

New winds in the sails

The Icelandic economy seems to be accelerating again in H1 after a slowdown in 2006 despite a high policy rate and vows from the Central Bank not to cut the rate any time soon. This expansion will however be short-lived and the cooling will continue in 2008, following a depreciation of the ISK. Economic growth will still be positive in the next years and driven by exports. Inflation targets will not be reached until late 2009.

Strong tailwinds

There are several indications that the Icelandic economy is taking off again. Signs are visible in most markets, whether it be housing, stock and car markets or the sales of television sets and use of credit cards. Moreover, several bad news items, such as the reduction in the cod quota, in the first half of the year have not managed to shake the confidence of Icelandic consumers that is currently running high.

Interest rates have little bite

The acceleration occurs despite the fact that the real interest rate stands at around 10%, but widespread inflation-indexation and appreciation of the ISK seem to provide a cushion against the high interest rate. It is clear that when the Icelandic krona's good fortune runs out the bite will be felt. Research expects that the ISK will peak in Q3 this year but will depreciate sharply in mid 2008.

A chill from the ISK

Research estimates a 1.8% growth this year driven mainly by exports. However, the economy will experience a swift chill some way into next year, soon as the ISK will recede from the current level with a resulting drop in private consumption. That chill will though be short-lived and Research expects economic activity to step up in the year 2009 because of several investment projects and increased consumption. Economic growth in 2009 will measure around 3%.

Uncertainty reigns

In Research's estimate, the Central Bank's string of interest rate cuts will start in March of next year, just as the Central Bank assumes in its forecast. Research expects the uncertainty regarding growth figures, the ISK and the real estate market all indicating a slower rate cut process rather than a faster one. Tremendous uncertainty reigns in the Icelandic economy, as the current state of affairs could also be seen as a prelude to another expansion or the beginning of a longer decline.

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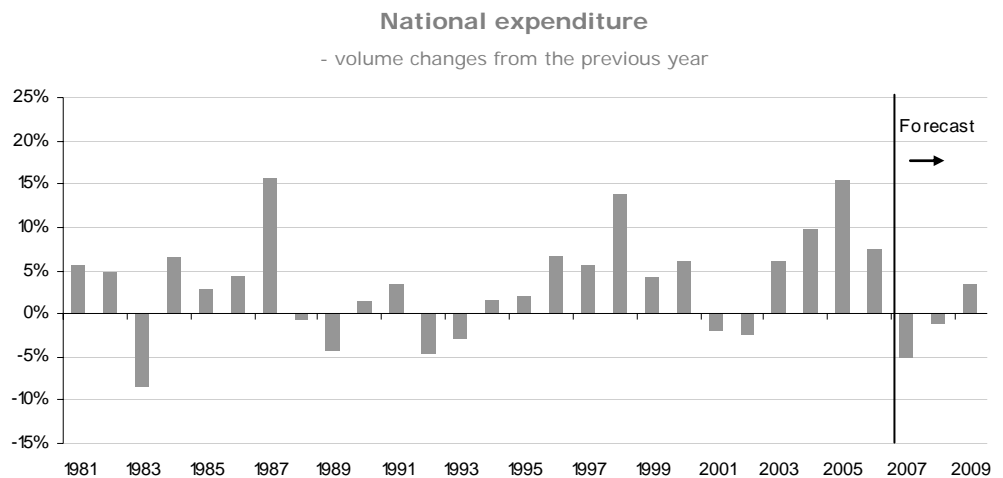
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A year ago most economic indicators pointed to a slowdown of the Icelandic economy following a currency depreciation, decline in the stock market and pessimistic foreign analysis reports. Research interpreted these as signs of a soft landing where consumption and investment would stall but economic growth would be driven by exports. This has come to pass in many respects and a considerable slowdown in the economy has been experienced since then. The growth in private consumption was 4.6% in 2006 compared to a growth of 12.9% in 2005 and will decline to 2.1% this year according to Research's forecast. Additionally, economic growth was close to zero in the first quarter according to Statistics Iceland. It should also be mentioned that more exports and less imports in the first half of this year compensated for a contraction in domestic demand.



Sources: Kaupthing Research, Central Bank of Iceland

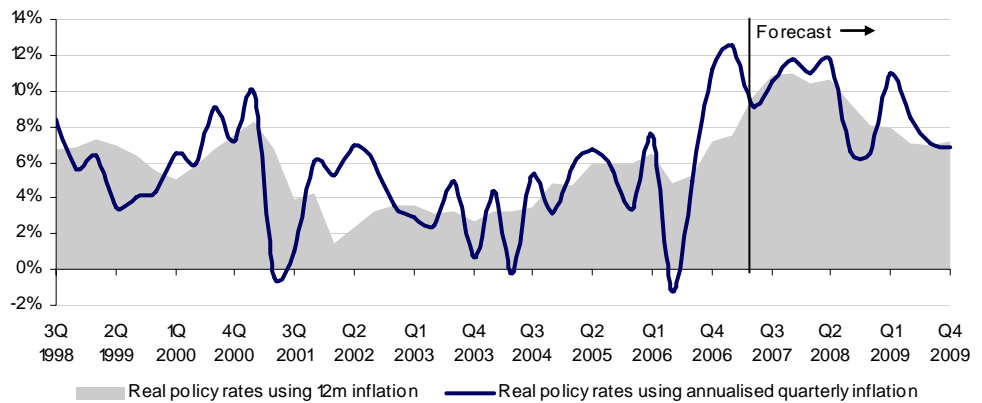
However, winds have turned again in the first half of this year and signals showing that the economy activity is about to accelerate again are rife. These indications are visible in almost every market, e.g. sale of property, stocks, cars or television sets, or the use of credit cards. In fact the economy seems to have caught such a strong tailwind that even bad news in the first half of this year such as the Fitch credit rate downgrade of the Icelandic state or cutbacks in the cod quota haven't managed to unnerve the optimistic Icelandic consumer. In Research's view this is a temporary state of affairs which does not change the fact that the economy is receding after overheating in 2005-2006.

10% real interest rates don't bite on the economy

At first glance it seems peculiar that the economy can accelerate again considering that the Central Bank's interest rates are currently at 13.3% and real interest rates have been at around 10% since last autumn. Such an interest rate would probably have managed to cool and even deep-freeze most western economies but has as of yet had little impact on the Icelandic economy. The reason is the distinctive way in which the Central Bank's interest rate policy is transmitted to Iceland's homes and businesses.

Real policy rate of the Central bank

- compared to Kaupthing Research's forecast

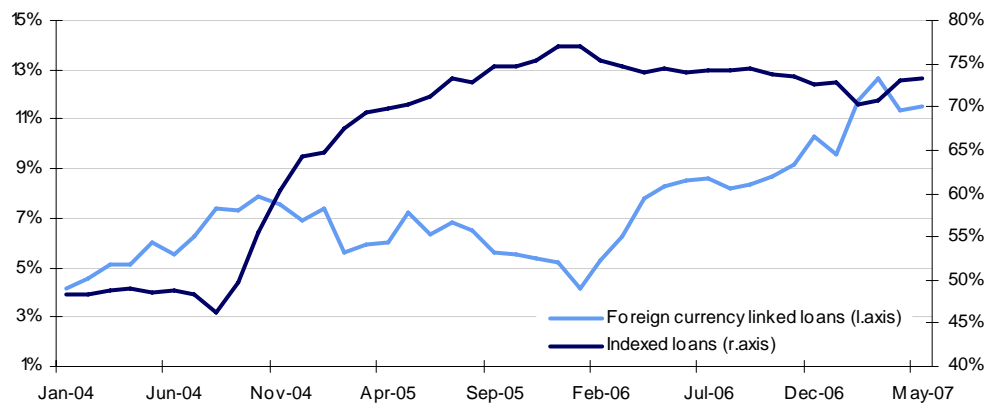


Sources: Kaupthing Research, Central Bank of Iceland, Statistics Iceland

The largest part of homes' debt or 75%, is in inflation-indexed loans with a fixed real rate. A tight monetary policy has no effect on the payment burden on outstanding loans and actually lowers it if the interest rates keep inflation at bay. Secondly, the ISK has appreciated significantly in H1 which has increased purchasing power and also directed many towards foreign currency loans, circumventing the Central Bank's tight monetary policy. Thirdly, an ongoing labour demand, wage drift and tax cuts have increased purchasing power by 5% in the first half of the year and thus offset the negative income effects of higher interest rates. Finally, higher asset prices, particularly stock prices have brought about the same effect.

Household's debt

- % of total household's debt



Source: Central Bank of Iceland

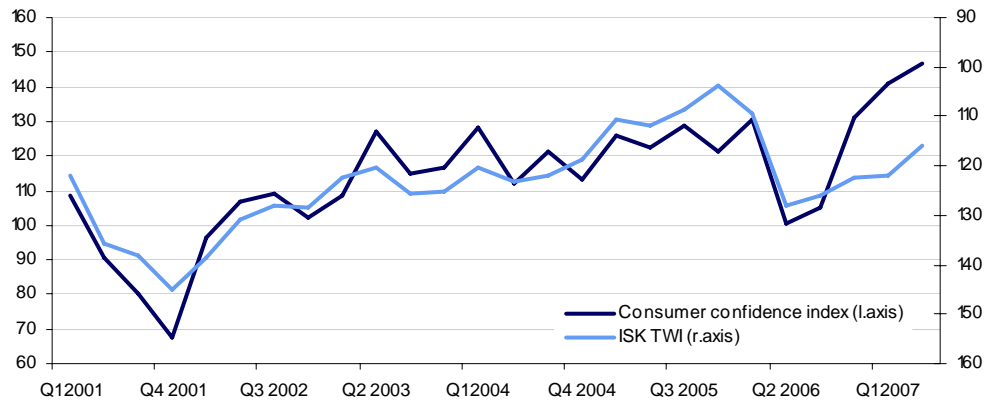
Many Icelandic companies are financed in foreign currency and have recently made substantial gains from the appreciation of the ISK. Also, many labour intensive industries have been able to avoid wage drift by hiring foreign workers. Increased turnover in retail has without doubt also benefited many companies.

