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Arion Bank

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Landsbanki debt extension can greatly mitigate refinancing risk

Our latest balance of payments analysis suggests that the heavy and frontloaded foreign debt repayment schedule of domestic parties remains a risk factor going forward, despite our projection of handsome current account surpluses throughout the coming years. However, the risk could be greatly mitigated by extending Landsbankinn debt.

The balance of payments crisis (you probably missed) in 2009-2013

At the risk of sounding paradoxical, we have a number of reservations about the widely employed method of analysis used in the first note of this month's edition of the Icelandic Economic Update. New data compiled by the CBI demonstrates how comparing current account balances and foreign debt repayment can be a misguided approach to identifying balance of payments pressures.

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Landsbanki debt extension can greatly mitigate refinancing risk

Accounting principle demands that a country's current account balance must always be equal to changes in its net international investment position. The outlook for Iceland's current account is therefore a key factor when it comes to lifting capital controls, since a current account surplus gives an indication to the amount of foreign currency the economy is generating net of its imports to improve its external balance sheet, for instance by paying down foreign debt.

Our latest forecast of the current account indicates that the handsome surplus Iceland has been experiencing since 2009 will start to decline in the coming years. Contrary to some forecasters, however, we believe that the decline will be modest and gradual. We find it extremely unlikely that the surplus will turn into deficit anywhere in the near term, as this would be in diametric contradiction to empirical evidence from other sudden stop episodes of the last 20 years.

Additionally, any country's ability to run a current account deficit is entirely contingent on external investors' willingness to finance its imports in excess of exports. For precisely that reason, we sometimes find ourselves puzzled when policy makers simultaneously express concern that, on the one hand, Iceland's current account surplus might turn into deficit and, on the other, that it has limited access to foreign credit. The two statements must be at least partly incompatible.

Our long term view on the current account consistent with empirical evidence

Our long term current account forecast for 2014-2020 is underpinned by the economic outlook Arion Research published last February, its underlying assumptions being an unchanged nominal exchange rate and stable terms of trade.

The surplus in our forecast is driven by continuing export growth, particularly in the tourism sector, although it will be partly offset by import growth in tandem with recovering domestic demand. Our assumptions therefore account for the possibility of hefty import volume increases, although we can hardly imagine imports growing anywhere near as fast as they did during the boom years of 2003-2008. During that period, imports were fuelled by an unprecedented credit expansion and appreciation of the ISK exchange rate, both of which were caused by massive inflows of external hot money. In the absence of such inflows, we find the probability of an unsustainable and sudden boom in imports to be low.

While the trade balance will remain firmly in the green according to our projections, the current account surplus will come to be weighed down by a widening deficit on net factor income. We attribute the increases in net factor outflows mainly to higher global interest rates and a recovery in the aluminium sector, leading to increases in retained earnings.

