

## Cooler times ahead

The state of the Icelandic economy has altered since our last forecast, after the deepening of the sub-prime crisis on the international markets. The economy is more cooling down, opening up the possibility that the Central Bank of Iceland will cut interest rates sooner than previously forecast.

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### Chill winds from abroad (p.2)

The sub-prime crisis has extended its reach to Iceland, with widening CDS spreads for the banks and a badly performing stock market. The opportunity cost of capital has therefore risen sharply for financial institutions, while the capacity of people and companies to borrow money has been greatly impaired. This development increases the bite of the Central Bank's interest rate measures, and triggers a far more rapid cool down of the economy than previously forecast.

### Time to cut interest rates (p. 3)

Kaupthing Research believes that the Central Bank now has scope to begin cutting interest rates, the sooner the better. Any further delay in cutting rates would greatly restrict the time frame for rate cuts to be effective, leading to a much steeper and riskier series of interest rate cuts.

### ISK vulnerable (p. 9)

Kaupthing Research forecasts that the ISK will weaken at the beginning of the rate cutting process during the third and fourth quarters of this year, and all forecasts are based on this assumption. However, the interest-rate differential is that great – partly supported by interest cuts by central banks in neighbouring countries – that the ISK will continue to enjoy considerable support.

### Real yield dropping (p.12)

Kaupthing Research believes that the yield on indexed and nominal bonds will drop next year. This slip is primarily due to falling policy interest rates and we assume that the Central Bank of Iceland will embark on a relatively swift rate cutting process in mid April or possibly sooner in mid March.

### Kaupthing Research's economic forecast (p.16)

Kaupthing Research estimates a 5% contraction in private consumption over the next two years, although this will to some extent be offset by new hydropower and aluminium sector investments and further government projects.

See [important disclosures](#) on last page of this report

## Cool down far more rapid than previously thought

The state of the Icelandic economy has altered since our last forecast in October after the deepening of the sub-prime crisis on the international markets. Share prices have plummeted and credit spreads have risen sharply. Furthermore, the slowdown on the real estate market has been faster than Kaupthing Research expected, partly due to the fact that indexed lending rates were hiked sharply in November. Looking ahead, Kaupthing Research identified two effects on economic developments in Iceland.

- **The high CDS spreads of the Icelandic banks** means that interest rates on Icelandic business activity have been pushed very high. Wider spreads raise the opportunity cost of capital for financial institutions and result in more restrained lending and higher lending rates.
- **Price decreases on the asset markets – both in real estate and equities** – undermine the capacity of people and companies to borrow money. The sharp decline in asset prices has a direct impact on household consumption and experience shows a close relationship between private consumption and share prices. Moreover, history has also shown a close link between investment and share prices. Therefore, we can expect a sluggish real estate market and a winding down of activity in the construction industry.

It goes without saying that this converse trend has intensified the impact of the Central Bank's policy interest rate. Kaupthing Research believes that the Central Bank is closely monitoring developments and is not prepared to risk delaying the rate cutting process until the economy is really at crisis point. It is therefore likely that the rate cutting process will begin at the next interest rate setting meeting on 14 February, or at the very latest, when the next Monetary Bulletin is issued on 10 April.

### Important that Central Bank cuts rates

As the policy interest rate is currently 13.75%, the Central Bank's stance on monetary policy remains extremely tight. It is critical however, that the rate cutting process gets under way and that the Central Bank can begin to lower interest rates and then let the speed of cuts be decided further along the track. Any further delay in cutting rates would greatly restrict the time frame for rate cuts to be effective, leading to a much steeper and riskier series of interest rate cuts.

Kaupthing Research forecasts that the ISK will weaken at the beginning of the rate cutting process during the third and fourth quarters of this year, and all forecasts are based on this assumption. However, the interest-rate differential is that great – partially supported by interest cuts by central banks in neighbouring countries – that the ISK will continue to enjoy considerable support. In this context it is important to remember that the ISK is floating and that a volatile exchange rate is simply a feature of the Icelandic financial landscape. A certain amount of instability in the ISK is therefore unavoidable once the rate cutting process gets under way. Kaupthing Research believes, however, that it is important that the Central Bank clearly indicates that it has no exchange rate target and that it will not let any short-term fluctuations in the exchange rate knock it off course, even if inflation may increase in the short term. Otherwise there is a risk that Iceland's monetary autonomy is being ceded to speculators on the FX market.

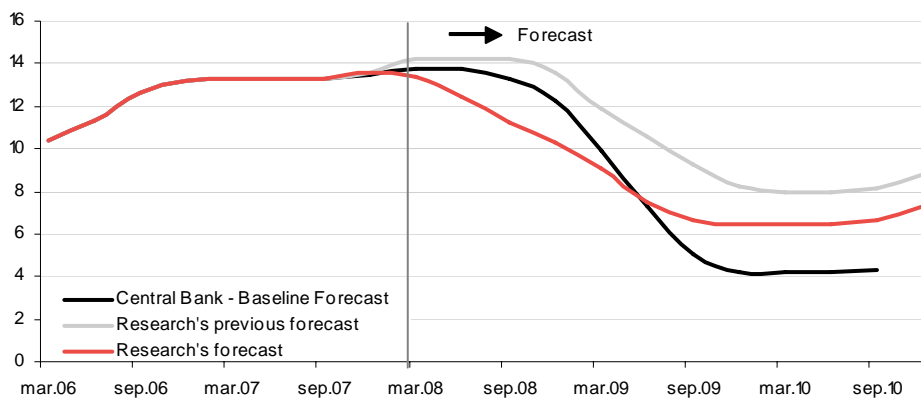
## Policy rate forecast: Rates at 9.75% at year-end

Kaupthing Research believes that the policy interest rate will be cut sharply this year, ending the year at 9.75%. The rate cutting process will probably bottom out at 6.5% in 2009, and then hydropower and aluminium sector investments and public investments will reignite activity. Any delay to the rate cutting process will inevitably result in a steeper and deeper series of cuts.

We expect the Central Bank to initiate the rate cutting cycle no later than on its next policy rate meeting in April. The Central Bank may even cut rates in March due to indications of a contraction in loans and a slower real estate market, coupled with questions over financial stability. Kaupthing Research, however, believes that a delay in getting the ball rolling will simply result in more rapid cuts further along the line, as the Central Bank's own forecast indeed indicates.

### Kaupthing Research's policy interest rate forecast

- plus the Central Bank's alternative scenario and Kaupthing Research's October forecast



Sources: Kaupthing Research, Central Bank of Iceland

### Three indicators of an economic cool down in Iceland

#### A) Sharp drop in share prices

**Change in market value of shares listed on OMX Nordic in Iceland**  
 - as percentage of GDP, from 2 July 2007



Sources: Kaupthing Research, Bloomberg

#### B) Widening CDS spreads

**5-year CDS spreads of Icelandic banks**

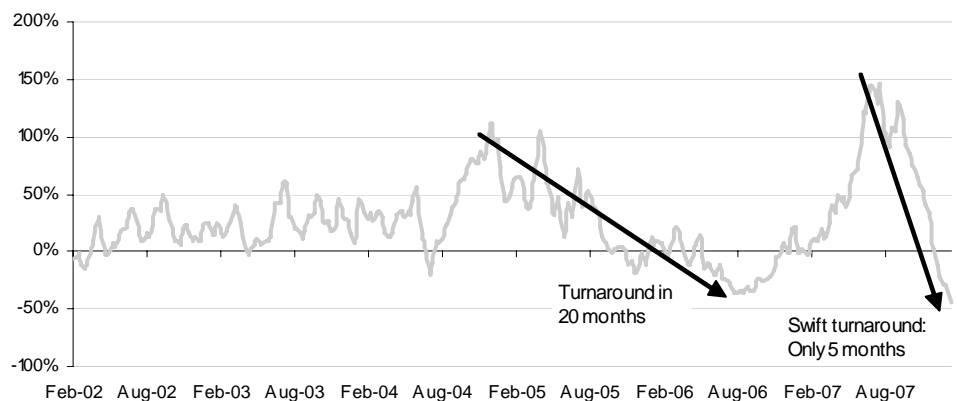


Sources: Kaupthing Research, Bloomberg

#### C) Decreasing turnover on real estate market

**Activity on the real estate market**

- YoY change in volume of real estate transactions in Reykjavik area (7-week average)



Sources: Kaupthing Research, Land Registry of Iceland

## Uncertainties in forecast

### Sharper drop in asset prices

- A decrease in share prices and real estate prices will significantly cool down the economy.
- These factors could reduce consumption and inflation pressure more rapidly than forecasts assumed.
- Our forecasts assume a minor decrease in the nominal price of property and a turnaround in share prices in the second half of the year. The uncertainties will be more likely to lower assets prices, particularly real estate prices.

### Will the banks' CDS spreads tighten significantly?

- A sharp tightening in the Icelandic banks' CDS spreads would counteract the current decrease in loans.
- **However, a major drop in the banks' CDS spreads globally does not appear to be in the offing.** The CDS spread of many of leading financial companies in the US is currently very high, or over 100 points.
- One of the most critical factors for a change in this area would be a rally on the financial markets and a return of investors' appetite for risk.

