

Research

Iceland: Recovery in uncertain times

- The Icelandic economy is now recovering after the collapse of the Icelandic banking sector in October 2008. We believe that the recovery could prove sustainable, as macroeconomic imbalances have been reduced significantly.
- We expect Icelandic GDP growth of around 3-4% y/y in the coming two to three years, but growth could surprise on the upside if certainty about the Icelandic funding situation increases.
- While the recent “no” vote in the second Icesave referendum adds to the uncertainty surrounding the Icelandic recovery, we think it is unlikely to derail the recovery.
- Inflation is likely to continue to ease and should stay below the Icelandic central bank’s inflation target of 2.5% through 2011-13.
- PPP estimates indicate the ISK is around 25% undervalued versus the euro on an on-shore basis. The offshore ISK rate is much more undervalued.

Icelandic macro outlook

	2010	2011	2012	2013
National account				
GDP ¹	-3,5	2,9	3,3	3,7
Private consumption	-0,2	2,9	1,2	1,2
Fixed Investments	-7,7	15,6	16,7	14,3
Public consumption	-3,2	-3,1	-2,8	-0,1
Exports	1,1	6,2	0,5	1,1
Imports	3,9	7,6	-2,3	-1,4
Output gap	-7,6	-5,3	-4,2	-2,3
Labour market				
Unemployment	8,0	9,0	9,2	9,4
Prices & wages				
CPI (year-average)	5,4	2,5	1,6	1,2
Wages	4,8	3,8	4,2	4,4
External balances				
Trade balance	7,8	11,2	9,2	11,1
Current account	-7,9	-1,1	-2,5	-0,1

Source: Reuters EcoWin and Danske Markets

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The worst is behind us

Prior to the collapse of basically the entire Icelandic banking sector in October 2008, there had been a tremendous build-up of imbalances in the Icelandic economy. These imbalances were already very visible in early 2006 when we published our research note *Geysir crisis* (March 21, 2006), forecasting a hard landing in the Icelandic economy and serious financial distress.

The warnings turned out to be right, but it should also be noted that the collapse occurred only after the collapse of Lehman Brothers and the output loss following the banking crisis has actually been relatively small compared with what we have seen in, for example, the Baltic countries. In our view, this is mostly the result of Iceland's flexible exchange rate regime, which to a very large extent, has helped soften the blow from the banking collapse. That said, it should also be noted that the strict capital controls put in place after the banking collapse have, to some extent, "frozen" the crisis and there is naturally considerable uncertainty about what happens once the crisis is "unfrozen" and capital controls are lifted.

The Icelandic government and the central bank have announced that a gradual lifting of capital controls will soon be initiated, but also that the complete process could take as long as four years. We believe that capital controls will be abolished faster if domestic and global financial conditions turn out to be favourable. A fast and successful phasing out of the capital controls could improve the macroeconomic environment more than expected in our forecast, as we have technically assumed a "neutral" impact of the gradual lifting of capital restrictions.

Recovery under way

It seems clear that the worst is behind us in macroeconomic terms and a moderate recovery appears to have taken off in the latter part of 2010. Our forecasts indicate that the recovery will continue in coming years. However, the recovery looks likely to be less buoyant than the one in South East Asia after the Asian crisis in 1997 or in Turkey after the 2001 crisis. Nonetheless, we see clear signs of a recovery beginning to take off and we believe the Icelandic economy should return to positive GDP growth (in year-on-year terms) in 2011.

The main drivers of the recovery are likely to be a recovery in private consumption and investment as the financial situation continues to stabilise and real income growth recovers, while the importance of net exports to the recovery are likely to decline in 2011-13 compared with 2010.

However, the shape and strength of the recovery will be hugely dependent on Iceland's funding conditions. In a situation with a high degree of clarity about the funding situation, the recovery could be somewhat stronger than our forecasts indicate. The "no" in the Icesave referendum is obviously important in this regard. More on this below.

Imbalances have been reduced significantly

The primary reason we are confident that a sustainable recovery is under way is that macroeconomic imbalances have been significantly reduced – with a largely balanced current account, a large trade surplus and property prices (more or less) back to pre-boom levels (in real terms). Furthermore, the public finance situation has clearly stabilised, with public debt likely to decline in coming years from the current (high) level of around 100% of GDP (in gross terms, excluding Icesave).

Furthermore, inflation remains well under control and on a declining trend. Obviously, inflation prospects will be very dependent on the outlook for the Icelandic kronúr (ISK), but given the significant fundamental undervaluation of ISK it is natural to assume that ISK will strengthen gradually over time.

