Icelandic Economic Update

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What is the significance of the IMF's review?

- On 16 April the second review of the joint Icelandic-IMF economic programme was completed after about a year delay and a loan facility of approximately EUR 120 million was approved. Following the IMF's review neighboring countries in Scandinavia approved on a loan facility, leading to a EUR 560 million increase in Iceland's foreign currency reserves. Thus the refinancing of Iceland sovereign debt has been guaranteed – at least up until 2012 and rating upgrades are likely to follow.

External trade moving in the right direction

- External trade continues to move in the right, northward, direction according to preliminary figures released by Statistics Iceland. We are forecasting ISK 200 billion goods and services surplus for 2010 or 12% of GDP but the forecast is sensitive to movements in private consumption that directly relates to the level of imports.

Calendar

Date	Title	Period
27 April 2010	Analytical accounts of the banking sector	March 2010
29 April 2010	Consumer price index	April 2010
30 April 2010	External trade in goods	Jan-Mar 2010
5 May 2010	MPC's interest rate decision	
7 May 2010	Auction Treasury Notes	

What is the significance of the IMF's review?

On 16 April the second review of the economic programme prepared by the Icelandic government and the IMF was completed and a loan facility of approximately EUR 120 million was approved. Following the IMF's review neighboring countries in Scandinavia approved on a loan facility, meaning that Iceland's foreign currency reserves increase by the equivalent of EUR 560 million (Poland has not yet approved its promised loan facility of EUR 50 million).

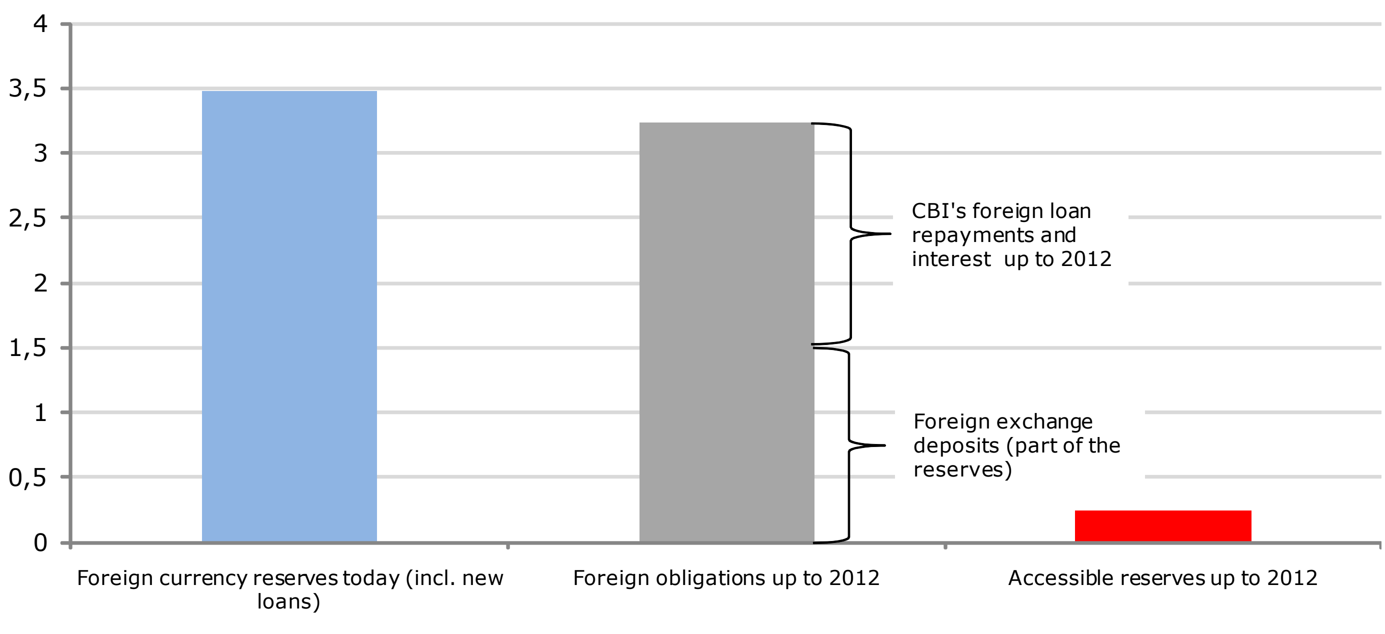
This is good news for Iceland and should have a positive impact on the nation's credit rating as there is no longer any risk of a sovereign default on foreign obligation up to 2012. As has become apparent, for example Moody's has changed its outlook for the Icelandic Government from negative to stable. Plan B, as the Central Bank of Iceland recently described it, is no longer as urgent. If Plan A had not come off, Plan B would have involved buying currency on the capital markets in order to accumulate enough reserves to pay off maturing debts. As the Central Bank governor pointed out, Plan B could have easily led to a weakening of the currency as buying currency means selling ISK.

