

ICELAND : RECESSION LOOMS ON THE HORIZON

⌘ Since the mid-1990s, growth rates in Iceland have been spectacular compared with the rest of Europe. Since 2004, economic activity in Iceland has been extremely buoyant, underpinned by explosive growth in domestic demand and ballooning household consumption and investment. However, these impressive growth rates were synonymous with major financial imbalances from the outset and in 2006 the Icelandic krona underwent its first crisis.

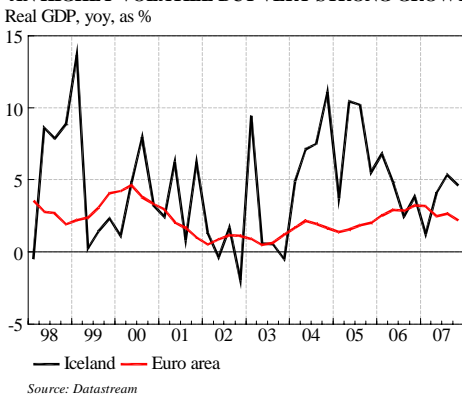
⌘ The problem is that heightened risk aversion sparked by the financial crisis coincided with a reversal of the economic cycle. Domestic demand was hit – and will continue to be hit – by a series of violent shocks: hard landing of the property market, end of the productive investment boom and severe difficulties facing households. To compound the situation, the Central Bank of Iceland (CBI) cannot shore up economic activity. In contrast, monetary policy will be procyclical: in a country which is extremely open and in which economic agents, households and companies are up against major currency risk, the CBI's leeway will be restricted over the long term by sharp upward pressure on inflation and the need to defend the krona.

⌘ Against this backdrop, fears about the stability of Iceland's financial system were aroused at the end of 2007. Confidence has been rocked by the highly international profile of Iceland's top three banks, the fact that their dimension is out of proportion with that of the national economy and that they have massive recourse to short-term external finance. A systemic crisis is nonetheless improbable.

A spectacular performance until now

Since the early 1990s, growth rates in Iceland have been well in excess of those in other European countries, Scandinavia included. As a result, this small country (GDP is estimated at some USD 18bn in 2008) with a population of approximately 300,000 ranks amongst the OECD leaders in terms of per capita wealth: per capita GDP (in PPP terms) is close to USD 40,000. Moreover, UN human development indicator¹, ranked Iceland in 1st position in 2006 and 2007.

AN HIGHLY VOLATILE BUT VERY STRONG GROWTH



GROWTH RATES IN ICELAND OVER THE LAST 10 YEARS

	GDP	Household consumption	Public cons.	Total invest.	Cap. goods investment	Resid. Invest.	Exports G&S	Imports G&S
1997-2007, CAGR (%)								
Iceland	4.4	5.1	3.7	8.9	9.6	9.7	5.1	8.3
Euro area	2.2	2.0	1.8	3.2	3.9	1.8	5.6	5.8
2004-2007, CAGR (%)								
Iceland	5.2	7.1	3.6	11.6	13.1	13.8	6.3	12.0
Euro area	2.4	1.6	1.8	4.3	5.6	3.6	6.2	6.1

Sources: Eurostat, Statistics Iceland.

Growth rates in Iceland have averaged 4.4% per annum over the last 10 years, despite the soft patch in 2002 and 2003. Furthermore, the economy has been gaining momentum since 2004: annual average growth rates have accelerated to 5.2% vs. 2.4% in the euro area.

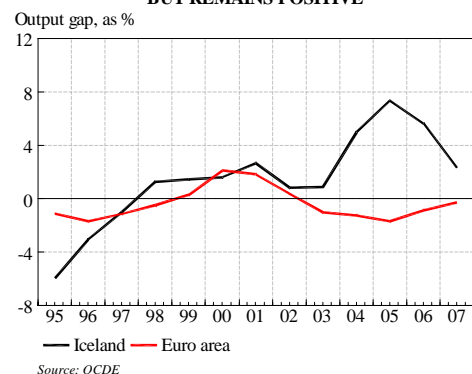
Domestic demand has been the key growth driver. Growth in household consumption has been extremely vigorous since 1997 and the pace has been accelerating since 2004 boosted by substantial wage increases, full employment (unemployment rate below 2% since 2005) and – until the beginning of 2006 and as

measured by Icelandic standards – well contained inflation. Growth in investment has been explosive. Investment in capital goods has been fuelled by major development projects concerning the construction of aluminium factories and related energy installations. In addition, households have invested very heavily in property. Growth in investment has consequently been exceptionally high: +28% in 2004, +36% in 2005 and +20% in 2006.

