Icelandic Economic Update

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Icesave still casts a long shadow

The decision of the president of Iceland on 5 January to put the "Icesave bill" to a national referendum created new uncertainty over Icelandic public finances. The Icelandic parliament had spent eight months wrangling over the issue before passing the bill at the end of 2009 with a very slim majority and no one expects the laws to pass in a popular vote which is set for 6 March. The Icesave issue itself is a bilateral dispute between Iceland on the one side and the British and the Dutch governments on the other, concerning legal obligations that have never been defined by any court. Thus the Icesave obligations can, as of yet, not be considered to be an Icelandic public debt in any legal sense unless acknowledged by the parliament or the nation in a popular vote. However, the main problem it poses to Icelandic public finances is that the British and Dutch governments have enough political clout to block any financial aid to Iceland, be it from the IMF, Scandinavia or the EU, unless the issue has been solved.

The European Union has a vested interest in the matter not being brought to court given the uncertainty over the outcome and what is at stake for cross-border deposit banking in the European Common Market. There are now persistent rumors circulating that the three countries involved are conducting back-room negotiations over a new Icesave bill, more beneficial to Iceland, that would replace the current one and thus the referendum would be aborted. However, as to date, nothing concrete has emerged. Thus, the prospect that Iceland will have to find its way out of the crisis on its own is now a real possibility.

Front-loaded maturity profile the main problem for the sovereign

The Republic of Iceland was virtually debt-free in foreign currency before the banking collapse of October 2008 and the level of foreign debt is still rather low (excluding any Icesave obligations). It is also worth mentioning that the Icelandic government itself has virtually no foreign debt repayments in 2010. However, on the flip side of the coin, the government had very meager foreign reserves going into the crisis and faces a rather front-loaded repayment schedule starting in 2011. Most notably, there is EUR 1 billion bond issue due in mid-year 2011. Therefore the Icelandic treasury needs to shift its maturity profile further into the future, which will be quite complicated without the help of the IMF and Iceland's Scandinavian neighbors. Without the help of the IMF the Icelandic government would presumably have to win credibility abroad by implementing steep fiscal cuts which would display the fiscal soundness of the sovereign. That would, of course, be an uphill battle.

Given a good degree of fiscal prudence and continuing trade surpluses it is unlikely that the Icelandic republic would default on its debt should the Icesave issue linger unsolved. However, without the help of the IMF, the capital controls would have to remain in place for some period of time. Foreign investors, blocked behind the capital controls, still own about 1/3 of the Icelandic money supply and the Icelandic krona (ISK) also has lost its appeal among locals as a store of value. Therefore, the Icelandic treasury must build-up reserves before the ISK can be floated, and that will take time with access to foreign capital.

Impact on the bond market - Temporary spike in inflation premium

The president's decision did not cause panic on the domestic bond market; the main impact was increased appetite for inflation-indexed bonds – possibly due to increased uncertainty regarding the outlook for the ISK. The inflation premium on the bond market therefore rose after the decision – however the market has normalized again as inflation numbers published on 26 January were far below expectations.

Supply of government bonds in 2010
– Treasury recommencing indexed bond issues

The Government Debt Management agency recently published its issuance schedule for 2010. It provides an indication of the expected supply of bonds in 2010. The total supply will mostly be in line with previous estimates; although it turns out that the government plans to start issuing indexed bonds again. As a result the government will be cutting back on its nominal bond issue.

The government has not faced any real problems financing its budget deficit at home, and indeed given the capital controls, Icelandic institutional investors like the powerful pension funds have very few other options than to invest domestically.

Indexed Treasury bond issue

The Icelandic government will begin issuing indexed treasury bonds during the second quarter, reaching ISK 50 billion this year and likely to increase in size in 2011. The government is clearly aiming to take advantage of a certain gap in the bond market as the Housing Financing Fund's indexed issue is at a minimum at present and its supply is in fact "negative" this year, i.e. the fund's payments to investors will exceed new issues by almost ISK 30 billion. For investors who wish to reinvest payments in indexed instruments, the government's new issues are therefore a welcome option.

