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Iceland

Macroeconomic Performance

Iceland is a wealthy, advanced industrialized country rated Aaa by Moody's. It has low government debt, sufficient external liquidity — both liquid foreign exchange reserves and standby credits — and ready access to external finance. In addition, the Icelandic economy has proven itself to be unusually flexible in response to its historic fluctuations.

With a population of under 300,000 and a GDP of $12 billion, Iceland is one of the smallest economies in the developed world. Its small size and propensity for volatile macroeconomic performance set it apart from many of its Aaa-rated peers. Prior to the mid-1990's, the dominance of the fisheries sector in GDP and exports was the principal cause of economic volatility. However, during the last decade such fluctuations are being sparked mainly by foreign investment cycles in power-intensive industries, exploiting the country's abundant low-cost and environmentally-friendly hydro- and geothermal energy. Iceland's sizeable net external indebtedness is another distinguishing characteristic of the country.

Current Investment Cycle and Credit Growth Add to Overheating Pressures

Iceland is currently at the peak of its largest-ever investment cycle. This investment wave, which spans 2003-2008, involves the establishment of an aluminum smelter owned by Alcoa in eastern Iceland, plus the expansion of existing capacity of the Nordural smelter owned by Century Aluminum in southwest Iceland. The total cost of these projects (including the necessary power capacity expansion for the Alcoa plant) is massive in Icelandic terms — estimated at $3.5 billion, about 30% of 2004 GDP, and close to 35% of the costs are occurring in 2005. Upon completion of the cycle, Iceland's aluminum capacity is expected to increase by 170%, raising its share in merchandise exports close to 35% from 20% in 2002. Aluminum exports will rival the fisheries sector's dominance as that sector's contribution to merchandise exports is expected to fall from over 60% to 45% over the period. The promise of these huge investments helped Iceland achieve a relatively soft landing after the last boom cycle in the late 1990's.

While inflation has remained under control, running at just 3.5% at present thanks largely to the exchange rate appreciation and aggressive tightening of monetary policy, other macroeconomic indicators reveal signs of overheating. The most obvious manifestation is in the external accounts — the current account deficit and the huge buildup in debt (the latter to be discussed in greater detail in the last section of this analysis). The huge inflation of asset prices, with the equity market having doubled since 2003 and housing prices up 40% are other key indications.

The sheer scale of the projects is part of the reason for the growing imbalances. Huge capital inflows associated with the project have caused a large real appreciation of the ISK (about 15% since 2003), with the obvious bias created for imports. This has helped fuel a current account deficit twice the size related to the projects — at over 12% of GDP. Beyond the exchange rate, the projects also have important spillover effects on employment (although, by design, most construction-phase labor is imported from abroad under temporary contracts), increased job security and real wages, and thus on consumer confidence. These factors have helped unleash a credit-driven consumer spending boom, and a related increase in demand for imports.

The restructuring of the financial markets and the huge growth of the financial sector are equally important contributors to the overheating. Credit creation continues to expand rapidly (40% yoy) even though the Central Bank has hiked its policy rate a cumulative 420 basis points in the last 15 months. Banks' and corporates' access to foreign-financed credit has rendered such monetary tightening somewhat ineffective, and just like the rest of the world, long-term interest rates have remained low. Iceland's external indebtedness is already an important ingredient in the current account deficit, with net factor payments amounting to 2.5% of GDP.

Last year's steps toward liberalization of the mortgage market, while a welcome development in terms of financial market reforms, has exacerbated demand pressures by contributing to a competitive surge in household (particularly ISK) borrowing. Household debt is equivalent to a 190% of disposable income — quite high, although similar to some other European countries. Extensive home ownership and the youthfulness of Iceland's population increase the propensity to leverage in order to build up assets. Moreover, because of income growth and refinancings, households' debt servicing capacity has improved. Still, a sharp correction in asset prices could result in considerable payments problems for debtors.

Policy Challenges

The large-scale foreign investment projects pose challenges to policymakers due to the distortions they introduce during the construction period. On the positive side, the buildup in aluminum output capacity has diversified the export base, reducing the dependence on the fisheries sector, and has been an essential driver of the country's phenomenal growth in the past decade. The new smelters have boosted export revenues, coincidentally at a time when fish exports have stagnated, and provide a positive impulse to government finances from related corporate tax receipts. The latest project in eastern Iceland is also important from a regional perspective because it provides employment in areas outside of the capital where so much of the population is concentrated. However, these pluses need to be weighed against the negatives: the problem of renewed economic overheating and Dutch disease[1] abetted by the real appreciation of the exchange rate; the swelling external debt; and the introduction of a new source of vulnerability with concentration in the potentially volatile aluminum market.