As a result the contribution of foreign trade to growth has been sharply negative. This is not surprising for a small insular economy that imports approximately 42% of what it consumes. That said, largely due to wind power potential and metallurgy plants, volume growth in exports picked up to 6.3% in annual average terms between 2004 and 2007, which represents a considerable increase relative to the past. The trade deficit is nonetheless extremely high and peaked at 13.4% of GDP in 2006 (25.4% in the case of the current account deficit)

The imbalances in Iceland's economy are not merely a matter of external deficits. Since 2006, weaknesses in the growth model have been apparent: sharp upward move in inflation, high volatility in industrial investment, property market overheating, record debt levels – colossal external debt – in all sectors and concerns about the stability of the national financial system.

THE OUTPUT GAP IS STARTING TO NARROW BUT REMAINS POSITIVE

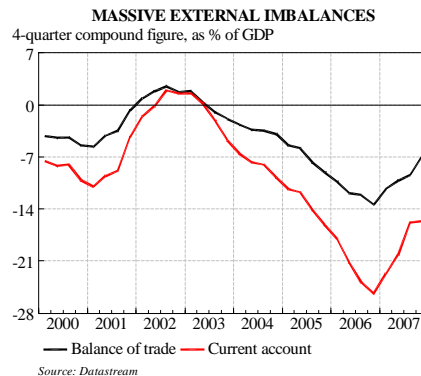
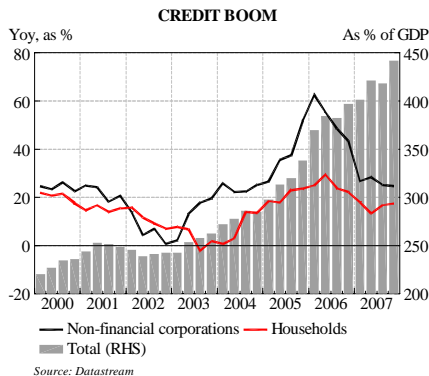
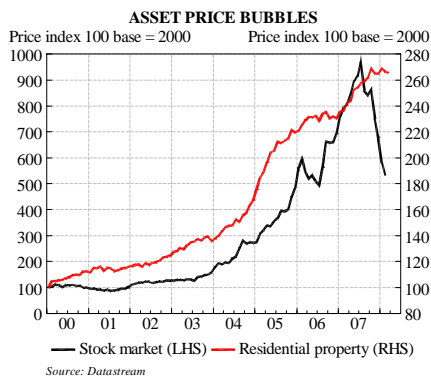


And so, the party is over. Growth rates slowed to 3.8% in 2007. For the first time since 2003, domestic demand contracted and the only factor that shored up growth was the coming on stream of new aluminium factories.

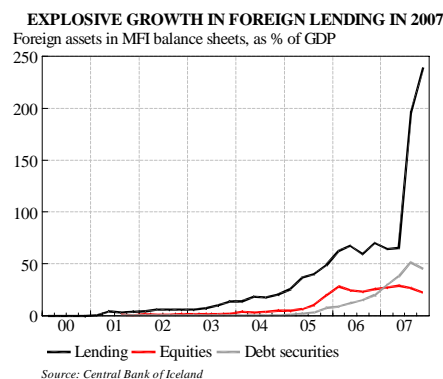
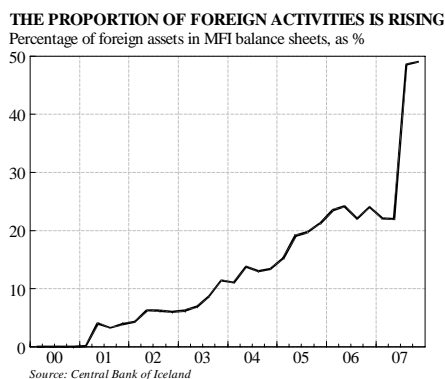
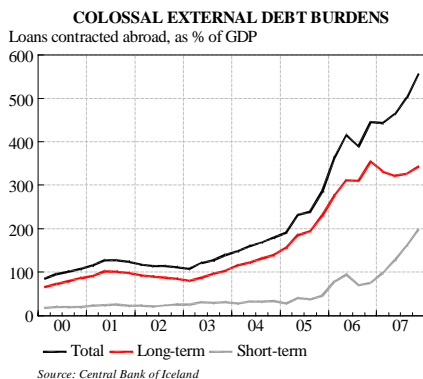
¹ This indicator takes the performance of the healthcare and educational systems, in addition to per capita wealth, into account.

