

High policy rate paves the way to equilibrium

The economy is slowly moving towards equilibrium with a contraction in national expenditure this year, but growth will nevertheless be positive due to a turnaround in foreign trade led by a surge in aluminium exports. The ISK exchange rate will be supported by strong buying side and continue to fluctuate within a relatively narrow range due to the considerable interest-rate differential between Iceland and abroad. This range will undoubtedly widen next year, however. We believe that inflation will be around target in mid-2008 and that the current account deficit will persist.

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Icelanders upbeat, strong ISK

Icelanders remain positive on the economy, which can be seen from the fact that the consumer confidence index is at an all-time high and the main assets markets have rallied. The ISK has strengthened since the beginning of the year and been relatively steady around the trade weighted currency index value of 120 for two consecutive months in which negative events, such as a downgrading of the Icelandic state's credit rating, have been met by a very strong buy side in the ISK. It is Kaupthing Research's belief that the strength and stability of the ISK over the past months can be attributed to the Central Bank's statements that it would maintain a tight stance on interest rates over the next years and even hike rate some more in the event of a depreciation of the ISK. Such persistence, however, increases the likelihood that the currency market may experience a backlash when the cool-down starts to spread across the economy and the Central Bank's cycle of interest rate cuts begin to kick in. The real exchange rate of the ISK is not high, though, when viewed in a historical context, particularly compared to the Euro.

A cool-down in the autumn

According to Kaupthing Research's economic forecasts, the economy will be moving towards greater equilibrium with a tight monetary stance and large hydropower and aluminium sector investments drawing to an end. Aggregate expenditure is expected to contract by about 5.5% this year and remain at this level into the next, and the inflation target should be met by mid-2008.

Long-term outlook is bright

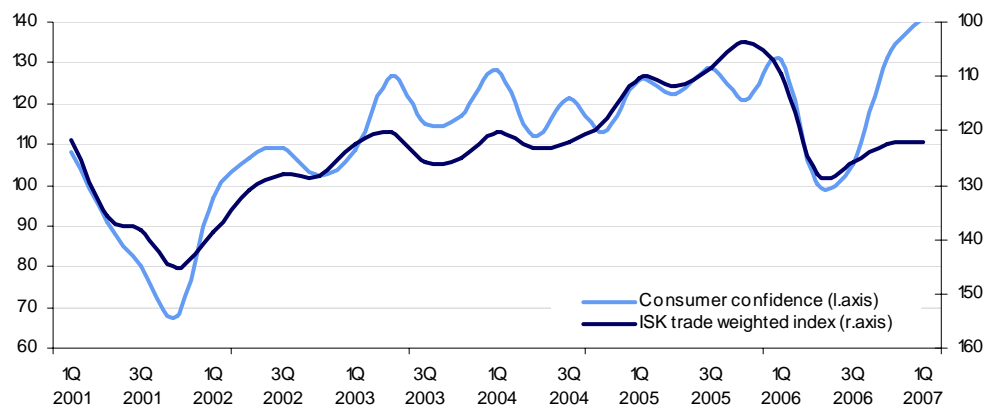
The real locomotive driving economic growth in Iceland is first and foremost the internationalization or European integration of the Icelandic economy, coupled with low taxes. This locomotive is still advancing at full-steam and will continue to pull the Icelandic economy ahead.

Short-term outlook

Cause for cheer

Some cause for cheer has returned to the Icelandic economy over the past months, which can be gleaned from, among other things, the consumer confidence index which is now at an all-time high. The main asset markets have rallied, turnover has increased on the real estate market and the OMXI-15 share index has risen by 20.7% since the beginning of the year. The optimism of households can probably be attributed to wage increases and tax cuts, which boosted their purchasing power in the first quarter by as much as 5%. It is also well-known that expectations are raised in the run-up to an election and this election year is no exception.

Forecast - ISK exchange rate

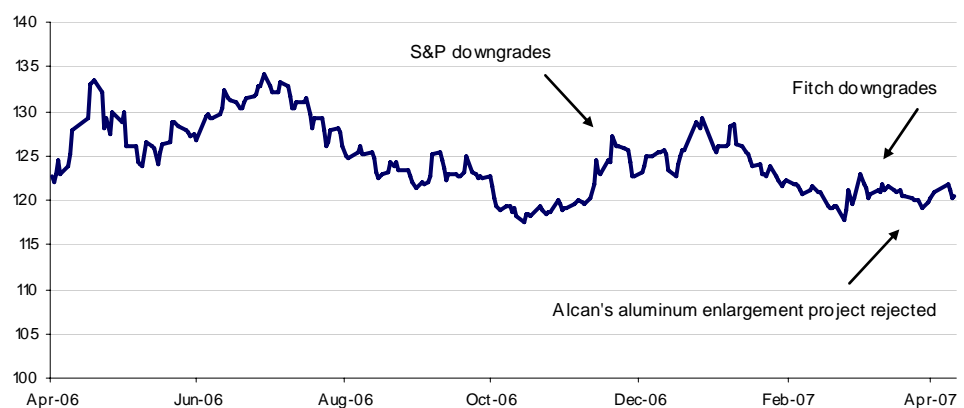


Source: The Central Bank of Iceland, Capacent Gallup

Strength of the ISK

Consumer confidence has undoubtedly been boosted by the strengthening of the ISK since the beginning of the year and its relatively steady position at an index value of around 120 for two months. This stability persisted, despite both S&P and Fitch's downgrade of the Treasury's credit rating, some turbulence on the international currency market in March, and the rejection of the expansion plan for the Alcan plant by referendum in Hafnarfjordur. In the face of these events, which should have had a negative impact on the ISK, selling pressure was met by a strong buy side on the currency market. The ISK thus seems to be trading within a certain range around 120 since any rise in the index is used as a buying opportunity. Both foreign and Icelandic investors seem to be drawn to the ISK, as can be seen from the large issuance of ISK-denominated bonds and an increase of foreign borrowing in Iceland.

The exchange rate of the ISK over the past 12 months



Source: Central Bank of Iceland

The Central Bank maintains exchange rate

In the opinion of Kaupthing Research, the strength and stability of the ISK over the past months can be attributed to the Central Bank's statement regarding its intention to maintain a tight stance on interest rates over the coming years, combined with its promise to hike interest in the event of a depreciation of the ISK. The Central Bank has published an interest rate forecast projecting a 20-25% increase in accumulated interest differential over the next 2-3 years, and promised to raise interest further if the exchange rate drops. In other words, if these interest statements are to be believed, the exchange rate of the ISK may drop by about 20-30% until 2009 without borrowers of foreign short-term loans sustaining any losses, if the Icelandic cost of capital is taken into account during the period.

Outlook for the next 6-12 months

Kaupthing Research expects the ISK will continue to trade within a narrow band in the second quarter and probably the third. This band, however, may widen somewhat as the year progresses, but in view of the current situation it is difficult to envisage anything other than that there will be a strong buy side in the ISK every time the exchange rate index comes close to the 130 mark. It should be borne in mind, however, that such a narrow band on the currency market can disappear relatively fast, as it did last spring when currency expectations were overturned in the space of a few weeks. On the other hand it is difficult to see any imminent trigger event which could bring such a situation about unless the carry trade were to fall globally or the combined effect of diminishing growth expectations and worsening macroeconomic conditions here in Iceland would at some point in time erase the buying side on the currency market.

