

Economic and monetary chronicle 2006

January

On January 1, the second phase of the income tax cuts approved by Parliament in autumn 2004 went into effect. The personal income tax rate was lowered from 24.75% to 23.75%. The personal allowance was raised by 2.5% and the average municipal income tax rate was lowered marginally from 12.98% to 12.97%. Thus the total personal income tax PAYE rate will be 36.72% in 2006, compared with 37.73% in 2005.

On January 1, net wealth tax on private persons and legal entities was also abolished, i.e. it will not be levied on assets held at the end of 2005. The surcharge on highest incomes was also abolished at the end of the year; it will be levied this summer in the final settlement of taxes on income earned in 2005, but will not be levied on income in 2006.

On January 20, Fitch Ratings assigned Straumur-Burðar ás Fjárfestingabanki investment bank ratings of long-term BBB-, short-term F3, individual C/D and support 3. The rating outlook was stable.

On January 26, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.25 percentage points to 10.75%. Other Central Bank interest rates were also raised by 0.25 percentage points. Interest rates on one-week certificates of deposit and the repo rate were raised as of January 31 and other rates as of February 1.

February

On February 21, Fitch Ratings affirmed the Republic of Iceland's issuer default ratings for long-term foreign and local currency at AA- and AAA respectively. The country ceiling was also affirmed at AA and the short-term foreign currency rating at F1+. The outlook was revised from stable to negative.

On February 24, the Central Bank of Iceland's revised internal Rules on the preparation, rationale and presentation of monetary policy decisions were formally ratified. The Rules were set with reference to the provisions of paragraph 3, Article 24 of Act No. 36/2001 on the Central Bank of Iceland. They have now been revised in light of experience and also the fact that as of 2006, the Board of Governors of the Central Bank of Iceland announces its interest rate decisions on fixed, preannounced days.

March

On March 16, Standard & Poor's Ratings Services affirmed its AA long-term foreign currency and AA+ long-term local currency sovereign credit ratings on the Republic of Iceland. At the same time, the A-1+ short-term foreign and local currency ratings on Iceland were affirmed. The outlook remains stable.

On March 28, Standard & Poor's Rating Services announced its first credit rating for an Icelandic bank, Glitnir Bank (formerly Íslandsbanki). The ratings were long-term A- and short-term A-2, with a stable outlook.

On March 30, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.75 percentage points to 11.5%. Other Central Bank interest rates were also raised by 0.75 percentage points. Interest rates on one-week certificates of deposit and the repo rate were raised as of April 4 and other rates as of April 1.

On March 31, Kaupthing Bank issued € 500 million (43.5 b.kr.) of króna-denominated structured covered bonds. Issued to finance the bank's residential housing loans in Iceland, the bonds were assigned an Aaa credit rating by Moody's Investors Service.

April

On April 4, Moody's Investor Service published a Special Comment on the Icelandic economy which found that Iceland is not experiencing undue risk to solvency or liquidity as result of recent volatility in the nation's business and financial cycles. The report is published on the Moody's website.

On April 4, Moody's Investor Service affirmed the deposit and debt ratings of Landsbanki Islands at A2 long-term and P-1 short-term. At the same time, the rating agency altered the outlook to negative from stable for Landsbanki's financial strength rating, which is currently C.

On April 4, Moody's Investor Service affirmed the deposit and debt ratings of Kaupthing Bank at A1 long-term and P-1 short term. At the same time, the rating agency put the bank's financial strength rating C+ on review for possible downgrade.

On April 4, Moody's Investor Service affirmed the deposit and debt ratings of Glitnir Bank at A1 long-term and P-1 short-term. At the same time, the rating agency altered Glitnir Bank's outlook to negative from stable for the bank's financial strength rating.

On April 24, Moody's Investors Service affirmed its ratings on the Republic of Iceland at Aaa for long-term obligations and P-1 for shortterm obligations, both in foreign and domestic currency, with a stable outlook.

May

On May 1, changes to the Central Bank's Rules on liquidity entered into force. One objective of the review was to preclude intragroup transactions aimed at sidestepping the Bank's liquidity rules.

On May 1, changes to the Central Bank's Rules on foreign exchange balance entered into force. Two main changes were made: uniform exposures for individual currencies were introduced and financial institutions were allowed to maintain a separate positive foreign balance outside their total foreign balance as a hedge against the effect of exchange rate movements on their capital adequacy ratios.

On May 4, the Central Bank of Iceland published its Financial Stability report for 2006.

On May 4, the Ministry of Finance and National Debt Management Agency (NDMA) announced a new benchmark series of Treasury securities. The Minister of Finance assigned the NDMA to introduce regular issues of two-year Treasury notes and three-month Treasury bills in order to support economic policy decisions and improve interest rate formation in the bond market.

On May 8-15, an IMF mission visited Iceland for consultations with representatives of the authorities and the private sector. The mission's concluding statement was published on the websites of the Central Bank of Iceland and IMF on May 15.