Total supply in line with previous estimates

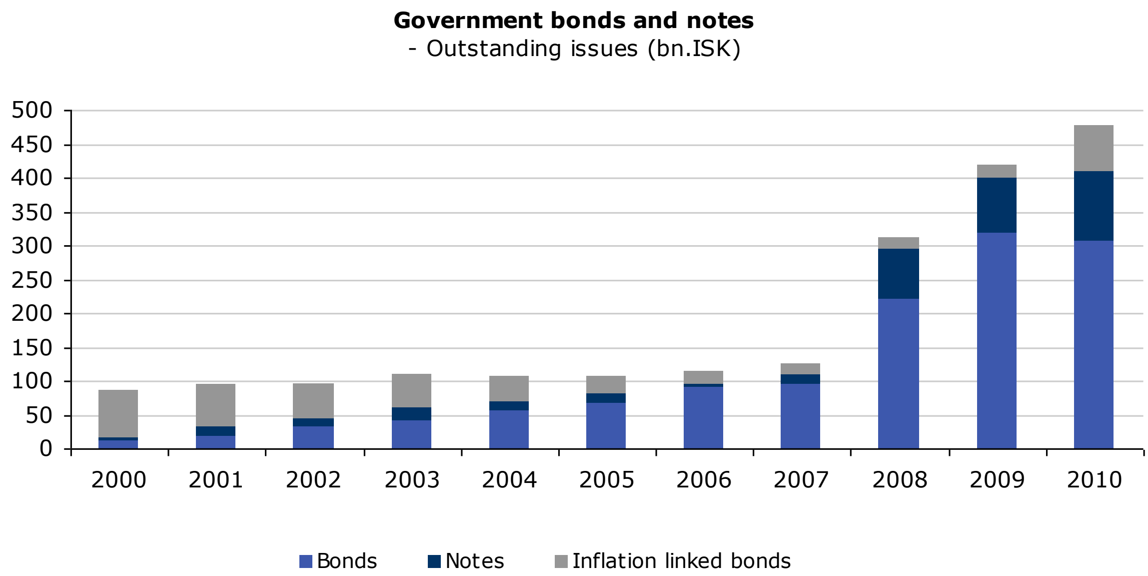
The government's plans contained few surprises concerning the total supply of treasury bonds in 2010. The net issue of treasury bonds will amount to approximately ISK 58 billion, which is in line with the Fiscal Budget Information published last October.

It is nevertheless worth remembering how small the amounts involved actually are when compared to past issues. The ISK 58 billion planned this year is risible next to the increase of almost ISK 300 billion in government issues in 2008-2009.

The supply of government-backed bonds is discussed in more detail below.

New nominal bond series

Other new bond series include a 2-year nominal series to be issued in the first half of the year and a 5-6 year indexed series scheduled for the second half of the year. This latter series will bridge the gap between series RIKB13 and RIKB19.



