STANDARD & POOR'S

CREDIT RESEARCH REPORT

Credit Ratings

Local currency
AA+/Stable/A-1+

Foreign currency
AA-/Stable/A-1+

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Iceland (Republic of)

Rating history

Long-term *foreign currency rat*ing raised to 'AA-' from 'A+'......February 2005

Short-term local currency rating of 'A-1+' assigned......May 1998

Long-term local currency rating of 'AA+' assigned; foreign currency ratings raised to 'A+/A-1+'......March 1996

Foreign currency ratings of 'A/A-1' assigned......February 1989

Default history since 1975

None

Year

2005

Population

0.30 million

Per capita GDP

$52,650

Current government

Prime Minister Halldor Asgrimsson heads a center-right coalition composed of the Independence Party and the Progressive Party. President Olafur Ragnar Grimsson is head of state.

Election schedule

General elections

Last......May 2003

Next......May 2007
Presidential elections
Last......June 2004
Next......June 2008

Major Rating Factors

Strengths:

- Stable and mature political institutions.
- Very high per capita income and strong growth prospects.
- Healthy public finances and a rapidly declining debt burden.

Weaknesses:

- Very high and rapidly rising levels of external debt throughout the economy.
- Very high external financing needs due to external debt and high current account deficits.
- Small, relatively undiversified economy.

Rationale

The ratings on the Republic of Iceland are supported by its stable political institutions, a very wealthy and flexible economy, and healthy public finances. The ratings remain constrained by very high levels both of external financing needs and of external debt throughout the economy.

The financial sector in Iceland has recovered from the imbalances created by the pre-2001 lending boom. Improved regulation and supervision, as well as the expansion of operations within the Scandinavian region and beyond, and the recent entry of commercial banks into the mortgage market, leave the sector much more resilient and less sensitive to developments in the Icelandic economy, as well as providing easier access to funds. Nevertheless, rapidly increasing levels of already very high external leverage are a source of concern.

Public finances remain healthy. Thanks to strong economic growth, privatization proceeds, and budget surpluses up to and including 2006, gross general government debt will continue to decline rapidly, to less than 22% of GDP by 2008, from 50% in 2001.

Iceland boasts stable and flexible political institutions, which enjoy broad public backing. The country's flexible economy generates one of the highest per capita GDP levels in the world. Growth is forecast to average 3.9% between 2005 and 2008. The boom in domestic demand and credit growth that is driving economic expansion is also fueling macroeconomic imbalances, however, creating the risk of a disorderly unwinding once the demand boom ends.

External financing needs are among the highest of any rated sovereign, driven by very high levels of external debt throughout the economy, and large current account deficits. Levels of net external debt continue to rise rapidly, despite a steep decline in central government debt. Driven by high real interest rates in Iceland, foreign funds are channeled into the Icelandic economy mainly through domestic banks, which account for about 75% of net external debt. Ongoing investment projects place strain on the current account, pushing the deficit to almost 14.0% of GDP in 2005. Nevertheless, completion of the investment projects, a cooling in domestic demand, and rising exports should help to push the deficit down from 2007 onward.

Outlook

The continuing rapid growth in domestic demand, driven by consumer and business confidence, large-scale investment projects in energy-intensive industries, and a credit boom, creates mounting macroeconomic imbalances. In addressing the expansionary pressures, monetary policy is already carrying the majority of the burden, increasing the risk of unbalanced economic adjustment once demand growth comes to an end. Consequently, adhering to, or (better still) exceeding the government's medium-term fiscal framework is central to maintaining the sovereign ratings. Fiscal policy, rather than monetary policy would be required to accommodate further unforeseen adjustment needs. Any further significant increase in net external leverage, or an aggravation of macroeconomic imbalances on the back of the large investment projects could weaken Iceland's creditworthiness.

Table 1

Republic of Iceland Selected Indicators

	2008f	2007f	2006f	2005f	2004	2003	2002	'AA' Median 2005
GDP per capita ($)	59,662	57,408	53,291	52,646	42,944	36,390	29,585	33,868
Real GDP (% change)	2.4	1.0	6.3	5.8	6.2	3.6	(1.3)	3.2
Real GDP per capita (% change)	1.4	0.1	5.3	4.9	5.1	2.8	(1.9)	2.4
General government balance (% of GDP)	(1.5)	(0.8)	0.9	2.3	(0.1)	(2.1)	(0.8)	(1.5)
General government debt (% of GDP)	21.8	22.9	24.8	27.1	36.3	41.4	45.7	40.6
Net general government debt (% of GDP)	14.8	13.9	14.3	15.3	26.3	27.2	29.7	34.1
General government interest expenditures (% of revenues)	4.8	5.0	5.1	5.9	6.2	7.0	7.2	6.4
Domestic credit to private sector and NFPEs* (% of GDP)	173.3	173.2	179.3	182.2	171.2	135.3	109.8	146.8
Consumer price index (average; % change)	2.5	3.5	3.5	2.5	2.3	1.4	5.3	2.5
Gross external financing needs (% of CARs and usable reserves)	289.0	294.8	312.4	281.3	240.2	228.0	193.9	211.2
Net public sector external debt (% of CARs)	N.A.	79.4	89.7	76.0	100.8	110.0	110.6	(6.1)
Net banking sector external debt (% of CARs)	282.5	290.7	305.1	290.9	254.8	166.6	129.6	9.3
Net nonbank private sector external debt (% of CARs)	23.6	23.3	23.7	22.0	12.2	22.1	21.5	12.7

*Standard & Poor's estimates that, in a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 10%-20% of bank credit; see "Global Financial System Stress Appendix 1", published on July 8, 2004, on RatingsDirect, Standard & Poor's Web-based credit analysis system. NFPE—Nonfinancial public enterprise. CARs—Current account receipts. f—Forecast. N.A.—Not available.