### Positive turnaround on the international financial markets

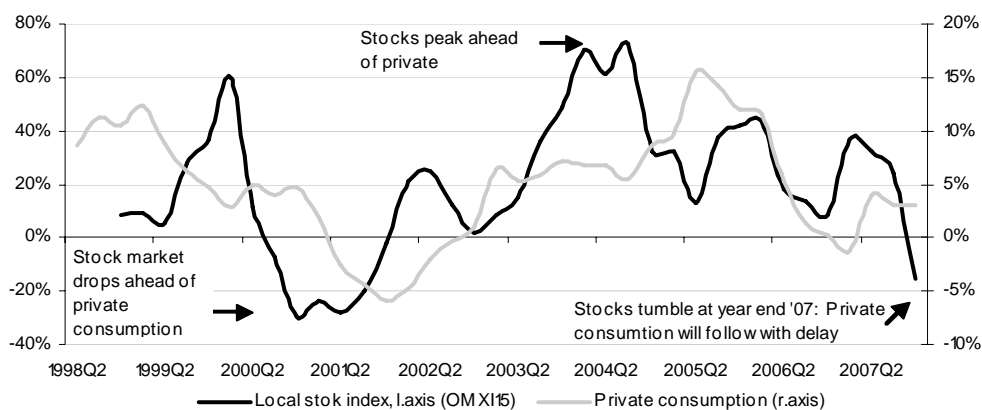
- Positive developments on the international financial markets would result in a brighter outlook in various ways.
- This is a key prerequisites for a significant tightening of the Icelandic banks' CDS spreads.
- Rallying stock markets would also have a positive wealth effect, stimulating consumption and inflation pressure.
- There is a risk, however of continuing negative news from the international financial markets, such as the precarious position of US monoline insurers.

### Will a cut in interest rates signal a weaker ISK, even financial instability?

- A cut in interest rates could weaken the ISK and add to inflation pressure.
- Declining consumption and a rapid cool down in the housing market might keep inflation in check, even if the ISK does give ground.
- The Central Bank's course of action in the latest baseline interest rate forecast was based on pushing the economy into a crisis and then cutting interest rates by ten percent over a short time.
- We believe this course of action will invite the risk of a huge depreciation of the ISK and even financial instability. However, a rate cutting process begun at the rate time is far more likely to keep the currency and financial system stable.

### Stock market and private consumption

- YoY change



Sources: Kaupthing Research, Central Bank of Iceland

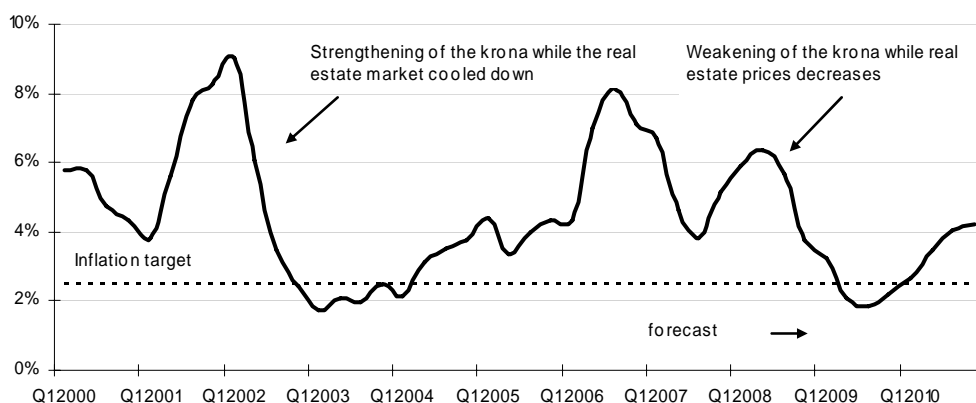
## Inflation: Target reached with cooling housing market

Inflation has exceeded the Central Bank's target since the beginning of 2004 and remains some way off the target. Kaupthing Research expects inflation to decelerate sharply in 2008, similar to what happened in 2002-2003. The Central Bank of Iceland will reach its target in the first half of 2009 if our forecast proves accurate.

- A prerequisite for attaining the inflation target is the cool down of the real estate market – but this will happen even if the ISK depreciates significantly during the forecast period.

### Kaupthing Research's inflation forecast

- based on 12-month change



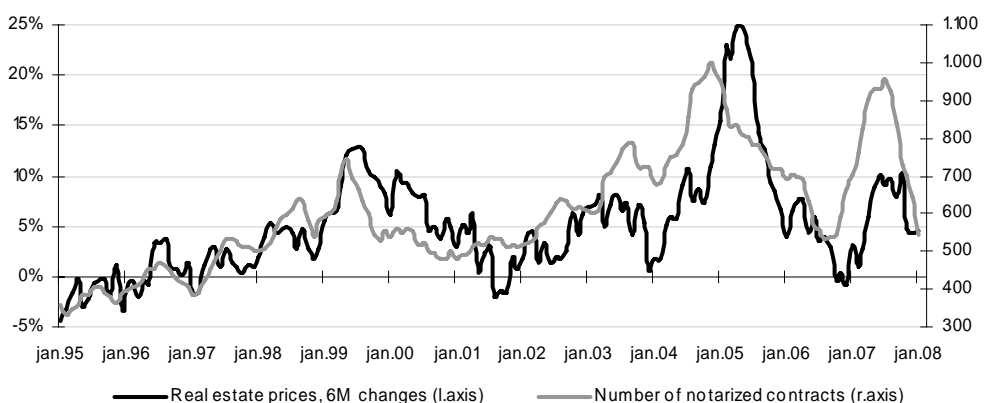
Sources: Kaupthing Research, Statistics Iceland, Central Bank of Iceland

## High interest cools down the real estate market

Activity on the real estate market has contracted significantly in the first few weeks of the year and this trend is likely to continue in the medium term. The rate of cool down is greater and faster than Kaupthing Research expected in its last forecast in November.

### Housing prices and turnover in Reykjavík area

- turnover compared with 6-month moving average

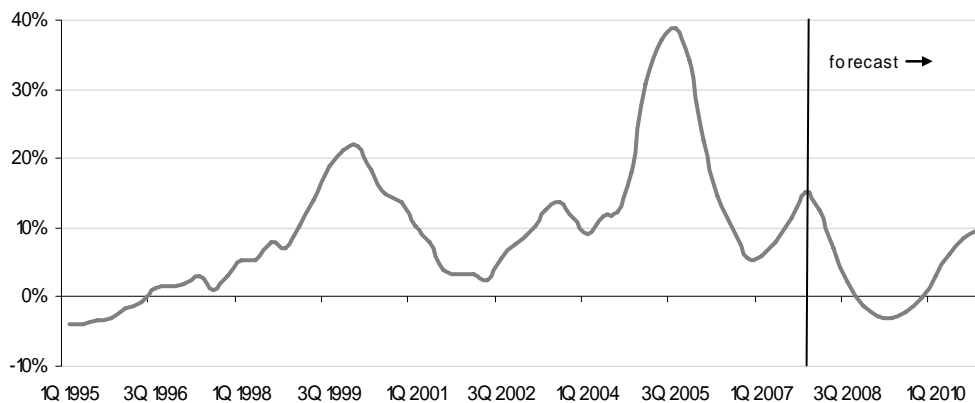


Sources: Kaupthing Research, Land Registry of Iceland

Today the price of housing is 15% higher than it was a year ago. Kaupthing Research projects a swift turnaround in the price of housing, which will start to fall at the end of the year. This backward trend will continue into 2009, and property prices will therefore help peg back inflation later in the year. The uncertainty is, however, to lower real estate prices than estimated in our forecast.

### Development of housing prices in the Reykjavik area

- change from previous year



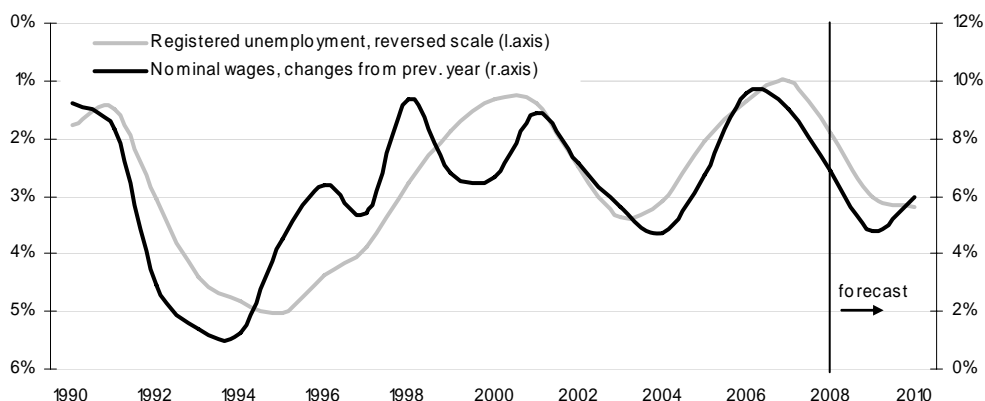
Sources: Kaupthing Research, Land Registry of Iceland

### Labour market still an area of uncertainty

An overheated labour market remains uncertain factor for medium-term inflation, and the Central Bank has announced that it will take action if new union salary agreements do not match their expectations.

Kaupthing Research believes that assumptions have changed rapidly in recent weeks and it is likely that union salary agreements will be moderate in light of the state of the economy and the medium-term inflation outlook. The discussion has now moved on to the possibility of raising salaries afterwards instead of in advance as is the norm. If this happens, it will reduce the uncertainty since salary increases only apply to those who have not benefited from wage drift during the year.