The loan facility represents a certain quality assurance stamp on the government's economic policy and could facilitate foreign loans to power utilities and thus result in more investments in the hydropower sector.

A promising start – we've got the loans but what next?

The loan facility from the IMF has guaranteed the liquidity of the Icelandic treasury. However, the currency reserves are not sufficient for the Central Bank of Iceland to go on any kind of offensive in lifting the capital controls and floating the ISK. Most of the CB´s currency reserves are tied to the refinancing of the sovereign and could not been spent in defense of the ISK. We estimate that the Central Bank has a mere EUR 230 million at present at its discretion to allocate to the currency market. Far more considerable reserves are needed in order to relax the restrictions on foreign currency. It therefore comes as a no surprise that the IMF makes it perfectly clear in its press statement that there will be no relaxation of the current capital controls for the time being.

CBI's foreign currency reserves up to year 2012
- in EUR billion



Source: Central Bank of Iceland & Arion Research estimates

Weak currency reserves, major loans soon reaching maturity

In the medium term, we expect the Central Bank's efforts to amass foreign reserves will increasingly be focused on buying currency at the home front – particularly if the ISK continues to appreciate due the trade surplus. In our opinion there is little room for the further strengthening of the ISK. But there is a risk, of course, that the ISK may depreciate, particularly if the Central Bank buys large amounts of foreign currency. The most likely outcome, though, is that the ISK will remain at a similar level since the Central Bank is unwilling to jeopardise stability. The Central Bank's current aim is to safeguard the stability of the exchange rate rather than strengthen the ISK.

As the diagram above illustrates, the foreign reserves will amount to approximately EUR 3.5 billion including the recently secured loans. The situation looks good at first glance. However, the Central Bank can only use a tiny proportion of the currency reserves we refer to above. EUR 1.5 billion of the current foreign currency reserves are deposits belonging to deposit institutions at the Central Bank of Iceland, i.e. funds which cannot be used to pay off long-term obligations. Instalments and interest on foreign loans from 2010-2012 total approximately EUR 1.8 billion. And if the refinancing of the power companies is added the mix, the situation looks even bleaker.

In other words, the foreign reserves need to be bolstered significantly if they are to provide the support necessary for the Central Bank to be able to relax the current capital controls. In this respect the loan facilities from the IMF and Scandinavia and Poland are of paramount importance. Under the arrangement with the IMF and Scandinavia and Poland, Iceland has a further EUR 1.8 billion in loan facilities at its disposal, most of it becoming available this year and next. It also appears likely that there will be a current account surplus over the next few years which might enable the Central Bank to build up its foreign reserves. The Central Bank's EUR 500 million collateral in FIH is not included in the current reserves either. It is clear, however, that this route, without weakening the ISK, will take some time.

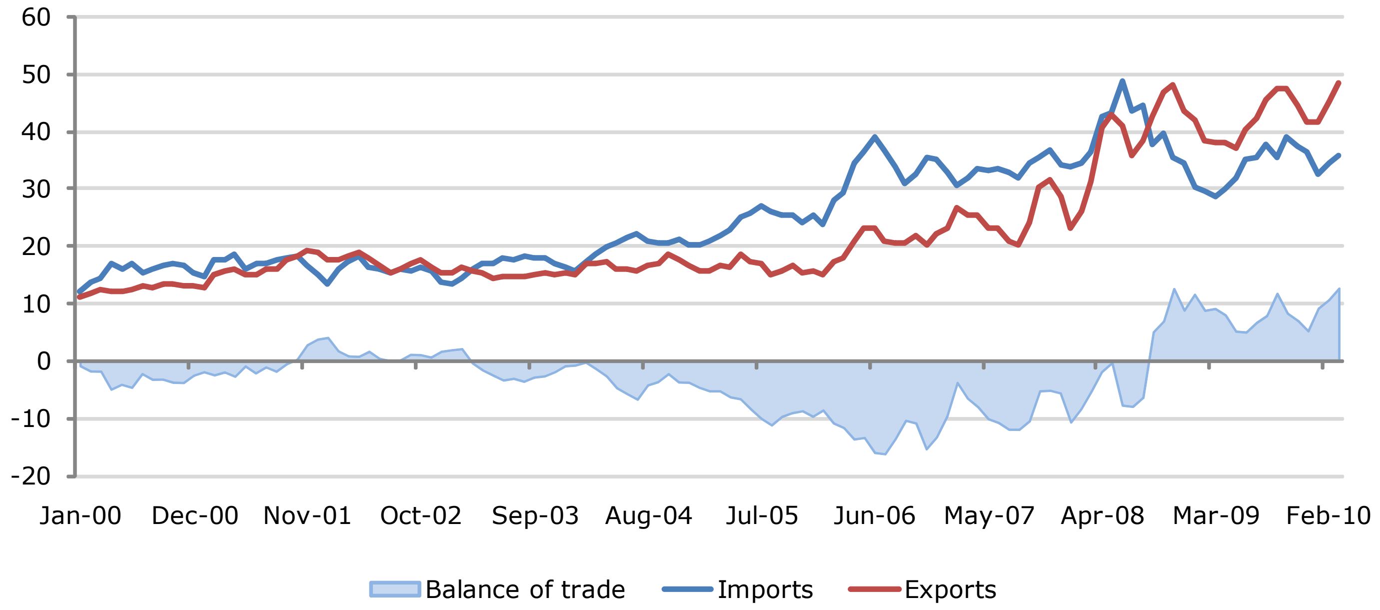
External trade moving in the right direction

