	1 / 178
Main religions	Lutheran (81%) Roman catholic (3%)	Gini index (income distribution)	n.a.
Head of State (president)	Olafur Ragnar Grimsson	Population below \$1 per day (PPP)	n.a.
Head of Government (PM)	Johanna Sigurdardottir	Foreign trade	
Monetary unit	Krona (ISK)	2009	
		<i>Main export partners (%)</i>	<i>Main import partners (%)</i>
		Netherlands	Norway
		UK	Netherlands
		Germany	Germany
		Norway	Sweden
		<i>Main export products (%)</i>	2006
		Marine products	51
		Aluminium	24
		Other manufacturing products	15
		Agricultural products	2
		<i>Main import products (%)</i>	
		Industrial supplies	25
		Capital goods (excl transport)	24
		Transport equipment	20
		Consumer goods	14
		<i>Openness of the economy</i>	2010
		Export value of G&S (% of GDP)	60
		Import value of G&S (% of GDP)	51
		Inward FDI (% of GDP)	1.0
Economy			
		2010	
<i>Economic size</i>	<i>bn USD</i>	<i>% world total</i>	
Nominal GDP	13	0.02	
Nominal GDP at PPP	12	0.02	
Export value of goods and services	8	0.04	
IMF quatum (in mln SDR)	118	0.05	
<i>Economic structure</i>	2010	5-year av.	
Real GDP growth	-3.5	2.5	
Agriculture (% of GDP)	5	5	
Industry (% of GDP)	25	24	
Services (% of GDP)	70	70	
<i>Standards of living</i>	<i>USD</i>	<i>% world av.</i>	
Nominal GDP per head	39153	398	
Nominal GDP per head at PPP	36355	311	
Real GDP per head	51296	641	

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

After the steep fall of economic activity in 2009, Iceland's economy contracted by another 3.5% in 2010. The economy is likely to recover modestly in 2011. Unemployment increased to 7.8% in the first three months of 2011, up from 7.6% one year ago and 2.3% three years ago, when the country enjoyed almost full employment. On 9 April 2011, the Icelandic electorate rejected a proposal to compensate the British and Dutch governments for the almost EUR 4bn they paid to the accountholders of Icesave, when the bank collapsed in the autumn of 2008. Litigation is now likely against Iceland at the Court of the European Free Trade Association. This creates uncertainty for Iceland, as the country may have to sign up to a less favorable repayment deal. Despite the sharp economic contraction the country still enjoys a relative high standard of living, while the work force is highly skilled and the country has significant unexploited natural resources. However, the economy is very small and dependent on a limited number of sectors. Furthermore, the country needs to reinvent its economic model, as the pre-crisis economy was based on an unsustainable credit and housing boom.

Political and social situation

Since April 2009, a coalition of the Social Democratic Alliance and the Left-Green Movement has been in power, with Joanna Sigurdardottir as prime minister. However, the government is under strong pressure, and the opposition Independence Party is gaining popularity. Two lawmakers of the Left-Green movement have recently defected and the government narrowly survived a vote of

no confidence in April 2011. The government aims to become a member of the European Union. However, the recent rejection of the Icesave repayment deal is likely to complicate the accession of Iceland, as the British and Dutch governments have said that Iceland can only become an EU member once the Icesave dispute has been settled.

Economic policy

The government aims to reduce the fiscal deficit and restructure the banking sector, which collapsed in late 2008. The government deficit declined to 7.8%, down from 10% in 2009 (and 13.5% in 2008). As a percentage of GDP public debt is likely to have peaked at 126% in 2010, though the recent rejection by the voters of the Icesave deal has resulted in a more uncertain outlook. The government has made progress in the restructuring of the banking sector and is working to improve supervision. However, capital controls are still in place. The Central Bank has plans to gradually reopen the capital account once macroeconomic stability has returned and the financial sector has been restructured. At 5%, inflation returned to single-digit territory in 2010, after two years with high inflation (12.7% in 2008 and 12% in 2009). Inflation in March 2011 stood at 2.3% year-on-year. As inflation declined, the central bank has been able to lower its policy rate to 4.25% in February 2011.

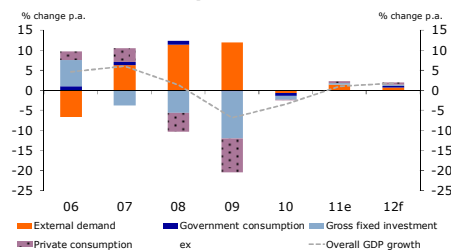
Balance of Payments

The enormous current account deficit (equal to 25% of GDP in 2008) posted until the crisis struck has been reduced, as imports collapsed through the contraction of the economy. The current account is likely to be close to balance in 2011, with Iceland posting surpluses on the trade and services account, but a deep deficit on the income account. Iceland's dependence on the fishing and the aluminum sectors gives the country a rather small export base. However, the country has a lot of potential to diversify into geothermal energy. The country's USD 2.1bn IMF program helped to boost the foreign reserves.