The ISK and the laws of gravity

Looking over the stage, it seems inevitable to come to the conclusion that the ISK appreciation is the main reason for the ineffectuality of higher interest rates. It is also apparent that when good fortune turns its back on the ISK the scenario will turn to its opposite. Homes and businesses might then simultaneously experience high interest rates and inflation. The exchange rate is now supported by high domestic interest rates and promises by the Central Bank of even further interest rate increases if the currency

weakens. At the same time carry trade has been lively in foreign markets with a positive impact on high yielding currencies. It is difficult to say how long these conditions will last. There is a general consensus that the current level of the krona cannot be sustained indefinitely but the timing of a weakening is difficult to predict and might depend on events in international markets. It is also clear that the start of the interest rate cutting cycle can not be postponed forever by the Central Bank.

Consumer confidence and ISK TWI



Sources: Central Bank of Iceland, Capacent Gallup

Research predicts that the ISK will peak in the second half of this year and then expects a fairly swift weakening period around mid 2008. History shows that the depreciation of the ISK often takes the form of leaps and bounds. Research also expects a more sudden cool-down of the economy next year in wake of the currency depreciation. As a result, inflation will increase and bring about a drop in private consumption. The chill will be short-lived, however, partly because of the large construction efforts being planned by the state and private sectors connected e.g. with new aluminium projects. That way economic activity will already increase again in 2009. It is also noteworthy that stock holdings are very common in Iceland and the market cap of listed companies is three times the value of GDP – this reflecting the growing scale and internationalization of the firms' activities. Thus, the economic development might be more influenced by the stock market rather than the other way around.

It has been claimed that the pass-through from the recent currency appreciation has been very limited. However, one does not know how development might have been without the strengthening of the ISK. Thus, a currency appreciation may have kept prices in check against domestic price increases though without lowering them. Therefore, it seems likely that a substantial inflation pressure could be unleashed if the currency depreciates and accumulated cost effects from increased wage drifts might then appear as in fact happened in 2006. Thus, Research expects inflation to start to accelerate again in the second half of 2008. As the year 2009 progresses, on the other hand, Research expects a new strengthening phase for the ISK which will slow down the inflation. Therefore, the Central Bank will reach its inflation target at the end of 2009. Timing is admittedly difficult for the above sequence of events that Research deems most likely.

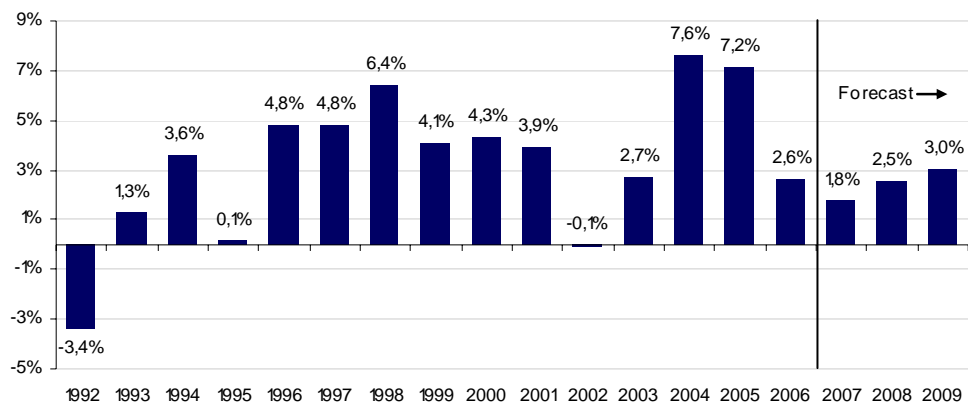
Prelude to another expansion?

Downturns are generally considered dull and tiresome, not to say poisonous to the spirit. Even so, a certain amount of slack is necessary for the long-term health of the economy, especially after a prolonged expansion. The opportunity can be used to re-evaluate the situation, economize and reorganize unproductive enterprises but also ensure price stability. The risk has to be acknowledged for the Icelandic economy that a new expansionary period might occur at the time that all factors of production are operating at full capacity, almost no labour is available and prices are unstable. This is one of the main reasons for the Central Bank's tough stance on the interest rates but Research expects the first cut to occur in March 2008. On the other hand, Research shares the Central Bank's worries to a certain extent but reiterates that a very tight interest rate policy for a long time increases the risk of a hard landing.

Economic forecast: Export driven growth

Economic growth will slow down this year. The main driving force will be the turnaround in foreign trade as exports will rise due to increased aluminium production. Kaupthing Research expects investments to drop by 25% in 2007-2008 and consumption growth to diminish. Economic growth was zero in Q1 2007 according to estimated data from Statistics Iceland. Research, however, expects increased growth in the next quarters and economic growth to be 1.8% for the year as a whole. In 2008-2009 Research expects growth to be 2.5-3%. As in the Quarterly Economic Forecast published in April 2007, Research takes into account further investment in the aluminium and hydropower sector, as it is assumed that a new plant will be constructed in Helgúvík. Research expects these investments to begin at the end of 2007 and that they will be well advanced in 2009.

Economic growth in Iceland 1992-2009

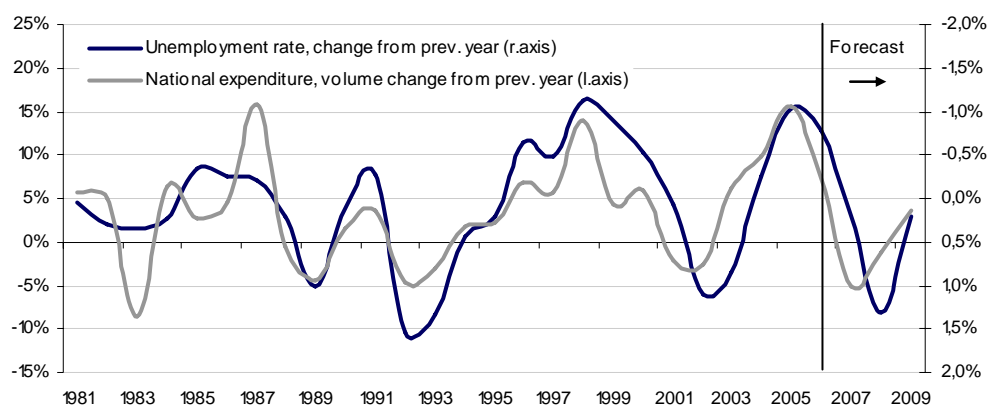


Sources: Kaupthing Research, Statistics Iceland

Domestic demand will diminish

Research expects national expenditure to decrease by 5.1% this year, the biggest contraction in 24 years, attributed to diminishing business sector investment as current large scale investments come to an end. This contraction will hold until the end of 2008, as Research expects private consumption to drop and the unemployment rate to slowly increase in the next couple of months. The unemployment rate is, however, very low at the moment and was around 1.2% in the first half of the year, according to the Directorate of Labour. Research expects the unemployment rate to be around 1.5% this year and 2.8-3% in the next two years. In 2009, Research expects investments to pick up again as projects in Helgúvík will be well advanced and domestic demand to increase by 3.5% in real terms between years.

National expenditure and the unemployment rate



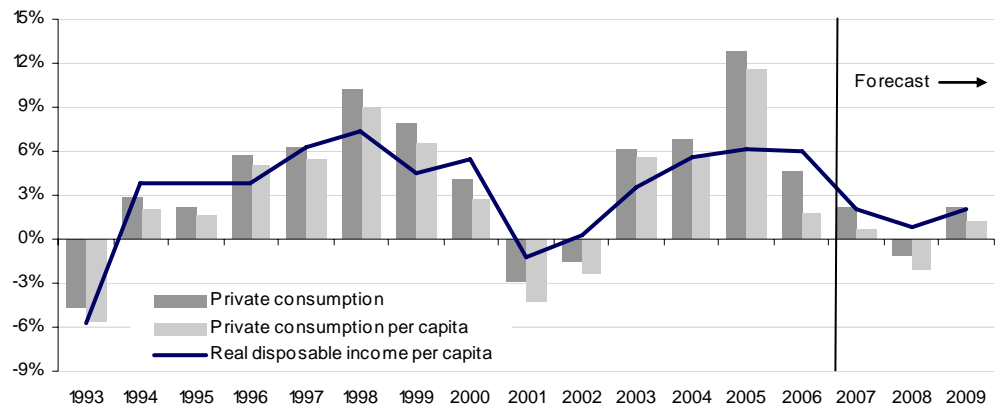
Sources: Kaupthing Research, Statistics Iceland, Directorate of Labour

Further consumption growth this year but a contraction next year

Private consumption decreased in real terms by 1.2% in Q1 2007 from the same quarter in the previous year, according to estimated data from Statistics Iceland, ending the five year continuous consumption growth. The drop in consumption in the first quarter was mainly explained by a decrease in the purchase of vehicles, while most other components in consumption showed increases from the previous year. However, indicators are showing positive consumption growth in Q2 2007. In view of the aforementioned factors, Research has re-estimated its forecast for consumption this year; private consumption is now expected to grow in real terms by 2.1% this year, compared to the 0.3% increase in the previous forecast published last April. Continuing wage increases, lower inflation, tax-cuts at the beginning of March, a strong krona, as well as a considerable rise in the equity market are the main driving forces behind continuing growth in private consumption this year. On the other hand, interest rates will remain high this year, which will moderate further consumption growth. Research expects a contraction in private consumption in the year 2008 that can be attributed to high real interest rates, depreciation of the ISK that will cause some pass through effect into the price level. Research also believes that households' real disposable income will stagnate next year. In 2009, Research expects interest rates to be lowered further and household's real disposable income to increase again leading to a 2.2% increase in private consumption from the previous year.

