

## Is Something Rotten in the State of Iceland?

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Normally, it would be a pleasure for a small economy like Iceland to catch the attention of research units of international banks. In the last few months, however, the Icelandic banking system and Icelandic economists have been struggling to get the true story across to a number of new analysts and media that are turning their sights on the Icelandic scene for the first time.

*Den Danske Bank* yesterday published a research note on the Icelandic economy entitled "Iceland: Geyser crisis". To many outsiders, a Danish bank such as Danske Bank should be ideally suited to report on the Icelandic economy, in view of the historical ties between the two countries. Unfortunately, the DB report starts out with the following apt disclaimer: "Iceland is not a core part of our research universe. We cover the currency, but we do not publish fixed frequency forecasts on the economy". The findings of the report are unusually categorical, as DB maintains that there is a substantial chance for a financial crisis and deep recession in Iceland in 2006 and 2007.

We at Landsbanki Research do not agree with this conclusion. We feel that the report severely over dramatises macroeconomic imbalances in Iceland and the likelihood of a hard landing in the economy. The report also contains numerous statistical inaccuracies and omissions all of which put the Icelandic economy in a bleaker light than is warranted.

The following are some of our main points of disagreement with the report.

### Economic outlook

Danske bank forecasts a 5-10% decline in GDP in 2006-2007.

- This would mean a much deeper recession than has previously occurred in Iceland (with the exception of the severe recession in 1968 after a series of simultaneous setbacks in the all-important fisheries sector). This triggered a 6.7% fall in GDP over a two-year period, following average annual GDP growth of 8.9% during the preceding five years).
- Economic forecasts from IMF, OECD and the Central Bank of Iceland do not envisage a recession in the Icelandic economy. Although these forecasts do take into account falling investment, as aluminium and power projects currently underway near conclusion, they also factor in a number of infrastructure projects and private investments planned for 2007-2008. These have been placed on hold while the large projects have been in progress. Additional investment in the aluminium and power sector are also on the horizon.
- Available information on investment in 2006-2008, both public and private, make a recession of this magnitude extremely unlikely to occur.

Danske Bank analysts state correctly that a correction of the exchange rate for the Icelandic *króna* (ISK) will lead to a rise in household debt, as the depreciation will lead to a temporary spike in inflation, boosting the CPI-indexation of housing mortgages. This seems to be the main reasoning behind the forecast of a severe fall in private consumption and GDP. Such a drop, they conclude, would trigger balance sheet problems for households and financial institutions, deepening the international liquidity crises.

- This reasoning is flawed. The design of the indexation system in Iceland is such that a temporary spike in inflation has a minor impact on current debt service. This is



because the inflation component of the interest rate is spread over the entire maturity of the loan. Most Icelandic mortgages (80%) have a 40 year term.

- Despite an increase in household debt the average loan-to-value ratio has remained stable at around 50%. Hence, a spike in inflation is extremely unlikely to lead to balance sheet problems for households.
- Overall, we remain confident that the necessary and expected ISK adjustment will not lead to balance sheet problems for households. The separate assessments of international organisations and rating agencies support this view.

## The Exchange Rate and Financial Stability

A correction to the ISK exchange rate has long been anticipated and has therefore been incorporated into the plans and risk assessments of economic actors. This is a fundamental difference between the situation in Iceland and those situations which led to the Asian Crises of the late 1990s.

The ISK adjustment is an important factor in the reduction of economic imbalances in Iceland. It will rein in growth of private consumption and imports and strengthen the competitiveness of exports and the non-sheltered sector. Thus, given the present economic situation in Iceland, the exchange rate adjustment is not a risk factor but a necessary part of regaining equilibrium. Historically the real ISK exchange rate tends to appreciate during an economic upswing and is normally corrected upon its conclusion with a depreciation of the króna. The economic system is adapted to fluctuations of this kind, and the widespread CPI-indexation of credit and savings is an important component here. In this respect the current situation is similar to that developing towards the end of previous business cycles. Despite the indebtedness of households, this correction will most likely take place without causing major difficulties for that sector.

