

**COUNTRY PROFILE:** REPUBLIC OF ICELAND

**DATED:** APRIL 2009

**CREDIT GUARANTEE:**

IES/02: ATTACHMENT A

<b>CGIC rating &amp; comment</b>	ZZ; We remain off cover in this market.
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#### **Recent Political Highlights**

- Social Democrat Johanna Sigurdardottir took over as Prime Minister, after Geir Haarde, of the centre-right Independence Party, resigned in January amid mass street protests following the country's economic collapse. Sigurdardottir was Iceland's first female PM and she took office as the head of a coalition of her centre left Alliance party and the Left-Green movement. The new government was set to be in power until snap elections on 25 April.
- Iceland's interim centre-left government has won a resounding victory in the April 25 parliamentary elections. The Social Democrats under the leadership of Johanna Sigurdardottir won, with 29.8% of the votes. Sigurdardottir has been the prime minister for the last 84 days. The conservatives' Independence Party got 23.7% of the vote securing 16 seats, conceded defeat after its worst elections results in decades. They have been the largest party for decades but for the first time in the history of the Icelandic Republic left parties got majority. The Left Green Movement got 21.3% of the vote and a new party led by protesters got 7.2%. The left-green formed a minority government with the social democrats 84 days ago and both parties had said they planned to continue their coalition if they got enough votes but that doesn't necessarily mean they will form a new government.
- The two coalition parties will now have to reach an agreement on how to move forward with an EU application but the Left Green Movement remains eurosceptic. The collapse of the financial system has led to a major shift in opinion in favor of joining the EU and adopting the euro. Previous opposition to this move stemmed from Icelanders' concern about losing control of their fishing resources.

#### **Recent Economic Highlights**

- Iceland became an independent republic in 1944 and went on to become one of the world's most prosperous economies. Its prosperity initially rested on the fishing industry, but with the gradual contraction of this sector the Icelandic economy developed into new areas. Following the privatisation of the financial sector in the early 2000s, domestic banks expanded aggressively in foreign markets and consumers and businesses borrowed heavily in foreign currency loans, fuelling exceptional growth. Per capita income swelled to \$37,200 in 2007, the fifth-highest in the world. The global financial crisis of 2008 exposed the Icelandic economy's dependence on the banking sector, leaving it vulnerable to collapse.
- Iceland became a glorified hedge fund, as a relaxation of regulatory controls and Europe's highest interest rates encouraged currency traders to speculate on higher returns on the krona that allowed bankers to rack up debt amounting to 10 times the size of the economy and accounted for 90% of gross external debt. GDP growth is estimated at 0.3% in 2008 and the IMF predicts the economy will shrink 10.5% this year with household consumption plunging 25% and a 34% drop in fixed investments. The krona lost more than two-thirds of its value against the euro after the three major banks were unable to get short-term funding. The collapse galvanised the population to organise demonstrations that toppled the pro-free market administration of Prime Minister Geir Haarde in January. His was the first government to fall victim to the global crisis. The economy is projected to shrink until early 2010 and unemployment is likely to surpass 10% over the next two years.
- In October 2008, the government took over control of all three of the country's major banks in an effort to stabilise the financial system. Shortly after this, Iceland became the first western country to apply to the IMF for emergency financial aid since 1976. The central bank imposed capital restrictions at the end of the year to avert a sell-off of the currency.
- Iceland wants to encourage foreign ownership of its banks and may enable creditors of failed lenders to become shareholders as a means of achieving a stable financial system. Foreign creditors have waited since October last year to find out how they can recoup as much as 10.5 trillion krona (\$89bn) in debt. The state took over the banks without making itself liable for their foreign obligations. Iceland is relying on a \$10.1bn IMF-led loan to rebuild its economy after the banking collapse brought down the krona. Largely untapped natural resources are likely to provide the key to its recovery from the economic crisis, though concerns have been raised over their potential environmental impact.
- Iceland is hopeful that it can finance its budget deficit internally and will draw on reserves both from the central bank and pension funds to do so. Iceland's budget deficit will be 150bn-R160bn krona (\$1.31bn) this year. The government has reserves of the same amount at the central bank and can draw on those as well as the national pension funds that have considerable investment capacity. Should the government struggle to cover its deficit internally, it may once again call on its neighbours for help. Iceland will have a gross debt of between 80-100% of GDP at the end of this year.
- Iceland is developing a plan to ask domestic owners of foreign assets to exchange their holdings for the country's bonds owned by overseas investors as the government seeks to rebuild confidence in the economy. International investors own as much as 400bn krona (\$3.6bn) in local currency denominated bonds, which the central bank is concerned, may be dumped once capital controls imposed during the banking crisis are removed. A large outflow of money will destabilise the krona. The government may also encourage foreign investors to exchange their Icelandic bond holdings for securities with longer maturities to stem outflow of capital. The proposed plan is significant because it gives international investors an exit, having had their investments frozen since trading in the krona was stopped last year.
- With Iceland's economic meltdown sending its currency into freefall, tourists who saw this remote North Atlantic Island as prohibitively expensive are now flocking to its volcanic scenery. Last year 502,000 tourists visited the nation of just 320,000. In 2006, tourism accounted for 4.1% of GDP and currently employs an estimated 8200 people.

#### **Latest Trade Developments**

- Main exports: fish and fish products, aluminium, animal products, ferrosilicone and diatome.
- Main imports: machinery and equipment, petroleum products, foodstuffs and textiles.
- Major trade partners: Netherlands, Germany, UK, Ireland, US, Spain, Japan, Sweden, Denmark, China and Norway.
- South African exports to Iceland totaled R101.5m in 2008 and R1m in the year-to-February 2009.