Private consumption and real disposable income

- real changes from the previous year



Sources: Kaupthing Research, Statistics Iceland

Public consumption 2.5-3.0% in next couple of years

In Q1 2007 public consumption grew in real terms by 2.2%, according to estimated data from Statistics Iceland. Research's forecast for public consumption remains unchanged from the previous forecast; public consumption is expected to grow by 2.5% in real terms this year and 3% in 2008-2009. Thereof it is estimated that government spending will grow by 2% in real terms this year, which is in line with the government's long-term targets.

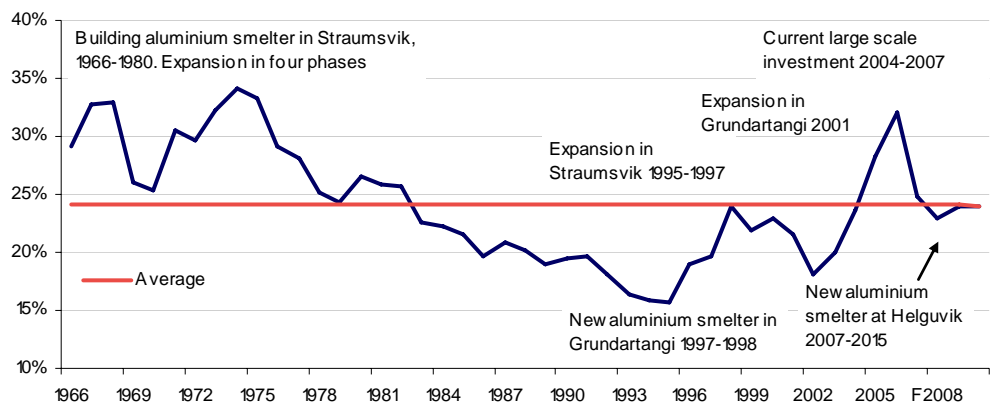
Considerable drop in business sector investment

Current aluminium and hydropower sector investments come to an end this year, but they have been the main force behind the high levels of business sector investment in recent years. Gross fixed capital formation peaked last year, amounting to 32% of GDP, the highest level since 1973-1974 or since the aluminium smelter in Straumsvík was being built. Kaupthing Research expects investment to return to equilibrium this year and be around 25% of GDP. According to estimated data from Statistics Iceland, investments decreased in real terms by 40% in Q1 2007 from the same quarter last year. The drop in investment can be attributed to a decrease in aluminium and hydropower investments, now that they have to a large extent come to an end. There were also irregular items such as aircraft exports (which are subtracted from

investments) that have an impact on the results. In Kaupthing Research's opinion, investments in aluminium and hydropower investments will contract this year by ISK 75 bn from the previous year. As was mentioned in the Quarterly Economic Outlook in April, Kaupthing Research believes that further investments in the aluminium and hydropower sector are likely, once the current investments come to an end. The new economic forecast, therefore, assumes that a new aluminium smelter will be built in Helguvík. The project in Helguvík is, however, much smaller in size than current investments. Research expects investments in Helguvík to start this year but the bulk of investments won't take place until 2009-2011. Research has lowered its forecast for business sector investment and now expects a contraction of 32% this year, attributed among other things to the above-mentioned aircraft trade. Research further expects a 12% contraction next year. In 2009, the heavy industry projects are expected to be well advanced and business sector investment is expected to grow by 7% in real terms from the previous year.

Gross fixed investment as % of GDP

- from 1966-2009, according to Kaupthing Research forecast



Sources: Kaupthing Research, Statistics Iceland

Residential property investment still growing

According to estimated data from Statistics Iceland, residential property investment grew in real terms by 7% in Q1 2007 from the same quarter in the previous year. The housing market has been heating up in recent months, triggering off an incentive to construct new housing. Kaupthing Research expects residential property investment to grow in real terms by 3% this year. In Research's opinion, the housing market will cool down at the end of the year and residential property investment will therefore decrease by 7% next year. In 2009 Research expects residential property investment to grow by 5%.

Considerable growth in public sector investment next year

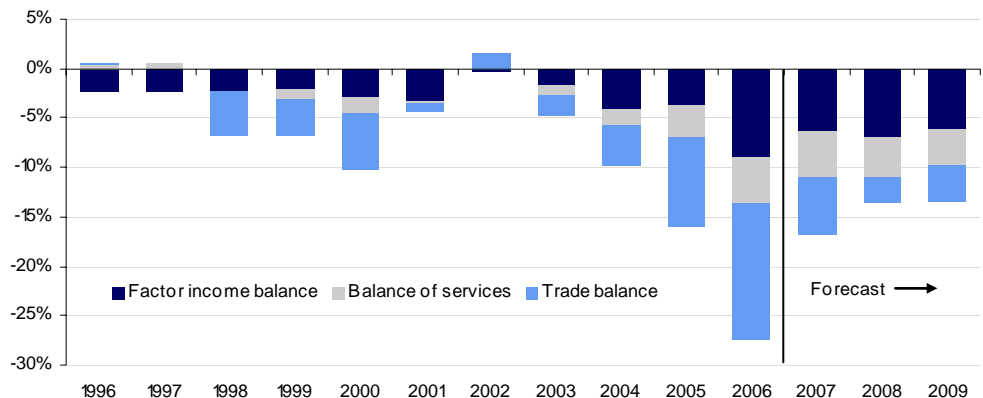
Research has raised its forecast for public sector investment this year and the next in response to the new Road Transport Plan, which was approved earlier this year. Recently the government agreed to earmark ISK 6.5 bn for road construction as a counterbalancing measure against the cut in cod quota. Projects that had been scheduled for 2011-2018 have now been put forward to 2008-2010. Kaupthing Research expects public sector investment to grow in real terms by 8% this year from the previous year and by 32% next year. In 2009, Research expects public sector investment to grow by 11%.

The current account deficit: Still high despite subsidence

The current account deficit decreased considerably in the first quarter of 2007 from the previous year. The current account deficit amounted to approximately 9% of GDP in the first quarter, which is far less than the record heights in 2006 when the deficit amounted to 27% of GDP. Foreign trade in the first quarter cannot be considered typical for the year in whole, however, since the trade deficit was unusually low, due to irregular items and because the improvement in the factor income deficit was probably only a temporary reprieve. All things equal, the current account deficit is likely to improve from the previous year and amount to 17% of GDP in 2007. On the other hand, it is estimated that the deficit will amount to around 13.5% of GDP in 2008 and 2009 which is still a high ratio in international context. An important factor is that the forecast estimates a continuing high balance of income deficit of 6-7% of GDP. It should be borne in mind that the high balance of income deficit recently measured does paint an unnecessarily poor picture of the Icelandic economy, partly because of certain unique characteristics of the economy and associated measurement problems. It should also be kept in mind that this aspect of the forecast is the most volatile and least foreseeable. However, at the same time the trade balance is a good indicator of the external equilibrium of the Icelandic economy and this particular component will improve considerably in the coming years, according to the forecast.

Current account and its sub-categories

- as % of GDP



Sources: Kaupthing Research, Central Bank of Iceland

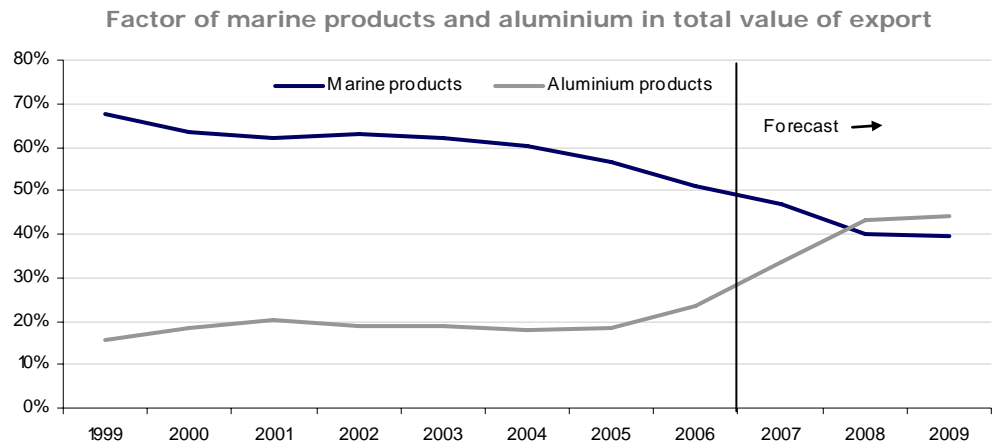
Trade deficit to decrease over the next years

In 2006 the trade deficit broke all previous records and measured 13.7% of GDP. Imports related to investments and substantial private consumption accounted for this deficit to a large extent. The trade deficit has diminished so far this year and Research expects a continuing decrease throughout the year ending at 5.8% of GDP, partly due to an increasing level of aluminium production. The forecast estimates that the trade deficit will reach a low at 2.7% of GDP in 2008, then slightly increasing again in 2009.