This narrow band of the ISK will mean that inflation can subside relatively swiftly now in the spring months as the economy shifts towards greater stability with the Central Bank's tight monetary policy and the completion of large hydropower and aluminium sector investments. According to the economic forecast of Kaupthing Research, national expenditure will contract by around 5.5% this year and remain at this level into the next. The macroeconomic forecast assumes the ISK will depreciate by about 10% over the next 12 months which will contribute to the cooling of the economy.

Such a high and steady exchange rate, however, increases the danger of heightening tensions present in the economy. The public will see a considerable boost in purchasing power and, at the same time, businesses and individuals will feel they can substantially lower costs of capital by taking foreign loans. Equally it is clear that the current position of the exchange rate is fuelled by the high policy rate and continuous position-taking in the ISK and this will weigh on the currency once the Central Bank begins cutting policy interest rate. One should bear in mind, however, that at this point in time the real exchange rate of the ISK, when viewed in its historical context, is not particularly high compared to the euro.

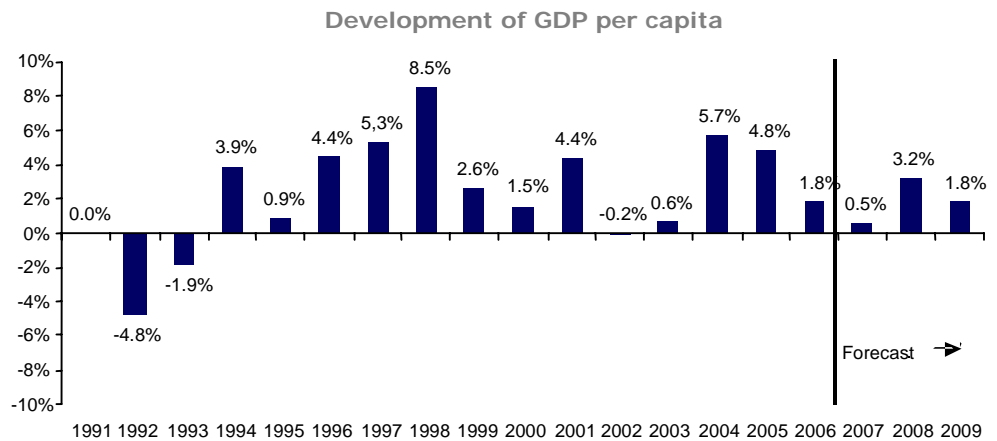
This should be considered a fairly good approach for a landing, notwithstanding the high expectations, some ongoing pressure on wages and the delicate balance in the currency market, but there is still no guarantee that it will be a soft landing. In other words, it is not known whether a tolerable equilibrium can be achieved in the economy without some period of further instability. But by landing we mean that inflation will be close to the inflation target set by the Central Bank, that excess demand will not give rise to wage increases on the labour market, and that the trade deficit will be reduced.

Longer-term outlook

Slowdown or long-term trend?

Looking further ahead in time, the development of the Icelandic economy can be viewed in two ways. On one hand, as an economy that is sinking towards a slowdown and, on the other, as one that has taken yet another step towards economic integration with Europe. From a slowdown point of view, the outlook is not very bright. Over the past three years national expenditure has grown by 11% between years and Kaupthing Research forecasts that, between 2007 and 2009, there will be little to no increase in national expenditure, which represents a real turnaround.

From the integration point of view, the outlook is considerably brighter. The rapid growth is not a bubble phenomenon. It doesn't stem from large hydropower and aluminium sector investments, the re-hauling of the real estate market or feeble fiscal policies. These three factors have contributed to the current overheating of the economy but the real engine of growth in Iceland is nevertheless first and foremost the internationalization or European integration of the Icelandic economy, coupled with lower taxes and liberalization. This can be gleaned from the fact that the population of Iceland has grown by 15% since 1995, while the economy has grown by 60% in real value.



Source: Kaupthing Research, Statistics Iceland

Since 1995, the Icelandic economy has been like a magnet drawing funds and labour from Europe, since the marginal productivity of these domestic factors of production has been higher in Iceland and this influx has enhanced economic growth. In addition to this, there has been the much-discussed expansion by Icelandic companies abroad. The combined effect of these convergences, international expansion, European integration, internationalization – or whatever we want to call it – permeate through the economy in a variety of ways that have a positive impact on the country by generating assets and revenues abroad and good employment opportunities at home. These international influences continue nevertheless to appear as negative factors in economic statistics as wage drift, a factor income deficit, current account deficit and accumulated foreign debt. An old Icelandic saying reminds us that a man needs strong bones to withstand the good times, and Icelanders would do well to tackle this integration process with less instability than has been witnessed so far.

Iceland is, however, not alone in this regard and shares this trend with many of the main peripheral EU countries which have been drawn to the heart of Europe as the table below shows.

Iceland compared to some peripheral EU countries

	External balance of goods and services (% of GDP)	Economic Growth (%)	HICP (%)
	4Q 2006	4Q 2006	2006
Iceland	-17,3	2,6	4,6
Estonia	-21,6	10,9	4,4
Latvia	-	11,7	6,6
Lithuania	-36,3	6,9	3,8
Hungary	8,7	3,2	4,0
Czech Republic	-7,7	5,8	2,1

Source: Statistics Iceland, Eurostat

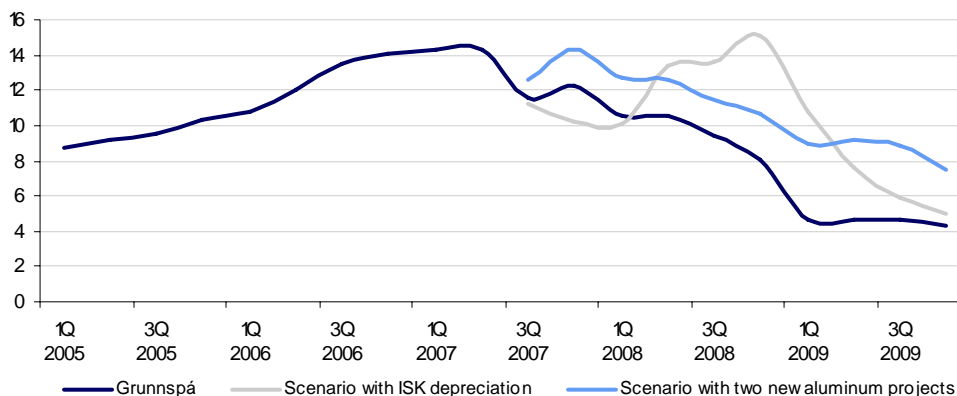
A leaking dam?

The economy is slowing down. This is clear because economic growth per capita was negative last year; while the GDP grew by a mere 2.6%, the population increased by 3% and the labour force grew by 6-7%. Kaupthing Research expects this transition to continue over the next two years so that the growth of total demand will be far less than in previous years and, in fact, a contraction in national expenditure is forecast. This does not alter the fact, however, that the favourable currents that have been keeping the Icelandic economy afloat since 1995 are still in place and the economic outlook for the future is very promising.