Comparative Analysis

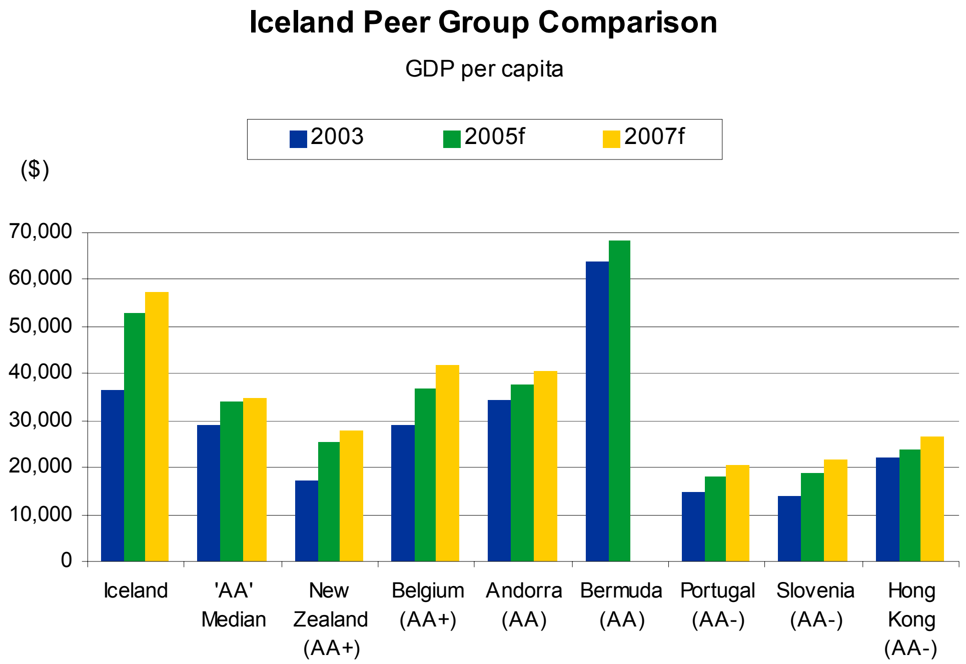
- The Icelandic economy is prosperous and flexible, with per capita incomes substantially higher than in most peers.
- Iceland's fiscal stance and declining general government debt levels compare favorably with its peers.
- Iceland compares unfavorably with virtually all its peers in terms of external exposure.

Iceland's economic structure and export base remain relatively narrow, depending largely on an array of marine products, aluminum—whose export share is set to increase markedly in the coming years—and tourism. As a small, open, and relatively undiversified but wealthy economy, Iceland's peers include New Zealand (rated foreign currency AA+/Stable/A-1+; all references to ratings hereafter are to foreign currency sovereign credit ratings), which is also an insular economy with a dependence on agriculture. In addition, Bermuda and the Principality of Andorra (both AA/Stable/A-1+) are both small and undiversified but wealthy economies. The Hong Kong Special Administrative Region, the Republics of Portugal and Slovenia (all three AA-/StableA-1+), and the Kingdom of Belgium (AA+/Stable/A-1+) also provide useful comparisons. That said, Belgium and Portugal are far more diversified economies, and as members of EMU, are not affected by the external pressures that are Iceland's major weakness.

Iceland is wealthier than peers, and still growing fast

Iceland is substantially wealthier than almost all its peers, with GDP per capita forecast to reach $52,650 in 2005, compared with the 'AA' median of $33,900 (see chart 1). Levels of wealth have been growing rapidly in recent years, thanks both to solid economic growth and to an appreciating exchange rate. Iceland's level of wealth is only exceeded by that of Bermuda, at a staggering $68,250, which is supported by the island's status as an offshore financial and international business center, as well as by its extensive tourism industry. The level of GDP per capita reflects the high productivity and flexibility of Iceland's labor force and the economy as a whole. This has kept unemployment (2.5% of the workforce in 2005) lower than in any of Iceland's peers, and endows the country with a solid ability to digest external shocks.

Chart 1



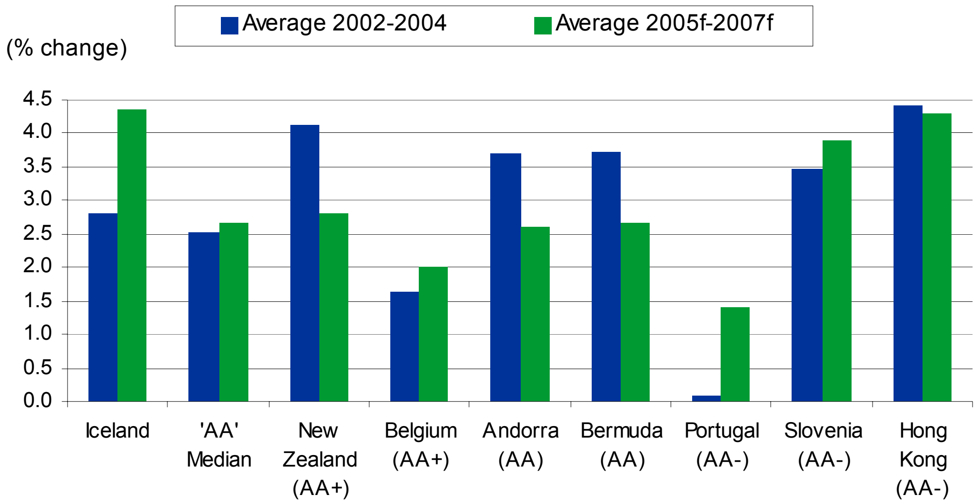
Data for Bermuda for 2007 not available. f--Forecast.