Exports of aluminium and cod below expectations

Big increases in exports are expected this year but at a slower pace than previously thought. The increase in aluminium production will be less than formerly scheduled and cutbacks have been made in the cod quota. The reduction in export value resulting from the cuts in the cod quota will amount to approximately ISK 15-20 billion when the consequences have been fully absorbed. This year export revenue will decline by around ISK 5-6 billion and will continue to decline by around ISK 10 billion in 2008. The reason for less aluminium exports this year is that aluminium smelting in the east will probably not reach 100 thousand tons at the end of the year as former plans indicated. Next year it is intended that the production will be close to full capacity at 340 thousand tons (full capacity will be 346 thousand tons).

Irregular items partly explain decrease in current account deficit this year. Exports increased by a third in the first half of the year 2007, but it needs to be taken into account the fact that the temporary imports of aircrafts amplified the deficit last year and, by the same token, reduced it again this year when the same aircrafts were exported. After subtracting the abovementioned exports of aircrafts export growth amounted to 30% so far this year and imports increased by almost 1%.



Sources: Kaupthing Research, Central Bank of Iceland

Balance of services improves slightly

The deficit on the balance of services was around 3.9% of GDP in the first quarter. Research expects the deficit to be around 4.7% of GDP this year compared to 4.5% deficit in previous year. In the next two years Research expects the service deficit to be around 3.6-4.1% of GDP.

Balance of income contributes most to the deficit

Almost a third of the current account deficit in the first quarter can be traced to a deficit in the balance of income, which is a similar share as last year. Research predicts that the deficit in balance of income will weigh most heavily in the current account deficit in 2007 and to be around 6% of GDP this year and 7% in the next. However, Research estimates that it will decrease again and measure at 6% of GDP in 2009. To some extent, the balance of income deficit reflects the nation's worsening debt situation and an unbalance between the interest revenues and the interest payments of the economy, but this aspect is usually very volatile between years.

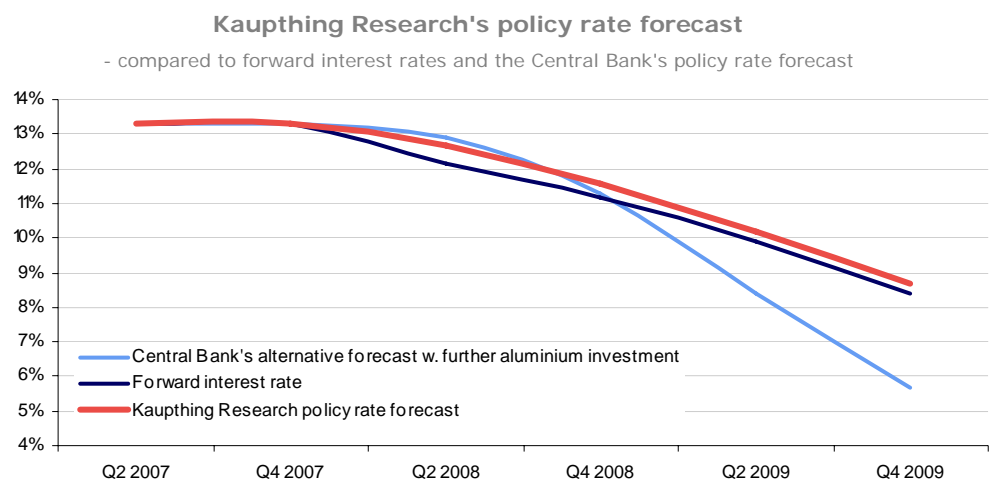
Policy rate forecast: A slower lowering process

Short-term outlook for interest rates: Decrease in March 2008

In Research's opinion, the Central Bank of Iceland (CBI) will start lowering its policy rate in March next year, as the CBI stated in its baseline forecast. However, as forward interest rates indicate, market participants expect that the process of lowering policy rates will start earlier and initially evolve somewhat faster. Research believes it is unlikely that the process of lowering interest rates will begin earlier than the CBI is estimating, in view of the uncertainty with regard to upcoming economic growth figures, the exchange rate of the ISK and the housing market, which all seem to indicate a slower rather than faster lowering process. Research forecasts a substantial depreciation of the ISK in mid 2008 and expects it to slow down the lowering of the policy rate process but not to stop it.

Medium-term outlook for interest rates: A slow decrease

Research expects the policy rate to come down to 11.5% by the end of 2008, which is close to the Central Bank's forecast and forward interest rates. What stands out in the Central Bank's forecast, however, is its expectation of a substantial lowering of its policy rate in 2009 – even though the bank's deviation forecast is taking into account the new aluminium plant by Century Aluminium in Helguvík, as Kaupthing Research's forecast also does. It is quite clear from the graph below that, in terms of forward interest rates, market participants do not believe there will be an as sharp drop in policy rates in 2009 as the one predicted by the Central Bank. Research forecasts even higher interest rates in 2009 and that the policy rates will be down to 8.5% by the end of 2009. In Research's opinion, it is quite likely that the economy will be entering into a new phase of expansion towards the end of this forecast horizon and that the process of lowering the policy rate will either come to an end or start on a new upward cycle.



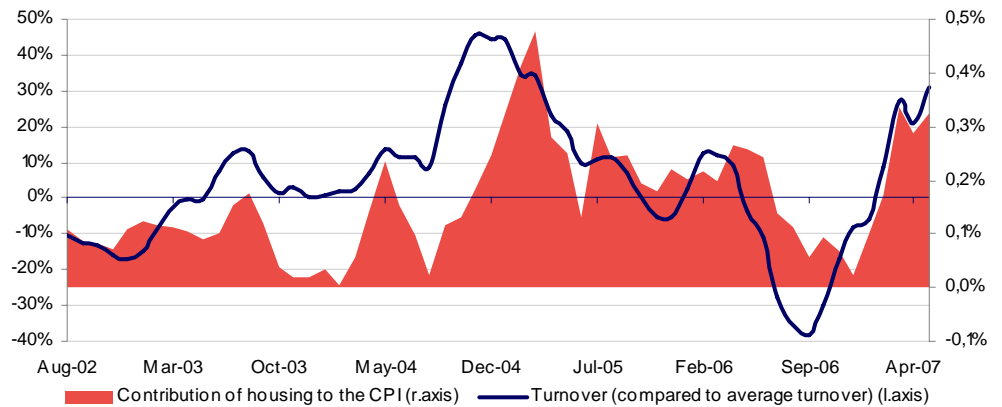
Sources: Kaupthing Research, Central Bank of Iceland

The housing market still generating heat?

There have been signs of a renewed upturn in the housing market for some time, which can be gleaned, for example, from the fact that the number of notarized contracts of sale has increased by 25% compared to the same seasons over the past five years. This growing activity in the real estate market has been accompanied by rises in real estate prices and led to a 0.3% increase in the Consumer Price Index between months, which is equivalent to an annual increase of 3.6%. In view of these figures, it is hardly surprising that housing prices are the main driving force behind inflation at the moment.

Housing prices and activity on the real estate market

- contribution of housing prices to CPI and turnover on the housing market comp. to the seasonal average



Sources: Land Registry of Iceland, Statistics Iceland

The significance of the Housing Financing Fund (HFF)

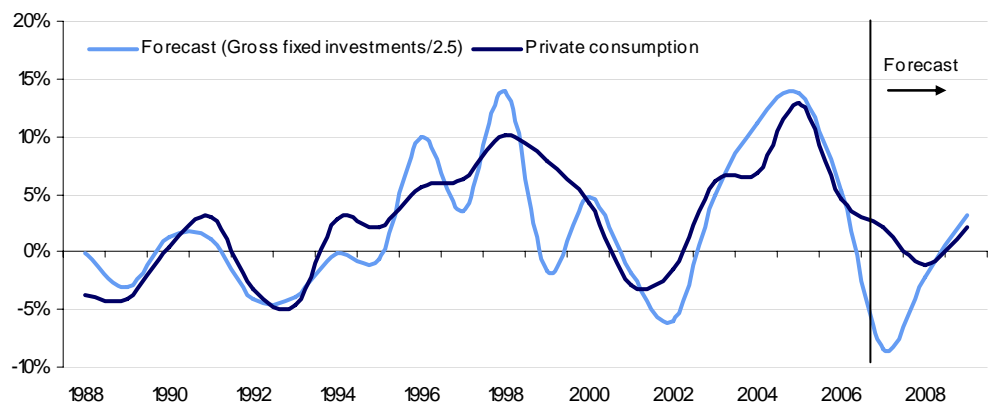
Uncertainty with regard to the lowering of the Central Bank's policy rate is not the only factor tending towards higher interest rates. Indexed interest rates have risen recently, and in the light of the current situation the Housing Financing Fund might have to raise its interest rate up to 5.25% in its next offer of HFF bonds. Although this increase could have some dampening effect on the housing market, it is not certain that this increase alone would have any great impact on the market. If the government, on the other hand, decides to reform the HFF – which seems quite possible – it could considerably decrease the supply of borrowing on the housing market and smooth the way towards a swifter lowering of policy rates.