The current situation has been characterised by the very rigorous application of monetary policies in the face of enormous increases in national expenditure where state expenditure have combined with investments and private consumption. Unfortunately the tighter monetary stance in the Icelandic economy is in some ways, however, akin to a leaking dam, failing to fulfil its intended purpose. There is a limit to how far one can go in applying interest rates as a tool in such a small and open currency area because prolonged high rates are likely to create an incentive for currency substitution. This is one of the reasons why Kaupthing Research believes that this hard line policy on interest, which the Central Bank presented in its last Monetary Bulletin will only slow down the economy but not push it into a deep recession, particularly if conditions internationally are favourable and the expansion abroad by Icelandic companies continues without any hiccups.

Real interest rates of the Central Bank

-relative to inflation and the Bank's own policy rate path (annualised quarterly change for inflation)



Source: Monetary Bulletin March 2007

One needs to bear in mind that the revenues and costs of a large and growing part of the Icelandic economy are denominated in foreign currencies and therefore no longer carry domestic financing costs. It can in fact be said that the tight monetary stance over the past year – with a high exchange rate and high interest rates – has been a considerable incentive to expand overseas and has increased the benefits of leaving the Icelandic currency area. Furthermore Icelandic households are to a large extent protected from high real interest rates by having inflation-indexed liabilities. Despite the tight monetary stance, there haven't been any real changes in real overdraft interest, which has been at about 15% since the mid 1990's when interest was deregulated in Iceland. In other words, the competition in the banking sector with the lowering of the interest differential has in some ways offset the Central Bank's monetary policy.

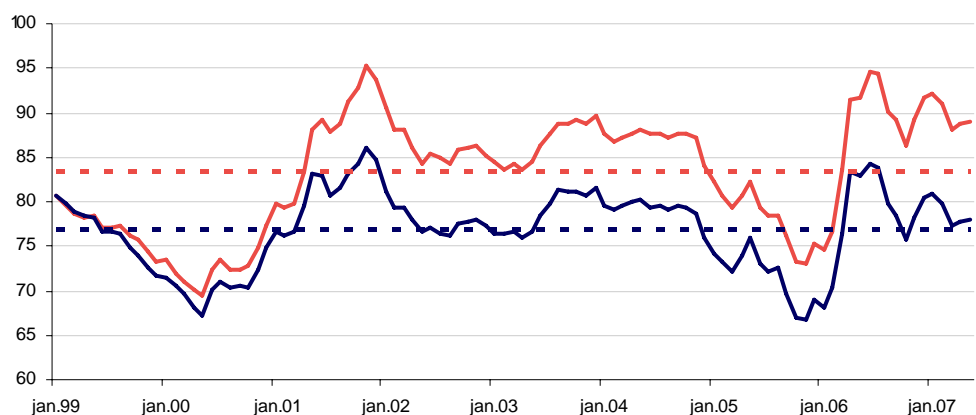
This does not mean that the Icelandic monetary policy is ineffective. However, the effects are more variable and unforeseeable than they are elsewhere since they have an uneven effect on sectors and materialize most strongly in exchange rate expectations and changes in the exchange rate. It can therefore come in spurts – when rates fluctuate or rate expectations shift. It is possible that it will be too much too late – when the Central Bank starts looking into lowering interest rates.

Is the ISK expensive or inexpensive compared to the euro?

The Icelandic króna has followed the euro quite closely since the latter was launched in 1999, both in terms of its nominal and real exchange rate. This is perhaps not surprising in view of the fact that 60% of Icelandic exports are to the eurozone and a growing proportion of Icelanders' financial liabilities are denominated in euro. One should also remember that most of the foreign market participants that trade in ISK are constantly monitoring the ISK/euro cross rate as the benchmark to whether the ISK is expensive or not.

Measured against the euro, the ISK is by no means expensive, as can be seen in the graph below – when viewing the exchange rate for the past six years. The real rate is very close to the average and the nominal value is weaker than the historical average or similar to where it was between 2002-2003. If the ISK has appreciated against other currencies, such as the US dollar, this may be attributed to its following the euro's ascent and also its strengthening against other currencies at the same time. It is also noteworthy that the real ISK/euro exchange rate has been relatively stable over these past six years, which indicates that powerful price-equalising forces are at work between the two currency areas. If this is the case, the ISK has become a kind of semi-satellite to the eurozone and it would be better if Iceland stopped using the trade-weighted average rate index and move over to the ISK/euro cross rate instead.

The real rate and nominal rate of the ISK against the Euro

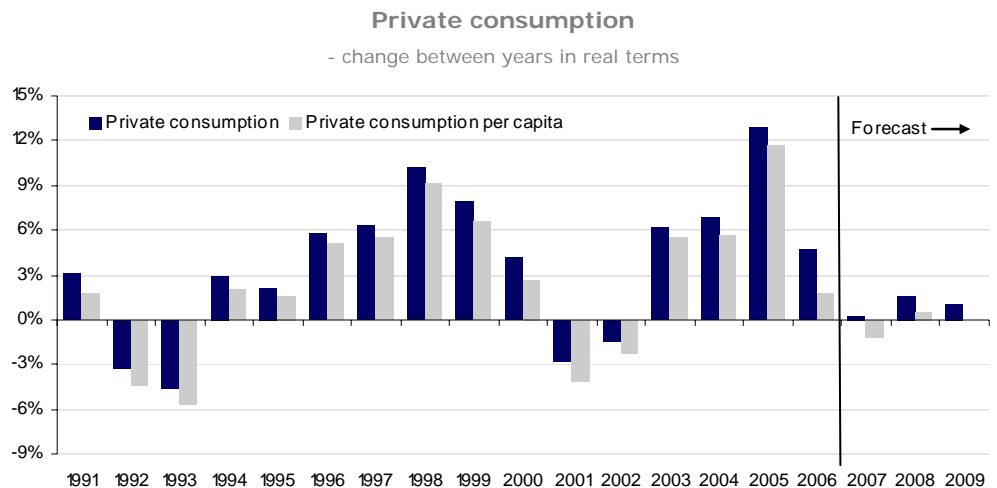


Source: Kaupthing Research, Central Bank of Iceland

Economic Forecast 2007-2009

Private consumption

Private consumption increased by 4.6% in real terms in 2006, compared to 13% growth in 2005, according to estimated data from statistics Iceland. The consumption growth decreased fast in the last quarter of 2006 and was 1.2% in 4Q 2006 from the same quarter last year, which is the lowest growth in 4 years. Lower growth is attributable to high inflation, depreciation of the ISK and high interest rates. Kaupthing Research estimates that households' purchasing power increased by 5% in 1Q 2007, due to lower inflation and high wage increases, which could reveal further growth in consumption in that quarter. Kaupthing Research, however, estimates that interest rates will remain high this year, which will undermine household higher purchasing power. Due to the above-mentioned assumption, Kaupthing Research estimates that private consumption will increase by 0.3% this year. In 2008-2009 growth is expected to be between 1-1.6%, due to lower interest rates and inflation.