CONCERNS OVER THE STABILITY OF THE FINANCIAL SYSTEM A FEW CHARTS TO ILLUSTRATE THE SITUATION

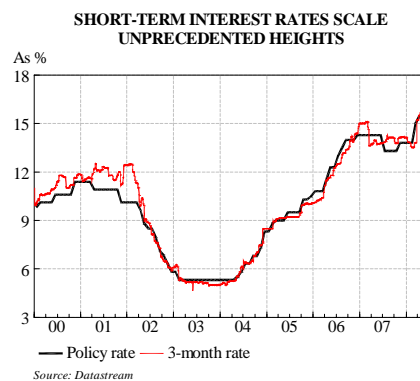
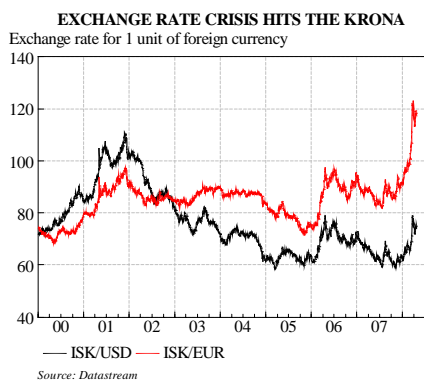
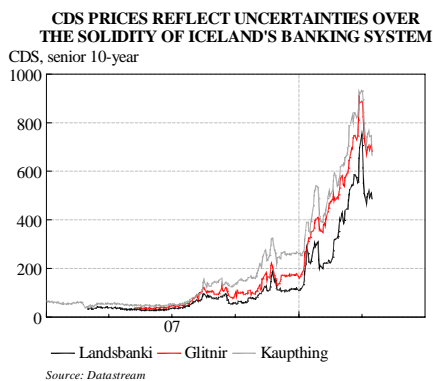
Numerous imbalances in Iceland's economy



Rapid international expansion of Icelandic banks and heavy buying of foreign assets



Risk aversion brutally highlights flaws in the financial system



RATINGS OF MAJOR ICELANDIC DEBT ISSUERS

	S&P			Fitch			Moody's		
	LC / FC	Last	Outlook	LC / FC	Last	Outlook	LC / FC	Last	Outlook
Sovereign (Rep. Iceland)	AA- / A	17/04/2008	-	AA- / A+	01/04/2008	-	Aaa / Aaa	05/03/2008	-
Kaupthing	Lg / St			A / F1	01/04/2008	-	A / F1	05/03/2008	-
Glitnir	BBB+ / A-2	21/04/2008	-	A / F1	01/04/2008	-	A2 / P-1	05/03/2008	-
Landesbanki				A / F1	01/04/2008	-	A / F1	05/03/2008	-

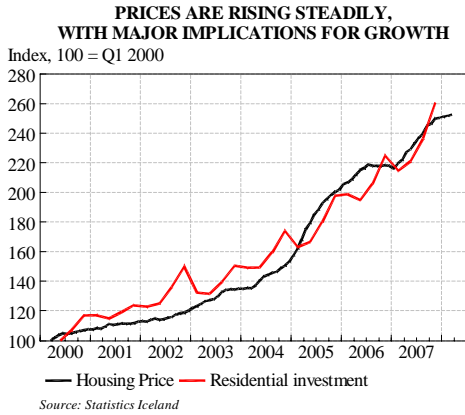
Source: Reuters

Iceland has thus entered a period of crisis after economic overheating. The situation is reflected by the trend in the output gap (the difference between real and potential GDP) which peaked at almost 8% in 2005 and stood in excess of 2% in 2007.