### Registered unemployment and general salary trends



Sources: Kaupthing Research, Statistics Iceland

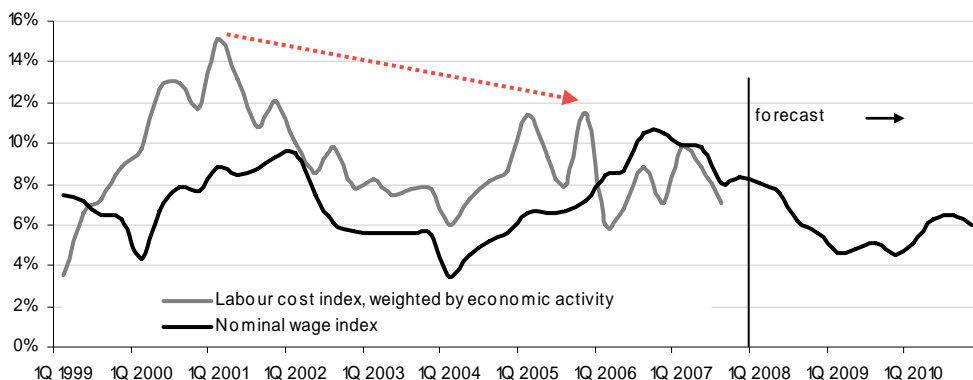
### Salary costs pinned back by imported labour

The current upswing brought significant salary increases, and year-on-year salary rise measure 10%, the highest on record. However, the real labour cost increases was slightly less, or an average 8%, compared with 15% in 2000-2001.

It has been claimed that considerable cost pressures remain in the system following the current economic upswing. This may well be true to a certain extent, but Kaupthing Research believes that the import of foreign labour has pegged back rising costs in many sectors. It is nevertheless difficult to accommodate foreign labour in certain activities, where education and linguistic proficiency are required and a certain amount of pent up demand could therefore still exist. This particularly applies to public sector jobs, e.g. in education and the health service, rather than on the open job market.

#### Salaries and salary costs

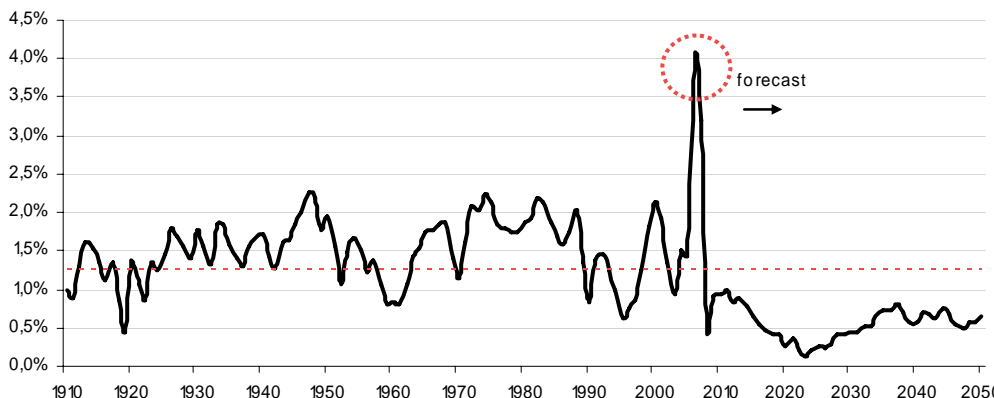
- based on 12-month change



Sources: Kaupthing Research , Statistics Iceland

#### Population increase in 20-65 age group

- based on population forecast of Statistics Iceland



Source: Statistics Iceland

## ISK to depreciate this year

Kaupthing Research expects the ISK to be weaker than in its last forecast, as the outlook is for a narrower interest-rate differential and less risk-seeking on the international markets. Less tolerance to risk makes it more likely that high interest currencies will depreciate, especially those in countries with a high current-account deficit. Kaupthing Research also believes that the ISK is bound to depreciate once interest rates are cut. The extent of such depreciation is very difficult to predict, however.

The situation on the FX market is rather special as the euro has strengthened markedly against the US dollar and other currencies. Consequently, the ISK is at an all-time low against the euro, but is very strong against the dollar. Since Icelandic exports are increasingly aimed at the euro zone or closely related currencies, the EUR/ISK cross is perhaps the best way of assessing the strength of the ISK.

The ISK is likely to depreciate sooner in the current forecast than the previous one. This is because the Central Bank is likely to commence its series of interest rate cuts sooner than expected and this will erode the interest-rate differential more quickly.

The exchange rate index will average 136 points mid-year and strengthen slightly towards the end of the year according to the forecast.

### Uncertainties in the forecast

The main uncertainties in the forecast are developments on the international markets and the extent of the economic slowdown in Iceland.

#### Gentler economic cool down

- If the economy cools down less than forecast, the rate cutting process could be slower and the ISK stronger.

#### Slower rate cutting process despite cooling economy

- If rate cuts are too slow, there is a risk of more a pronounced depreciation of the ISK. Assuming that the economy will slow down as we forecast, any delay to the rate cutting process in the short term will simply mean sharper rate cuts in the long term. If the rate cutting process is as set out in the Central Bank's forecast, in which the economy is forced into deep trough before a very rapid series of rate cuts is initiated, then the depreciation of the ISK will be far greater.

#### Further investments in industry?

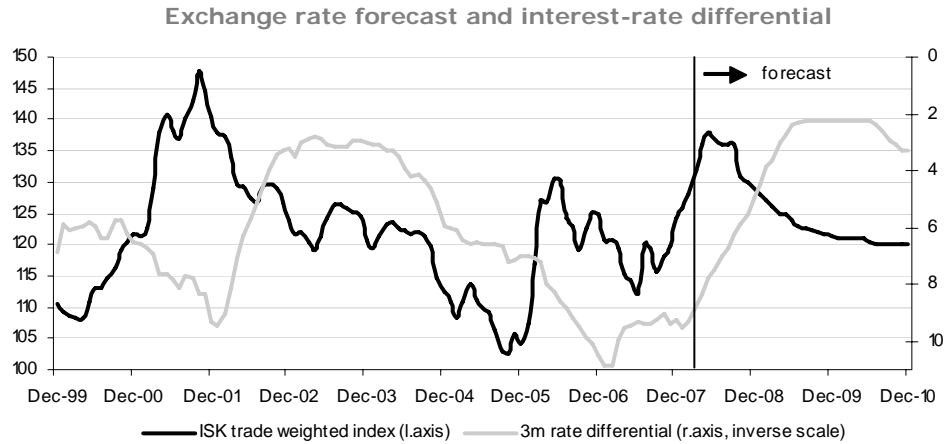
- Uncertainty over new investments in industry, are likely to result in the appreciation of the ISK.

#### Developments on the international markets

- The direct impact on the exchange rate of the ISK through changes in the risk appetite of FX traders, and the indirect impact through the stock market and the rapid cooling of the economy.

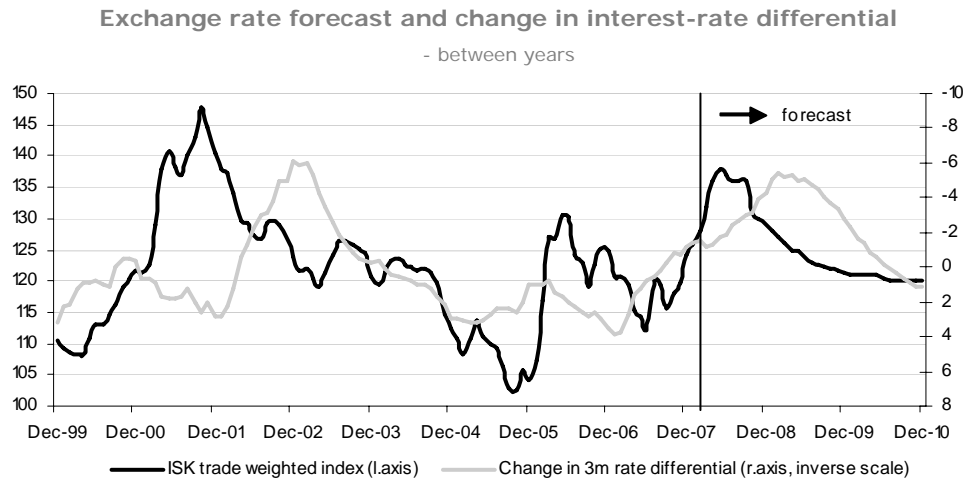
### Interest-rate differential with abroad narrows during year

Although the interest-rate differential with abroad will continue to be substantial, a narrowing differential will reduce position taking in the ISK. The short-term interest-rate differential with abroad (3 months) is currently around 9% and will fall to approximately 2.5% when it bottoms out in 2009.



Sources: Kaupthing Research , Bloomberg

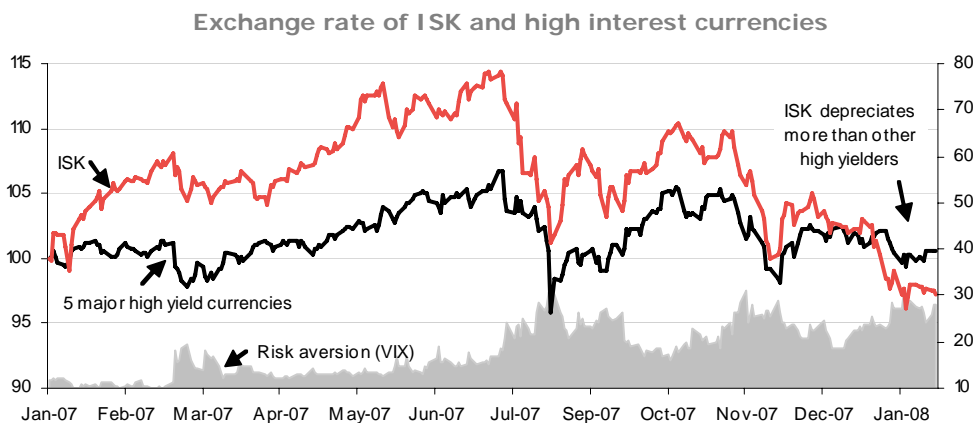
As the interest-rate differential drops, the ISK is likely to depreciate. It is not unlikely that the exchange rate of ISK will reach a low (and the index a high) well before the interest-rate differential with abroad is at its minimum – just as happened in the last downturn.