On May 12, Kaupthing Bank issued subordinated bonds in the amount of 1,250 million US dollars (88.5 b.kr.). The issue is classified as Tier 2 capital.

On May 18, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.75 percentage points to 12.25%. Other Central Bank interest rates were also raised by 0.75 percentage points. Interest rates on one-week certificates of deposit and the repo rate were raised as of May 23 and other rates as of May 21.

On May 24, Glitnir Bank announced that it had acquired all the shares in the Swedish finance group Fischer Partners Fondkommission AB. The acquisition price was 3.7 b.kr.

On May 26, the NDMA signed an agreement in connection with Treasury securities issues and secondary market making. New rules on facilities for primary market makers entered into force on May 30. Primary market makers for Treasury securities – Glitnir Bank, Kaupthing Bank, Landsbanki, MP Fjárfestingarbanki investment bank and Straumur-Burðarás Fjárfestingabanki investment bank – have exclusive access to NDMA's securities lending facilities. The agreement covers all Government securities, replacing the previous two. On May 30, the NDMA auctioned a new series of three-month Treasury bills, RIKV 06 0901, maturing on September 1, 2006.

June

On June 5, Standard & Poor's Ratings Services revised its outlook on the Republic of Iceland to negative from stable on the increasing likelihood of a hard landing for the country's economy. At the same time, Standard & Poor's affirmed its long-term AA- foreign and AA+ local, and its short-term A-1+ foreign and local currency sovereign credit ratings on the republic.

On June 12, Glitnir Bank issued subordinated bonds in the amount of 500 million US dollars (37 b.kr.). The issue is classified as Tier 2 capital.

On June 14, the NDMA issued a new series of two-year Treasury notes, RIKB 08 0613, maturing on June 13, 2008.

On June 22, the Federation of Labour (ASÍ) and Confederation of Employers (SA) signed a two-part agreement on a review of wage settlements. A joint ASÍ-SA review committee agreed on a wage development safety net which guarantees all employees covered by its settlements a minimum wage rise of 5.5% over the preceding year. SA and ASÍ, along with the latter's national associations, also agreed on a 15,000 kr. increment to all monthly wages as of July 1 inclusive.

On June 22, the Government of Iceland announced the following seven-point measures to facilitate the agreement on a wage review between ASÍ and SA: 1) The personal income tax credit (personal allowance) will be increased by 8.3% over and above the previously decided 2.25% increase and will be indexed to the CPI. 2) Legislation on mortgage interest allowance will be reviewed if rising housing prices erode these tax credits substantially. 3) Child allowances will apply to children up to the age of 18 instead of the present 16. 4) The personal income tax rate will be reduced by 1% in 2007 instead of the announced 2% cut. 5) Contributions to adult education and job training will be increased. 6) The Government will initiate cooperation with the social partners on foreign labour issues and the underground economy. 7) Basic monthly unemployment benefit will be increased by 15,000 kr. as of July 1. The ceiling for income-related unemployment benefit will also increase from 180,000 kr. to 185,000 kr.

On June 27, in continuation of the social partners' agreement, the Government agreed on: 1) a temporary reduction in the Housing Financing Fund's maximum loan-to-value ratio from 90% to 80% of house sale price and a reduction from 18 m.kr to 17 m.kr. in the maximum mortgage amount; 2) a temporary postponement of tenders and new public works investment by the central government; 3) initiation of talks with local authorities on comparable postponements on their part.

July

On July 1, the Housing Financing Fund's loan-to-value ratio was temporarily lowered from 90% to 80% and the maximum mortgage amount from 18 m.kr. to 17 m.kr. as part of the government's restraint package.

On July 4, Glitnir Bank announced that all conditions for its acquisition of the Swedish brokerage firm Fischer Partners Fondkommission AB had been met and the transaction was complete. The acquisition price was 3.7 b.kr.

On July 6, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.75 percentage points to 13%. Interest rates on overnight loans and required reserves were raised by 0.5 percentage points and other Central Bank interest rates by 0.75 percentage points. All raises were made as of July 11. The Board of Governors also decided to assess the need for further monetary restraint in the middle of August and announce a decision on interest rates on August 16.

On July 17, Standard & Poor's Ratings Services lowered its long-term local currency issuer credit rating on the Icelandic Housing Financing Fund (HFF) to AA- from AA+. The rating was removed from Credit-Watch. At the same time, the AA- long-term foreign currency and the A-1+ short-term foreign and local currency ratings on HFF were affirmed. The foreign currency outlook is negative but the local currency outlook is stable.

August

On August 16, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.5 percentage points to 13.5%. Interest rates on

overnight loans and required reserves were raised by 0.25 percentage points and other Central Bank interest rates by 0.5 percentage points. Interest rates on one-week certificates of deposit and the repo rate were raised as of August 22 and other rates as of August 21.

September

On September 12, Moody's Investors Service downgraded the Bank Financial Strength Rating of Kaupthing Bank from C+ to C. At the same time it affirmed Kaupthing's A1/Prime-1 deposit ratings. The outlook on all ratings is stable.