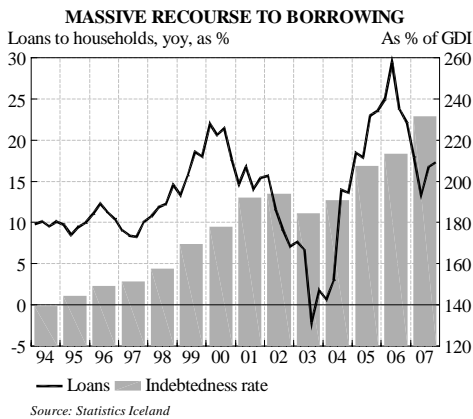
As explained below, all components of domestic demand are set for a severe correction.

Domestic demand is hit by multiple shocks

Property market downturn on the horizon



Residential property prices rose by 15.2%, in annual average terms, between 2000 and 2007 – which represents a total increase of approximately 150%. At the same time, residential investment literally exploded: growth rates were in line with those of prices. Furthermore, the construction sector accounted for one quarter of job creations during this period. The sector's contribution to economic growth has consequently been colossal since 2000.



Households had massive recourse to borrowing to buy property. Apart from a brief downward blip in 2003, growth in lending to households (mortgages account for 61% of loans) has been in excess of 10% for more than 10 years and has topped 15% since the end of 2004. However, the momentum no longer looks sustainable.

Households are faced with a series of negative developments:

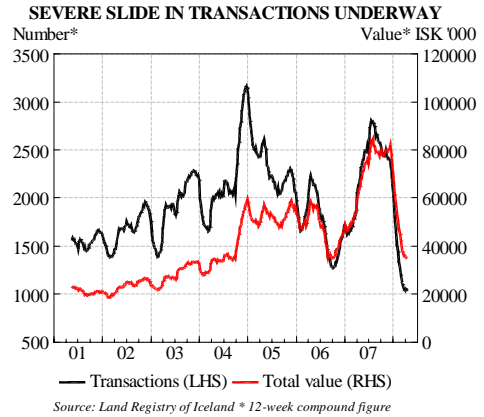
⌘ Access to credit is set to become tighter as the crisis of confidence rocking the Icelandic banking system has increased the cost of capital for banks considerably (see previous inset on CDS);

⌘ Loan interest rates are less attractive. The prime rate charged on inflation-indexed home loans – which account for 88% of home loans and 54% of total loans - increased from some 4.50% at the end of 2005 to over 6.50% this April and inflation is accelerating. The trend in loans denominated in foreign currencies (12% of home loans) is similar because the krona has tumbled against other currencies: notably the euro, the dollar and the Swiss franc. As a result of the high percentage of loans (home loans and consumer loans) indexed to inflation (67% of total bank loans to

households), the increase in the cost of borrowing concerns a high proportion of existing loans as much as new loans;

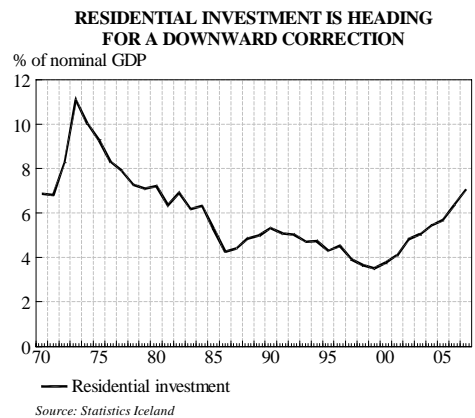
⌘ Growth in real wages is being severely undermined by inflation (see page 4) and turned negative in the first quarter of 2008;

⌘ Household indebtedness has been rising constantly for almost 20 years and was equivalent to nearly 240% of disposable income in 2007 which is the highest level in the OECD apart from Denmark.