Source: Kaupthing Research, Statistics Iceland

Public consumption

In 2006 public consumption grew by 2.9% in real terms according to estimated data from Statistics Iceland. Kaupthing Research estimates that public consumption will increase by 2.5% in real terms this year. Thereof it is estimated that government spending will grow by 2% in real terms, which is in line with the government's long-term targets. In 2008-2009 it is estimated that public spending will increase by 3%.

Business sector investment

Previous years have been characterized by high levels of investment in the economy, which were mainly fuelled by the current aluminium and hydropower sector investments. According to estimated data from Statistics Iceland, business sector investment grew by 14% in real terms last year, which was higher than Research had expected, since investment in other sectors of the economy was also high. Kaupthing Research believes that business sector investment will decrease by 26% this year, mostly due to contraction in the aluminium and hydropower sector investments. As was mentioned in the Quarterly Economic Outlook in January, Kaupthing Research believes that it is more likely than not that there will be further investments in the aluminium and hydropower sectors once the current investments come to an end. Now that it is clear that the Alcan expansion in Hafnarfjörður will not take place, Kaupthing Research believes that it is likely that a new plant will be constructed in Helgúvík instead, as there is now energy available. The economic forecast therefore takes into account investments in Helgúvík. The project in Helgúvík is similar in size to Alcan's but will

probably be spread over a longer period of time. Research expects business sector investment to decrease by 12% in 2008. By 2009 the heavy industry projects are expected to be well advanced and business sector investments are expected to grow by 7% in real terms from the previous year.

Residential property investment

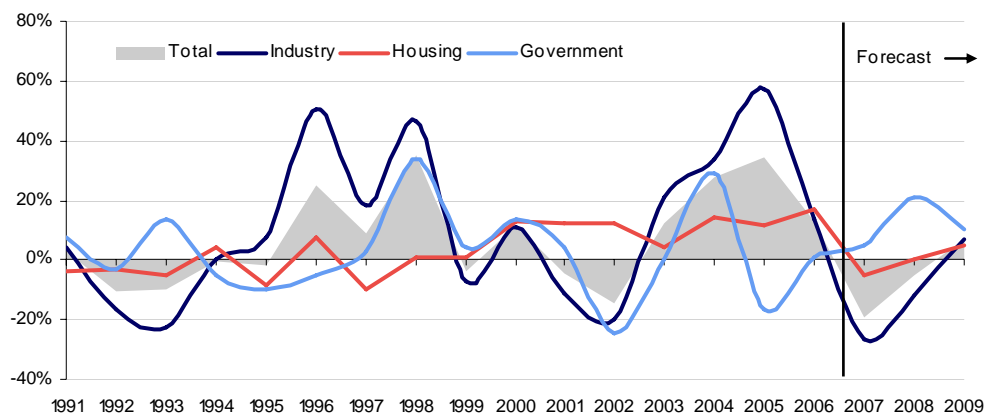
Investment in residential property rose by 17% in real terms last year, which is the highest growth in 33 years. Over the last two years the great increase in residential property prices has provided an incentive to construct new housing. It appears that the housing market is cooling slower than was expected. Kaupthing Research therefore expects smaller decreases in residential property investment this year than was previously forecast. This year Research expects a 5% drop in residential property investments and unchanged growth next year. In 2009 Research expects a further expansion on the housing market and residential property investment to grow by 5%.

Gross fixed capital formation

At the same time as Research expects business sector and residential property investments to drop, it also expects public sector investment will grow considerably over the next few years. However, the government's share in total investment is only around 10%, therefore gross fixed investment is mostly determined by evolutions in the business sector and residential property investments. Based on the assumptions set out above, Kaupthing Research expects the gross fixed investment to drop by 19% in real terms this year and 5% next year. In 2009 Research expects gross fixed investment to grow by 7%, as heavy industry investment will be well advanced and slight growth in residential property investments.

Gross fixed capital formation

- change between years in real terms



Source: Kaupthing Research, Statistics Iceland

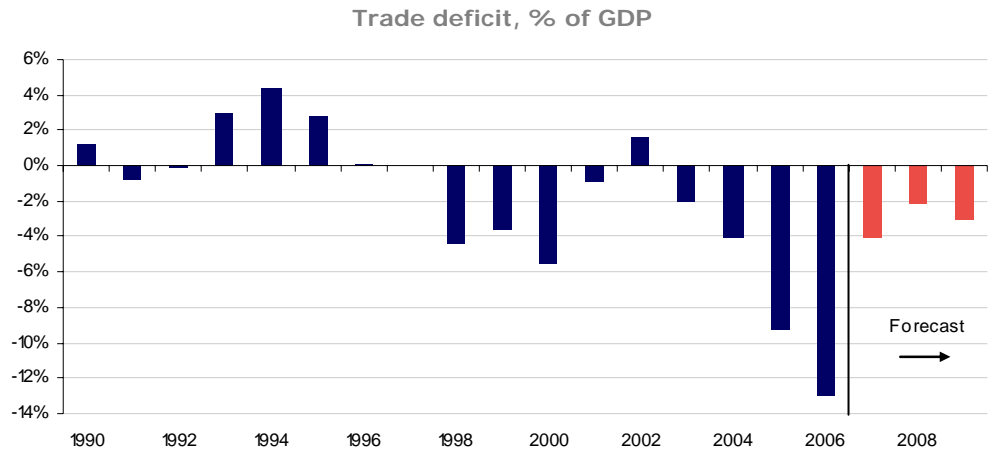
National expenditure

Based on the assumption set above, Kaupthing Research estimates the national expenditure to decrease by 5.5% this year compared to 7% growth in 2006. The contraction in national expenditure this year is mostly explained by a drop in heavy industry investment. In 2008, national expenditure is expected to grow by 0.4%, due to further growth in private consumption. Kaupthing Research expects national expenditure to grow by 2.8% in 2009, as heavy industry investments are expected to increase once again.

Trade balance

The trade deficit reached an all time high last year and was around 13% of GDP. The high deficit last year is due to increased imports in relation to large scale investment projects and growth in private consumption. It is clear that there will be a turnaround in the trade balance this year, which is supported by the figures for Q1. According to preliminary figures from Statistics Iceland, the trade deficit amounted to ISK 18 bn in the last three months, compared to ISK 36 bn in Q4 2006. Exports rose by 13% in Q1

compared to the same period last year on a fixed rate of exchange while imports were slightly down. Research expects to see a drop in imports this year in line with decreased investment. At the same time, exports will rise due to increased aluminium production. Research expects the trade deficit to amount to 4% of GDP this year and to be around 2% of GDP in 2008. In 2009 Research expects the deficit to rise to 3% of GDP, due to further aluminium investments.