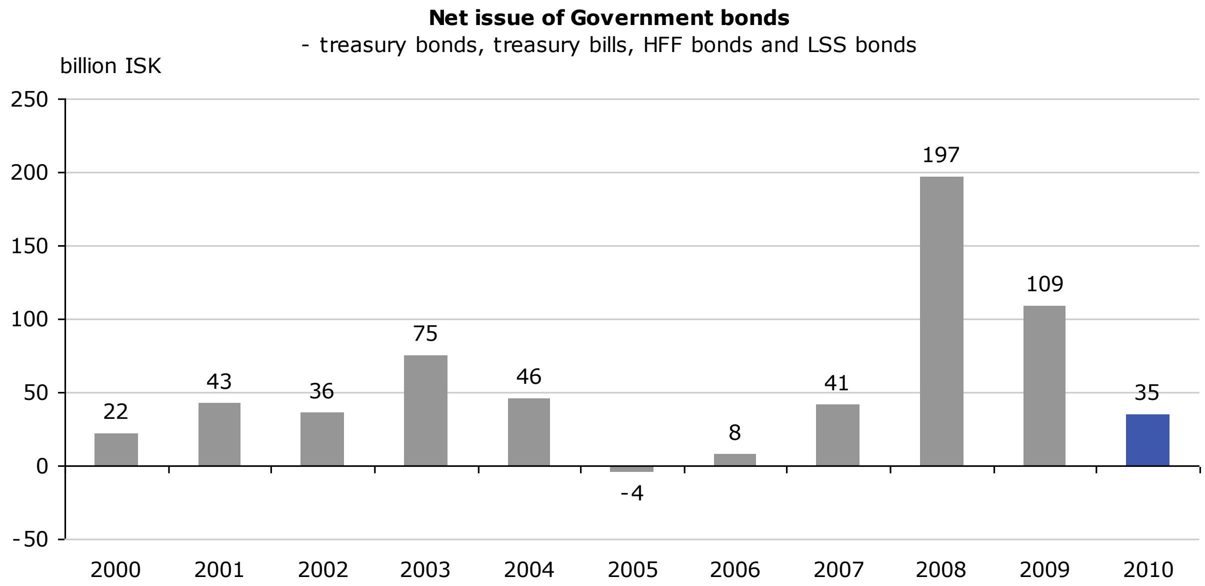
Limited supply this year

The issuance of government-backed bonds rocketed following the collapse of the Icelandic economy, growing by ISK 300 billion in 2008-2009 – the majority of this increase being in the form of nominal treasury bonds. The net increase in the issue of government-backed bonds and bonds issued by municipal authorities in Iceland (LSS) will only be approximately ISK 35 billion in 2010. This is equivalent to the average annual issue in 2000-2007 (government-backed bonds refer to nominal and indexed treasury bonds and treasury bills and indexed bonds issued by the Housing Financing Fund – HFF).

At the same time there is high demand for bonds as foreign exchange restrictions have limited the availability of other investments besides bonds and deposits. The bond supply has remained rather low considering the investment capacity of the pension funds, which we estimate to be around ISK 100 billion this year.

The following factors might distort this scenario of limited supply:

- If foreign exchange restrictions were lifted the bond supply on the secondary market would increase if foreign market participants cashed out their positions. Foreign investment options would then open up to Icelandic investors again. However, we think it is very unlikely that these restrictions will be relaxed in the next few years.
- The situation might also change if international loan facilities (including the currency loan from Iceland's allies and the IMF) were to become unavailable to Iceland for a long period, because then the government and Icelandic companies would have to resort increasingly to sources of funding from within Iceland.
- Thirdly, it should be remembered that ISK 100 billion of government-backed bonds (approximately ISK 70 billion in HFF bonds and ISK 30 billion in treasury bonds) are tied up in the Central Bank of Luxembourg. These bonds could end up on the market again at some point and thus boost the bond supply. A solution to this issue is being worked on so that the bonds can be freed up. Various options exist on selling the bonds and it is thus difficult say what effect it might have on the bond market.