Sources: Kaupthing Research , Bloomberg

### Risk aversion crucial factor

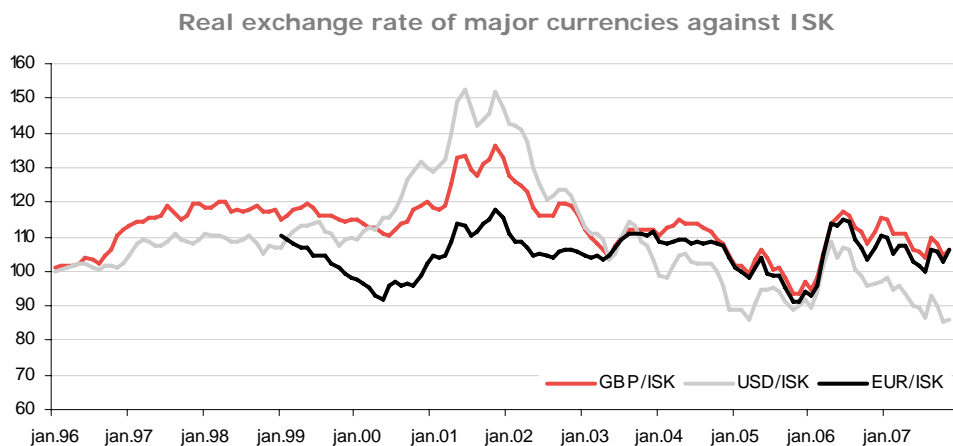
The risk tolerance of investors on the international markets will play an equally crucial role as the interest-rate differential for the exchange rate of the ISK. Investors are likely to remain risk-averse for the time being, as signs point to continuing difficulties on the financial markets and in the US economy.



Sources: Kaupthing Research , Bloomberg

### ISK approaching historical average real exchange rate

At the beginning of 2008, the real exchange rate of the ISK has been approaching its historical average. In January the real exchange rate of the ISK was about 5% above its 10-year average. It is therefore difficult to explain the sharp depreciation of the ISK with the real exchange rate. This does, however, support Kaupthing Research's view that the ISK will not depreciate to the same extent as it did during the last series of interest rate cuts in 2001. The current-account deficit will be significantly reduced as the ISK weakens, which will give investors more confidence that it will appreciate anew.



Sources: Kaupthing Research , Bloomberg

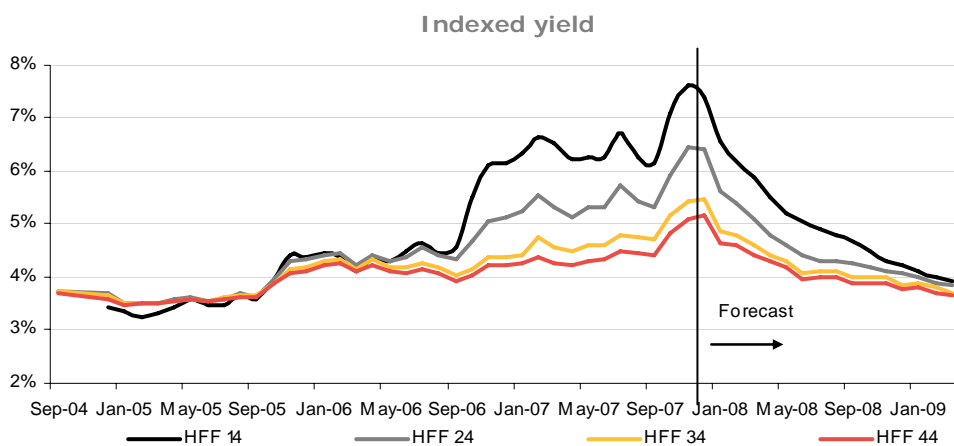
### Announcement to be made on new investments in industry

In the next few months the government is likely to announce the go-ahead for a new aluminium plant at Helguvík in SW Iceland. The project is, however, only expected to be a third of the size of the heavy industry projects now coming to an end. In 2008-2010 the investment in the Helguvík plant will be about 2-4% of domestic product. News that the investments will be going ahead is nevertheless bound to strengthen the ISK, and the uncertainty is to some extent bound up in the question whether more investments in this sector will be undertaken, e.g. the possible aluminium plant at Húsavík in NE Iceland.

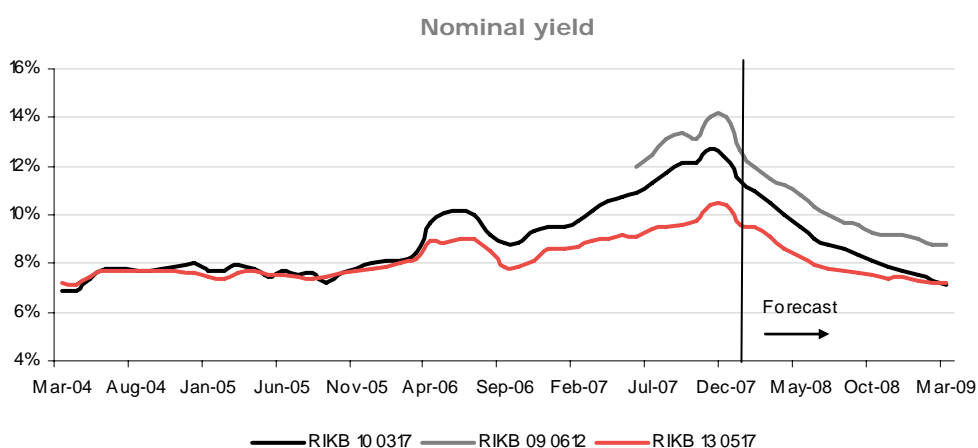
## Bonds: Yields drop further

Kaupthing Research believes that yields on indexed and nominal<sup>1</sup> bonds will fall next year, mainly as a result of a drop in the policy interest rate. This is regardless of whether you look at the Kaupthing Research's interest rate forecast, or the Central Bank's forecast from November - both project a rapid decline in interest rates in 2008-2009 – although the Central Bank assumes that the rate cutting process will commence later and be quicker. In both cases, the real interest rate will fall in Iceland.

We base our forecast on investors' opportunity cost, i.e. on our forecasts on policy interest rates and inflation on an annual basis, and then assess what the yield should be at the end of each quarter if our projections for the economy pan out. We use the expectation theory and examine the accumulated average of nominal and real interest rates. According to historical data, the market seems to value long-term real interest rates at around 3.5%, which we think is pretty near the mark and we thus assume this figure.



Sources: Kaupthing Research, Mentis database



Sources: Kaupthing Research, Mentis database

<sup>1</sup> Kaupthing Research does not forecast the yields of RIKB 08 0613 and RIKB 08 1212.

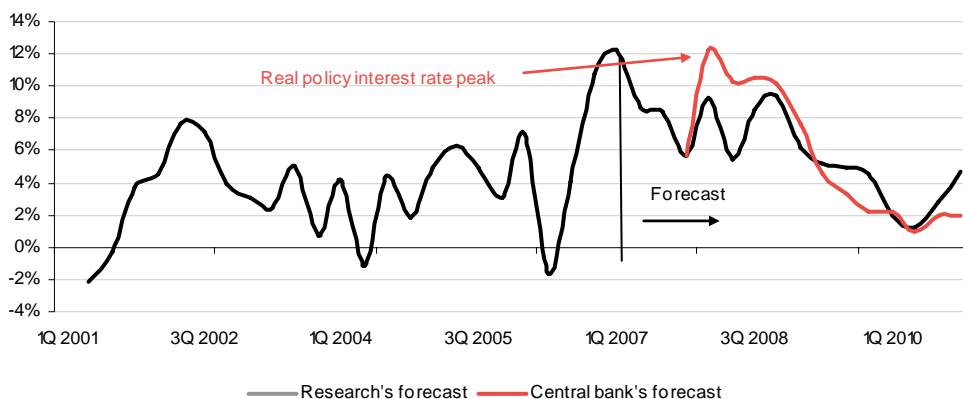
### Real interest rates remain high – drop at end of year

According to Kaupthing Research's forecast real interest rates will remain relatively high throughout 2008 on the back of decreasing inflation and higher policy interest rates. We expect real policy interest rates to start falling at the end of the year, mirroring other interest rates.

The Central Bank is taking a tight monetary stance and its interest rates are currently at an all-time high. This present danger that now when the situation is getting tough, the Central Bank will be too slow to react – according to the Central Bank's baseline forecast on inflation and policy interest rates, then real policy interest rates will peak during the second half of 2008 when the contraction in the economy is well advanced.