The recent trend in the residential property market bears out the above-mentioned scenario. The tide would appear to have turned. At the beginning of April, the number of transactions (12-week compound figure) fell to the lowest level witnessed since 2001. The tumble has been particularly dramatic (-48% between the last week of December and the second week of April) since the peak reached in the middle of July: -62% in nine months.

To compound the situation, quarterly growth rates in prices slowed sharply to 0.3% in the first quarter of 2008 (vs. +3.7% and +2.3%, respectively in the third and fourth quarters of 2007) and have turned negative in real terms.



The economic implications of the property market recession in prospect will not be negligible. In value terms, the contribution of residential investment to GDP has increased substantially since 2000, making a break with the long-term trend: 7% of GDP in 2007 vs. less than 4% previously. This means that the contraction in household residential investment will impact directly on growth.

To make matters worse, consumption will be adversely affected by job losses and the drying-up of the property-related wealth effect.



A switchback ride for productive investment

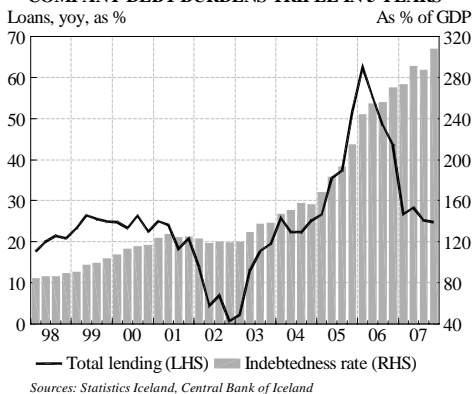
INVESTMENT IN CAPITAL GOODS COLLAPSES AS MAJOR PROJECTS REACH COMPLETION



Investment in capital goods has also been a growth driver since 2004. Due to the scarcity of labour and the squeeze on production capacity, companies stepped up investment outlay for improving productivity.

Much of the momentum was nonetheless provided by major investment programmes in the metallurgy and energy sectors. However, the completion of these projects in 2007 resulted in a severe contraction in productive investment (-14.8% in annual average terms) which dragged down total domestic demand in its wake. The decline will continue in 2008 as no substantial investment programmes are scheduled this year. Excluding heavy industry, non-financial companies followed a similar pattern to households and had recourse to borrowing to finance productive investment by borrowing. Lending to companies rose by 25% on an annual basis in the fourth quarter of 2007. Between 2005 and 2007, growth rates in lending averaged 37%.

COMPANY DEBT BURDENS TRIPLE IN 5 YEARS



As is the case for households, access to credit will become tighter for companies. On top of the financial crisis, factors specific to Iceland will come into play: the recession looming on the horizon; rising interest rates; high company debt levels; and the substantial investment undertaken in the past.

In 2009, the contraction in total investment in capital goods should be stemmed by the widely-expected launch of a project to construct a new aluminium factory and create the necessary hydroelectric capacity.

Households reel under a series of shocks

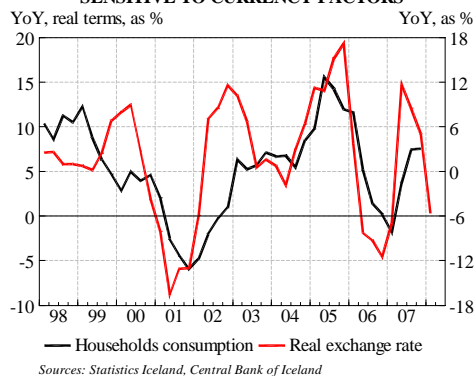
The exchange rate spells bad news – and will continue to do so – via imported inflation

Growth in household consumption was extremely vigorous between 2003 and 2005, but has been more volatile since 2006. Icelandic consumption is heavily reliant on imported goods and is consequently highly sensitive to fluctuations in the krona (see chart below). Currency weakness impacts via imported inflation. In 2006,

the severe slide in the krona against the euro sparked a sharp upward move in inflation: as measured by the harmonised consumer price index (Eurostat), inflation peaked at 7% (annual average rate of 4.6%). The national inflation index, which includes housing (index weighting: 23%), peaked at 8.5% (annual average rate of 6.7%).