The weight of aluminium and hydropower and real estate investments

Increases on the housing market embody a wealth effect and therefore encourage further private consumption – in the same way that the vast increases in share prices have done recently. In addition to this, construction is a labour intensive industry and vast construction projects therefore increase the likelihood of an expansion of the labour market – as the continued build-up of the aluminium and hydropower sector will do. Research expects business and real estate investments to contract by one third this year and the business investments to decrease by 12% in 2008. If this forecast is right, the expansion of the economy will contract, increasing the likelihood of a swifter lowering of the policy rate. On the other hand, business investments will start to grow again in 2009 with a lot of activity in Helguvík, which could rekindle private consumption again – particularly if they are accompanied by further real estate and large scale industrial investments.

Forecast of private consumption in relation to gross fixed investments

- Forecast calculated as: $\text{Change in private consumption} = \text{Change in gross fixed investments} / 2.5$

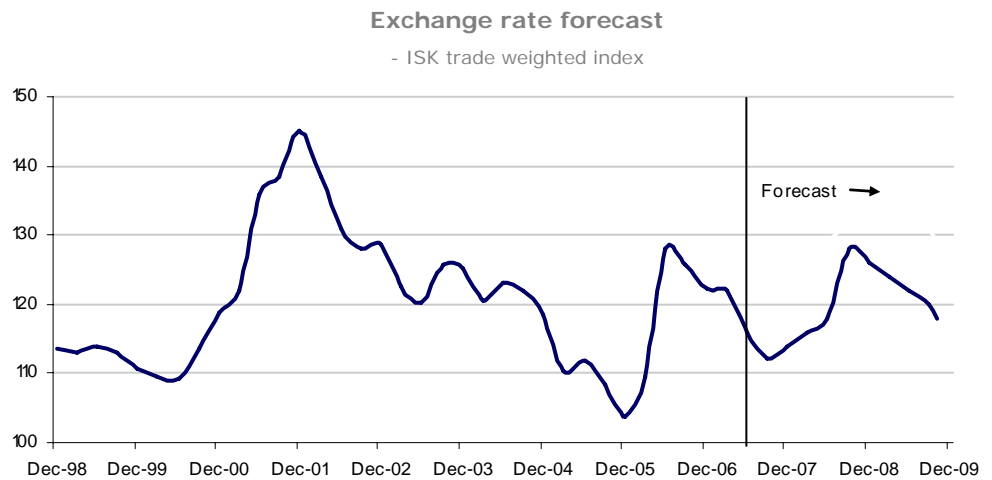


Sources: Kaupthing Research, Statistics Iceland

Exchange rate forecast: A strong ISK for the moment, but weakening next year

ISK will remain strong for remainder of the year

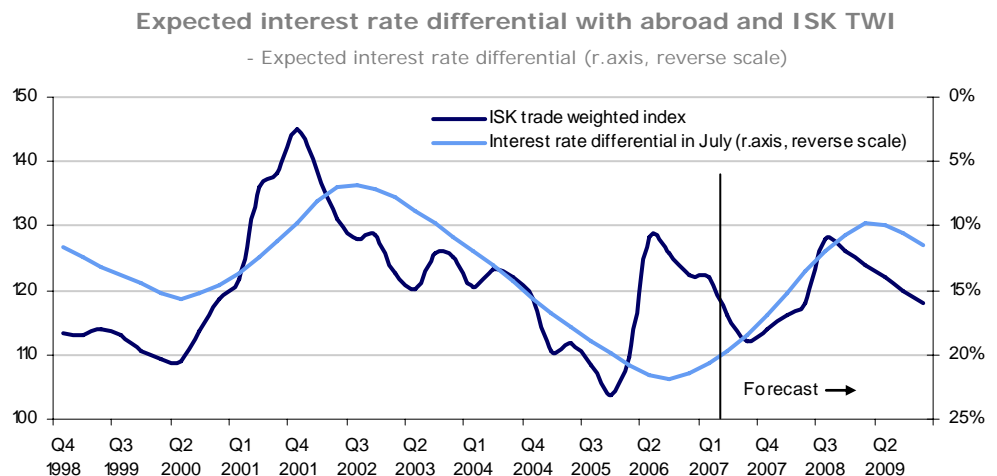
According to Research's latest exchange rate forecasts, the ISK will remain buoyant over the next 6 to 12 months, although the peak will probably be reached in the third quarter this year. A great deal of glacier bonds will reach maturity next autumn, which could create some danger of the exchange rate weakening considerably. In Research's opinion, however, most glacier bonds will be extended as the outlook is that the owners of the bonds will make good gains and the interest rates being offered will still be among the highest in the world.



Sources: Kaupthing Research, Central Bank of Iceland

A weaker ISK in 2008

In 2008 the interest rate differential with abroad will have somewhat diminished, while the prospect of a high current account deficit will persist. The danger in such circumstances is that negative news domestically or outside Iceland could trigger off a weakening of the currency. There is already considerable concern that the carry trade could suffer a shock, which would have a negative impact on high yield currencies such as the ISK – as was the case in 2006. Domestic news, on the other hand, can also increase the likelihood of a swift lowering of the policy rate and consequently the depreciation of the ISK. At some point in time, the cooling of the economy might begin and be faster than was anticipated.



Sources: Kaupthing Research, Central Bank of Iceland

New phase of growth will strengthen ISK

Although the interest rate differential with abroad will contract considerably over the next years, the outlook is that interest rates will continue to be high in Iceland in international context because of strong demand, continuing activity in the aluminium and hydropower sector and various other projects in Iceland over the coming years. This will undoubtedly support the ISK in the coming years although fluctuations will always be present, but according to Research's forecast it is likely that the krona will re-enter a strengthening phase in 2009, following its weakening in the previous year.

Kaupthing Research's exchange rate forecast

- Real figures for July and average value projections for 4F 2007-2009

	17.07.2007	Q4 2007	Q4 2008	Q4 2009
ISK TWI	112	114	126	118
EUR	83	81	93	87
USD	60	59	69	65

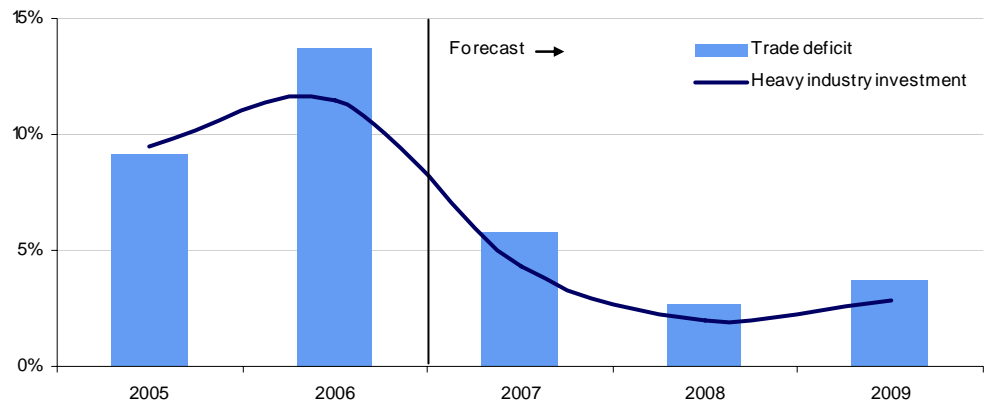
Sources: Kaupthing Research, Central Bank of Iceland

Persistent deficit and high real exchange rate?

As the graph below shows, the trade deficit will continue somewhat, even though looking past the continuing of large scale projects. The deficit on income and services will account for about 15% of the current account deficit in 2008 and 2009, which is extremely high in an international context. If this forecast holds, this will cause continuing concern around the sustainability of the economy and render the economy more vulnerable to external shocks.

Aluminium and hydropower sector-driven deficit?

- Trade deficit and aluminium and hydropower sector investments as % of GDP

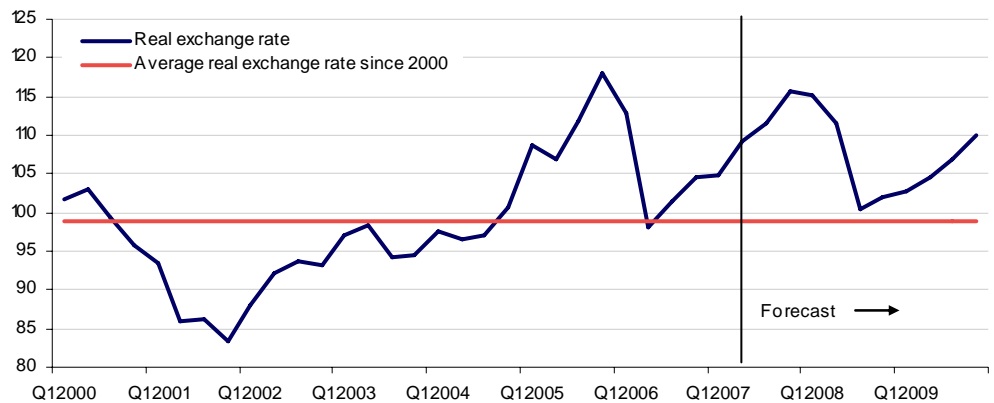


Sources: Kaupthing Research, Central Bank of Iceland, Statistics Iceland

According to the benchmark real exchange rate, the ISK will continue to be high. If one extrapolates the real exchange rate of the ISK according to inflation and exchange rate forecasts, one can see a weakening of the ISK in mid 2008 will bring the real exchange rate close to the average real exchange rate since 2000 (which was similar to its average value in 1980). If the ISK manages to regain its strength - as we predict here - it will deviate from its average real exchange rate and be about 10% above the average real exchange rate at the end of the forecast horizon.