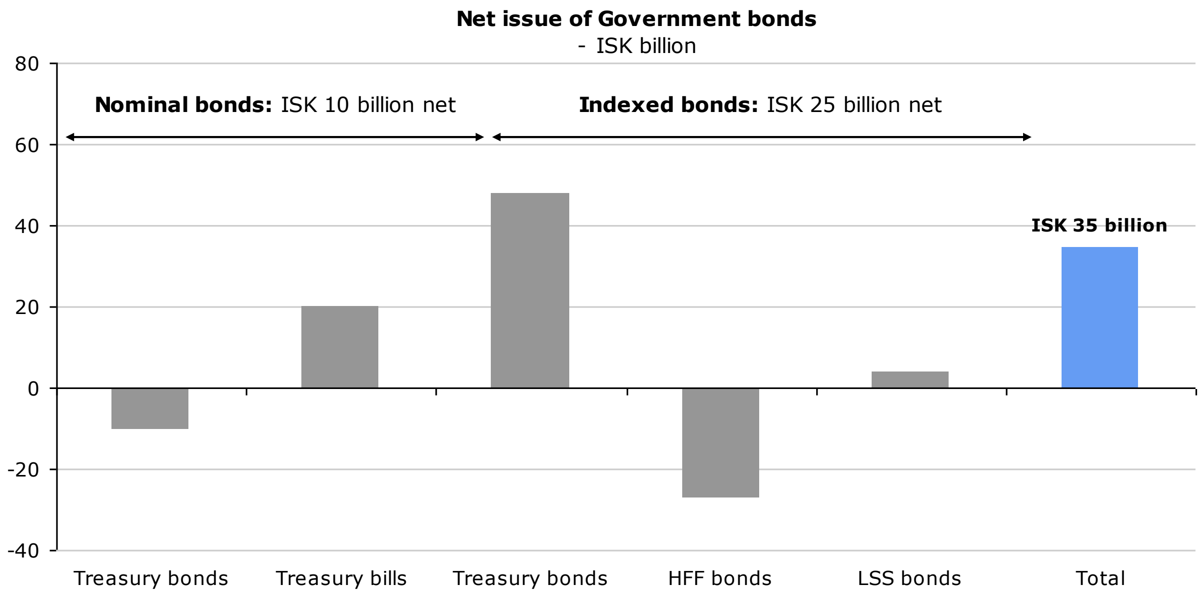


Indexed issue replacing nominal issue

Bond issues in 2010 can be divided into nominal and indexed instruments:

- **The indexed bond issue will total ISK 25 billion net.** Before the new issue was announced it appeared that the net supply of indexed bonds would in fact be negative this year, i.e. maturities would exceed new issues. However, it is now clear that the supply will be positive in net terms. Given the huge demand for indexed instruments, it should be relatively easy for the government to sell them at reasonable terms.
- **The nominal bond issue will amount to ISK 10 billion net.** It had initially appeared that the issue of treasury bonds would be well over ISK 10 billion. The

issue of indexed bonds will partly replace the nominal issue. Overall then, the total amount of nominal instruments, including treasury notes, will increase only slightly.



The government chips away at savings

The treasury will collect ISK 60 billion on the credit market. However payments on HFF bonds will exceed the amount raised by new issues by almost ISK 30 billion. The net issue of the Icelandic government, the Housing Financing Fund and municipal authorities (LSS) can be broken down as follows:

I. Government issues will increase by ISK 58 billion this year:

- **Total issue.** The total issue of bonds and bills will be ISK 190 billion. Taking into consideration the instruments reaching maturity, the net issue will be ISK 58 billion as noted above.
- **ISK 10 billion nominal bond issue**. The nominal bond issue will be approximately ISK 10 billion net, i.e. issues of new nominal instruments will exceed those reaching maturity by about ISK 10 billion in 2010.
- **Indexed instruments added to the mix.** Weighing against the meager supply of nominal instruments is the government's plan to issue a new series of indexed bonds worth ISK 50 billion (only ISK 2 billion will be subtracted from this amount because of buybacks and maturities of treasury savings bonds.)

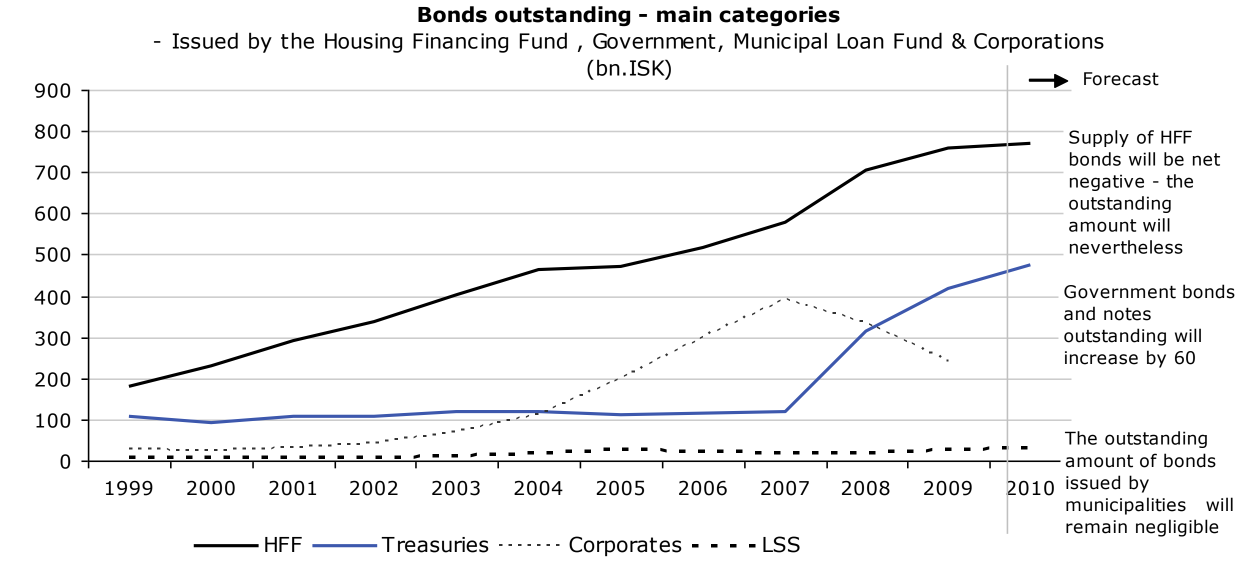
II. The Housing Financing Fund (HFF) will pay out net ISK 27 billion this year:

- New issues are expected to range between ISK 32-42 billion this year. However, payments from the HFF to investors will be ISK 61-69 billion, meaning that the net issue will be negative by approximately ISK 27 billion.

III. The Municipal Loan Fund (LSS) is expected to net ISK 4 billion this year:

- New issues are estimated to be ISK 7-9 billion and payments to investors are estimated at ISK 4 billion.

The above assumptions are all based on previously issued issuance schedules. Other factors are subject to uncertainty. The municipal authorities could launch their own bond issues but this is not taken into account above. There is also a good deal of uncertainty surrounding possible issues by the power utilities Landsvirkjun and OR.



Central Bank cuts interest rates

The Monetary Policy Committee (MPC) decided on 27 January to cut interest rates by 50 bps. The decision was broadly in line with expectations as the Central Bank governor had hinted further cuts in a recent interview on Bloomberg and unexpected deflationary numbers for January probably also helped. In the interview before the decision, the Central Bank governor said that there was room to cut interest rates further - despite the refusal of the president of Iceland to approve the Icesave bill. He pointed out that decisions on monetary policy are not taken on the basis of international disputes, but are rather shaped by economic developments and trends in inflation and the exchange rate. The governor had, however, said that there was less scope for cutting interest rates than before. This can also be found in the MPC's statement, which was published following the interest rate cuts:"However, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, the MPC will have limited room for maneuver."

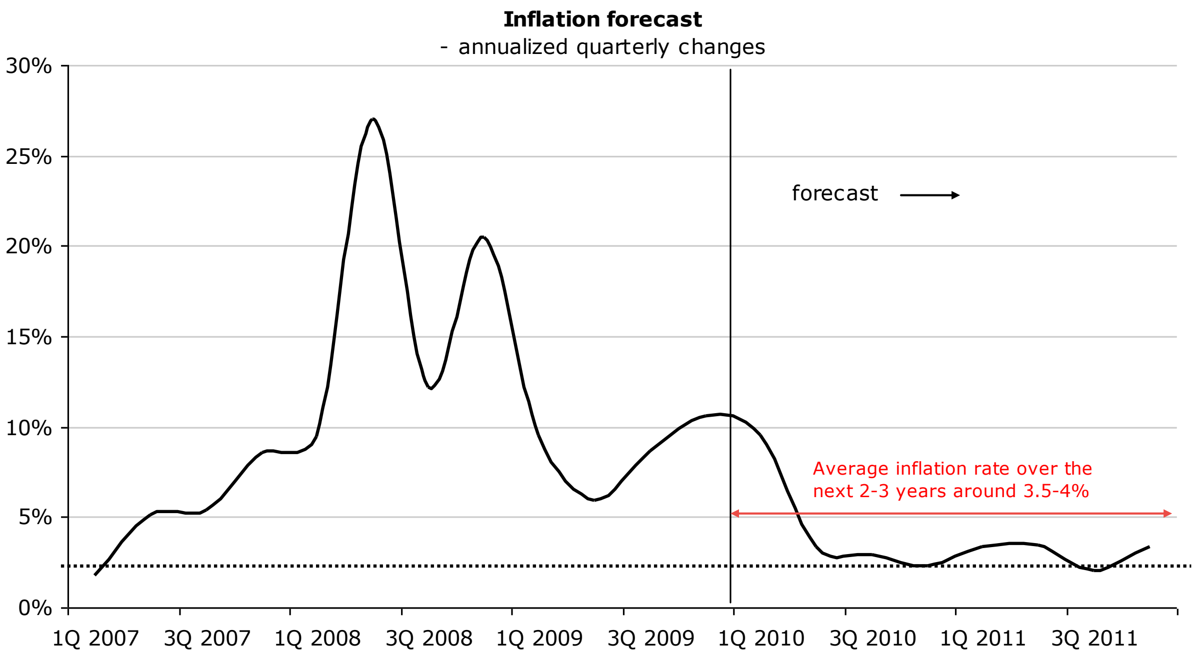
The Central Bank's deposit rates are now 8%; deposit rates have the most pronounced impact on the capital market at the moment and therefore reflect the monetary stance more clearly than other interest rates. It is obvious that if the Icesave affair remains unresolved for long it will delay the progress of the IMF program, which is bound to have an effect on the process of cutting interest rates further. The MPC's next meeting is on 17 March, while the Icesave referendum is scheduled on 6 March.