Despite its relative affluence, Iceland's growth performance exceeds that of most of its peers. Average growth of 2.8% over 2002-2004 exceeded the 'AA' median of 2.5%, despite negative growth in 2002. For the period 2005-2007, Iceland's growth is forecast to exceed that of all its peers (see chart 2). Growth in Iceland is more volatile than in most peers, however, as the economy swings from boom to bust and back. The gap between maximum and minimum annual growth during 2002-2007 is forecast to be 7.6 percentage points, while it is 6.2 percentage points for Hong Kong, the runner-up in this regard.

Chart 2

Iceland Peer Group Comparison

Real GDP



f--Forecast.

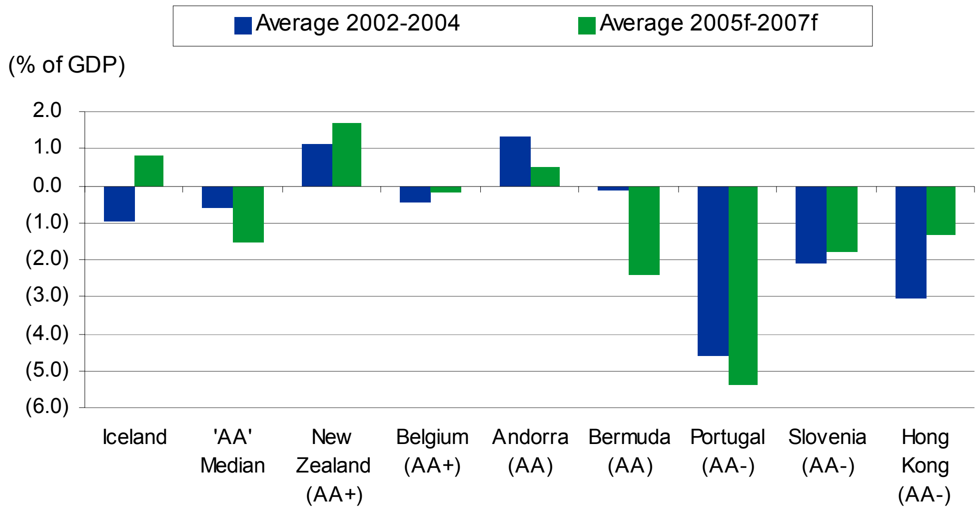
Fiscal consolidation compares favorably with peers

Iceland's government has made good progress in consolidating its fiscal accounts, on the back of broad-based support for prudent macroeconomic policies following the economic turmoil of the 1980s. Despite the reappearance of moderate general government deficits in 2002-2004, Iceland's fiscal stance still compares well with that of its peers, particularly Portugal and Hong Kong, but also Slovenia, which continue to run moderate to sizable general government deficits (see chart 3). Budget surpluses in 2005 and 2006 will be helped by strong revenue growth and cutbacks in government investment, as the economy experiences an economic boom partly fueled by the ongoing investment projects. As the investments and the economic boom come to a halt around 2007, however, the budget is forecast to fall back into deficit.

Chart 3

Iceland Peer Group Comparison

General government balance



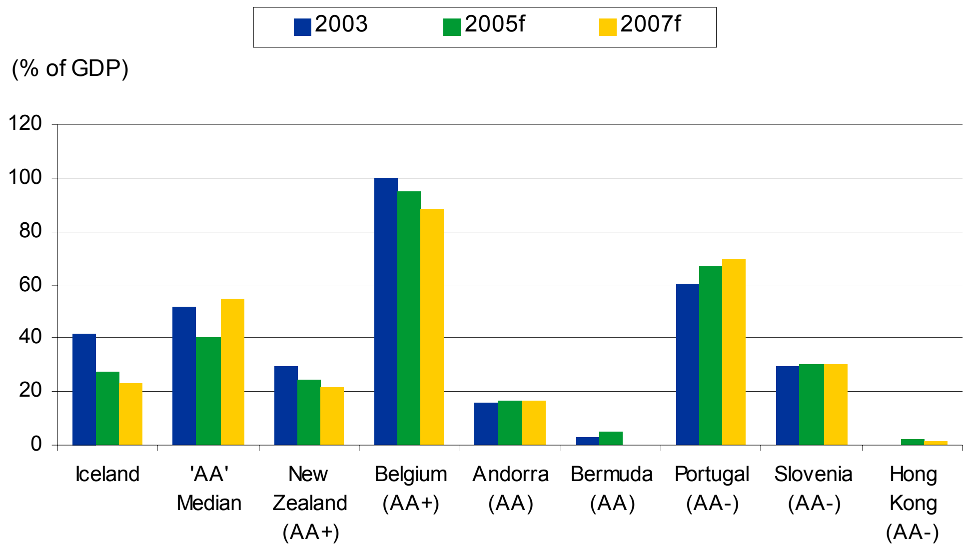
f--Forecast.