Real exchange rate of ISK

- in relation to domestic prices (CPI) with and without housing costs and the average real exchange rate



Sources: Kaupthing Research, Central Bank of Iceland

High interest rate expectations have kept exchange rates high

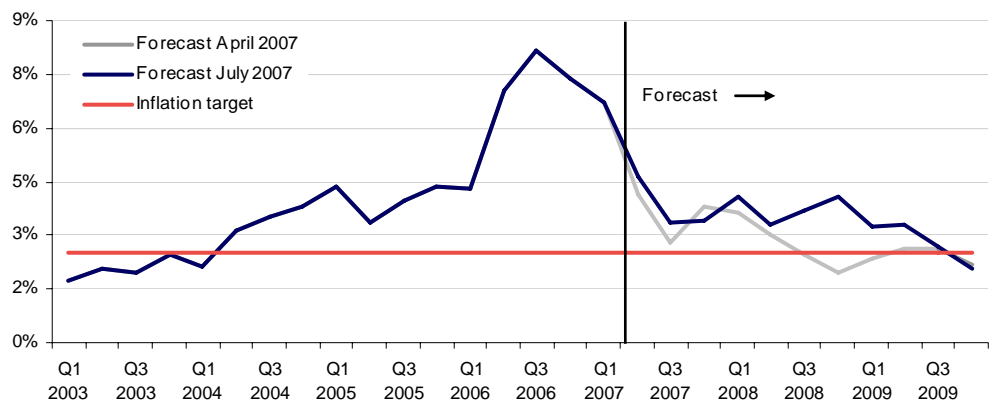
Since Kaupthing Research's last exchange rate forecast was issued, high interest rate expectations have risen considerably in Iceland. The Central Bank is now expected to start diminishing its policy rate later than was previously anticipated and it appears that the interest rate differential with abroad will continue to be high. One can expect that, among other things, annual returns over the next two years will be around 10% higher in Iceland than in its trading countries. This, coupled with the healthy state of carry trade globally, makes the ISK resilient to negative news this year. The year started with a downgrading of Standard & Poor's credit rating for the Icelandic state and there was a considerable downswing on foreign markets in February. This was followed by figures on Iceland's record high current account deficit and Fitch's downgrading of Iceland's credit rating. This in turn was followed by the population of Hafnafjordur's rejection of plans to enlarge the aluminium plant in April and last, but not least, a threat to substantially cut the cod catching quota came in June. One might argue that these factors should have led to a considerable weakening of the ISK, but the exact opposite has occurred.

Inflation forecast: Target will be met by end of 2009

Kaupthing Research has increased its inflation forecast for this year and the next. We now expect the Central Bank of Iceland to reach its inflation target by the end of 2009 instead of the end of 2008, as was previously forecasted. The reasons for this higher forecast can be attributed to developments on the housing and labour markets, but the new forecast expects housing price increases to decrease slower and that the tension in the labour market will persist longer than was expected. In the second half of 2008, the ISK exchange rate is expected to sharply weaken, which will temporarily lead to increased inflation. Kaupthing Research expects twelve month inflation to be on average 4.5% this year, 3.8% next year and 2.8% in 2009. The main risk profiles in Kaupthing Research's inflation forecast are exchange rate developments and developments on the real estate market.

Development of inflation and Kaupthing Research's forecast

- 12 month changes in CPI



Sources: Kaupthing Research, Statistics Iceland

Inflationary pressure still at work although measured inflation has fallen

The twelve month inflation rate has rapidly decreased over the past months, which can be primarily attributed to VAT tax cuts on food in March, as well as the decrease of the surge in inflation which was caused by the depreciation of the ISK in 2006. Twelve month inflation now measures at 3.8% and has not been this low since August 2005. Despite diminishing inflation, there are still signs of inflationary pressures in the economy; there has been a surge in real estate prices over the past months, as well as the household purchasing power increased substantially in the first two quarters of the year causing strong domestic demand. There have also been considerable wage increases between years, which have gradually had an effect on consumer prices. The appreciation of the ISK over the past months, however, has only had a very slight impact on prices. However, one does not know how development might have been without the strengthening of the ISK. If the tax cuts in March are blinked, Statistics Iceland estimates that inflation in July would have measured at 5.1% instead of 3.8% as measured inflation shows.

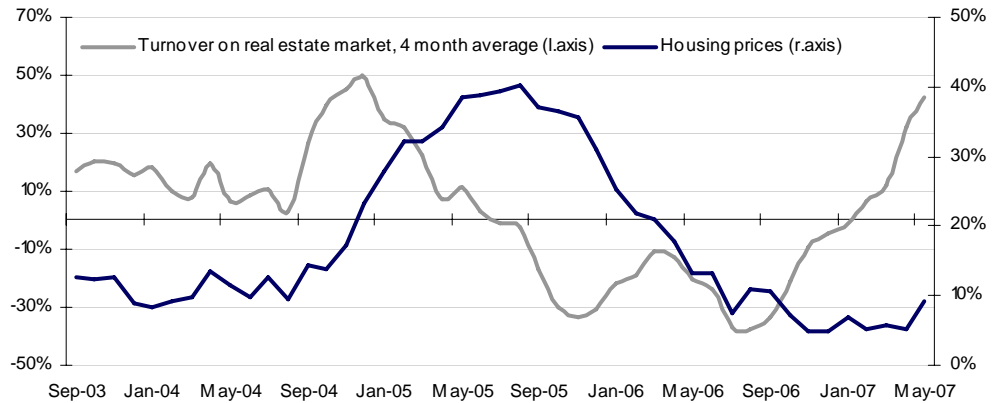
A lively real estate market

The real estate market is back in full swing after a slightly slack summer last year and the current 12 month price increase for housing in the capital area measures at 9.2%. Real estate prices weigh heavily in the consumer price index (CPI) and rising housing prices in the country as a whole have been the main factor in the rising of the consumer price index over the past twelve months. Activity on the real estate market escalated at the beginning of the year and there seems to be no shortage of demand for housing. This increased competition on the housing loan market generated a rise in the supply of loans, both domestic and foreign, which in turn had an impact on real estate prices. Because real estate prices occupy such a large proportion of the CPI, the

evolution of the real estate market has a great impact on the development of inflation. Rising real estate prices also have a wealth effect which further fuels demand in the economy. Kaupthing Research expects activity on the real estate market to slow down as the year progresses, which will slow down the property price increase.

Development of housing prices and activity on the real estate market

- compared to last year

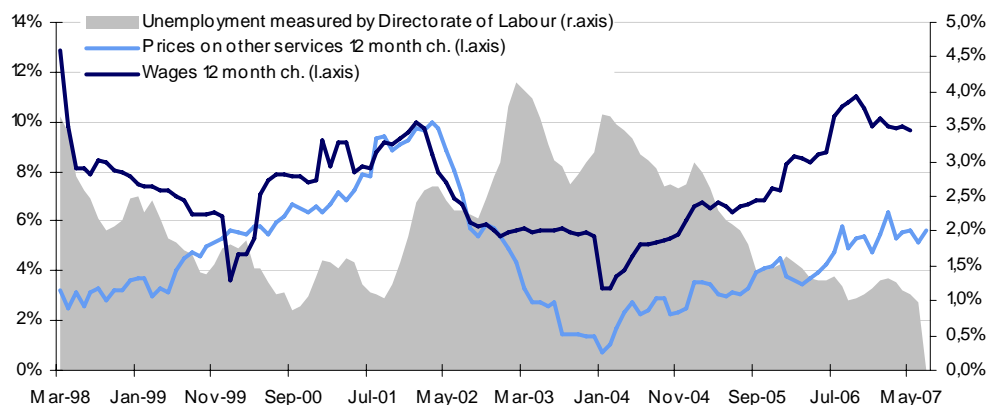


Source: Land Registry of Iceland

Domestic demand strong – price rises in services affect consumers

There has been considerable tension on the labour market in the past year with no apparent cool-down in sight. Unemployment is very low and there have been considerable wage increases between years. Recent surveys revealed a considerable shortage of labour, it indicating wage pressures will slowly ease over the coming months. Wage increases over the past year have gradually filtered down to consumer prices and mainly manifested themselves in increases in the price of several services, with the current twelve month increase measuring around 6%. Recent figures indicate that private consumption has risen again in the second quarter this year after a slight contraction in the first quarter. Domestic demand is, therefore, still very strong, which is perhaps not surprising in view of the fact how rapid household purchasing power has increased in the first months of the year. Kaupthing Research expects wages to rise by an average of about 8.4% this year, 5.6% next year and 6.7% in 2009.