## Foreign Indebtedness

- Den Danske Bank indirectly acknowledges that part of the foreign indebtedness in Iceland is the result of investments abroad. They examine the income generated by these investments and compare this to the servicing costs of this foreign debt. Their comparison does not, however, give a fair picture of the situation, due to the fact that such a major portion of the investment took place late in 2004 and in 2005. These investments have not yet begun to bring in revenue.
- While it is true that total foreign debt is 80% of total debt in the economy, it must be borne in mind that half of this foreign debt has been re-lent to foreign borrowers outside of Iceland. Only 30% of the total foreign lending is being serviced by the Icelandic economy, as can be seen in statistics published by the Central Bank of Iceland.
- The fact that such a large portion of borrowed capital has been re-lent to parties abroad is a key factor distinguishing the situation in Iceland from that of Thailand. It means that an ISK depreciation does not affect the repayment capacity of these debtors, unlike the situation in Thailand, where foreign loans were primarily used for domestic investments.

## The Analytical Approach

The Danske Bank analysts are highly selective in their references to public sources and rating agencies, systematically excluding information which contradicts their hypothesis.

Their report states, for instance:

"We have long been sceptical about the sustainability alone. Reports from the IMF and the OECD, as well as the Financial Stability report from the Sedlabanki (the Icelandic central bank), prepared in 2004 and 2005 all seemed wary of the situation. The imbalances have only grown worse since then."

No reference is made to publicly available economic forecasts for Iceland by these same parties, or to recent statements by the Central Bank and the Financial Supervisory Authority confirming the strength of the financial system.

- The introduction to the Financial Stability report quoted in the Danske Bank report states: *"The finding of the Central Bank's analysis is that in spite of rapid expansion and the macroeconomic imbalances that need to be tackled in the coming years, the Icelandic financial system is broadly sound. It is sound in the sense of being equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to redistribute risks appropriately."*
- In its quarterly Monetary Bulletin, issued on 2 December 2005, the Central Bank forecasts GDP growth of 6.4% for 2006 and 4.1% for 2007.
- David Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, has stated publicly that the banking sector is on a strong footing: "As far as I can tell the banks are ... acting responsibly ... with the good foundation that they have, it's absurd to talk about a crisis." (Source: Central Bank website, [www.sedlabanki.is](http://www.sedlabanki.is)).
- On 14 March 2006, the Financial Supervisory Authority (FME) published the results of stress tests it has carried out examining the capacity of the Icelandic banks to withstand economic shocks. The stress test assumes that a financial undertaking is simultaneously subjected to 20% loss on loans in default, a 35% drop in the value of domestic equity assets, a 25% drop in the value of foreign equity assets, a 7% drop in the value of its market bonds and a 20% ISK depreciation. To pass the test, the financial undertaking's capital adequacy ratio may not drop below the mandatory 8% prescribed by law, in spite of being simultaneously beset by all of the aforementioned shocks. Calculations by FME of the impact of the stress tests on the Icelandic banks' capital adequacy ratios show that all three would be fully capable of withstanding such a trial without their capital adequacy falling below the mandatory minimum. In other words, the resilience of the Icelandic banks is substantial.
- In a report published in October 2005, IMF predicts GDP growth of 4.9% in Iceland in 2006, 3.1% in 2007 and 2.6-3.1% annually from 2008 to 2010.

The Danske Bank specialists quote a report from Fitch Ratings of 21 February 2006, confirming Iceland's sovereign rating but downgrading the outlook from stable to negative.

- No mention is made of the fact that Fitch has subsequently confirmed its ratings and outlook for all of the Icelandic banks.
- Nor is mention made of the fact that both Moody's and Standard&Poor's have since that time confirmed unchanged ratings for both Iceland and its banks.

The report discusses likely liquidity crises.

- Danske Bank disregards publicly disclosed information on banking sector liquidity in Iceland. The banks have disclosed that they have sufficient liquid assets to meet their international financing needs over the next 1-2 years, even without accessing international capital markets.

## A Few Additional Points

- In assessing the credit growth of deposit money banks, Danske Bank analysts disregard the changes which have occurred in mortgage financing in Iceland and other structural changes to the financial sector. A large part of the credit growth is in fact a transfer of residential mortgage lending from the publicly owned Housing Financing Fund, pension funds and insurance companies. In view of this, a broad aggregate is the most reliable measurement in assessing credit growth. If this is taken into account, the 12-month credit growth of the domestic system is 30% and not 61%, as stated in the Danske Bank report. This figure is included in the public statistics of the Central Bank of Iceland.
- The comparison to financial crises in Thailand and Turkey is scarcely convincing, since the analysts elect to disregard basic differences in the economies, such as the exchange rate arrangements and use made of foreign borrowings.

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