#### Real policy interest rate forecast of Kaupthing Research and Central Bank

- based on forecast on policy interest rate (annual return) and inflation (quarterly change on annual basis)



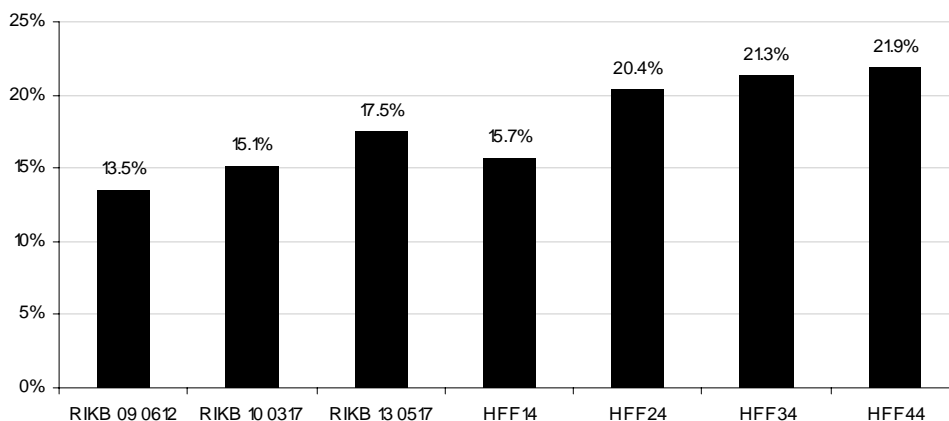
Sources: Kaupthing Research , Central Bank of Iceland

### High returns ahead

There has been a high turnover on the bond market so far this year, and the turnover record was broken several times at the beginning of January. The altered interest expectations held by market participants and upheaval on other markets have had an impact in this respect, and Kaupthing Research expects turnover to remain high this year. If our yield forecast proves accurate, then the 12-month return on bonds will be considerable. When calculating the return we assume that repayments and interest on the bonds are reinvested at forward rates according to inter-bank rates and at rates in interest swap agreements as current today.

#### 12-month return

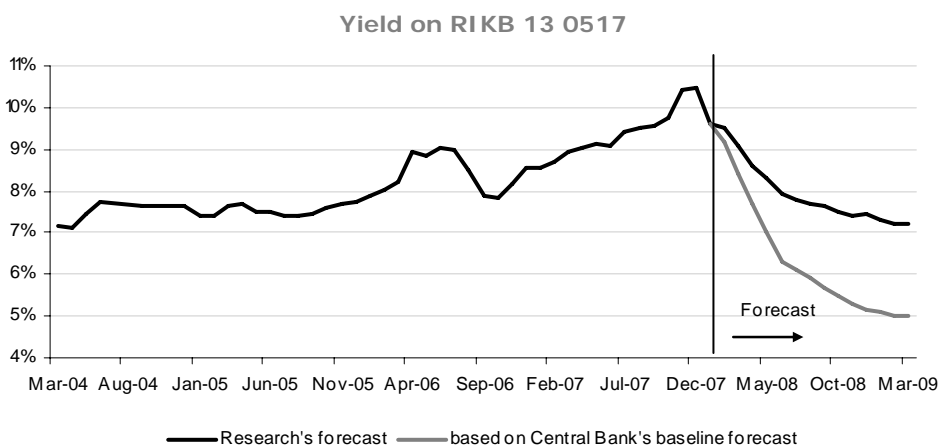
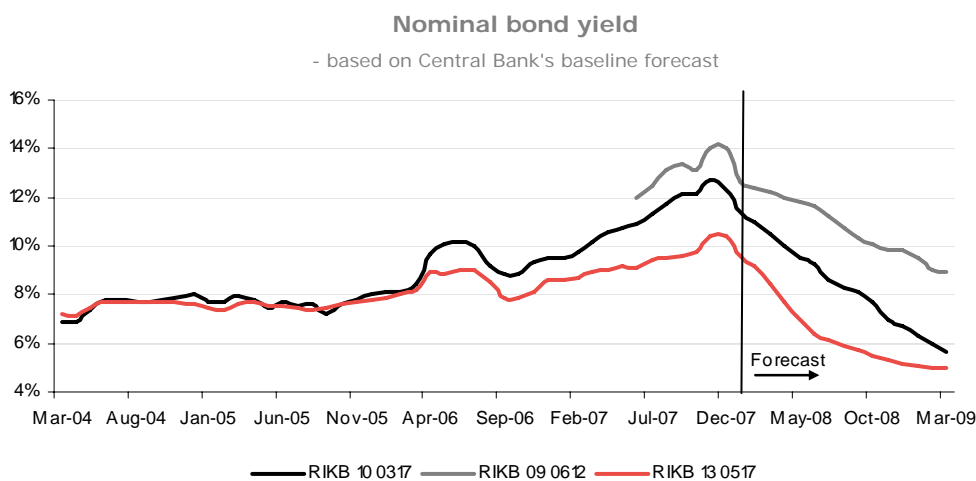
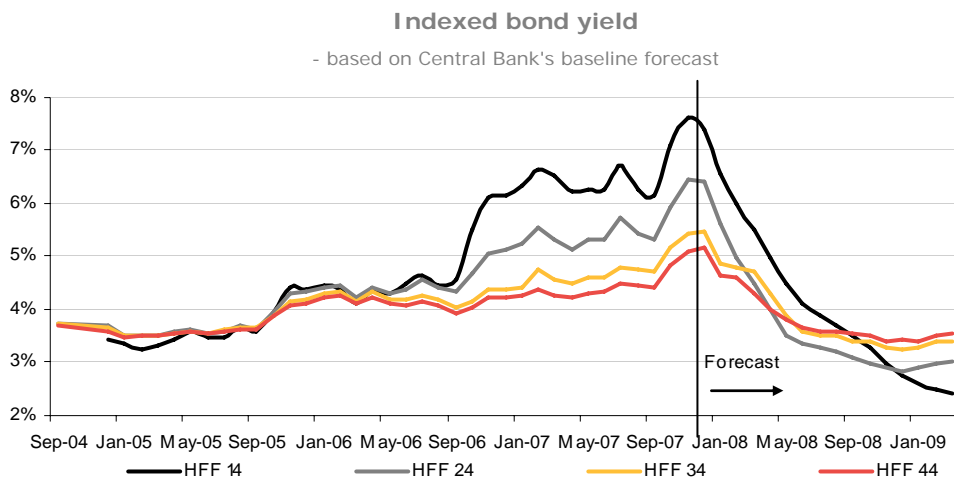
- based on Kaupthing Research's forecast, return from 1Q 2008



Source: Kaupthing Research

### Even greater drop in yields – according to Central Bank's baseline forecast

Kaupthing Research has forecast bond yields using the Central Bank's interest and inflation curve. The Central Bank forecasts a steeper rate cutting process, which will commence later, or in the third quarter of 2008. Consequently, the yield will fall far more quickly during the forecast period if the Central Bank's forecast proves accurate. According to sources from Central Bank they believe that long-term real interest rates are around 4% or even higher, and we base our assumptions on this in the long term.



## Alternative scenarios for the indexed yield

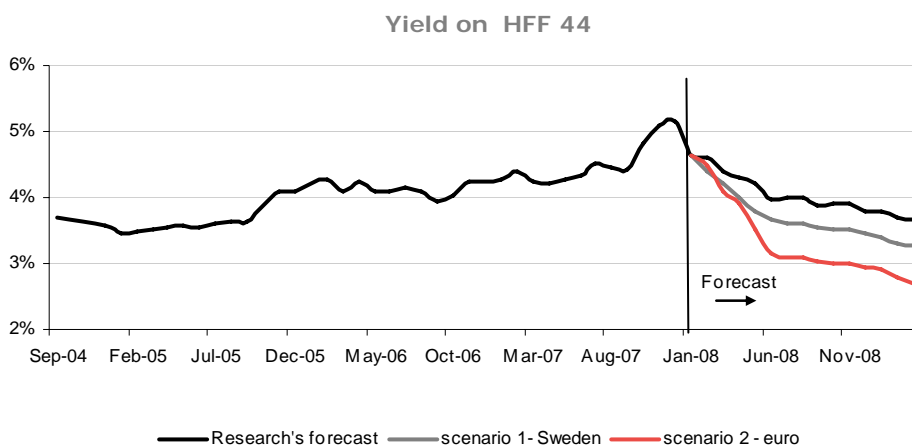
As a matter of interest Kaupthing Research has proposed two alternative scenarios for the indexed yield based on two systematic changes to the Icelandic interest environment. Firstly, where arbitrage on cross-border capital transactions entail that long-term real interest rates head in the direction of the same real interest rates in Sweden. This is in many ways a convenient comparison – particularly as far as the indexed market is concerned which is a similar size to the one in Iceland. The Swedish indexed market is slightly more liquid than the Icelandic one, but the difference is not great. The depth of the markets is similar. A second scenario is put forward, in which it is assumed that the euro will be adopted in five years and that interest rates in Iceland move towards euro zone levels.

### Scenario 1 - Sweden

- Long-term real interest rates head in the direction of the same real interest rates in Sweden (average 2.8% since 1999).
- The Swedish market is in many ways similar to the Icelandic market, e.g. has an indexed yield and the country has its own currency.
- Liquidity and depth of the market comparable.
- Conclusion: Yield falls more next year than in Kaupthing Research's forecast.