In our preliminary inflation forecast, we have conservatively assumed a gradual 25% appreciation of the ISK over the next three years. It should be noted, however, that this is not a forecast, but rather a technical assumption. The reason that we still do not publish a forecast for ISK is due to the fact that capital restrictions remain in place.

Given the assumption of a gradual appreciation of ISK over the medium term inflation should remain below Sedlabanki's inflation target of 2½% during the entire forecast horizon. This would mean that Sedlabanki should be able to continue easing monetary policy for some time to come despite the gradual recovery in the economy and tightening of monetary conditions globally.

Icesave “no” creates uncertainty, but will not derail the recovery

On Saturday, a majority of voters voted “no” in the second referendum on the so-called Icesave deal. This effectively means that the issues will have to be resolved in the international courts in a legal case involving Iceland, Britain and the Netherlands.

The outcome of such legal proceedings is clearly uncertain and the economic importance – especially the importance for Icelandic public finances – is extremely hard (if not impossible) to quantify. However, in terms of the short-term macroeconomic impact, we do not expect to see any major negative impact of the “no” vote. The reason for this is that the Icelandic capital restrictions mean that there will basically be no capital outflows regardless of the referendum outcome. In that regard, it should be noted that a ruling in the case should be expected within the next two years – hence before the total (re)liberalisation of capital flows is expected. That said, the “no” vote could have a negative impact on the speed of liberalisation of capital flows and hence longer term it could also have a negative impact on growth.

It has been suggested that the “no” vote could have an impact on Iceland's credit ratings. This is clearly a risk and as such the “no” vote could potentially also increase Iceland's funding costs. The size of the increase in funding costs will, to a large extent, depend on the global financial environment and the Icelandic government's response in terms of additional measures to ensure investor confidence. In that regard, it should be noted that there is no room for fiscal loosening in Iceland given the wider financial, legal and political uncertainties.

It should be noted that the Icelandic government already have said it will accept any ruling from the international courts even if the ruling were to go against Iceland.

Concluding, the “no” to the Icesave deal creates additional uncertainty and could have a negative impact on Iceland's funding cost and credit rating, but overall we do not expect it to derail the macroeconomic recovery in the Icelandic economy.

ISK is (at least) 25% undervalued on a PPP basis

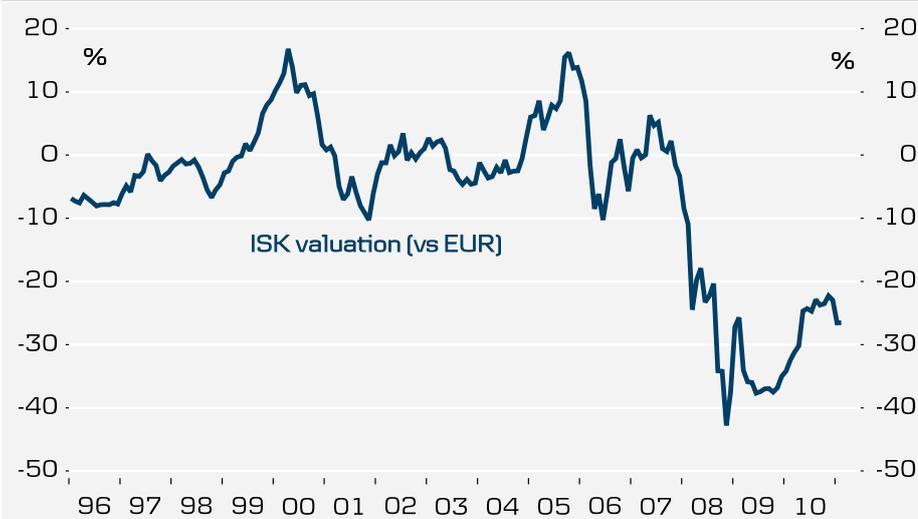
Our assumption of a gradual 25% appreciation of the ISK reflects a simple *Purchasing Power Parity* (PPP) estimate based on eurozone and Icelandic consumer prices. However, note that this reflects an undervaluation of the *on-shore* EUR/ISK rate (currently around 162). Note also, that the (highly illiquid) *offshore* EUR/ISK rate (currently around 249-259) indicates an even larger undervaluation of the ISK.

The relatively larger undervaluation in terms of the offshore EUR/ISK rate is to a large extent due to the liquidity shortage in the offshore markets and the fact that “impatient” investors with locked-in ISK positions want to get out of their positions. Many of the impatient investors would obviously want to take the opportunity to get rid of their positions once capital controls are lifted – regardless of the undervaluation of the ISK. Therefore, the transition back to free capital movement and a truly flexible exchange rate regime will not necessarily be a smooth one. On the other hand, the clear undervaluation should help significantly curb the initial possible sell-off in the ISK. Furthermore, we

would tend to expect that the flows could turn positive quite fast if EUR/ISK gets off to a good start in a freely floating environment.