The key immediate challenge is the careful coordination of monetary, fiscal and incomes policies to contain financial risks posed by the credit boom. Public finances are insufficiently tight, and the consequence is an overreliance on restrictive monetary policy with the unfortunate incentives this creates for foreign debt accumulation. The general government surpluses programmed for this year and next are arguably inadequate. In the Ministry of Finance's most recent April macroeconomic forecast, fiscal surpluses were expected to be less than half the size of those registered during the last investment wave in spite of the grander scale of the current cycle. Revenue buoyancy related to the housing finance boom and the exchange rate appreciation (because of taxes related to increased imports) is likely to result in bigger surpluses than expected, but not to exceed the levels posted in the previous, smaller investment cycle. In addition, although restrained fiscal expenditure (maximum real growth in public consumption and transfers of 2% and 2.5%, respectively, over the medium term) is a welcome policy adjustment in light of the expansion of public consumption during the last boom period, it is coming from a high base. Furthermore, Moody's is particularly concerned about the pro-cyclical stimulus to demand provided by the income tax cuts scheduled for 2005-7.

Failure to contain inflation poses a risk of igniting a wage/price spiral, which is why the Central Bank has been so vigilant in tightening monetary policy in the past two years. The March 2004 wage agreements were based on inflation not exceeding the upper limit of the inflation target (4%, with the actual target being 2.5%) and public sector wage restraint. Violation of either premise threatens the reopening of the wage agreements this Autumn, although this prospect seems unlikely at this juncture.

Moody's Aaa rating indicates its strong belief that the government of Iceland can withstand these challenges without risk to its debt repayment capacity. While a hard landing may not be avoided at the end of this cyclical upturn, government finances are strong enough to overcome any of the consequences. The proven flexibility of the economy, in particular the labor market, to rebound from adverse circumstances reduces the likelihood of a long, painful adjustment.

1. *The expansion of the aluminum sector is squeezing the profitability of other industries because of adverse movements in relative prices.*

Political/Social Developments

Iceland's small size, wealth, and homogenous population have helped create a consensus-based society and a political climate characterized by only small ideological differences between political parties. These unique characteristics have allowed policymakers to make financially painful decisions when necessary to preserve the country's universal wellbeing with little if any political fallout.

Icelanders share similar values on such issues as environmental conservation and the maintenance of the social welfare network. Incomes are significantly higher and more evenly distributed than the OECD average, and unemployment is very low — factors which reduce political conflict. Icelanders' common perspective on economic and social policy has provided the basis for the country's remarkable success to date in achieving sustainable economic development.

Government Finances and Debt

General government finances in Iceland are strong, reflecting modest direct debt, high labor force participation rates, low unemployment, a young population, a well-funded pension system, and negligible defense expenditures. General government debt was equivalent to 36% of GDP and 75% of annual revenues at the end of 2004. Fiscal surpluses since 1996, with the exception of 2003, and privatization proceeds have just about halved these ratios from 61% of GDP and 153% of revenues a decade ago. The sale of Iceland Telecom targeted for later this year will complete the government's privatization program and also be used to retire more debt.

Minor Nominal Surpluses Persist Despite Rapid Increases in Spending

General government finances were in deficit prior to 1997, a consequence of the restructuring of the fisheries sector and cuts in real incomes. Since that time the general government has posted surpluses, except for 2003, during the trough between the two investment cycles, when rapid growth in government expenditure intended to stimulate economic activity in the pre-investment cycle phase fueled a 1% of GDP deficit.

Fiscal surpluses have been achieved in spite of spending overruns by both the central and local authorities associated with the rapid increase in government consumption. Expenditure overruns have averaged close to 10% of budgeted expenditures during the past several years, both during the 1990's investment cycle and after. The general government spending ratio to GDP has climbed by six percentage points since 1997 to 47.4% of GDP, high even by the standards of its fellow Nordics after taking into account the relatively less generous social welfare system and nonexistent defense bill. Public consumption in Iceland is among the highest in the OECD at over 25% of GDP, due mainly to wage and salary costs (although this ratio is set to decline because of the 2% real growth cap on such expenditures and faster GDP growth). Wage growth in the public sector has outpaced that of the private sector in recent years, albeit from a lower base.