Inflation expectations

Despite the fact that tax increases will temporarily nudged up inflation in the first months of the year, we believe that the rate of inflation will drop sharply during the year. We forecast that inflation over the next 12 months will be 3% (from Q1 2010 – Q1 2011), while the 3-year inflation rate will be around 3.5%.

The main reasons for a possible drop in inflation will be changes to the exchange rate and salaries.

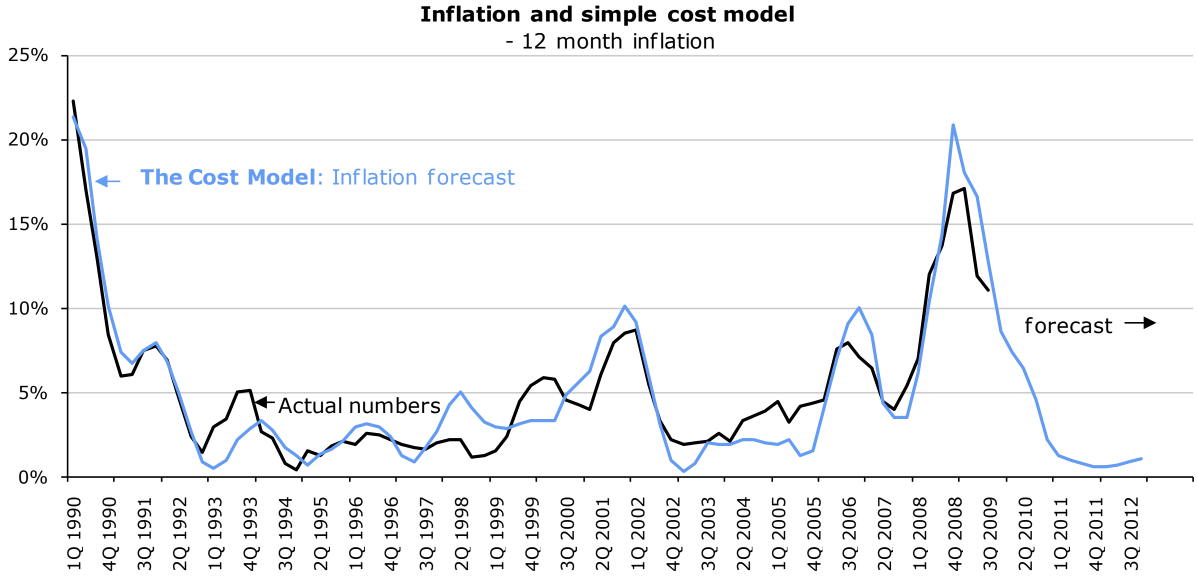
We expect the exchange rate of the ISK to remain at a similar level and that there will be little prospect of raising salaries owing to the collapse in general demand and higher than normal unemployment.



Our inflation forecast is considerably higher than suggested by the cost model

Historically, trends in the exchange rate and salaries have had a pronounced effect on inflation patterns. In order to better examine the cost effect (i.e. the effect with regard to trends in salary and the exchange rate) we have devised a simple cost model in which inflation is calculated by using previous inflation rates and trends in the exchange rate and salaries. The diagram below shows that the cost model fits the data quite well.

It is interesting to note that a model based on the aforementioned assumptions forecasts a sharp decline in the rate of inflation. In other words, the model implies that if the exchange rate and salaries only change moderately, inflation will recede rapidly. It is only if the long-term relationship between the exchange rate, salaries and inflation changes that we can expect higher inflation.