The Icelandic central bank (Sedlabanki) would probably not like to see a too swift recovery of the ISK so the bank is likely to intervene to curb the possible strengthening of the Icelandic currency. On the other hand, the central bank is also well aware that a strengthening of the ISK would go a long way toward cleaning up the balance sheets of Icelandic households and corporations with significant foreign currency loans. Therefore, Sedlabanki would be interested to see a gradual and orderly strengthening of the ISK back to “fair value” levels over the coming years as the recovery gets under way, while at the same time building up additional FX reserves and further securing financial stability.

ISK is fundamentally undervalued



Source: Reuters EcoWin and Danske Markets

Economic growth

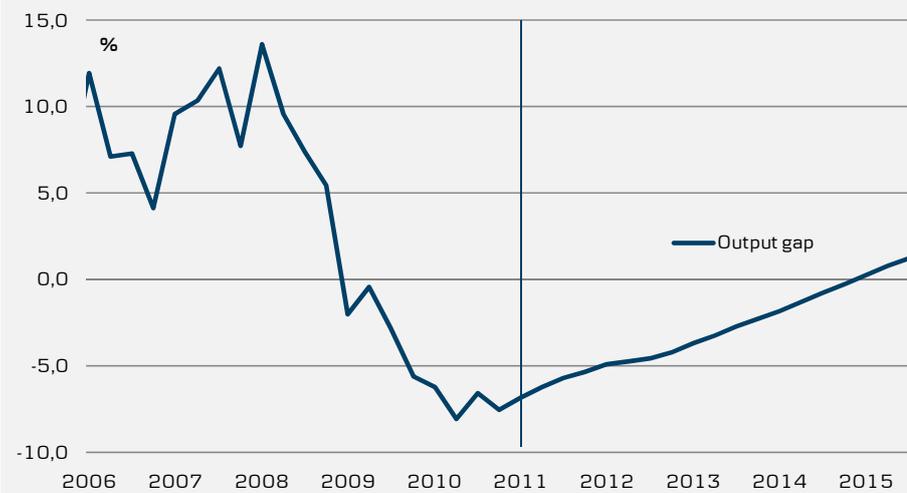
Gross domestic product



Source: Reuters Ecowin and Danske Markets

- Icelandic GDP continues to recover. We expect a continued recovery in the coming years.
- We see GDP growth of c3-4% y/y in 2011-13.
- We do not expect the “no” vote in the Icesave referendum to have a major negative impact on GDP growth in the short term even though it increases uncertainty concerning the forecast.

Output gap



Source: Reuters Ecowin and Danske Markets

- The output gap remains quite negative, but is likely to close slowly in the coming years.
- However, we do not expect the output gap to be closed before 2014-15.
- The large negative output gap should help contain inflationary pressures in the coming years.

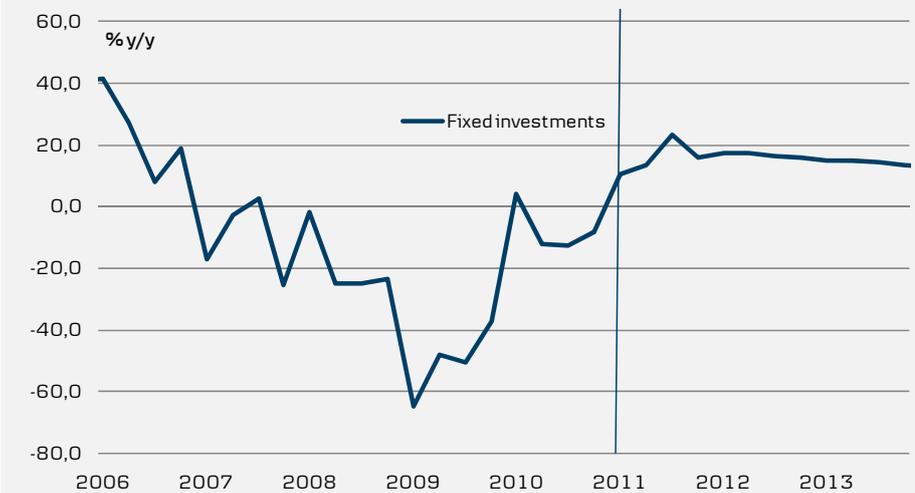
Private consumption



Source: Reuters Ecowin and Danske Markets

- Although private consumption has recovered, the challenging situation in the Icelandic labour market is likely to keep private consumption growth weak in the coming years. We expect private consumption to grow by c3% this year, but somewhat more slowly in 2012 and 2013 (c1.2% y/y in both years).
- Furthermore, the continued deleveraging process means that Icelandic households are likely to remain cautious going forward.
- Finally, tight fiscal policy is likely to curb real disposable income growth and hence growth in private consumption.