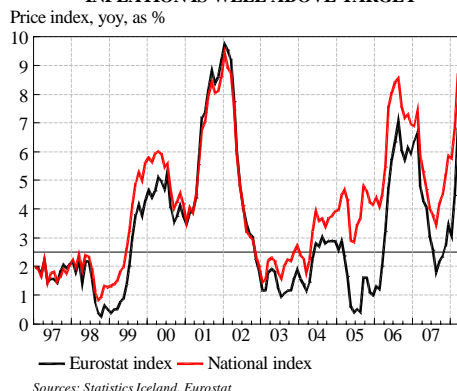
The appreciation of the krona in 2007 naturally had the opposite effect: the harmonised inflation rate fell back to between 2% and 4% yoy.

IMPORTS MAKE HOUSEHOLDS HIGHLY SENSITIVE TO CURRENCY FACTORS



Renewed weakness in the Icelandic currency in February 2008 drove the national inflation rate up rapidly: 8.7% in March vs. 5.8% in January (the harmonised inflation rate surged from 3.1% to 6.8% between January and February) due to the combined impact of imported inflation and the escalation in foreign currency-denominated prices of oil and food products.

INFLATION IS WELL ABOVE TARGET



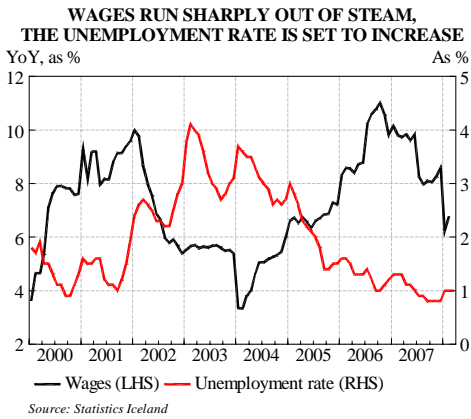
Given the increase in risk aversion triggered by the financial crisis and the scale of Iceland's external imbalances, the chances of a recovery in the krona this year look distinctly slender.

The Icelandic currency is likely to stabilise at current levels in the near future and then resume its downward path in the second half of this year and in 2009.

As a result, the upward move in inflation will gather pace over the short term. The national price index is likely to accelerate to 10% yoy in the second and third quarters of this year (the harmonised index is estimated at approximately 8.5%) before easing back slightly. In annual average terms, inflation will probably emerge at 6% in 2008 and 3% in 2009 (8.50% and 5% insofar as concerns the national index). The peak ought to be reached at the end of the summer.

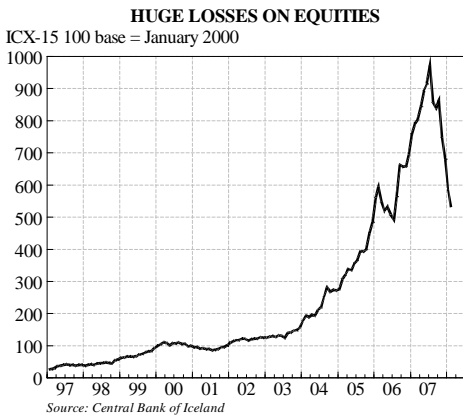
Severe deterioration in the job market

Household spending power will also be undermined by slacker growth in wages: +6% yoy in the first quarter of 2008 vs. +9% in the fourth quarter of 2007. The job market was still robust in February (unemployment rate of 1%) but is set to weaken steadily this year and next. The unemployment rate is likely to rise to 4% of the working-age population by the end of 2009. The slacker trend in employment will act as a brake on earned income and the increase in the unemployment rate will curb trade union bargaining power. We expect wage increases to be moderate – at around 5% in annual average terms – in 2008. Further downward pressure on consumption will be exerted by the departure of foreign workers following the termination of major construction projects.



Wealth effects dry up

Over the last few years, households have benefited from wealth effects related not only to the property market boom but also to the appreciation of financial assets, equities in particular. The performance of the Reykjavik stock market was highly impressive until last year: the ICEX 15 index achieved a ten-fold gain between 2000 and 2007 and trebled in value between the end of 2004 and the middle of 2007. However, by March 2008, the index had lost almost 50% relative to last summer's levels. The bursting of the equity market bubble will play a part in reducing households' financial leeway.