Source: Kaupthing Research, Central Bank of Iceland

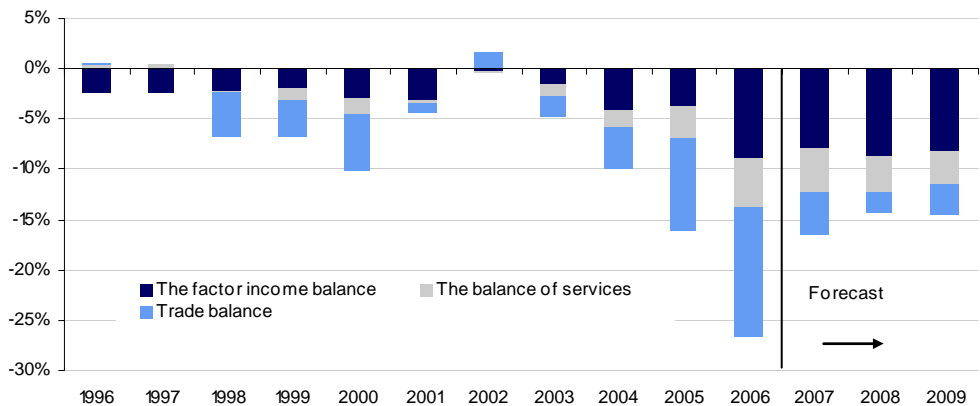
Balance of services

The deficit on the balance of services was around 5% of GDP last year. Research expects it to narrow slightly this year to around 4.5% of GDP. In the next two years 2008-2009, Research forecasts a deficit amounting to 3.5% of GDP. Research expects exports of goods and services to rise by 12% this year and around 11% in 2008 and by around 5% in 2009. Regarding imports, Research forecasts a drop of around 10% this year, which will remain unchanged in 2008, but expects imports to rise again in 2009 with further investment projects.

Current account

The current account deficit amounted to 26.7% of GDP in 2006. Around one third of the deficit was due to a deficit on the factor income balance, which increased substantially at the end of the year. In the latter half of 2006 the factor income deficit amounted to ISK 69 bn compared to ISK 25 bn in the first half. Increased deficit on the factor income balance can be traced back to a deterioration of the net foreign asset position, but there is increased imbalance between interest rate income and expenditure. Research forecasts the deficit will be around 8% of GDP in the next few years. All in all Research expects the current account deficit to be around 16.5% of GDP this year, around 14.3% of GDP in 2008 and around 14.5% of GDP in 2009.

Current account deficit – Kaupthing Research's forecast



Source: Kaupthing Research, Central Bank of Iceland

Kaupthing Research's economic growth forecast

The main driving force behind economic growth in 2006 was high business sector investments and growing private consumption. According to estimated data from Statistics Iceland, economic growth was 2.6% last year. Kaupthing Research expects economic growth to be similar this year, i.e. 2%, but unlike the previous year, the main force will be the turnaround in foreign trade. In 2008 Research expects 4.2% growth which can be mainly explained by the continuing increase in exports, as well as growing private consumption. Research expects economic growth to slow down in 2009 to 2.8% as imports of goods and services increase, due to further investments in the aluminium and hydro power sector.

Economic Forecast 2007 - 2009

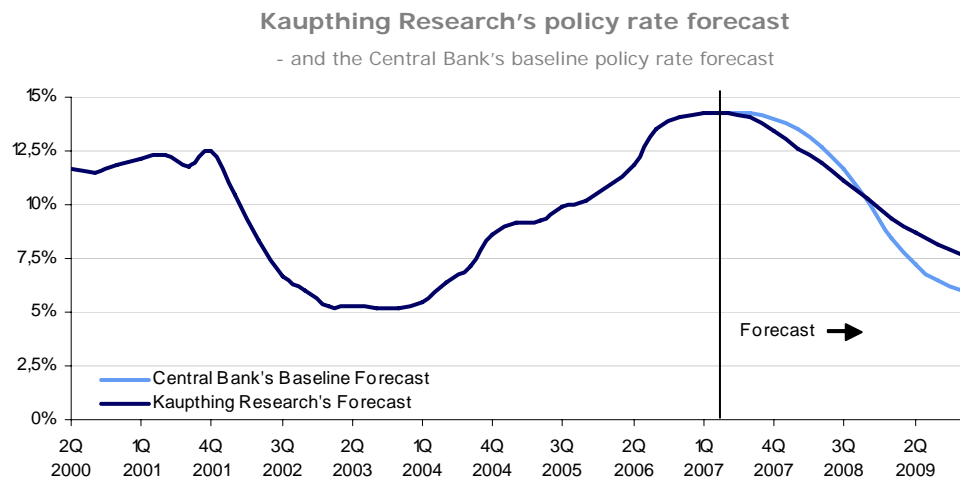
Real change between years, %	2006	2007	2008	2009
Private consumption	4,6	0,3	1,6	1,0
Public consumption	2,9	2,5	3,0	3,0
Gross fixed capital formation	13,0	-18,9	-4,9	7,1
- Business sector investment	13,8	-26,3	-11,9	7,2
- Residential property investment	17,2	-5,0	0,0	5,0
- Public investment	0,8	5,0	21,3	10,0
National expenditure	7,4	-5,5	0,4	2,8
Exports of goods and services	-5,6	12,0	11,0	5,0
Imports of goods and services	8,8	-9,1	0,4	4,8
GDP	2,6	2,0	4,2	2,8
Current account balance, % of GDP	-26,7	-16,4	-14,3	-14,4
- Trade balance	-12,9	-4,0	-2,1	-3,0
- Balance of services	-4,8	-4,5	-3,5	-3,3
- Factor income balance	-9,1	-7,9	-8,7	-8,1

Source: Kaupthing Research, Statistics Iceland

Policy Rate Forecast 2007-2009

Forecast on Central Bank Policy Rates

The Central Bank's current cycle of policy rate hikes is over in Kaupthing Research's view and the uncertainty now revolves more around when the bank will start the process of cutting rates. There are indications that the economy is starting to slow down as the main aluminium projects are being finalized and private consumption growth has reached a two year low. The Central Bank now claims that the current monetary stance is sufficient to bring inflation down to target (2.5%) within an acceptable time frame and that it will start lowering rates in November. Private consumption growth may have picked up in Q1 2007 as consumer expectations have been at an all time high. However, we believe that there will be sufficient signs later this year for the Central Bank to start lowering rates in September by 50 bp. The forecast assumes that rates will drop by around 50 bp on the following meetings (there are six meetings per year) but that the pace will increase in the second half of 2008. Policy rates will be around 13.25% at the end of 2007, 10% at the end of 2008 and 7.5% at the end of 2009.



Source: Kaupthing Research, Central Bank of Iceland

The Central Bank's baseline forecast assumes a slower cycle of declining rates than Kaupthing Research in the first half of the forecast period (2007-2009) but more cuts in the second half. The difference is partly explained by different growth forecasts. The Central Bank assumes a large decrease in investment and considerable unemployment at the second part of the period. This is quite pessimistic in comparison to our forecast, partly because we assume there will be another aluminium project. Kaupthing Research's forecast is roughly in line with the interest rate expectations implied by the swap rates.