As a result of conservative fiscal policies and sizable privatization proceeds, the general government debt-to-GDP ratio, estimated at 27.1% in 2004, continues to trend down more rapidly than in any of Iceland's peers, and remains well below the 'AA' median, which is forecast at 40.6% (see chart 4). By 2007, Iceland's general government debt levels are forecast to almost close the gap with New Zealand and Andorra, while Bermuda and Hong Kong should remain virtually debt-free. In contrast, debt levels in Belgium are the highest among Iceland's peers, at 95.2% in 2005, but keep on falling, thanks to sustained general government surpluses. Debt levels in Portugal are comparatively high, as well, and this remains the only sovereign among Iceland's peers where debt levels keep trending upward. The importance of debt levels as a constraining factor on the ratings of Portugal and Belgium is further compounded by their Eurozone membership. Adoption of the euro requires increased fiscal prudence, as monetary and exchange rate policies are no longer available to the government to complement the policy mix.

Chart 4

Iceland Peer Group Comparison

General government debt



Data for Bermuda for 2007 not available. f--Forecast.

External solvency and liquidity compare unfavorably

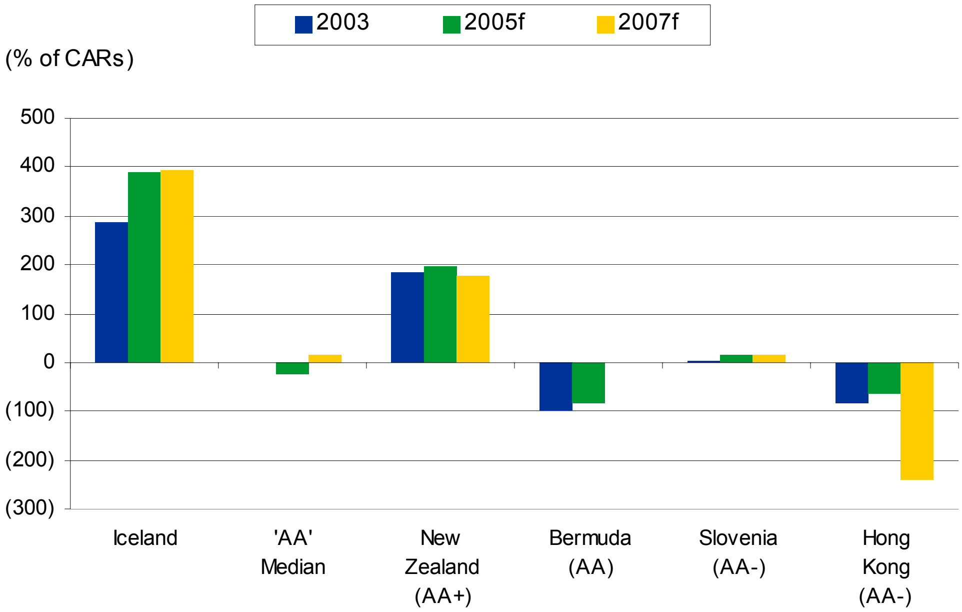
Iceland has displayed impressive adaptability in dealing with the imbalances created amid the boom of the second half of the 1990s. The current account deficit returned to a slight surplus in 2002, from a 10% of GDP deficit in 2000, without major economic disruption. Since 2002, however, the current account has worsened again on the back of another economic boom, and is forecast to reach a massive deficit of about 14% in 2005, after which it should decline again to below 6% by 2007.

As a result of current account deficits, as well as increasing leverage, particularly in the financial sector, net external debt levels continue to rise in Iceland, reaching 388% of current account receipts (CARs) in 2005. Net debt levels in Iceland by far exceed those of any other peer, including the 'AA' median, which is forecast to reach a net external asset position of 23% of CARs in 2005 (see chart 5). Belgium, Portugal, Andorra, and Slovenia (potentially joining EMU in 2007) benefit from membership in the Eurozone, which effectively shields them from balance of payments pressures, and instead allows them to enjoy the very strong external balance sheet of the Eurozone as a whole.

Chart 5

Iceland Peer Group Comparison

Net external debt



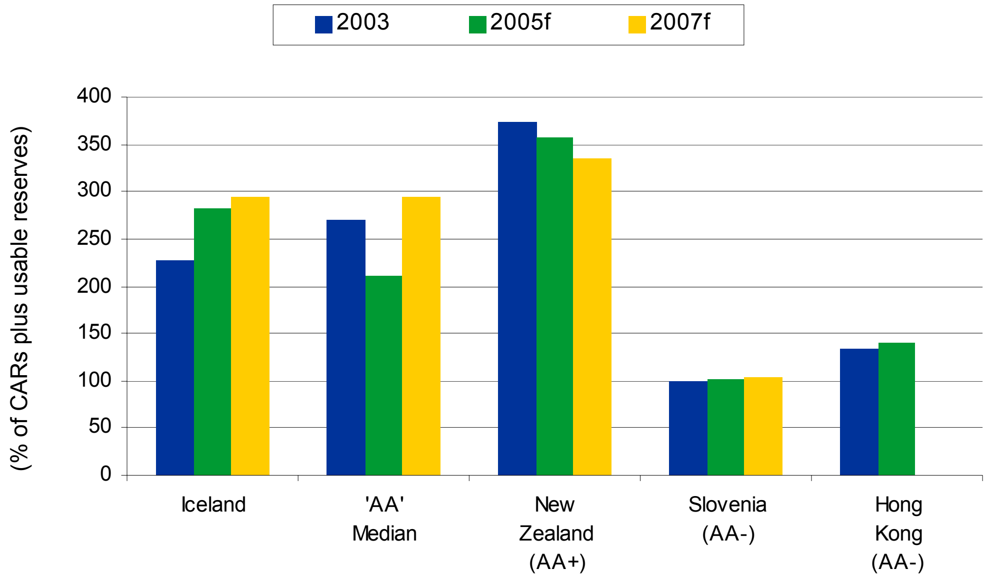
Data for Bermuda for 2007 not available. Andorra, Belgium, and Portugal are not included due to Eurozone membership. CARs--Current account receipts. f--Forecast.