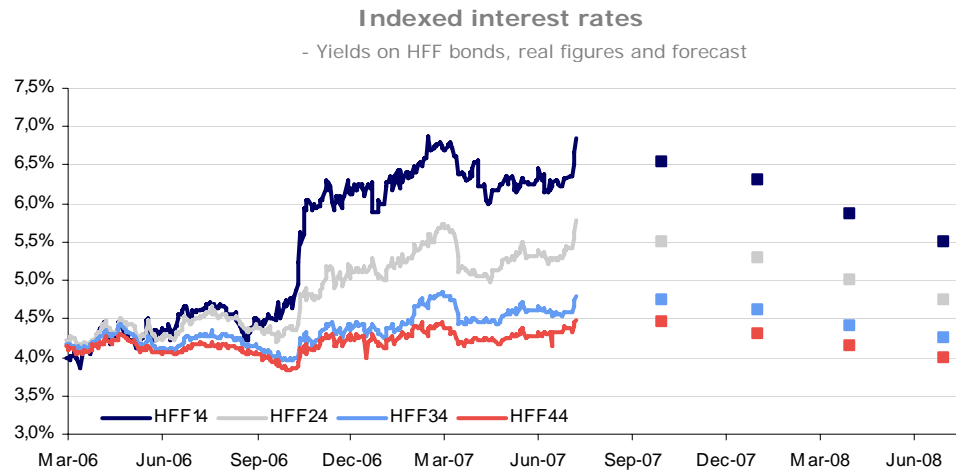
General wage increases, service price increases and unemployment



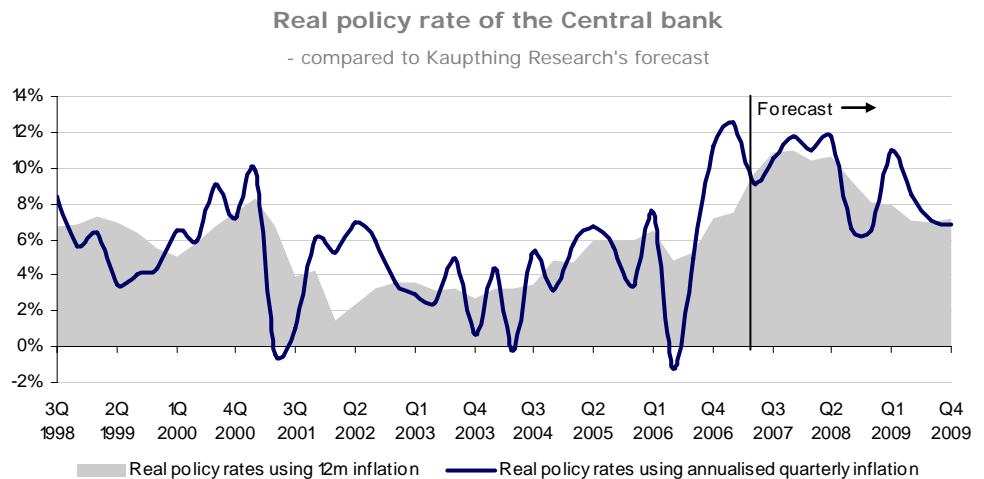
Sources: Kaupthing Research, Statistics Iceland, the Directorate of Labour

Real interest rate forecast: 10% real policy rate the next year

Inflation figures in March turned out to be considerably above expectations, partly because the tax cuts on food had less impact than expected. A poorer inflation outlook coupled with little change to the interest rate expectations, therefore, resulted a drop in indexed interest rates according to the yields of indexed bonds in March and April. The Central Bank managed to raise interest rate expectations at its meeting on July 5th by postponing any policy rate cuts until the first quarter of 2008.



Compared to the last forecast, Research now expects the real interest rate to be higher and to remain so for a longer period, both in terms of the Central Bank's real interest rate and yields on indexed bonds. A surge in inflation around mid 2008, caused by a weakening of the ISK, will however result in a short-lived fall in the real policy rate as can be seen in the graph below. According to the forecast, the Central bank's real policy rate will be around an annual average of 11% in 2007, 9% in 2008 and 8% in 2009. The reason why Kaupthing Research now expects a higher real interest rate than before is that it now expects a higher policy rate.



Indexed interest rates will slowly come down

In Research's opinion, yields on indexed bonds will remain high over the next months since summer sales will keep a rein on prices, which makes the purchase of indexed bonds less appealing. According to the forecast, yields will fall slightly at the end of the year, in anticipation of the Central Bank starting the process of lowering its policy rate. The expectation is that by mid 2008 yields on indexed bonds will be around 4.0-5.55%. Research forecasts a depreciation of the ISK in mid 2008, which at the same time will encourage a decrease in indexed yields.

Forecast of yields on HFF bonds

- at the end of the quarter

	17.07.2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
HFF14	6,92	6,60	6,35	5,95	5,55
HFF24	5,88	5,60	5,40	5,05	4,75
HFF34	4,91	4,85	4,65	4,40	4,20
HFF44	4,57	4,55	4,35	4,20	4,00

Sources: Kaupthing Research, Central Bank of Iceland

International economics

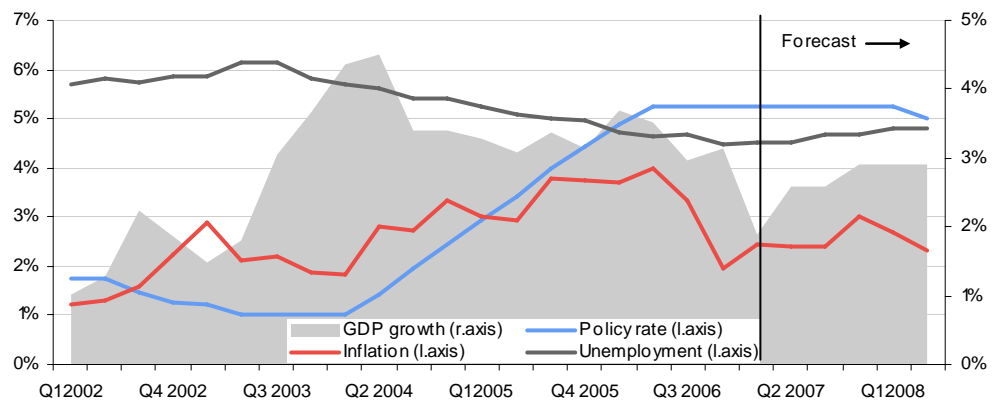
The global economic outlook continues to show positive signs, according to an IMF report published in April 2007. The IMF predicts 4.9% world growth in 2007 compared to an astounding 5.4% growth in 2006. In recent years, China, India and other emerging markets have been the main forces behind world economic growth. The year 2007 will be no exception to this trend. IMF predicts 7.5% economic growth in emerging markets, whereas Western Europe, Japan and the United States will grow by an average of 2.5% this year. Benign financial conditions and robust stock market earnings have helped to limit the spillovers from the downturn in the US housing market. Generally speaking, the world economic outlook remains in good shape. Nonetheless recent developments in oil prices and volatility in emerging financial markets are a cause of worry. Furthermore the US sub-prime mortgage market crisis is a case of particular concern. Without any major catastrophes occurring in 2007, the IMF predicts a similar growth rate in 2008.

A slowing US economy

The US economy has slowed significantly since early 2006, due to a downturn in the housing market. GDP growth amounted to 1.9% in Q1 2007, the lowest since 2003. The outlook for GDP growth for the rest of the year is more on the positive side and initial forecasts predict around 2% GDP growth for 2007. Despite a grim outlook in the housing market, private consumption remains robust and increased by 4.4% in the first quarter. Most forecasts assume an unchanged policy rate for the rest of the year, due to a tight labour market and increased inflation. The outlook for 2008 predicts increased GDP growth, a stable policy rate and decreasing inflation. Further weakening of the dollar is predicted this year only to be followed by a strengthening of the dollar in 2008. Most analysts agree that the full effect of the downturn of the housing market will not be evident until later this year.

USA – Main economic indicators

- 12 month change in GDP and CPI

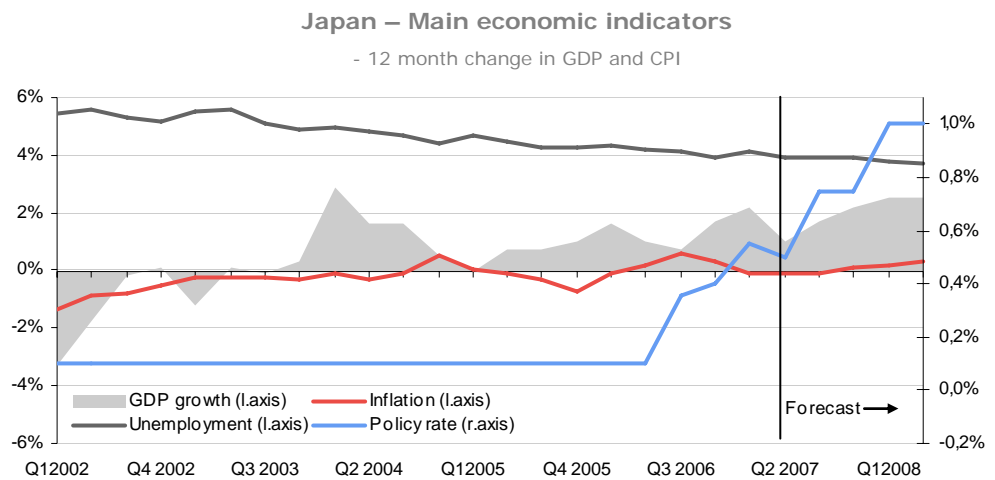


Sources: Bloomberg, EIU

Japanese recovery, slow but sure

It seems that the years of economic stagnation are finally over for the Japanese economy. After being plagued by deflation and lack of consumer confidence for more than a decade, the Japanese economy seems to be recovering slowly but surely. Last autumn, the Bank of Japan embarked upon gradually increasing the policy rate after a decade of a near zero policy rate trend. The current policy rate in Japan stands at 0.5% and most analysts expect an increase by 25 points in August. Further forecasts assume the policy rate will stand at 1.25% by mid-year 2008. A 25 point increase in the policy rate will probably not have a significant impact on the extent of carry trade, but a gradually closing interest rate gap between high yielding currency countries and low

yielding countries will undoubtedly diminish investor's interest in currency trade. However, the acceleration of the increase depends on a variety of factors. GDP growth in Q1 2007 amounted to 0.8%, exceeding analysts' expectations by 0.2 percentage points. Growth forecasts for 2007 predict around 2.7% GDP growth compared to 2.2% GDP growth in 2006. Increased GDP growth in recent years has been driven by booming corporate profits that have been ploughed back into investment. Most analysts estimate that the investment boom has peaked, which could cause less GDP growth in 2008. The labour market is showing positive signs with a decreasing unemployment rate standing at 3.8% in May, the lowest in 9 years. Initial forecasts predict an unemployment rate of 3.9% for 2007. Despite disappointing signs of deflation in Q1 2007, most analysts predict a slight increase in inflation in the latter part of 2007 and throughout 2008. One consequence of the carry trade has been a weakening of the yen. A further weakening of the yen is predicted in 2007 followed by a recovery in 2008.