External trade continues to move in the right direction according to preliminary figures released by Statistics Iceland. If our forecast of ISK 200 billion goods and services surplus for 2010 is to prove accurate, external trade needs to continue to improve and it is critical that we do not see a new surge in imports.

External trade has improved between years

External trade has been running at a surplus recently, with exports totalling ISK 40-50 billion a month while imports have been ISK 30-40 billion a month. There was a trade surplus of almost ISK 11 billion a month during the first three months of 2010, compared with almost ISK 10 billion during the same period last year.

Imports & Exports (3 month average)
-in ISK billion

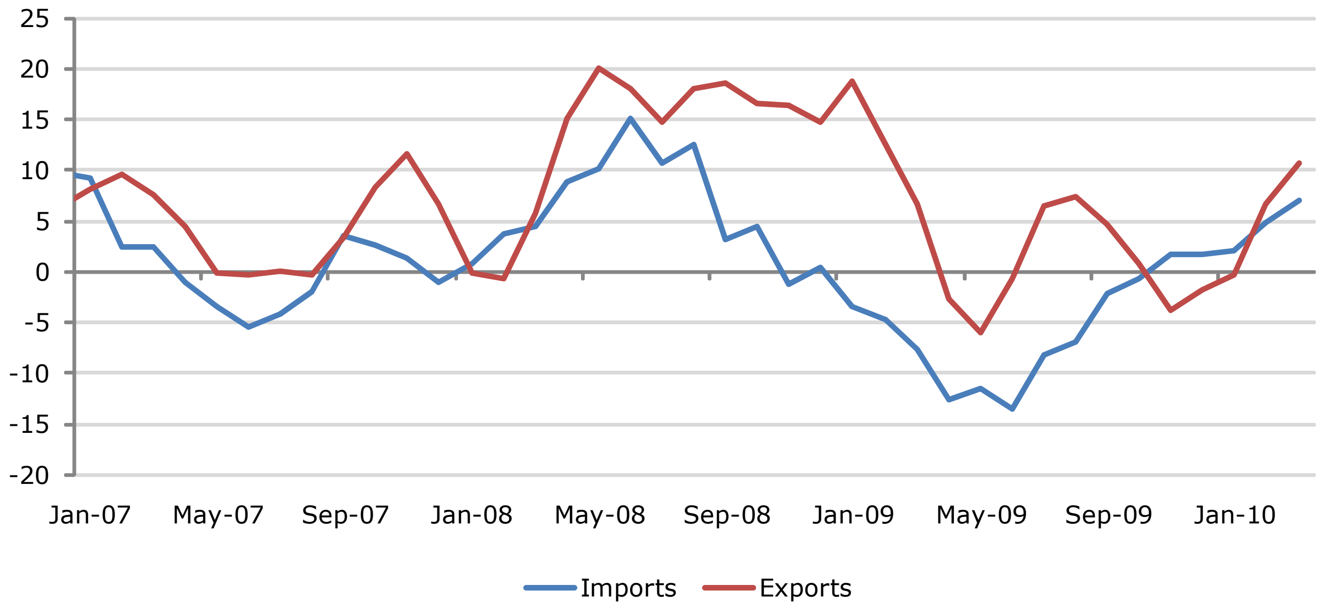


Source: Statistics Iceland

Over the last two years exports have grown almost continually between years. Last month exports grew by ISK 10 billion year on year.

The main cause for concern is the fact that imports have begun to grow again after a major slump. In recent months imports have grown by ISK 7 billion a month compared with the previous year. However, imports will grow at much the same rate as consumption and investment in Iceland – and while these factors are experiencing a pronounced slump, imports are unlikely to take off again.

Growth in monthly imports & exports between years (3 month average)
- in ISK billion



Source: Statistics Iceland

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