Iceland's gross external financing needs (current account payments plus external debt with a residual maturity of up to one year) as a share of CARs plus usable reserves continue to grow on the back of widening current account deficits and external leverage (see chart 6). Among all rated sovereigns, only the U.K. (AAA/Stable/A-1+), New Zealand, and Grenada (SD/—/SD) have higher financing needs, with the first two benefiting from internationally more liquid currencies (the British pound sterling and the New Zealand dollar, respectively).

Chart 6

Iceland Peer Group Comparison

Gross external financing needs



Data for Bermuda not available. Data for Hong Kong for 2007 not available. Andorra, Belgium, and Portugal are not included due to Eurozone membership. CARs--Current account receipts. f--Forecast.

Political Environment

- Iceland's political institutions enjoy broad public backing and provide the flexibility to respond quickly to changing economic circumstances.
- Iceland has a long tradition of stable coalition governments.
- The issue of EU membership is debated intermittently, but Iceland will not apply to join in the foreseeable future.

Iceland's creditworthiness faces no appreciable political risks. The country enjoys well-established, stable, and predictable institutions, and both internal and external security risks are negligible. The ruling coalition, consisting of Prime Minister Halldor Asgrimsson's Progressive Party (PP) and its senior coalition partner, the Independence Party (IP), holds a majority of five seats in the 63-member parliament. In accordance with a coalition agreement, David Oddsson of IP, who had been Iceland's prime minister for 13 years, stepped down in September 2004 and, after a brief stint as Minister of Foreign Affairs, became chairman of the central bank's board of governors in October 2005.

All mainstream political parties share a commitment to responsible macroeconomic policies, as memories of the economic turmoil that followed populist excesses in the 1970s and 1980s remain fresh. The central elements of the current government's program are further improvements in the health care and education systems, reductions in taxes while maintaining a balanced budget, and fiscal policies conducive to economic stability, to dampen the stimulatory effects of upcoming large-scale investment projects.

The prospect of EU and Eurozone membership is debated intermittently and remains a divisive topic. The PP announced in early 2005 that it would examine closely and in detail the possibility of

EU membership. That said, further EU integration remains highly unlikely as long as membership in the EU would also entail adopting the EU's Common Fisheries Policy. Iceland is part of the European Economic Area (EEA), however, together with Norway and Liechtenstein. This grants the country many of the benefits of EU membership, particularly free trade and free movement of capital and labor.

Economic Prospects

- Iceland's economy is one of the wealthiest in the world, dominated by the fisheries and energy sectors.
- Large-scale investment projects in aluminum smelting and power generation will continue to have a significant effect on the Icelandic economy until at least 2008.
- Although the economy has demonstrated its flexibility to correct macroeconomic imbalances in the past, a renewed credit and demand boom threatens macroeconomic stability.

Table 2

Republic of Iceland Economic Indicators

	2008f	2007f	2006f	2005f	2004	2003	2002
Nominal GDP (bil. ISK)	1,272.1	1,212.0	1,115.0	998.0	885.0	811.2	782.4
Nominal GDP (bil. $)	18.2	17.3	15.9	15.6	12.6	10.6	8.5
GDP per capita (000 $)	59.7	57.4	53.3	52.6	42.9	36.4	29.6
Real GDP (% change)	2.4	1.0	6.3	5.8	6.2	3.6	(1.3)
Real GDP per capita (% change)	1.4	0.1	5.3	4.9	5.1	2.8	(1.9)
Real domestic demand (% change)	(1.1)	(5.6)	5.5	9.5	8.9	8.7	(4.0)
Real investment (% change)	(5.4)	(20.5)	(4.0)	28.0	21.0	20.5	(19.6)
Gross domestic investment (% of GDP)	17.0	18.8	23.9	26.1	23.0	20.3	17.7
Gross domestic savings (% of GDP)	14.6	13.1	12.1	12.3	14.7	15.2	19.2
Real exports (% change)	9.4	13.5	5.7	3.8	8.3	1.4	3.9
Unemployment rate (average claimant count; %)	3.5	2.8	2.1	2.5	3.1	3.4	2.5

ISK—Icelandic krona. f—Forecast.

Economic structure

Iceland's population is among the richest in the world, with an estimated per capita income of $52,650 in 2005. Despite its geographical isolation, Iceland will export about 32% of its GDP in 2005. Fishing and fish-processing remain important to the Icelandic economy, but their significance both to GDP (9.6% of GDP in 2004, down from 12.5% in 2001) and exports (61% of merchandise exports in 2004, down from 72% in 1995) continues to decline.