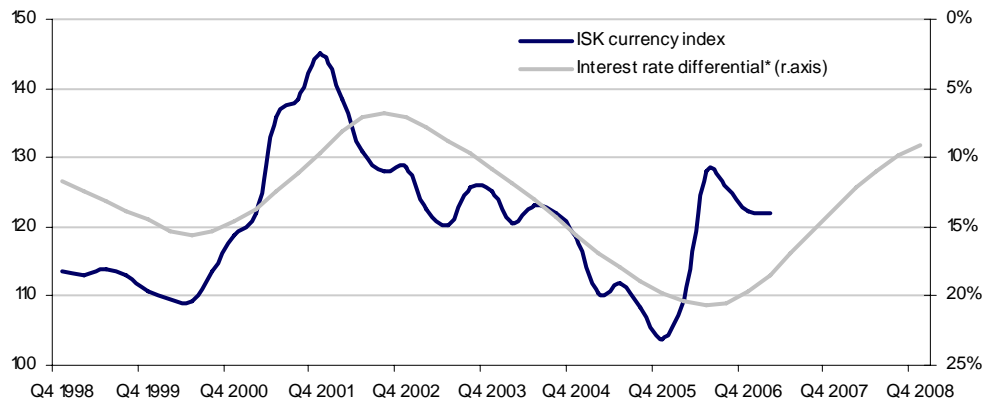
Exchange Rate Forecast 2007-2009

Resilience of the Icelandic krona

The Icelandic krona was in a downswing at the beginning of the year after Standard and Poor's downgrade of the Republic of Iceland. Since then the currency has strengthened and remained quite stable around EUR/ISK 88.5 or 120 on the trade weighted index. The stability has been remarkable when negative news flows over the period are taken into account. There was a global market downswing at the end of February which eroded carry-trades, and record high current account deficit figures in March which led to a sovereign downgrade from Fitch. Furthermore, Alcan's proposed aluminium project which would have supported the ISK was rejected in a referendum. This news should have affected the ISK negatively but there was a strong buying side for the ISK on the currency market. To mention a few examples, considerable amounts of Eurobonds in ISK have been issued and locals have been swapping their loan portfolios for foreign denominated debt.

The most obvious explanation for the krona's resilience is the high interest rate differential with abroad which encourages position taking in the ISK by foreigners as well as foreign borrowing by locals. The Central Bank's policy rates are currently at 14.25% which is quite high in a global perspective. As the diagram below shows, the accumulated interest differential between Iceland and the main trading partners is estimated to be around 18%. Therefore, the ISK may depreciate by 18% in the next two years before position taking in the ISK bears a loss. Furthermore, the Central Bank has said it would respond by hiking rates if the currency was to depreciate significantly. Therefore, the ISK could depreciate by more than 20% over the next two years before position taking in the currency would produce losses.

Interest rate differential with abroad and the ISK



*Expected cumulative interest differential with abroad over the next two years

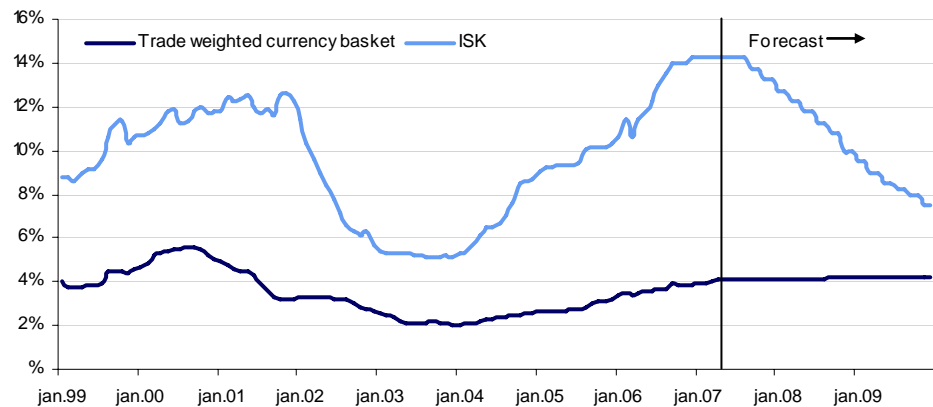
Source: Kaupthing Research, Statistics Iceland

The road ahead: Shrinking interest rate differential

Although the ISK is refusing to budge at the moment, there are some signs that suggest that this will change in the medium term. The interest rate differential with abroad will shrink considerably in 2008 and 2009 if Kaupthing's policy rate forecast proves to be correct. The differential is currently at 10% but will reach 4% in 2009 according to the forecast (3 month rates, ISK and trade weighted basket). A lower interest rate differential will decrease the incentive for ISK position taking. Expectations of policy rate cuts will keep the ISK from rising far above EUR/ISK 88.5 or 120 on the trade weighted index in Kaupthing Research's view.

Outlook for interest rate differential

- 3 month rates in ISK and trade weighted currency basket



Source: Kaupthing Research, EcoWin

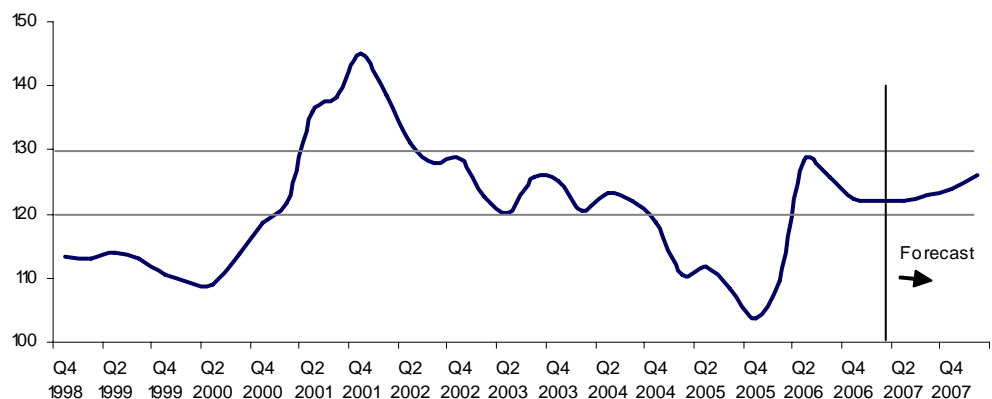
There are few signs of significant monetary tightening in other economies in general in the next 12 months. Nevertheless, higher policy rates in low-yield countries could have a large impact on global markets and high yield countries such as Iceland in particular. For example, policy rate hikes by the Bank of Japan could cause the yen to strengthen which could erode carry trades and therefore impact the ISK.

Exchange rate forecast

Short term forecast: ISK strong for the next 6-12 months

Kaupthing Research expects the ISK exchange rate to waver within the 120-130 band over the next 6-12 months. Expectations of a drop in the exchange rate due to the prospect of a reduction in the interest differential with abroad and the ongoing current account deficit will probably encourage position-taking in the ISK if it goes higher than the 120 index value and therefore prevent any further strengthening. On the other hand, a large group of people, both in Iceland and abroad, is waiting on the sidelines for position-taking in the ISK when the exchange rate index comes close to the 130 mark, particularly individuals and businesses interested in foreign loans.