External position

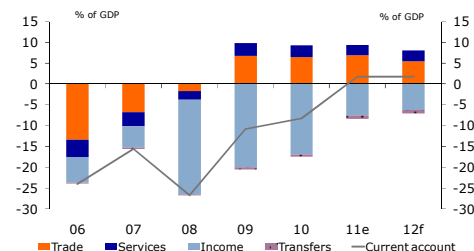
Iceland's foreign reserves have grown markedly in the past years. They increased to USD 4.1bn, which is equal to almost 8 months of imports. However, the rejection of the Icesave repayment proposal also creates uncertainty for the external position, as litigation may result in a higher amount of compensation to be paid to the United Kingdom and the Netherlands. Furthermore, this increased uncertainty has also made Iceland's access to the capital markets, at least in the short run, more costly and difficult. What is more, the country has a large negative net foreign asset position. As this is largely the result of the financial sector, this position may improve once the banks have been fully restructured.

Chart 1: Growth performance



Source: EIU

Chart 2: Current account



Source: EIU

Iceland							
Nominal GDP in bn USD	16.7	20.4	16.9	12.1	12.6	11.8	11.2
Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
<i>Key country risk indicators</i>							
GDP (% real change pa)	4.6	6.0	1.4	-6.9	-3.5	1.0	1.8
Consumer prices (average % change pa)	6.7	5.1	12.7	12.0	5.4	2.5	4.0
Current account balance (% of GDP)	-24.0	-15.6	-26.8	-10.8	-8.3	1.7	1.8
Total foreign exchange reserves (mln USD)	2301	2579	3515	3813	4123	4370	4370
<i>Economic growth</i>							
GDP (% real change pa)	4.6	6.0	1.4	-6.9	-3.5	1.0	1.8
Gross fixed investment (% real change pa)	22.4	-11.1	-19.7	-50.9	-8.2	3.0	3.0
Private consumption (real % change pa)	3.6	5.6	-7.9	-15.6	-0.2	1.0	1.0
Government consumption (% real change pa)	4.0	4.1	4.6	-1.7	-3.2	-1.0	1.5
Exports of G&S (% real change pa)	-4.6	17.7	7.0	7.0	1.1	4.2	3.2
Imports of G&S (% real change pa)	10.4	-0.7	-18.4	-24.0	3.9	1.6	2.8
<i>Economic policy</i>							
Budget balance (% of GDP)	6.3	5.4	-13.5	-10.0	-7.8	-5.1	-3.8
Public debt (% of GDP)	31	28	69	115	126	124	124
Money market interest rate (%)	12.4	14.3	15.8	13.2	8.3	5.3	5.9
M2 growth (% change pa)	60	91	34	3	17	2	7
Consumer prices (average % change pa)	6.7	5.1	12.7	12.0	5.4	2.5	4.0
Exchange rate LCU to USD (average)	70	64	88	124	122	145	158
Recorded unemployment (%)	1.3	1.0	1.6	8.0	8.3	n.a.	n.a.
<i>Balance of payments (mln USD)</i>							
Current account balance	-3990	-3195	-4518	-1312	-1040	200	200
Trade balance	-2239	-1386	-300	806	810	800	600
Export value of goods	3477	4793	5399	4158	5097	5900	5500
Import value of goods	5716	6179	5699	3352	4286	5120	4960
Services balance	-690	-689	-345	373	356	300	300
Income balance	-1026	-1060	-3834	-2422	-2132	-900	-700
Transfer balance	-33	-60	-39	-71	-75	-100	-100
Net direct investment flows	-1669	-3348	4999	-2202	1930	2350	2800
Net portfolio investment flows	11340	-8602	2974	-9516	-7893	-5450	-4250
<i>External position (mln USD)</i>							
Total foreign debt	7227	12379	9528	3725	4194	n.a.	n.a.
Total foreign exchange reserves	2301	2579	3515	3813	4123	4370	4370
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	-13.4	-6.8	-1.8	6.7	6.4	6.8	5.4
Current account balance (% of GDP)	-24.0	-15.6	-26.8	-10.8	-8.3	1.7	1.8
Inward FDI (% of GDP)	23.3	33.7	7.2	0.5	1.0	1.5	1.7
Foreign debt (% of GDP)	434	606	565	308	333	n.a.	n.a.
Foreign debt (% of XGSIT)	942	1020	560	495	330	302	n.a.
International investment position (% of GDP)	-100.5	-115.3	-492.1	-686.3	n.a.	n.a.	n.a.
FX-reserves import cover (months)	3.3	3.4	5.1	8.6	7.7	7.2	7.3

Source: EIU, IMF & Moody's

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