Large-scale investment projects in aluminum smelters, along with the necessary expansion of energy generation, continue to have a marked effect on the Icelandic economy. The overall investments over the period 2003-2008 amount to an estimated 27% of 2004 GDP. Roughly one-half of the investments will be in energy generation, mainly undertaken by national energy producer Landsvirkjun (foreign currency AA-/Negative/A-1+; local currency AA+/Negative/A-1+; see also full analysis published on RatingsDirect, Standard & Poor's Web-based credit analysis system, on Nov. 2, 2004). The investments will almost triple aluminum production in Iceland, contributing to the diversification of the economy and further reducing the dominance of marine products in merchandise exports. Further projects are under discussion for the period after 2008.

Icelandic companies, particularly in the financial sector, are generally profitable and, due to the limited size of the domestic market, have increasingly sought to diversify abroad. In the process, net foreign direct investment (FDI) has turned negative, accompanied by increased leverage. Corporate debt levels reached 166% of GDP in 2003, up from 80% in 1998.

Economic growth

The economy is currently experiencing a boom, with growth rates unseen for almost 20 years. GDP Growth, which is forecast to reach about 6.0% in 2005, and to average 5.5% between 2003 and 2006, is driven by investments, buoyant consumer spending, and very rapid credit growth (see also section headed "Monetary Policy" below).

The economic boom is fuelling macroeconomic imbalances, as evidenced by current account deficits of about 13% of GDP 2005-2006, rapidly increasing external leverage, strong asset price inflation, and high and still rising short-term interest rates. The Icelandic krona (ISK), which has constantly appreciated over 2002-2004, has so far maintained its value. There is a risk, however, of a downward correction in the currency's value as the investment projects draw to an end in 2007, and the economic imbalances need to be unwound. Growth is forecast to slow to an average of 1.7% in 2007-2008.

The current boom is a reminder of Iceland's previous boom-bust cycle, which ended in recession and contraction of GDP in 2002. Even then, the economy demonstrated remarkable flexibility in unwinding the macroeconomic imbalances without major economic repercussions. Since then, the economy has become more flexible and robust, thanks to comprehensive structural reforms, the introduction of a flexible exchange rate, and privatization and restructuring of the financial sector. This is also evidenced by the World Economic Forum's growth competitiveness ranking, which ranks Iceland 7 out of 117. On the other hand, the very high and still rapidly rising external leverage of the economy, particularly of the financial sector, poses the risk of a disorderly adjustment, particularly in the face of potential exchange rate fluctuations.

Fiscal Flexibility

- The general government balance will return into surplus in 2005 and 2006. Debt continues to trend downward, to reach 21.8% of GDP in 2008.
- Fiscal prudence over the coming high-investment years will be of critical importance, to assist monetary policy in stabilizing the economy.
- Contingent liabilities remain important, but the outlook for the banking system has improved in the past three years.

Table 3

Republic of Iceland Fiscal Indicators

(% of GDP)	2008f	2007f	2006f	2005f	2004	2003	2002
Public sector gross debt	83.7	84.6	88.8	93.6	110.4	114.5	112.3
Of which general government debt	21.8	22.9	24.8	27.1	36.3	41.4	45.7
Of which central government debt	15.9	16.7	18.2	19.8	28.6	34.2	38.0
Public sector net debt	73.7	72.6	76.2	78.5	96.8	96.6	92.9
Of which general government net debt	14.8	13.9	14.3	15.3	26.3	27.2	29.7
Of which central government net debt	10.5	9.5	9.4	10.0	20.7	21.9	24.8
General government revenues	39.3	39.9	42.0	46.5	47.1	45.4	44.8
Of which central government	28.7	29.2	30.6	34.8	35.4	33.8	32.9
General government expenditures	40.8	40.7	41.1	44.2	47.1	47.5	45.6
Of which central government	30.2	29.9	29.6	32.1	34.4	35.5	33.3
General government balance	(1.5)	(0.8)	0.9	2.3	(0.1)	(2.1)	(0.8)

Table 3

Republic of Iceland Fiscal Indicators (cont.'d)							
(% of GDP)	2008f	2007f	2006f	2005f	2004	2003	2002
Of which central government	(1.5)	(0.8)	1.0	2.7	1.0	(1.7)	(0.4)
Of which local authorities	(0.1)	(0.1)	(0.3)	(0.6)	(1.2)	(0.5)	(0.4)
General government primary balance	0.4	1.2	3.1	5.1	2.8	1.1	2.4
Central government primary balance	0.0	0.9	2.8	5.1	3.6	1.1	2.4
General government balance (% of revenues)	(3.7)	(1.9)	2.2	4.9	(0.1)	(4.5)	(1.9)
General government interest payments (% of revenues)	4.8	5.0	5.1	5.9	6.2	7.0	7.2
Central government interest payments (% of revenues)	5.4	5.5	5.8	6.9	7.3	8.4	8.5

f—Forecast.

