Iceland's government is preparing to unveil a proposal that will make it a world leader in providing debt relief to households even as creditors and economists warn the measures risk backfiring.

The government has promised to deliver recommendations on how to relieve consumers burdened by mortgages linked to inflation this month. It has previously flagged it would force write downs on such loans and also provide new tax deductions on interest rate payments.

The nation's Financial Services Association estimates Iceland's banks have since the economic collapse in 2008 forgiven about $2 billion in debt, a world record at 14 percent of gross domestic product. Prime Minister Sigmundur David Gunnlaugsson won April elections on promises to provide even more relief to households.

"The problem with Icelandic policy makers, both on the left, the right and center, is that they always opt for short term solutions," said Lars Christensen, chief emerging markets economist at Danske Bank A/S in Copenhagen. "That was true when everything was booming in Iceland. Then nobody was willing to look ahead. That's also true today, whereas politicians seem to be eager to send checks to everybody to ensure their popularity over the next couple of years."

Krona Assets

Gunnlaugsson is preparing relief for households that were hurt by a jump in inflation after the krona plunged following the nation's economic collapse in 2008. Most Icelandic households have their loans linked to consumer prices, which increases their debt when inflation accelerates. From January 2007 through December 2010, prices rose 37.3 percent, according to Statistics Iceland in Reykjavik.

Icelanders had 1.1 trillion kronur in linked mortgages at the end of June.

The 38-year-old premier has proposed paying for the measures by forcing write downs on krona-denominated claims totaling $3.6 billion, owned by the creditors of Iceland's failed banks Kaupthing Bank hf, Glitnir Bank hf and Landsbanki Islands hf.

Patrick Lenain, an economist at the Organization for Economic Cooperation and Development, said such a move would "raise questions" about Iceland going forward.

Trade Offs

"If, however, Iceland intends to finance debt write downs through the tax system, this would lead to a reduction in tax revenue," he said. "So this is a question of trade-offs. It's important to be aware of the costs of the measure and make sure that it is financed in a sustainable way."

Forcing the creditors to relinquish their krona assets could make it harder to lift the capital controls imposed in 2008. The restrictions were put in place after the krona slumped 80 percent against the euro offshore and are blocking as much as $7.2 billion in assets from being taken out of the economy.

Standard & Poor's cut the outlook on the north Atlantic island's BBB- credit rating to negative from stable on July 26, arguing the government's plan to forgive household debt will put pressure on public finances.

"The big risk is that you give relief to solvent entities or households or that you give too much debt relief," said Christensen at Danske Bank. "It can create the sense among Icelanders that they are being rewarded for taking on too much debt."

Taking Hardline

Iceland hasn't shied away from taking a hardline against investors. Its inability to back the banks in 2008 led to their demise and forced the country to seek a $4.6 billion bailout from the International Monetary Fund. Iceland's crisis management approach has since won praise from the IMF in its role in in resurrecting the $14 billion economy.

The island's economic expansion will this year and in 2014 outpace growth in the euro area and the OECD area, according to the Paris-based group. The economy will grow 2.7 percent next year, compared with 2.3 percent of the whole OECD, the group forecast on Nov. 19. It costs less to insure against an Icelandic default than it does to guard against a credit event in Italy, the third-largest economy in the euro area.

Iceland's central bank in June warned that the scope of the debt relief planned could be costly and jeopardize financial stability and push up inflation.

Bank View

Providing debt relief without accounting for the economic position and payment capabilities of households is "ineffective," Sedlabanki said in a letter to the Reykjavikbased parliament. Earlier this month Governor Mar Gudmundsson warned that financing debt writedowns on Sedlabanki's balance sheet would be tantamount to printing money.

"I don't need to spell out for you what the consequences of that will be," Gudmundsson told lawmakers in Iceland's parliament economic and commerce committee.

The OECD also advocates a limited approach, saying Iceland should instead raise rates and target relief only for financially distressed households.

Concerns remain that "general debt relief measures would benefit households that are not facing serious financial difficulties and therefore might not need that relief," said Lenain.