In an effort to be more transparent about fiscal policy, the government introduced a medium-term spending program when it presented the 2004 budget. This framework should be helpful in imposing more discipline on the budget process. The timing of its introduction is appropriate as well, in light of the long expansion cycle underway. Institutional changes were also introduced at the same time to contain spending overruns, and this has had a positive effect on last year's fiscal result.

Last year, general government finances reverted to a surplus position measuring 0.5% of GDP. This result, while a correction from the 1% of GDP deficit posted the prior year, is quite small considering the acceleration of economic activity. The structural balance remained in deficit. A nominal and structural surplus are programmed for this year, based on strong revenue performance and also substantial cuts in capital investment spending meant to counterbalance the large investments being made in the private sector (and by the national power company). Better than expected revenues so far this year are expected to contribute to an overshooting of the 0.9% of GDP projection made in the April as long as spending pressures are contained. Policymakers plan for only a slight tightening next year, then a significant relaxation of fiscal policy starting in 2007 once the project phase winds down.

Public Finances Protected Against Age-Related Spending Pressures

Public finances in Iceland are relatively more insulated against age-related spending pressures than other advanced industrial countries. Iceland's triple-pillared pension systems are heavily funded against rising future liabilities. Iceland enjoys the second highest labor force participation rate in the OECD after Switzerland and also unusually long working lives and workweeks. The population of Iceland is also relatively young and fast-growing. These unique demographic characteristic strengthen the revenue base and structural soundness of the pension systems over the long term.

Pension fund assets have grown rapidly and are equivalent to over 100% of GDP. In per capita terms, Iceland's pension situation is even better than Norway's. Norway's oil fund, the country's main source for pension savings amounted to about $35,000 per person, whereas Iceland's per capita pension fund assets stand at about $52,000.

Contingent Liabilities are Large

While the government has a low direct debt, contingent liabilities are large. State guarantees, primarily for debts of the state-owned Housing Finance Fund, amount to nearly 60% of GDP. The nature of the collateral and the financial strength of the institution suggest that these obligations are very secure. The sizeable debts of Landsvirkjun, the government-owned national power company, are also a huge contingent liability. Landsvirkjun is rated Aaa because of government support but its financial situation is not particularly strong because of the large debts it has accumulated to finance power expansion for projects in recent years (including $1.2 billion in support of the Alcoa project). Finally, the banking sector in Iceland represents another potentially burdensome contingent liability. Moody's considers all three commercial banks in Iceland as "too big to fail," a concept that is not affected by the banks having been fully privatized, meaning that the government would step in if necessary to shore up the financial system and protect depositors.

Peer Comparison

Iceland's general government debt ratios of 36% of GDP and 75% of revenues are lower than its peer group of Aaa-rated advanced industrialized countries whose average ratios are 57% of GDP and 97% of revenues. On the other hand, the government has extensive contingent liabilities which given the scope for volatility in this economy pose a certain degree of risk of becoming the responsibility of the fiscal authorities.

External Payments and the International Investment Position

Iceland's small size and openness, its relatively narrow economic base, and its large foreign debt render it susceptible to unusually large fluctuations by industrial country standards. Iceland's financial stability has become increasingly under stress by the current investment cycle and massive accumulation of debt.

Foreign Debt Accumulation Overwhelms Buildup in External Assets

All sectors in Iceland have continued to build up external assets. Households, largely via pension fund purchases, and institutional investors have increasingly placed their wealth overseas, an outgrowth of the capital account liberalization that occurred in the mid-1990s. Banks have built up external financial assets to $2.7 billion at end-2004 from just $324 million at end-2001, and have also accelerated foreign acquisitions over the past year. About half of the credit expansion has underwritten corporate foreign acquisitions. The steady buildup in official central bank reserves, standing at about $1 billion at present, to target three months of import coverage, mirrors the growth of imports.

At the same time, however, Iceland's international investment position (IIP) has deteriorated starkly to -87% of GDP at the end of 2004, from -70% just one year ago, with no immediate sign of waning. Iceland now ranks in second to last place among Aaa-rated sovereigns. Only New Zealand, with a net IIP of -98% of GDP, has a larger net international exposure than Iceland.