Revenue, expenditure, and balance performance

The principal fiscal policy challenge remains the need to accommodate the macroeconomic effects of the ongoing major investment projects, so that the burden of stabilizing the economy is not borne exclusively by monetary policy. Adherence to tight fiscal policy and general government surpluses, as outlined in the government's medium-term fiscal framework, are of critical importance. These policies include cutbacks in capital expenditures, the sensible scheduling of proposed tax cuts, and the use of privatization receipts for debt reduction. In the face of very strong growth in domestic demand and relatively high inflation (including housing prices) despite tight monetary policy, there have been repeatedly calls on the government to further tighten fiscal policy. In particular, cuts in personal income, wealth, value-added, and inheritances taxes, scheduled to take place over 2005-2007, risk fuelling domestic demand further. Fiscal tightening could only come from revenue overruns, however, as the government appears unwilling to reduce expenditure in excess of its medium-term plans.

Against this backdrop, the budget is forecast to be in surplus in 2005-2006, averaging 1.6% of GDP, as tax revenues remain strong and the government cuts back on capital expenditures. Over 2007-2008 the budget will dive back into deficits, averaging 1.1% of GDP, as tax cuts reduce revenues, and capital expenditures are increased to counteract the end of the investment projects.

Government debt and interest burden

Debt levels continue on a downward path, helped by moderate deficits or surpluses and strong GDP growth. Sizeable privatization proceeds of ISK67 billion ($1.1 billion, or 6.7% of 2005 GDP) from the sale of national telecoms operator Siminn will be used for debt reduction and financing budget deficits in coming years. General government debt is forecast to continue falling, reaching 21.8% of GDP in 2008, less than one-half the 49.6% recorded in 2001. About 5.9% of general government revenues go to interest payments, down from 8.7% in 2001.

Off-budget and contingent liabilities

Off-budget and contingent liabilities of the government stemming from the banking sector have been subsiding, in line with the decline of financial sector imbalances since 2001. The financial sector has undergone significant restructuring, following privatization of the last two government-controlled banks in 2002 and 2003. Both regulation and supervision have greatly improved since 2001. Furthermore, commercial banks have greatly expanded their operations abroad, significantly reducing their almost exclusive reliance on the Icelandic economy. They have been posting consecutive record profits since 2002, and (including the six largest savings banks) have seen their capital ratio increasing to 12.9% of risk-weighted assets in 2004, from 9.9% in 2000. ROE increased to 26.5%, from 10.7% in 2000. Nonperforming loans and appropriated assets peaked at 5.7% of total loans in 2002, from 4.0% in 2000, and have since decreased substantially, to 2.8% in 2004, also due to very rapid credit growth. Downside risks to the banking system remain, however, stemming primarily from very strong growth in domestic credit and external leverage.

In a reasonable worst-case scenario, Standard & Poor's estimates gross problematic assets in the financial system at 15%-30% of domestic credit to the private sector and nonfinancial public enterprises (NFPEs), bringing the contingent liability for the sovereign to 25.7%-51.4% of GDP in 2004.

The stock of debt guaranteed by the government is high, amounting to an estimated 64% of GDP in 2004. That said, 82% of those are guarantees on the debt of HFF, which is secured by real estate, and applicable fees should cover called guarantees under most plausible circumstances.

Monetary Policy

- A buoyant economy and structural changes in the mortgage market led to a surge of credit growth in 2004.
- Inflationary pressures will keep inflation at the central bank's upper tolerance limit until 2007.
- In response to inflation pressures, the central bank has rapidly raised the repo rate to 10.25% in October 2005.

Table 4

Republic of Iceland Financial Indicators

	2008f	2007f	2006f	2005f	2004	2003	2002
Consumer price index (% change)	2.5	3.5	3.5	2.5	2.3	1.4	5.3
Domestic credit to private sector and NFPEs (% change)	5.0	5.0	10.0	20.0	38.1	27.7	11.2
Domestic credit to private sector and NFPEs (% of GDP)	173.3	173.2	179.3	182.2	171.2	135.3	109.8
Short-term interest rate (%)	N.A.	N.A.	8.7*	8.9*	6.1	5.0	8.0
Long-term government bond yield (%)	N.A.	N.A.	3.6*	3.5*	4.1	4.1	5.0
Effective exchange rate index (31.12.1991=100)	N.A.	119.3¶	113.8¶	109.8¶	121.0	123.5	131.4
ICEX15 share index (year-end)	N.A.	N.A.	N.A.	4.552.9§	3,359.6	2,114.3	1,352.0

*OECD forecasts. ¶Ministry of Finance forecasts. §Oct 12, 2005. NFPE—Nonfinancial public enterprise. f—Forecast. N.A.—Not available.

The Central Bank Law of March 2001 reflects international best practice. The central bank's track record of independent monetary policy remains short, but dominated by considerable challenges. After successfully bringing down record inflation levels of about 10% in 2002, following the previous boom/bust cycle, the central bank is now, after a period of monetary loosening, faced with yet another sizeable inflation challenge.

Domestic credit grew by 38% in 2004, and continues to grow rapidly. This is driven not only by the buoyant economy and ample availability of (external) liquidity, but also by structural changes in the mortgage market. The reform of the Housing Financing Fund (Ibudalanasjodur, HFF; foreign currency AA-/Stable/A-1+; local currency AA+/Negative/A-1+) and the aggressive entry in the second half of 2004 of commercial banks into the mortgage market, offering attractive refinancing options, have both led to ample availability of cheap housing credit, further accelerating credit growth.