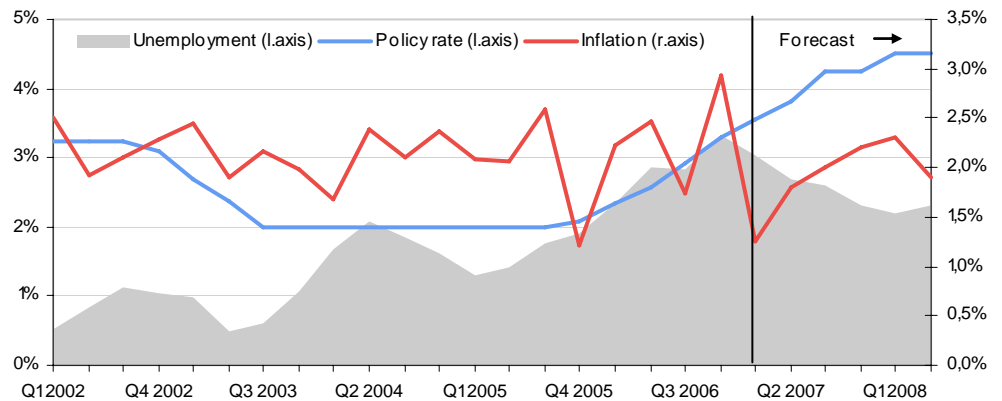


A recovering Eurozone

A robust economic recovery in the Eurozone has caught most analysts by surprise. GDP growth has increased steadily since mid 2005 and amounted to 3% in Q1 2007. Initial estimates predict a 2.3%-2.9% GDP growth for 2007. Better than expected German export numbers are driving the Eurozone recovery due to the opening of new markets in Asia and Eastern Europe. Unemployment in May stood at 7%, the lowest since 2000. Most forecasts predict a further decrease of the unemployment rate in 2007 and 2008. Forecasts assume private consumption will grow by 2% in 2007, increasing by 0.2 percentage points from 2006. The policy rate now stands at 4% after an increase of 25 points in June. According to the Central Bank of Europe a further increase in the policy rate is to be expected next autumn. CPI numbers for Q1 2007 showed the inflation rate standing at 2.23%, slightly above the target rate of 2%. Most analysts expect the Central Bank to achieve its inflation target early in the year 2008. The Euro has been strengthening steadily against the USD since 2002. The outlook is a relatively steady EUR/USD until the dollar recovers again in 2008.

Eurozone – Main economic indicators

- 12 month change in GDP and CPI



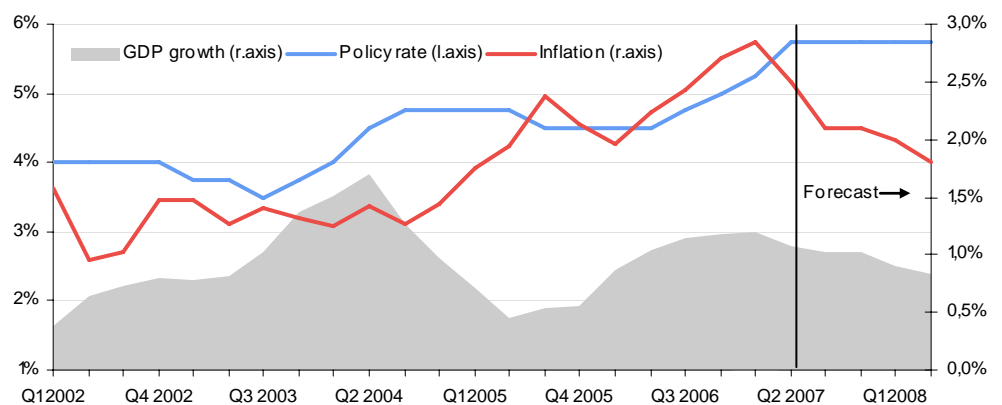
Sources: Bloomberg, EIU

Strong British growth

British GDP growth in the last twelve months has been far more robust than expected. GDP growth in 2006 amounted to 2.8% compared to a 1.9% increase in the previous year. GDP numbers in Q1 2007 still exceeded expectations with an annual rate of GDP growth climbing to 3%. Inflationary pressure has also been mounting. The first quarter annual inflation increase stood at 3.1%, which is a ten year high. Mortgage lending has been increasing significantly and consequently housing prices have risen by 10% this year. The Bank of England has responded hawkishly, by increasing the policy rate by 1.25% since September 2006. The policy rate currently stands at 5.75% and May's inflation increase of 2.5% gives rise to a slightly better outlook. Nevertheless, most analysts predict an increase in the policy rate by 25 points to 6% before the end of 2007. A higher policy rate will cause a slight contraction of the economy through a slowdown of the housing market. Furthermore, retail sales in the second quarter will see a considerable decrease due to bad weather. Much depends on the Bank of England's ability to contain inflationary expectations for the rest of the year.

UK – Main economic indicators

- 12 month change in GDP and CPI



Sources: Bloomberg, EIU

Economic forecast 2007-2009

Real change between years, %	2006	2007	2008	2009
Private consumption	4,6	2,1	-1,1	2,2
Public consumption	2,9	2,5	3,0	3,0
Gross fixed capital formation	13,0	-20,9	-5,2	7,4
- Business sector investment	13,8	-31,9	-12,4	7,4
- Residential property investment	17,2	3,0	-7,4	5,0
- Public investment	0,8	8,0	32,2	10,9
National expenditure	7,4	-5,1	-1,1	3,5
Exports of goods and services	-5,6	13,3	7,6	2,1
Imports of goods and services	8,8	-6,8	-2,2	3,5
GDP	2,6	1,8	2,5	3,0
Current account balance, % of GDP	-27,3	-16,7	-13,7	-13,6
- Trade balance	-13,7	-5,8	-2,7	-3,7
- Balance of services	-4,5	-4,7	-4,1	-3,6
- Factor income balance	-9,0	-6,3	-6,9	-6,2
Average change from previous year (%)				
Consumer price index	6,8	4,5	3,8	2,8
Nominal wages	9,5	8,5	5,8	6,8
Purchasing power	2,7	4,0	2,0	4,0
Unemployment according to Directorate of Labour	1,3	1,5	2,8	3,0
Unemployment according to Statistics Iceland	2,9	2,3	3,3	3,5
Effective price of foreign currency	11,7	4,2	4,1	0
Yearly average (%)				
Policy rates	12,6	13,3	12,3	9,8
Policy rates in real terms*	6,8	9,7	9,6	7,3
Policy rates in real terms**	10,3	11,0	9,0	8,4
ISK trade weighted currency index	121	116	122	121

* using 12 month inflation

** using annualised quarterly inflation

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

Inflation forecast

	Change from prev. year (%)	Quarterly change (%)
Q1 2007	6,7	0,4
Q2 2007	4,6	1,3
Q3 2007	3,4	0,9
Q4 2007	3,4	0,8
Q1 2008	4,1	1,1
Q2 2008	3,3	0,5
Q3 2008	3,7	1,3
Q4 2008	4,1	1,2
Q1 2009	3,3	0,3
Q2 2009	3,3	0,5
Q3 2009	2,7	0,7
Q4 2009	2,1	0,6

Exchange rate forecast

	ISK TWI	EUR	USD
Q1 2007	122	89	68
Q2 2007	116	86	64
Q3 2007	112	84	61
Q4 2007	114	83	60
Q1 2008	116	83	60
Q2 2008	118	83	61
Q3 2008	128	93	69
Q4 2008	126	93	69
Q1 2009	124	92	69
Q2 2009	122	88	66
Q3 2009	120	87	65
Q4 2009	118	87	65

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

Policy rate forecast (%)

	Policy rate	Annual yield	Policy rates in real terms*	Policy rates in real terms**
Q1 2007	13,3	14,2	7,5	12,6
Q2 2007	13,3	14,2	9,6	9,2
Q3 2007	13,3	14,2	10,8	10,5
Q4 2007	13,3	14,2	11,0	11,7
Q1 2008	13,2	14,1	10,4	10,9
Q2 2008	12,7	13,5	10,7	11,8
Q3 2008	11,9	12,7	9,3	6,6
Q4 2008	11,6	12,3	8,1	6,5
Q1 2009	10,8	11,4	7,9	10,9
Q2 2009	10,2	10,7	7,1	8,6
Q3 2009	9,3	9,8	7,0	7,1
Q4 2009	8,7	9,1	7,1	6,8

* using 12 month inflation

** using annualised quarterly inflation

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

Provisional release:

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