Foreign Borrowing Heightens Risks for Banks

The deterioration in Iceland's IIP has occurred in spite of the large foreign acquisitions by banks and corporates that have accelerated over the year. It is a consequence of large foreign borrowing, some project-related, but mostly relates to frequent bond issues by Icelandic banks. Total external debt ballooned to $27 billion at the end of 2004, triple the level of three years ago. Relative to GDP, external debt jumped to over 200% in 2004 from 142% in 2003. Short term debt has climbed to $5.7 billion, a multiple of official reserves. Debt service is very high at over 50% of current account receipts.

Generous liquidity conditions in overseas capital markets and the overreliance on tight monetary policy in Iceland have provided the incentive to borrow in relatively cheaper foreign currency intermediated by the local banking system. External debt increased by a whopping $11 billion last year in US dollar terms — up 70% of GDP — of which only $3.5 billion financed the current account deficit and acquisitions by both banks and corporates. Another $5.3 billion is accounted for by valuation effects from the sizeable appreciation of the ISK and exceptionally big outflows of errors and omissions that may overstate the amount of debt accumulated (or underestimate foreign assets). It follows that about $2.2 billion of the debt increase — nearly 20% of GDP — went to finance domestic consumption or investments. Foreign currency-denominated debt has grown to represent about half of total domestic credit.

Stronger financial supervision and regulation particularly since 2001 has improved the soundness of the financial system, and most onlending in foreign currency is indeed made to export-oriented corporates with natural hedges in foreign currency earnings. These corporate borrowers — principally fisheries (which then accounted for about 20% of banking sector loans, now down to 4%) — became instantly more profitable after the devaluation in 2001, and only minor debt payment difficulties occurred. Still, the banks remain exposed to a sharp deterioration in asset quality from corporates and households that have taken on foreign currency-denominated debt without foreign currency income. Banks also have some direct risk from the sheer fact that their regulated foreign currency exposure limit can be as high as 30% of equity, even though in practice banks approach this maximum conservatively. On a separate note, additional vulnerabilities to the financial system could derive from crossholdings among corporates and also banks, which give rise to the significance of concentration of ownership. Difficulties associated with these weaknesses could have significant effects on the economy because of its small size, the interconnectedness of businesses, and the banking and corporate sectors' hefty foreign-currency-denominated leverage.

Concerns also remain about external financing conditions for the banks in the next few years when large amortizations on foreign debts fall due. While in the event of adverse external financing conditions there would likely be a flight to quality, foreign investors might distinguish between Iceland and other Aaa-rated sovereigns because of the country's , and particularly the banking system's, large external debts. Banks' overseas acquisitions have also been financed through external borrowing, although principally through new equity and subordinated debt issues. While these acquisitions help reduce banks' asset concentration, they also may expose the banks to new risks.

Because of the inherent riskiness of bank lending in this small, concentrated economy along with other concerns outlined in *Moody's Banking System Outlook* (see link below), Moody's average financial strength rating for Icelandic banks is "C+" and bank bond ratings are in the "A" category, many notches below the Aaa government rating.

Rating History: Iceland

Action	Foreign Currency Bonds and Notes		Foreign Currency Bank Deposits		Local Currency Gov't Bonds	Date
	Long-term	Short-term	Long-term	Short-term		
Rating Assigned	A2	—	—	—	—	24-May-89
Rating Assigned	—	P-1	—	—	—	30-Oct-90
Rating Assigned	—	—	A2	P-1	—	2-Oct-95
Rating Upgraded	A1	—	A1	—	—	24-Jun-96
Rating Upgraded	Aa3	—	Aa3	—	—	30-Jul-97
Rating Assigned	—	—	—	—	Aaa	30-Jul-97
Rating Upgraded	Aaa	—	Aaa	—	—	21-Oct-02

Related Research

Banking System Outlook:

Iceland, December 2004 (90359)

Banking Statistical Supplement:

Iceland, April 2004 (86939)

Special Comments:

Moody's Sovereign Ratings: A Ratings Guide, March 1999 (43788)

A Quantitative Model for Local Currency Government Bond Ratings, September 2003 (79404)

A Quantitative Model for Foreign Currency Government Bond Ratings, February 2004 (81176)

Rating Methodology:

Revised Country Ceiling Policy, June 2001 (67679)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Iceland