Strong growth in aggregate demand, a tight labor market, and the ample availability of credit have led to mounting inflationary pressures (which, according to the definition used by the central bank, include housing prices). Despite an appreciating Icelandic krona and a rapid tightening of monetary policy, inflation repeatedly exceeded the central bank's inflation target tolerance limit in

2005, which is 2.5% with a band of plus or minus 1.5 percentage points. This situation is not expected to change much until well into 2007. On the way, the central bank has increased the repo rate to 10.25% in October 2005, from 5.3% in May 2004. Given the still-strong economy, further increases in policy rates cannot be precluded, particularly since further tightening of fiscal policy beyond the government's medium-term framework is at most expected to come from revenue overruns. Excluding housing prices, which have been strongly contributing to inflation since 2004, inflation levels looks slightly more benign, with the harmonized index of consumer prices growing by an average 1.9% 2003-2004, compared with 2.7% for the Icelandic consumer price index.

External Finances

- External financing needs remain dominated by very high levels of external debt and large current account deficits.
- Central government net external debt is falling rapidly, as the government repays external debt.
- The very high external leverage of the financial sector continues to increase.

Table 5

Republic of Iceland External Indicators

	2008f	2007f	2006f	2005f	2004	2003	2002
(% of GDP)							
Current account balance	(2.4)	(5.7)	(11.8)	(13.8)	(8.4)	(5.0)	1.5
Trade balance	1.2	(0.8)	(6.6)	(9.2)	(4.1)	(2.0)	1.8
Net foreign direct investment	(3.6)	(2.8)	0.4	(10.5)	(18.1)	(0.5)	(2.8)
(% of CARs)							
Current account balance	(5.8)	(14.3)	(32.0)	(37.8)	(20.6)	(12.9)	3.4
Net external liabilities	240.6	256.7	274.2	244.2	218.6	206.4	229.6
Total external debt	566.8	579.1	608.1	567.0	509.3	396.0	324.3
General government external debt	24.9	27.5	32.8	32.5	58.1	72.6	76.1
Net public sector external debt	N.A.	79.4	89.7	76.0	100.8	110.0	110.6
Net nonbank private sector external debt	23.6	23.3	23.7	22.0	12.2	22.1	21.5
Net banking sector external debt	282.5	290.7	305.1	290.9	254.8	166.6	129.6
Net investment payments	6.4	7.0	7.9	7.1	6.0	4.4	1.0
Net interest payments	7.3	99.4	8.4	7.8	6.9	8.5	8.6
Reserves/CAPs (months)	1.5	1.5	1.6	1.6	1.6	0.7	0.7
Gross external financing needs (% of CARs and usable reserves)	289.0	294.8	312.4	281.3	240.2	228.0	193.9

CARs—Current account receipts. CAPs—Current account payments f—Forecast. N.A.—Not available.

External liquidity low, despite a strong increase in reserves

Gross external financing needs (current account payments plus short-term debt by residual maturity as a percentage of CARs plus usable reserves) in Iceland are among the highest of all rated sovereigns, at a forecast 281% in 2005. Financing needs remain driven by large current account deficits and high levels of external debt. After a slight current account surplus in 2002 (at 1.5% of GDP), the current account will run massive deficits averaging 12.8% over 2005-2006, as the investment projects and buoyant domestic demand boost imports. From 2007 on, deficits should decline rapidly again, however, to reach 2.4% in 2008, as domestic demand contracts and exports rise as a result of the completion of the investment projects.

Levels of gross external debt, at 207% of GDP in 2004 compared with 82% in 1999, continue to grow rapidly, as real interest rates and current account deficits remain high, and Icelandic companies continue their leveraged acquisitions abroad. Principal payments on maturing debt are the dominant component of Iceland's external financing needs. Foreign investors have recently taken to buying local currency bonds, predominantly housing bonds. Also, since August 2005 there has been a steep increase in issuance of ISK-denominated bonds with maturities up to 24 months by highly rated non-Icelandic issuers, with total issuance exceeding ISK80 billion ($1.3 billion). Net FDI is not alleviating the external financing pressure, despite inflows from the investment projects. Expansion abroad of Icelandic companies, particularly in the financial sector, is leading to net FDI outflows, forecast at an average 14.3% over 2004-2005.

Iceland is the highest-rated sovereign that is not part of the IMF's Financial Transaction Plan, the Fund's principal source of remunerated funding.

Public sector external debt

Net general government external debt is falling rapidly, to about 13% of CARs in 2007, from 69% in 2002. This is due to government surpluses and privatization proceeds being used to repay external debt.

The share of foreign liabilities in central government debt is forecast to decline to an estimated 41% in 2005, from a peak of 67% in 2001. Euro-denominated accounts for roughly 50% of central government debt, with the remainder split among U.S. dollar, British pound sterling, Japanese yen, and Swiss franc debt. Net public sector debt is falling less rapidly, to 79% of CARs in 2007, from 111% in 2002, mainly due to increased investment by public utilities, and rising foreign investor appetite for ISK-denominated housing bonds.

Private sector external debt

Net financial sector external debt is very high and continues to rise rapidly, to a forecast peak of 305% of CARs in 2006, from 130% in 2002. The financial sector accounts for 75% of Iceland's net external debt. Banks continue to borrow heavily abroad, and have financed a series of domestic corporate takeovers in past years. In contrast to the lending boom that preceded the 2001 crisis, however, financial regulation and supervision have improved significantly, and banks' structure of financing has improved, as funding has shifted from interbank loans to capital market funding, and as maturities have increased. Net nonbank external debt is steady, by contrast, forecast to remain at about 24% of CARs.