### Scenario 2 - euro

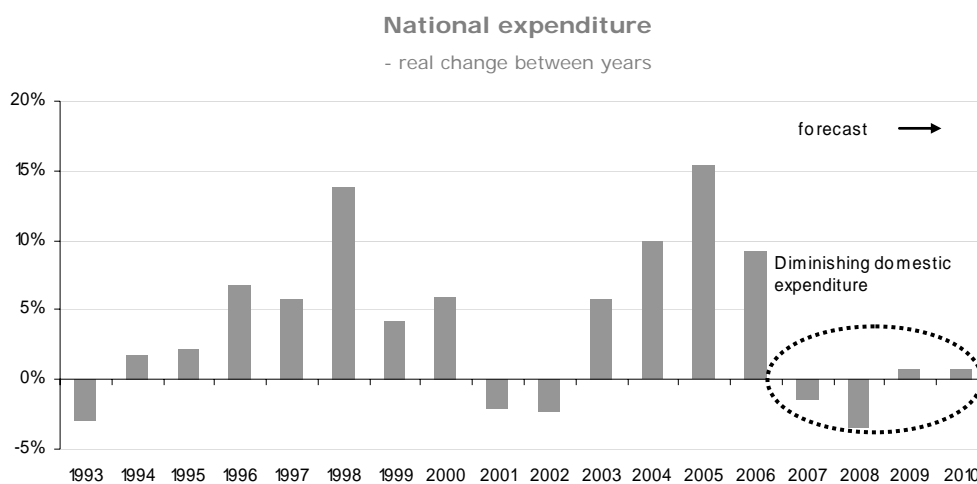
- Euro adopted within five years.
- Real interest rates same as in other euro zone countries (average 2.3% since 1999).
- Conclusion: Yield falls even more next year than assumed in Kaupthing Research's forecast and scenario 1.



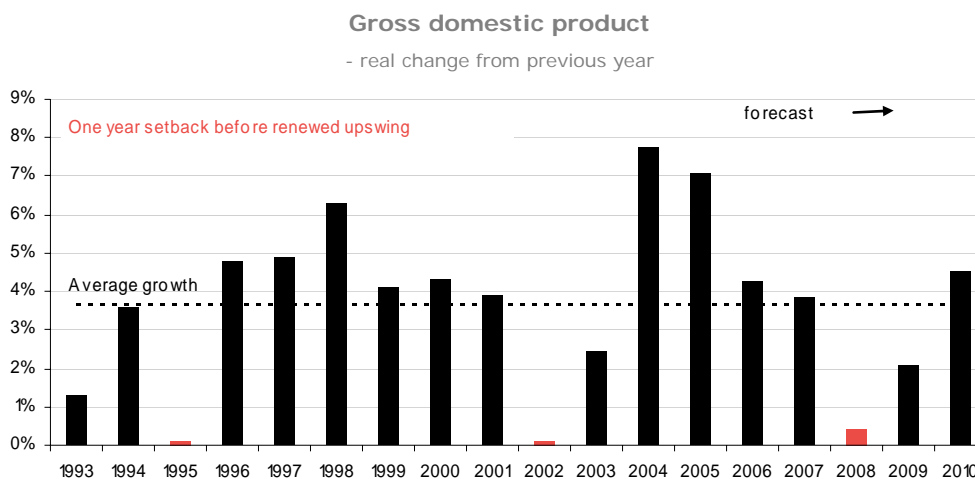
## Economic forecast: Unrest on foreign markets cools down economy

Up to now, the Central Bank's high policy interest rate has not had sufficient bite to rein in private consumption – and the signs are that there was significant growth in consumption during the fourth quarter of 2007. However, recent developments on the financial markets have triggered a cool down in the economy which started earlier and is expected to last longer than previously thought.

National expenditure will decrease during the year and will measure less than one percent throughout the forecast horizon, at the same time as private consumption and investment decrease. There will, however, only be a one year drop in economic growth before it recovers once again. Economic growth over the next few years will be fuelled by a turnaround in foreign trade, where aluminium exports will grow and imports decrease in line with shrinking national expenditure.



Sources: Kaupthing Research , Statistics Iceland



Sources: Kaupthing Research , Statistics Iceland

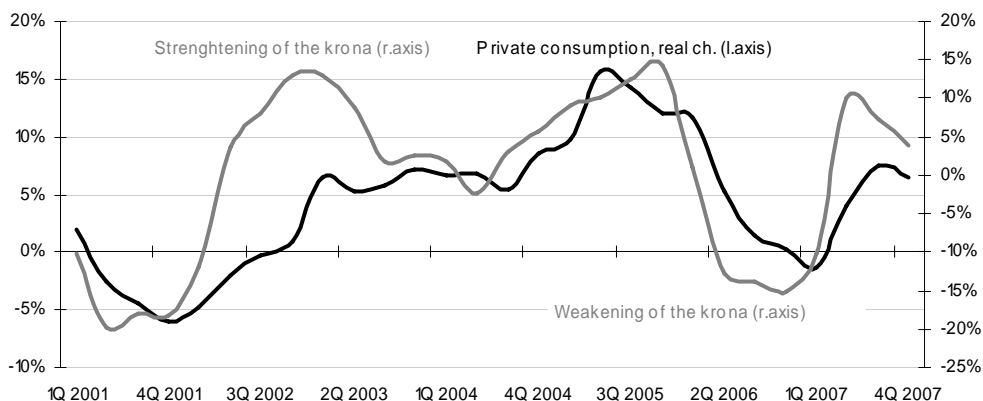
### High interest rates, weaker ISK and falling asset prices peg back consumption

Consumption in Iceland has proven to be sensitive to changes in the exchange rate of the ISK. After the sharp depreciation of the ISK between mid-2006 and early 2007, private consumption decreased rapidly. However, once the ISK began to strengthen in 2007, consumption swiftly recovered.

Kaupthing Research believes that private consumption will begin to contract as early as the first half of 2008 and that this situation will prevail into 2009, as the ISK begins to give ground.

#### Private consumption and the ISK exchange rate

- compared with real change from previous year in private consumption and depreciation/appreciation of ISK

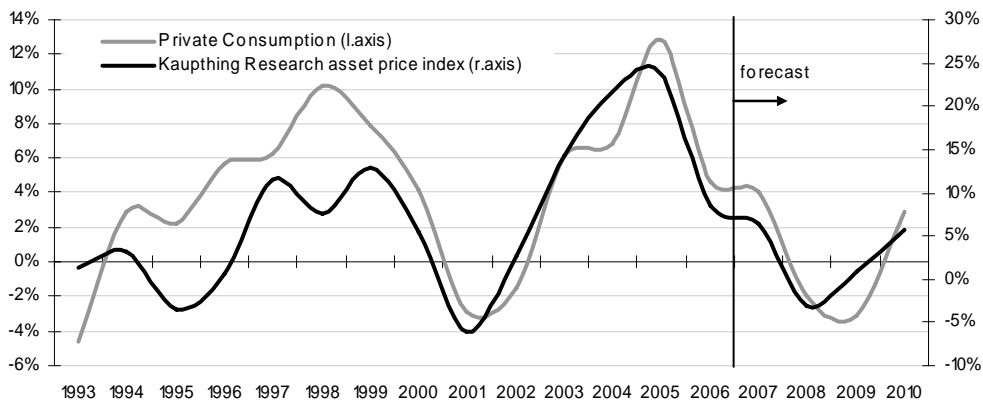


Sources: Statistics Iceland, Central Bank of Iceland

High interest rates, a weaker ISK, and falling asset prices are combining to peg back household consumption. Activity on the labour market will slow down, salary increases will decrease and unemployment will begin to rise later in the year as domestic demand rapidly recedes. Kaupthing Research expects the effects to be felt through to the end of 2009 and that the five-year upturn in private consumption which has just reached an end will be followed by a two-year drop, mirroring developments in the last economic downturn.

#### Private consumption and household asset prices

- real change between years



Sources: Kaupthing Research , FMR, Statistics Iceland, Kauphöll Íslands

## Investments down – continued public sector growth

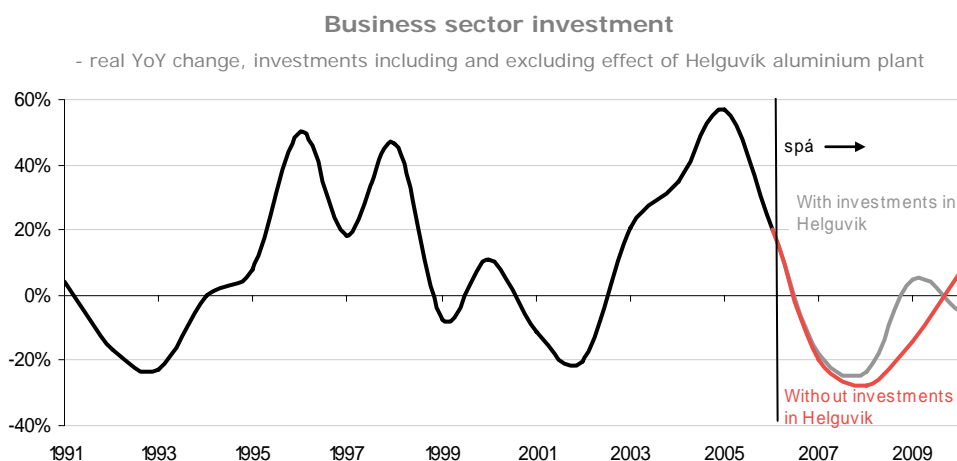
Gross fixed investment will decrease this year which will be reflected in falling business sector investments. However, growth seems likely to continue in public sector investments over the next few years. As is Kaupthing Research's autumn forecast, assumptions on further hydropower and aluminium sector investments remain unchanged, with a new aluminium plant in Helgúvík. These investments are split into two phases, the former peaking in 2010. After that public sector investment will decrease.