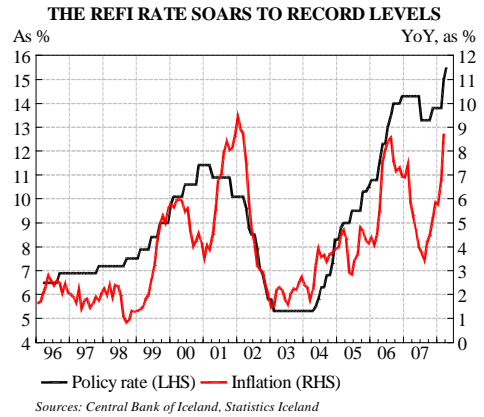


All things considered, consumption is going to slide into negative territory

In view of the above-mentioned factors, the outlook for consumption in 2008-2009 is far from inspiring. The rebound witnessed in 2007 will prove to be a drop in the ocean. Household consumption is expected to start slackening from the second quarter of this year onwards: the annual average decrease is estimated at 1.8%. The downward correction is set to continue in 2009 with a 3% tumble on the cards.

The central bank is forced to adopt a procyclical policy

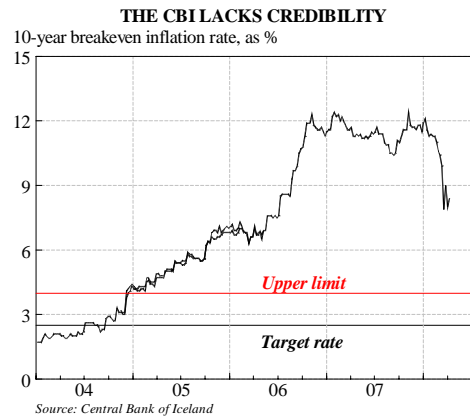
Given the inflation rate, monetary tightening is inevitable



The Central Bank of Iceland (CBI) has opted for inflation targeting (national definition) with a range of 2.50% to 1.50%. The problem is that, since 2005, the upper limit has been breached, despite a 750bp hike in key rates: the intervention rate soared from 5.3% in the middle of 2003 to 13.75% at the end of 2007.

The credibility of the CBI's battle against inflation has not been restored: 10-year breakeven inflation is well in excess of the target. Breakeven levels increased inexorably for some time, stabilised at around 10 to 12% from 2006 onwards and fell back to 8 to 9% in April.

Moreover, due to the severe depreciation of the krona which has caused a sharp upward move in inflation, the CBI has been forced to tighten the monetary screw twice this year: +125bp on March 25th and +50bp on April 10th. The CBI's intervention rate is currently standing at 15.5% - which is a record level for an OECD country.



The depreciation of the krona is set to continue over the long term, though the pace will probably be slower. This means that the CBI will have to tighten the monetary reins further. According to the CBI's latest projections, the intervention rate is likely to peak at 15.75% in Q2 and retreat thereafter. We believe that the intervention rate will peak at 15.75%, but suspect that cuts will be postponed until year-end and prove extremely gradual after then.

Monetary policy will consequently be procyclical in 2008, thereby exacerbating the economic slowdown. In 2009, there will be very little leeway for cutting rates because inflation is expected to remain at high levels and the currency is set to weaken further. As a result, the CBI will be able to do nothing to rescue Iceland's economy from recession.



Will the financial system weather the storm?

The trend in Icelandic bank CDS prices and the tumble in the national currency (see page 2) have rekindled concerns – raised by Danske Bank in a report published in 2006 – over the solidity of Iceland's financial system. Based on analysis of various leading indicators – factors that now add even greater weight to the bank's scenario – Danske Bank pointed out that the economic situation in Iceland was worse than that in Thailand before the 1997 crisis and barely better than that in Turkey before the 2001 crisis.

Danske Bank's analysis is based primarily on harbingers of economic crises:

- ## speculative property and equity market bubbles;
- ## strong growth in lending;
- ## inflation;
- ## overvaluation of the national currency followed by a short-term correction;
- ## current account deficit.

Moreover, the present situation is similar in many respects to the banking crises that rocked Scandinavia in the early 1990s.