On September 12, Glitnir Bank announced the issue of subordinated bonds in the amount of 250 million US dollars (18 b.kr.). The issue is classified as Tier 1 capital.

On September 14, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.5 percentage points to 14%. Other Central Bank interest rates were also raised by 0.5 percentage points. Interest rates on one-week certificates of deposit and the repo rate were raised as of September 19 and other rates as of September 21.

On September 25, Landsbanki announced that all conditions for its acquisition of Guernsey-based bank Cheshire Guernsey Limited had been met and the transaction was complete. The bank was included in the Landsbanki Group consolidated accounts as of the end of Q3/2006 and its name will subsequently be changed to Landsbanki Guernsey Limited.

November

On November 1, an agreement was signed confirming the Treasury's acquisition of the shares held in Landsvirkjun (the national power company) by the City of Reykjavík and Town of Akureyri, conditional upon the approval of their councils.

On November 9, Fitch Ratings affirmed Iceland's foreign and local currency issuer default ratings of AA-/AAA. The outlook remained negative. On November 24, Parliament approved a government bill raising mortgage interest relief, in keeping with a commitment made during the public sector wage review in June 2006.

On November 27, Kaupthing Bank issued new shares of nominal value 660 m.kr. in an offering to international institutional investors. On December 1, Kaupthing Bank made a further issue, after exercising overallotment option, of nominal value 99 m.kr. These new issues raised the total nominal value of the bank's listed shares to 7,404,530,530 kr.

In November, the Republic of Iceland completed a five-year €1 billion Eurobond issue in international bond markets. The entire proceeds from the issue were used to strengthen the foreign reserves of the Central Bank of Iceland.

December

On December 1, market makers in the FX market began trading in euros instead of US dollars. Their minimum indicative bid is set at € 3 million. Market makers continue to quote prices in US dollars.

On December 1, OMX AB shares were listed on Iceland Stock Exchange (ICEX) Main List. The listing of OMX was the first secondary listing on ICEX. OMX shares are primary-listed on Stockholm Stock Exchange.

On December 4, the state budget for 2007 was passed by Parliament. The surplus excluding irregular items is estimated at 9 b.kr., with total revenues amounting to 376 b.kr. and total expenditures 367 b.kr.

On December 4, the supplementary budget for 2006 was passed by Parliament. Additional revenues amounted to 44 b.kr. and additional expenditures to 20 b.kr., and additional borrowing of 87 b.kr. was authorised in order to strengthen the Central Bank of Iceland's foreign reserves.

On December 8, Parliament agreed to convert Municipality Credit Iceland into a statutory limited liability company.

On December 8, the Government agreed to raise unemployment benefit by 2.9% on January 1, 2007, instead of the previously announced increase of 2.25%.

On December 8, the Financial Supervisory Authority (FME) approved the merger of two savings banks, Sparisjóður vélstjóra and Sparisjóður Hafnarfjarðar.

On December 9, Parliament passed a government-sponsored bill raising the minimum pension fund contribution from 10% of wages to 12% and authorising funds no longer backed by employer guarantees to amend their articles of association accordingly.

On December 9, Parliament amended the Income Tax Act to lower the personal income tax rate by 1 percentage point at the beginning of 2007, instead of the previously announced 2 percentage points, while increasing the personal tax-free threshold by 14%. The personal tax credit was also indexed to the CPI and child allowance extended to the age of 18.

On December 9, Parliament agreed to extend the temporary cut in fuel tax and mileage tax on heavy-duty vehicles from 2004 until the end of 2007.

On December 9, Parliament agreed to cut VAT and excise on food, catering, compact discs and other categories from 14% or 24.5% to 7%, and to abolish commodity taxes on domestic and imported food excluding confectionery.

On December 9, Parliament agreed to cut the payroll tax by 0.45 percentage points, and 0.25% of the payroll tax base will be paid annually to pension funds in proportion to their disability benefit commitments, phased in at 0.15% in 2007 and 0.20% in 2008.

On December 19, Straumur-Burðarás investment bank announced its decision to prepare its accounts and annual financial statements in euros effective from January 1, 2007. At its annual meeting in March 2007, shareholders in Straumur-Burðarás approved an amendment to the company's articles authorising the board to determine the issue of company share capital in euros instead of Icelandic krónur.

On December 21, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its collateral loan rate in transactions with credit institutions) by 0.25 percentage points to 14.25%. Other Central Bank interest rates were also raised by 0.25 percentage points. Interest rates on one-week certificates of deposit and the collateral loan rate were raised as of December 27 and other rates as of December 21.

On December 22, Standard & Poor's Ratings Services lowered its foreign currency sovereign credit ratings on the Republic of Iceland to A+ long-term and A-1 short-term, from AA- and A-1+, respectively. At the same time, the long-term local currency rating on Iceland was lowered to AA from AA+, and the short-term local currency rating was affirmed at A-1+. The outlook was changed from negative to stable.