Exchange rate forecast – Next 6-12 months

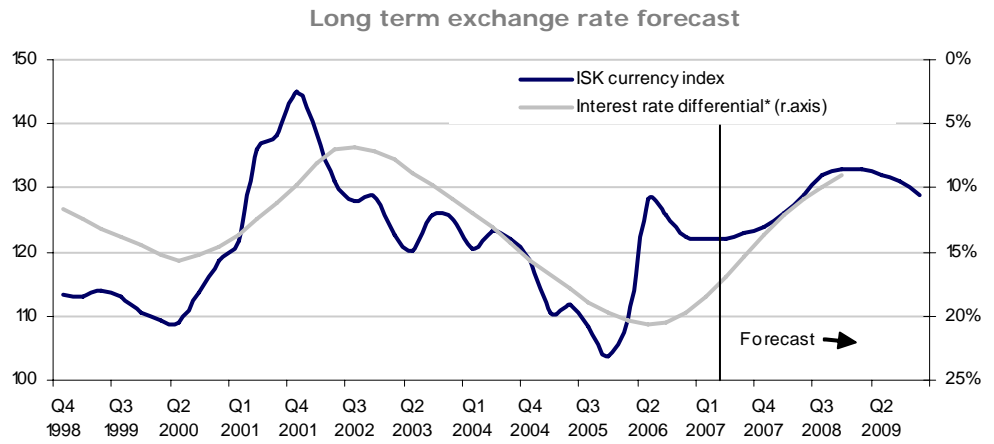


Source: Kaupthing Research, Central Bank of Iceland

Long term forecast: EUR/ISK reaches 96 in 2008

Kaupthing Research expects the ISK to depreciate next year with the EUR/ISK reaching 96 in Q2 2008 but to move back below that level in 2009 (130 on the ISK index). The EUR/ISK will be at 96 on average in 2008 and 2009 and therefore the ISK index will be around 130.

In short, the forecast assumes depreciation of the ISK but no big shocks on the currency market. The depreciation we forecast equates to the interest differential with abroad and furthermore it would bring the real exchange rate down to its average value. It should be noted, however, that there is great uncertainty in the forecast, not least regarding the assumptions regarding the Central Bank's policy rate.



*Expected cumulative interest differential with abroad over the next two years

Source: Kaupthing Research, Central Bank of Iceland

Inflation Forecast 2007-2009

The 12-month rate of inflation now measures 5.3%, the lowest since March last year. The tax cuts in March have lowered the annual rate substantially but there still seems to be considerable inflation pressure in the economy. Statistics Iceland has estimated that excluding the VAT tax cuts annual inflation would stand at 7.1%.

The real estate market is leading the inflation

The real estate market was quite lively at the beginning of the year which led to a rise in the CPI. From January to March, housing prices rose on average by 2.4% between months. The main reason for the pickup in the market is increased competition in the mortgage market and recent popularity of foreign mortgage loans by Icelandic households. The housing market is crucial regarding the development of the CPI. First of all, housing prices weigh heavily in the CPI and secondly, rising housing prices cause a wealth effect in the economy with pressure on domestic demand. However, Research expects this to be temporary and the market to cool down near the end of the year. In Research's opinion, housing prices will rise on average by 5.1% this year, around 2.3% in 2008 and in 2009 by 2.6%.

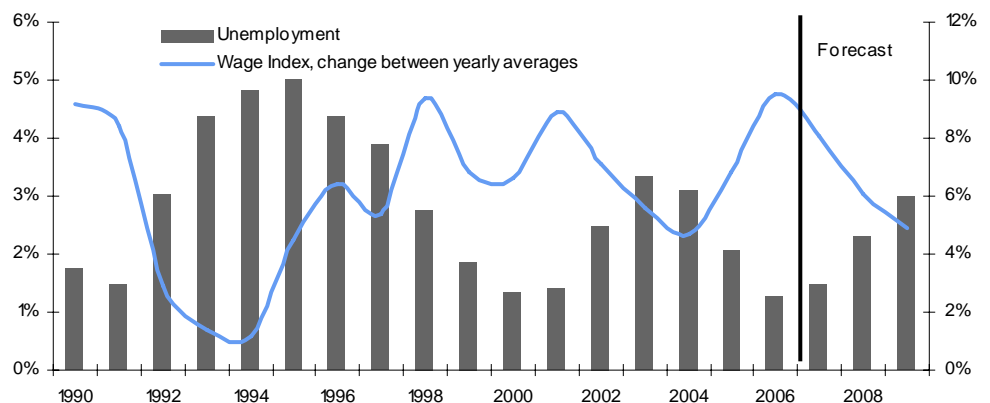
Domestic demand

For inflation to subside it is crucial that domestic demand cools down. In the latter half of 2006 the growth of private consumption slowed down considerably but there are indications that it picked up again in Q1 2007 in line with increased purchasing power. One indicator is the Consumer confidence index which reached an all time high in February and March. Furthermore, turnover in retail sales was up at the beginning of the year and revenue from value added taxes rose in the first two months of the year. Research however expects to see private consumption slow down by the end of the year, leading to less inflationary pressure. All in all Research forecasts national expenditure to drop by 5.5% in 2007.

The labour market

Wages have risen quite sharply in the last few quarters and put pressure on the price level. Twelve month rise in wages, according to Statistics Iceland's wage index, now stands at 9.8%. In the first two months of the year, wages rose by 3.9% which should support private consumption. Research expects to see wage growth to slow in the latter half of the year - in line with a drop in national expenditure and increased unemployment. This will cause less inflationary pressure in the economy. On average Research forecast a 8.1% rise in wages this year, around 6.1% rise in 2008 and a wage growth of 4.9% in 2009.

Unemployment and wage growth



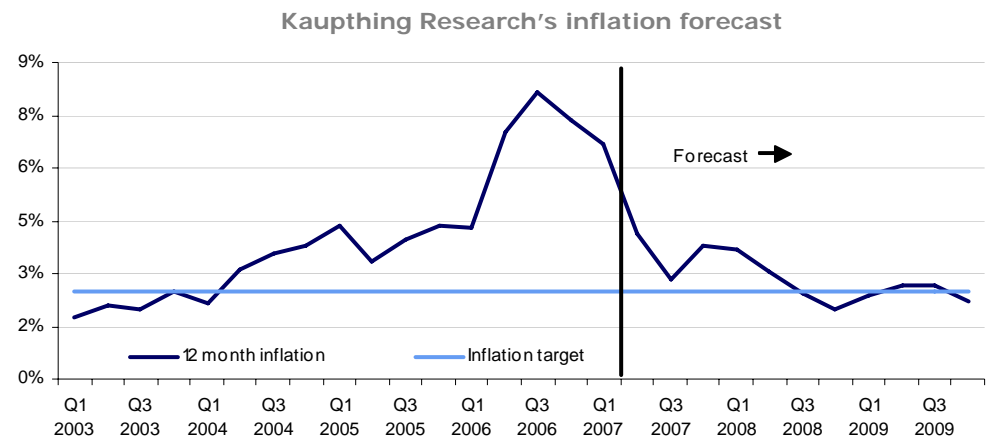
Source: Kaupthing Research, Statistics Iceland and Directorate for Labour

Petrol prices

Frá því í ágúst í fyrra fram í febrúar lækkaði verð á bensíni um rúm 15% sem hefur hjálpað til við að hemja verðbólguna. Frá því í lok febrúar hefur bensinverð hins vegar hækkað nokkuð samfara hækkun á heimsmarkaðsverði og má frekar búast við áframhaldandi hækkunum í ár. Það er því ljóst að þróun bensinverðs mun vinna gegn lækkun verðbólgu á næstunni.