That said, a number of factors imply that the situation is less serious than it might appear:

The banking sector watchdog (FEM) has integrated currency risk into banking regulations. The conclusions of its stress evaluation report released on February 6th, 2008 are that Iceland's top three banks should withstand a major economic crisis - combined impact of substantial depreciation in the value of Icelandic equities (-35%) and foreign assets (-25%); slide in the krona (-20 %); and a 20% increase in losses attributable to loan defaults. This stress is nonetheless comparable to the current situation. According to the FEM, liquidity ratios are still compatible with regulations;

Tier 1 ratios are particularly high at a weighted average of 9.2% of market capitalisation in Iceland (9.6% for Kaupthing Bank, 10.1% for the Landsbanki and 8.1% for Glitnir) vs. an average of 7.5% for leading Scandinavian banks. Glitnir is nevertheless on a downward slope: its Tier 1 ratio slumped from 10.8% to 8.1% between 2006 and 2007;

Due to their branch networks in the euro area and in Scandinavia (specific facilities in this case), Icelandic banks can

have recourse to the central banks concerned as lenders of last resort in addition to the CBI;

It would appear that movements in Icelandic bank shares are partly due to speculative trading by hedge funds rather than to widespread distrust in the system;

Bank ratings are still high despite the downgrades announced in March and April this year. The outlook is nonetheless negative;

Icelandic banks claim that they do not require access to foreign financial markets to obtain liquidity. Over the next 12 months, these banks will have to redeem almost 2,500 trillion krona (EUR 21.5bn and equivalent to nearly 2x GDP) of short-term debt securities. They would nevertheless appear to hold enough liquid assets to cope with the situation: liquid assets in bank balance sheets were worth more than 2,000 trillion krona, including 990 trillion krona of foreign assets, at the end of February. Moreover, the total amount of foreign assets held is standing at 4,902 trillion krona (3.8x GDP).

And so, in spite of the fact that the substantial imbalances in Iceland's economy look set for a correction in the near term, the risk of a systemic banking crisis can most probably be ruled out – especially as public finances are healthy and the State would doubtless intervene as lender of last resort if necessary.

In conclusion, recession is inevitable

Protracted recession in 2008/2009

Given the factors evoked earlier, there is little doubt that the recession will start in the second half of this 2008 and continue into 2009. GDP is likely to stagnate, in annual average terms, this year: +0.4% vs. +3.8% in 2007. In 2009 GDP is expected to move into negative territory (-1.1%), largely due to lower domestic demand.

State intervention will limit the scale of the crisis

Iceland's government has considerable room for manoeuvre as a result of the healthy fiscal surpluses built up in the past and the fact that it has no pension financing commitments because the system is 100% private. The public sector should consequently be able to counter a major recession by bolstering the economy via public sector consumption and investment.

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Annual growth rates (in real terms)	2003	2004	2005	2006	2007	2008 (f)	2009 (f)
Private sector consumption	6.1	6.9	13.0	4.4	4.2	-1.8	-3.0
Public sector consumption	1.8	2.2	3.5	3.9	3.3	3.5	4.0
Total investment	11.1	28.1	35.7	20.4	-14.8	-10.0	1.0
Stocks (contribution to growth)	-0.1	0.0	0.0	0.4	-0.3	-0.3	0.0
Total domestic demand	5.9	9.9	15.9	8.9	-1.8	-3.1	-0.6
Exports	1.6	8.4	7.2	-5.0	18.1	3.0	1.0
Imports	10.8	14.5	29.4	10.2	-1.4	-6.6	2.0
Real GDP	2.4	7.7	7.5	4.4	6.6	0.4	-1.1
Current account (% of GDP)	-4.8	-9.8	-16.1	-25.4	-15.6	-15.0	-7.0
Public account (% of GDP)	-2.8	0.0	4.9	6.3	5.2	1.5	-2.0
Consumer prices (national index)	2.1	3.1	4.0	6.7	5.1	8.3	5.0
Consumer prices (harmonised index)	1.4	2.3	1.4	4.6	3.6	5.9	3.0
Unemployment rate	3.3	3.1	2.1	1.3	1.0	1.5	3.7

Sources: Statistics Iceland, SG forecasts

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