Investments

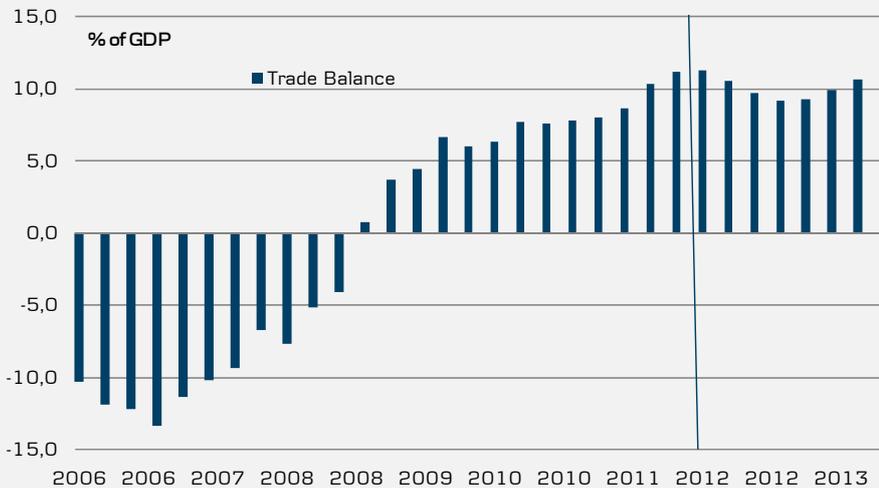


Source: Reuters Ecowin and Danske Markets

- Investment growth has recovered nicely, aided by ongoing investment in the natural resources sector.
- While we are relatively optimistic about the investment outlook in Iceland, considerable uncertainties regarding the “Icesave situation” and the lifting of capital restrictions are likely to weigh on foreign investors interested in committing long-term investments in the Icelandic economy.
- We expect investment growth of c13-16% y/y in 2011-13.

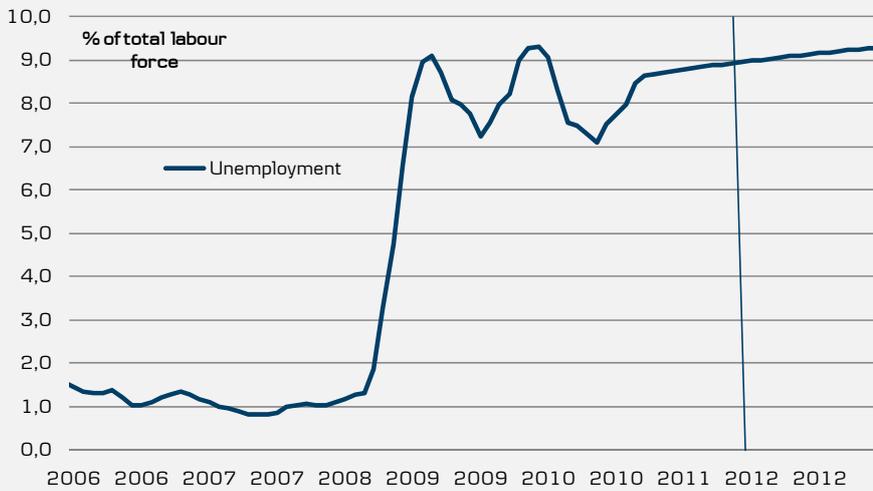
External balances

Trade balance



Labour market and prices

Unemployment



Source: Reuters Ecowin and Danske Markets

- The labour market situation remains very challenging in Iceland and we do not expect to see any major improvement in the coming years given the present growth outlook.
- As long as the output gap remains negative, we would not expect any drop in unemployment and unemployment is therefore likely to remain close to 10% throughout the forecast period.

Wages



Source: Reuters Ecowin and Danske Markets

- Wage growth has recovered moderately and we expect nominal wages to grow just above 4% y/y in the coming years.
- The high level of unemployment however is likely to keep wage growth in check. In that regard, it should be stressed that wage moderation is necessary to ensure an improvement in the labour market.

Inflation



Source: Reuters Ecowin and Danske Markets

- Inflation remains well under control in Iceland and we expect it to remain below the Icelandic central bank's inflation target of 2.5% over the forecast horizon.
- The large negative output gap and high level of unemployment clearly help curb inflationary pressures.
- Our forecast however to a large extent is dependent on the technical assumption of a 25% strengthening of the ISK over the forecast horizon. Hence, if the development in ISK were less favourable, inflation might be higher than our forecast.

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