### Business sector investment also down

The growth in investments in recent years has largely been connected with investments in heavy industry. These projects have now largely been completed and Kaupthing Research assumes a drop in business sector investment. However, business sector investments will pick up again in 2009 solely as a result of the Helgúvík project, which will peak that year.

### Other business sector invest drops sharply

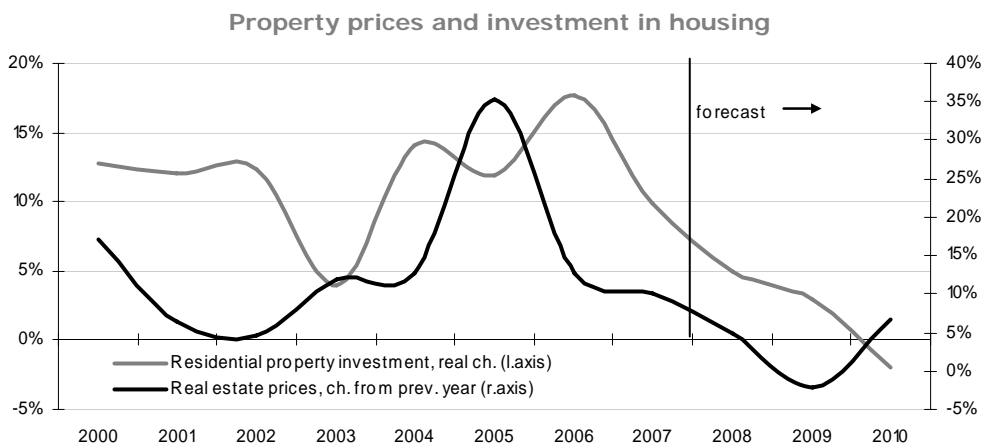
As heavy industry projects come to an end, the Icelandic economy is entering a downturn which discourages other companies from further investments. Kaupthing Research projects a major decrease in business sector investments not connected to heavy industry – a decrease which will extend until the end of 2009. The economy will start to recover in 2010, triggering new investments in the business sector.



Sources: Kaupthing Research, Statistics Iceland

### Investments in housing lose pace as market cools down

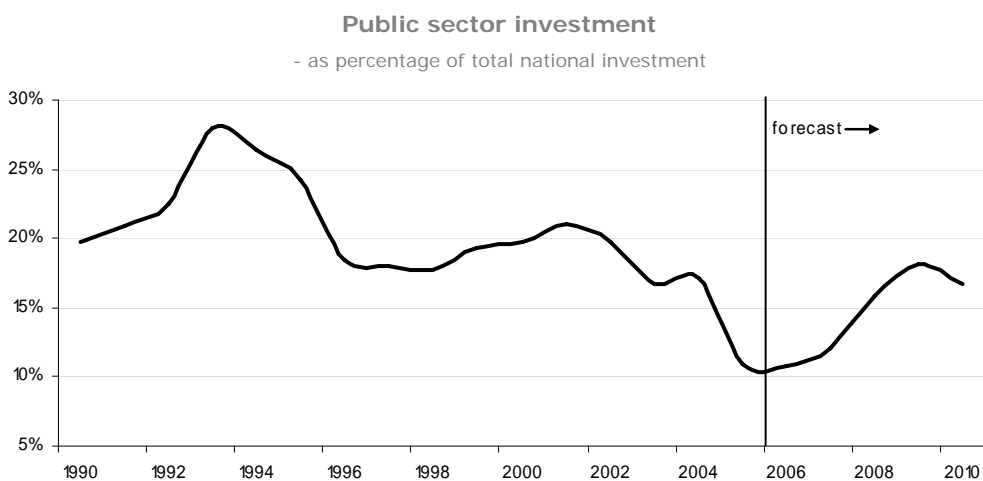
Turnover figures for the Reykjavik area in January indicate up to a 50% drop between years (measured in the number of notarised sale-purchase agreements). Activity is set to be sluggish on the real estate market, which removes the incentive to invest in new construction projects. The effect of this may be delayed since certain building projects are at different stages of completion. Consequently, Kaupthing Research assumes that the growth in investments in housing will decline and will even shrink in 2010.



Sources: Kaupthing Research , FMR, Statistics Iceland

### Sustained growth in public sector investments

As business sector investment projects wane, there will be an upsurge in public sector investment projects. Ahead lies a period of significant public sector investment, including government measures to compensate for the cut in the cod quota announced last autumn. Additional measures are also being discussed although no announcements have been made, and as a result these potential measures are not included in the present forecast.

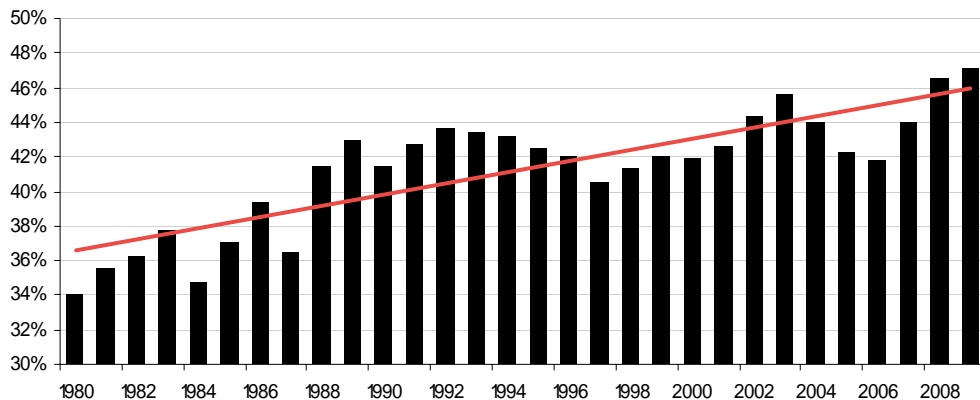


Sources: Kaupthing Research , Statistics Iceland

Public sector investments require increased spending. The ministry of finance's autumn forecast assumes that government expenditure will increase steadily over the next few years to reach 50% of GDP at the end of 2009.

### Government expenditure as a percentage of GDP

- based on ministry of finance's forecast for 2007-2009



Source: Ministry of finance

## Current-account deficit decreases

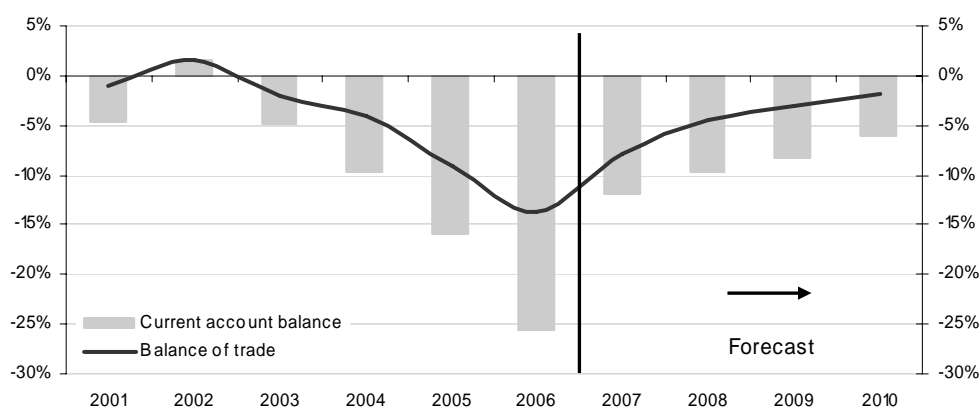
Kaupthing Research estimates that the current-account deficit will be 12% of GDP in 2007 – a vast improvement from 2006's figure of almost 26%. The deficit will continue to be eroded over the next few years, although more slowly:

- The current-account deficit in 2008 will be 9.7% of GDP
- 8.3% of GDP in 2009 and 6.3% of GDP in 2010

It is time that this trend emerged and if Kaupthing Research's forecast proves accurate, the current-account deficit will be approaching a sustainable level at the end of the forecast period. Important factors in this development are increased aluminium exports and falling demand domestically.

### Current-account balance and balance of trade

- as percentage of GDP



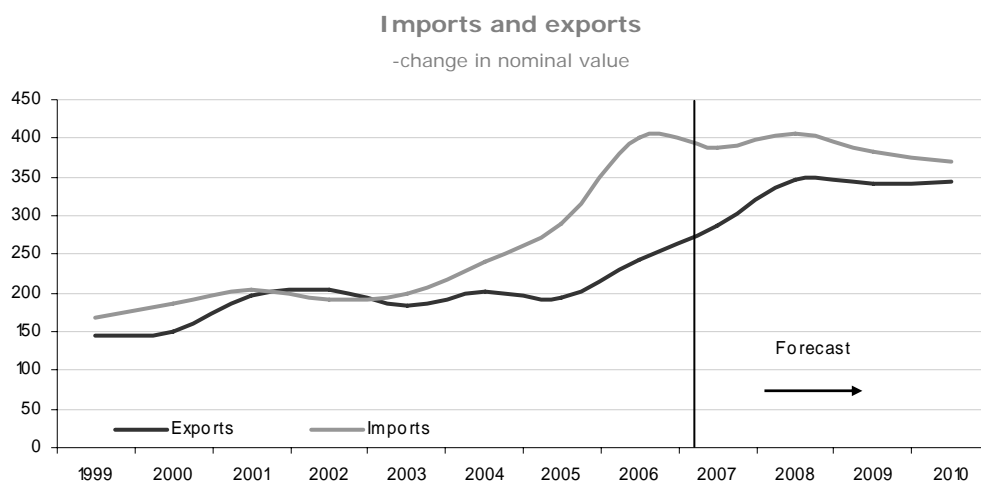
Sources: Kaupthing Research, Central Bank of Iceland

## Aluminium boosts current-account balance

One of the main reasons behind the massive trade deficit in recent years has been increased imports linked to hydropower and aluminium sector investments and high levels of private consumption. Delays to the construction projects in eastern Iceland have meant that the trade deficit has fallen less quickly than previously expected. However, the wheels have started to turn in eastern Iceland and Kaupthing Research estimates that 315,000 tonnes of aluminium will be exported in 2008 and that the full production capacity of 346,000 tonnes will be reached in 2009. At the same time aluminium prices have moved in the right direction which helps tip the scales. Kaupthing Research forecasts that the trade deficit will be 4.5% in 2008 and will continue to improve throughout the forecast period. Despite this positive change, the deficit will still be substantial in comparison with other nations.