Arguments for a higher rate of inflation than the one suggested by our model

High cost of capital. Firstly, we believe that the high cost of capital for companies (both due to the higher debt burden of foreign loans and greater difficulties in raising funding) will cause price levels to rise.

High inflation expectations. Persistently high inflation expectations could also stoke continued inflation.

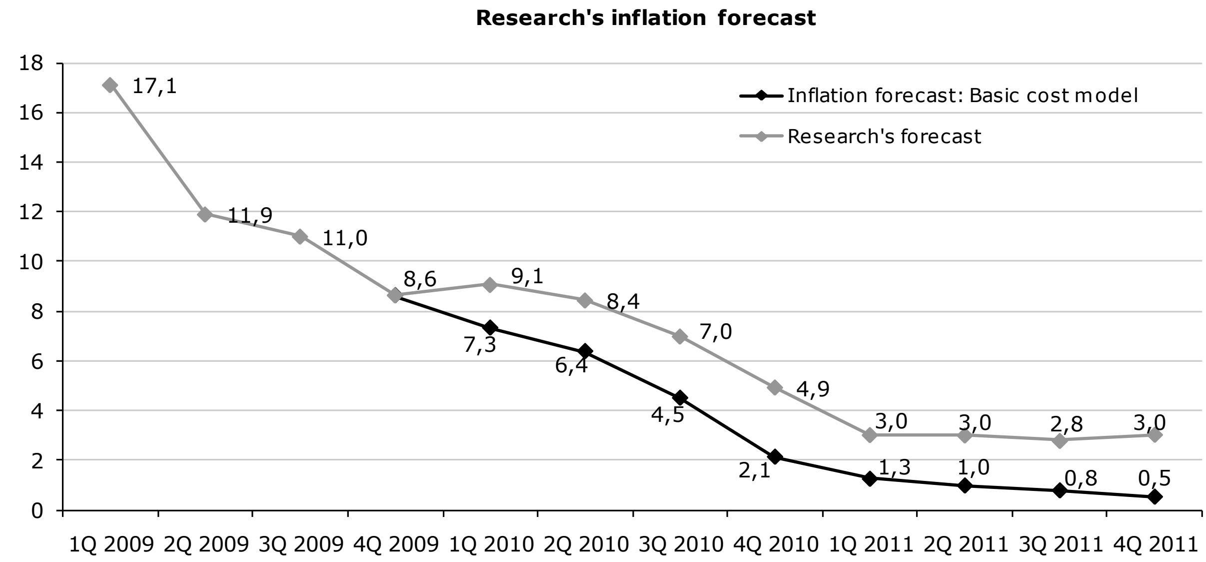
Spillover effect. If the need to raise prices still exists, it is likely it will emerge at the beginning of the year. More specifically, there will probably be a spillover effect following the recent tax increases. We therefore expect retailers to seize the chance at the beginning of the year to pass increased costs through to prices when the higher tax rates come into effect.

Do market principles not apply in Iceland?

One should be careful, however, to assign too much importance to the above effects. Just because these effects may indeed temporarily increase the markup on the price of imports, it is uncertain whether it will be permanent as two factors might come into play.

Firstly, new players who are not burdened with debt could take advantage of increasing prices for importers and create a space for themselves on the market.

Secondly, the falling cost of capital is bound to pass through to prices at some point. The big question is how long is it going to take before market principles begin to kick in? So despite its simplicity it is impossible to rule out that the cost model will in fact prove to be correct.



Uncertainties in the forecast

The most important uncertainties in this inflation forecast are as follows:

- **Factors which might lead to higher inflation.** The possible depreciation of the ISK, high inflation expectations and high costs of capital are the main uncertainties which could result in higher inflation.
- **Factors which might lead to lower inflation.** Our forecast assumes that a high cost of capital and high inflation expectations could result in higher inflation (see above). However, these factors might be overestimated and inflation actually might turn out to be lower.
- **Price of property.** Our forecast assumes that the price of property will generally remain unchanged throughout the forecast period (i.e. the effect on inflation will be minimal). The effect of property prices could be exaggerated, however, e.g. if housing prices began to drop sharply over the next few months, inflation could fall more rapidly.

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