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Economic Structure and Performance									
GDP Nominal (US$ Mil.)	7,980	8,376	8,373	7,603	8,493	10,531	12,236	15,231	16,462
Population (Mil.)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
GDP per capita (US$)	29,126	30,128	29,903	26,962	29,904	36,242	41,160	50,073	52,896
GDP per capita (PPP basis, US$)	25,726	26,691	28,804	30,249	29,749	30,658	--	--	--
Nominal GDP (% change, local currency)	10.7	6.9	8.5	12.5	5.1	3.8	6.3	15.3	8.1
Real GDP (% change)	5.6	4.4	5.7	2.6	-2.1	4.3	5.2	6.7	6.4
Inflation Rate (Consumer Price Index, % change, Dec/Dec)	1.7	3.2	5.1	6.4	5.2	2.4	3.9	3.5	3.5
Unemployment Rate (%)	2.8	1.9	1.3	1.4	2.5	3.4	3.1	2.1	1.9
Gross Investment/GDP	24.6	22.3	24.1	21.7	18.7	21.2	21.6	25.5	24.7
Gross Domestic Savings/GDP	20.1	17.4	17.0	21.2	20.7	17.9	15.6	19.0	17.8
Nominal Exports of G & S (% change)	6.7	2.0	0.6	5.8	8.1	11.4	20.0	7.7	13.2
Nominal Imports of G & S (% change)	22.3	3.1	6.3	-11.0	1.3	27.1	28.8	32.4	6.7
Real Exports of G & S (% change)	2.1	4.0	4.0	7.4	3.9	1.5	8.3	4.0	7.5
Real Imports of G & S (% change)	23.5	4.2	8.0	-9.1	-2.7	10.4	14.3	19.0	5.0
Net Exports of G & S/GDP	-4.6	-4.8	-7.1	-0.5	2.0	-2.9	-5.9	-13.6	-11.5
Openness of the Economy[1]	76.5	74.8	77.5	82.5	77.3	74.2	79.5	77.3	78.2
Government Finance									
Gen. Gov. Revenue/GDP	42.8	45.9	45.7	44.3	45.1	46.1	47.9	45.9	45.8
Gen. Gov. Expenditures/GDP	42.3	43.5	43.2	44.2	44.9	47.1	47.4	44.5	44.1
Gen. Gov. Financial Balance/GDP	0.5	2.4	2.5	0.2	0.2	-1.0	0.5	1.3	1.7
Gen. Gov. Primary Balance/GDP	4.2	6.2	5.9	4.0	3.5	2.6	3.8	4.3	4.2
Gen Gov Direct Debt (US$ Bils.)	4.0	3.7	3.3	3.4	4.2	4.7	5.2	4.9	4.8
Gen. Gov. Direct Debt/GDP	48.4	43.7	41.2	46.8	42.9	40.5	36.0	32.0	28.0
Gen. Gov. Debt/Gen. Gov. Revenues	113.1	95.1	90.1	105.5	95.1	87.9	75.2	69.8	61.1
Gen. Gov. Interest Payments/Revenues	8.7	8.2	7.5	8.7	7.4	7.8	6.9	6.6	5.5
Gen. Gov. FX and FX-linked Debt/Total	45.4	47.9	55.1	61.3	57.3	52.4		--	--
ST Gen. Gov. Direct Debt/Total	10.1	12.7	15.1	16.1	13.1	10.2	--	--	--
External Payments and Debt									
Nominal Exchange Rate (/$ eop)	69.5	72.6	84.7	103.0	80.6	71.0	61.0	63.0	65.0
REER (% change)[2]	-0.3	6.7	-6.1	-10.0	14.1	0.5	11.0	--	--
Relative Unit Labor Costs	82.9	91.9	100.0	86.0	91.7	96.6	98.3	--	--
Current Account Balance (US$ Mil.)	-555.3	-588.3	-881.3	-346.2	94.7	-552.6	-995.7	-1,927.7	-2,007.7
Current Account Balance/GDP	-7.0	-7.0	-10.5	-4.6	1.1	-5.2	-8.1	-12.7	-12.2
Net Foreign Direct Investment/GDP	0.9	-0.7	-2.7	-2.2	-2.7	-0.1	-17.1	--	--
Net Int'l Investment Position/GDP	-50.2	-49.4	-63.8	-75.7	-78.9	-69.3	-70.0	--	--
Official Foreign Exchange Reserves (US$ Mil.)	411.6	452.9	364.6	314.8	414.7	764.6	1,017.3	1,100.0	1,200.0
Net Foreign Assets of Domestic Banks (US$ Mil)	-1,358.8	-1,771.8	-2,383.4	-2,179.0	-1,316.6	-1,453.7	-905.5	--	--

[1] Sum of Exports and Imports of Goods and Services/GDP
[2] Real Effective Exchange Rate

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