Inflation around 4.5% this year

Research forecasts the annual rate of inflation to approach the Central Bank's inflation target in Q3 but to rise again at the end of the year. Research forecasts inflation to be 4.4% on average this year. In 2008, Research expects to see inflation around target in Q3 2008 but to be 2.8% on average. In 2009 Research forecast inflation to be 2.5% on average.

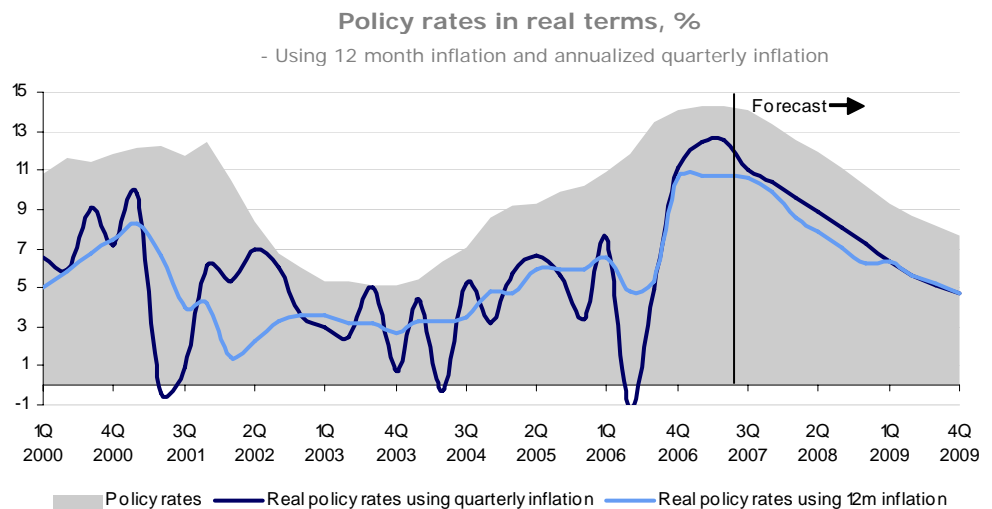


Source: Kaupthing Research and Statistics Iceland

Real Interest Rate Forecast 2007-2008

Whether measured by policy rates in real terms (using expected inflation) or by indexed yield on the bond market, real interest rates have probably already peaked in the current business cycle. A drop in inflation expectations after the government's announcement of VAT cuts on groceries sent the indexed yield on the bond market to 4.45%-6.88% in February. However, the VAT cuts caused a much smaller drop in the CPI in March than expected, which caused the indexed yield to start dropping again. Indexed yield in mid April ranged from 4.23% to 5.98% which was considerably lower than in February. Drops below this level are however difficult to foresee at the moment. The Central Bank will probably hold interest rates at 14.25% until Q3 and policy will remain high in real terms over the next few years according to Kaupthing Research's forecast. Policy rates will on average be around 10.5% in real terms in 2007, 7.5% in 2008 and 5.5% in 2009. Therefore, Kaupthing expects indexed yield to rise slightly from mid April's levels rather than to drop before the end of Q2.

It should be pointed out that GDP numbers for Q1 2007, which will be published in mid June, may prove to be negative for the bond market. As consumer expectations are at an all time high, GDP numbers may show an increase in private consumption which would diminish the case for policy rate cuts. The most important factor governing real yields, however, will be the evolution of inflation. There seems to be more upside than downside risk for inflation at the moment which makes indexed bonds more attractive.



Kaupthing Research believes that indexed yield will start dropping again in the second half of 2007 when we expect the Central Bank to start rate cuts and some expectations of an ISK depreciation will be priced in. It should be kept in mind, however, that the Central Bank has said it will hike rates further if the ISK depreciates significantly. Therefore, it will counteract drops in real rate expectations if inflation will spike.

Indexed yield forecast (HFF)

- at end of quarter

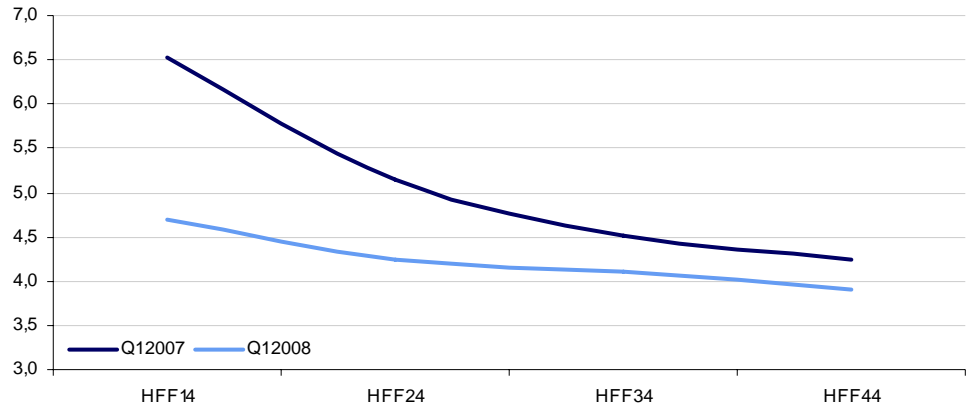
	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008
HFF14	6,54	6,00	5,70	5,25	4,70
HFF24	5,14	5,00	4,80	4,55	4,25
HFF34	4,52	4,55	4,50	4,30	4,10
HFF44	4,25	4,30	4,20	4,05	3,90

Source: Kaupthing Research and OMX

According to the forecast, indexed yield will range from 3.9% to 4.7% at the end of Q1 2008. Then yields will have dropped by 30-130 basis points since 15 April 2007.

Indexed yield curve

- At the end of Q1 2007 and according to forecast at the end of Q1 2008



Source: Kaupthing Research and OMX

Economic forecast 2007-2009

Real change between years, %	2006	2007	2008	2009
Private consumption	4,6	0,3	1,6	1,0
Public consumption	2,9	2,5	3,0	3,0
Gross fixed capital formation	13,0	-18,9	-4,9	7,1
- Business sector investment	13,8	-26,3	-11,9	7,2
- Residential property investment	17,2	-5,0	0,0	5,0
- Public investment	0,8	5,0	21,3	10,0
National expenditure	7,4	-5,5	0,4	2,8
Exports of goods and services	-5,6	12,0	11,0	5,0
Imports of goods and services	8,8	-9,1	0,4	4,8
GDP	2,6	2,0	4,2	2,8
Current account balance, % of GDP	-26,7	-16,4	-14,3	-14,4
- Trade balance	-12,9	-4,0	-2,1	-3,0
- Balance of services	-4,8	-4,5	-3,5	-3,3
- Factor income balance	-9,1	-7,9	-8,7	-8,1
Average change from previous year (%)				
Consumer price index	6,8	4,4	2,8	2,5
Wages	9,5	8,1	6,1	4,9
Purchasing power	2,7	3,8	3,3	2,4
Unemployment	1,3	1,5	2,3	3,0
House prices	12,7	5,1	2,3	2,6
Effective price of foreign currency	11,7	2,5	4,8	0,8
Yearly average (%)				
Policy rates	12,6	14	11,5	8,5
Policy rates in real terms	6,8	10,5	7,5	5,5
ISK trade weighted currency index	121	124	130	131

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

Provisional release:

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