### Increasing exports

Kaupthing Research estimated that the export value of aluminium will increase from just over ISK 80 billion to ISK 135 billion this year, before climbing to ISK 140 billion in 2009. At the same time, the export value of aluminium will exceed that of marine products for the first time this year. Following the 33% cut in cod quotas last summer, the value of marine products slumped by approximately ISK 15-20 billion, the effects of which will be felt in full over the next few years. Kaupthing Research expects construction to get underway in Helgúvík this year and that the first phase will be completed in 2010. An official announcement is expected shortly, and preparations have already begun. Nordurál's new aluminium plant in Helgúvík, with a capacity of 150,000 tonnes, will therefore commence production early 2011. According to the preliminary report, the second phase is planned for completion in 2015, when the total production capacity will be 250,000 tonnes.



Sources: Kaupthing Research , Statistics Iceland

### Is aluminium the only option?

Apart from Helguvík, the future of other heavy industry projects is far less clear at the moment. The likelihood of a new aluminium plant being erected in Thorlákshöfn or elsewhere in southern Iceland receded after Landsvirkjun changed its approach and decided not to get into negotiations with companies intending to construct new aluminium plants in southern or western Iceland. Instead the company has opted to put its resources into activities such as server farms or companies involved in purifying silicon for solar batteries, in the hope of maximising the price obtained for electric power and to diversify its business.

Plans for an aluminium plant at Húsavík have not yet been shelved and Kaupthing Research believes that calls to get this project off the ground will become louder towards the end of the current economic cycle, when signs of a downswing become more evident.

## Economic forecast 2007-2010

<b>Real change between years, %</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Private consumption	4,6	4,1	-2,0	-3,1	2,9
Public consumption	3,9	2,9	3,5	3,2	2,5
Gross fixed capital formation	19,8	-10,7	-12,1	7,0	-5,7
- Business sector investment	20,0	-18,1	-23,6	4,7	-5,2
- Residential property investment	17,8	9,9	5,0	3,0	-2,0
- Public investment	22,3	0,5	15,0	22,2	-12,9
<b>National expenditure</b>	<b>9,2</b>	<b>-1,3</b>	<b>-3,4</b>	<b>0,7</b>	<b>0,7</b>
Exports of goods and services	-5,1	18,8	6,8	4,4	0,9
Imports of goods and services	10,1	1,2	-3,5	0,9	0,2
<b>GDP</b>	<b>4,2</b>	<b>3,9</b>	<b>0,4</b>	<b>2,1</b>	<b>4,5</b>
Current account balance, % of GDP	-25,6	-11,9	-9,7	-8,3	-6,1
- thereof trade balance, % of GDP	-13,6	-7,9	-4,4	-3,0	-1,8
<b>Average change from previous year (%)</b>					
Consumer price index	6,8	5,1	5,4	2,4	3,6
Nominal wages	9,5	9,0	6,9	4,8	6,0
Purchasing power	2,7	3,9	1,5	2,4	2,4
Unemployment according to Directorate of Labour	1,3	1,0	1,9	3,0	3,2
Unemployment according to Statistics Iceland	2,9	2,3	3,0	4,1	4,0
Real estate prices	12,7	10,2	4,9	-2,1	6,8
Effective price of foreign currency	11,7	-2,1	11,1	-5,5	-3,0
<b>Yearly average (%)</b>					
Policy rates	11,8	13,4	11,9	7,5	6,8
Policy rates in real terms*	6,8	7,9	6,2	5,0	3,1
Policy rates in real terms**	10,3	7,8	7,8	5,2	2,4
ISK trade weighted currency index	121	118	132	124	121
EUR	88	88	98	91	87
USD	70	64	71	69	68

\* using 12 month inflation

\*\* using annualised quarterly inflation

Sources: Kaupthing Research , Statistics Iceland, Central Bank of Iceland

### Inflation forecast

	Changes from prev. year(%)	Quarterly changes (%)
1Q 2008	5,9	1,2
2Q 2008	6,4	1,7
3Q 2008	5,7	0,7
4Q 2008	3,8	0,2
1Q 2009	3,3	0,7
2Q 2009	2,1	0,6
3Q 2009	1,9	0,4
4Q 2009	2,2	0,5
1Q 2010	2,7	1,2
2Q 2010	3,5	1,3
3Q 2010	4,0	1,0
4Q 2010	4,2	0,7

### Exchange rate forecast

	ISK TWI	EUR	USD
1Q 2008	126	96	65
2Q 2008	136	101	72
3Q 2008	136	100	74
4Q 2008	130	96	71
1Q 2009	127	93	70
2Q 2009	125	92	69
3Q 2009	123	90	69
4Q 2009	122	89	68
1Q 2010	121	88	68
2Q 2010	121	88	68
3Q 2010	120	87	68
4Q 2010	120	87	69

Sources: Kaupthing Research , Statistics Iceland, Central Bank of Iceland

### Policy rate forecast (%)

	Policy rate	Annual yield	Policy rates in real terms*	Policy rates in real terms**
Q1 2008	13,4	14,4	7,1	8,3
Q2 2008	12,4	13,2	5,7	5,2
Q3 2008	11,3	12,0	5,4	8,5
Q4 2008	10,3	10,9	6,4	9,3
Q1 2009	9,1	9,5	5,7	6,3
Q2 2009	7,5	7,8	5,3	5,2
Q3 2009	6,7	6,9	4,8	5,0
Q4 2009	6,5	6,7	4,3	4,3
1Q 2010	6,5	6,7	3,8	1,8
2Q 2010	6,5	6,9	3,0	1,0
3Q 2010	6,7	6,9	2,5	2,6
4Q 2010	7,3	7,6	2,9	4,3

\* using 12 month inflation

\*\* using annualised quarterly inflation

Sources: Kaupthing Research , Statistics Iceland, Central Bank of Iceland

## Forecast of yields on bonds

at the end of the quarter

	2Q 2008	3Q 2008	4Q 2008	1Q 2009	12 month return
<b>RIKB 09 0612</b>	10.3%	9.5%	9.2%	8.7%	13.5%
<b>RIKB 10 0317</b>	9.0%	8.4%	7.7%	7.1%	15.1%
<b>RIKB 13 0517</b>	7.9%	7.6%	7.4%	7.2%	17.5%
<b>HFF14</b>	5.0%	4.7%	4.2%	3.9%	15.7%
<b>HFF24</b>	4.4%	4.3%	4.1%	3.8%	20.4%
<b>HFF34</b>	4.1%	4.0%	3.9%	3.7%	21.3%
<b>HFF44</b>	4.0%	3.9%	3.8%	3.7%	21.9%

## Scenario 1 – Sweden

at the end of the quarter

	2Q 2008	3Q 2008	4Q 2008	1Q 2009	12 month return
<b>HFF14</b>	5.0%	4.7%	4.2%	3.8%	16.0%
<b>HFF24</b>	4.3%	4.1%	3.9%	3.7%	21.2%
<b>HFF34</b>	3.9%	3.8%	3.6%	3.4%	24.9%
<b>HFF44</b>	3.7%	3.6%	3.5%	3.3%	28.5%

## Scenario 2 – euro

at the end of the quarter

	2Q 2008	3Q 2008	4Q 2008	1Q 2009	12 month return
<b>HFF14</b>	5.0%	4.7%	4.2%	3.9%	15.7%
<b>HFF24</b>	4.4%	4.3%	4.1%	3.7%	21.2%
<b>HFF34</b>	3.8%	3.7%	3.5%	3.2%	27.4%
<b>HFF44</b>	3.5%	3.3%	3.2%	3.0%	33.8%

## Based on Central Bank's baseline forecast

at the end of the quarter

	2Q 2008	3Q 2008	4Q 2008	1Q 2009	12 month return
<b>RIKB 09 0612</b>	11.6%	10.2%	9.7%	8.8%	13.4%
<b>RIKB 10 0317</b>	9.2%	8.1%	6.6%	5.4%	17.0%
<b>RIKB 13 0517</b>	6.3%	5.7%	5.2%	5.0%	26.1%
<b>HFF14</b>	4.1%	3.5%	2.7%	2.4%	19.7%
<b>HFF24</b>	3.4%	3.1%	2.9%	3.0%	26.4%
<b>HFF34</b>	3.6%	3.4%	3.3%	3.4%	24.9%
<b>HFF44</b>	3.7%	3.6%	3.4%	3.5%	25.1%

Sources: Kaupthing Research , Ecwin, Central Bank of Iceland

## Provisional release:

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