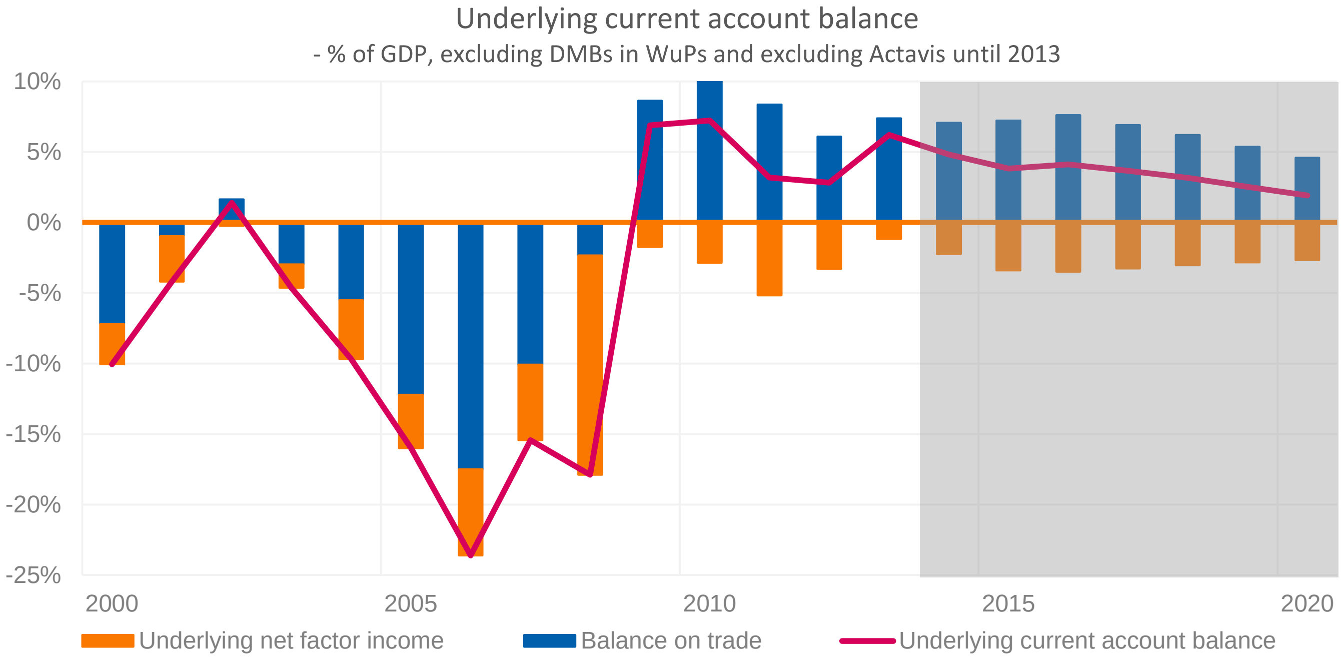


Fig. 1
Source: CBI, Arion Research forecast

If our projections materialise, the current account surplus (excluding deposit money banks in winding-up proceedings) will amount to 4,8% of GDP this year, but decline gradually to 1,9% in 2020. The surplus over the seven year forecasting horizon will average at roughly 3.3% of annual GDP, which is a sizable surplus despite being considerably smaller than the average annual surplus of 5.2% in 2009-2013.

It is in fact common for countries with high levels of external debt after prolonged bouts of current account deficits to show subsequent surpluses while imbalances are wound down. The adjustment trigger is usually a painful currency crisis brought about by a sudden stop in capital inflows, in which the exchange rate depreciates substantially. Indeed, we consider the main strength of our forecast to be the firm grounding provided by its similarity to developments in other crisis hit countries with comparable experiences. When comparing our forecast with a database of developments during 13 currency crises from the last two decades, it doesn't stand out as overly optimistic or unrealistic; on the contrary, it turns out to be rather typical.

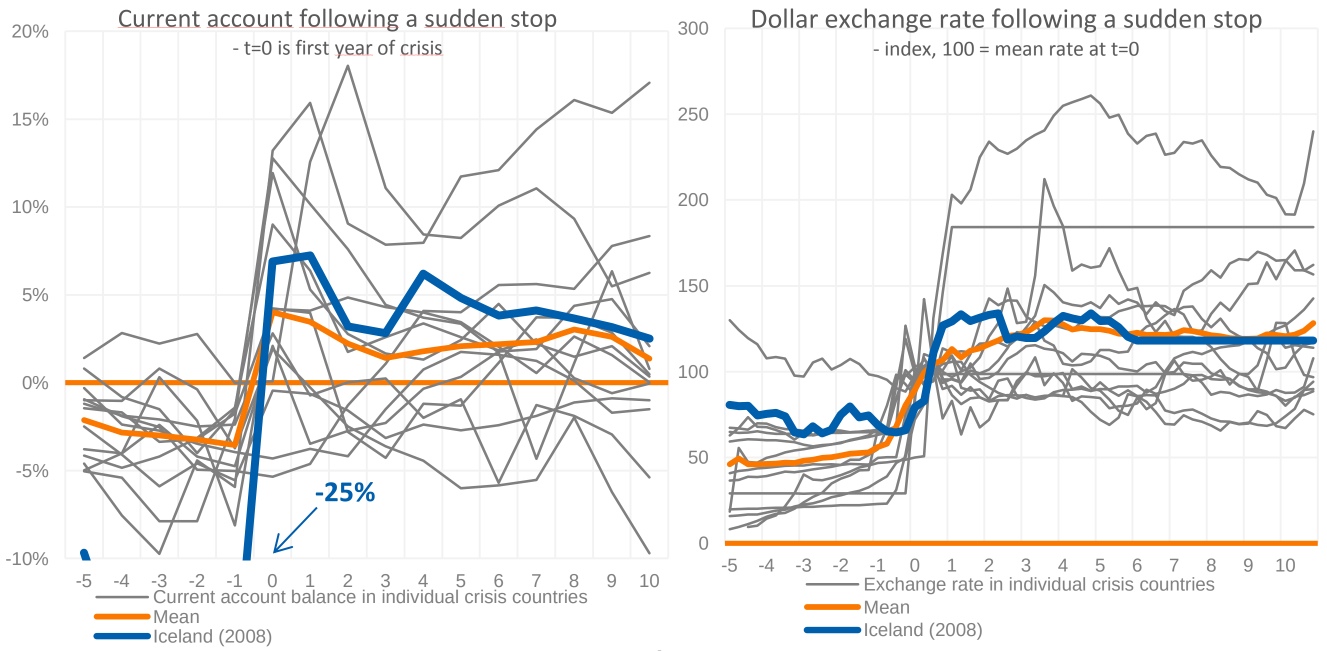


Fig. 2

Source: IMF, CBI, Arion Research forecast.

Sample consists of Argentina (2002), Brazil (1999), Ecuador (1999), Finland (1991), Indonesia (1998), Korea (1998), Malaysia(1998), Mexico (1995), Philippines (1998), Russia (1998), Thailand (1998), Turkey (2001) and Uruguay (2002).

Heavy and frontloaded repayment schedule remains a possible risk factor

A common method to identify potential balance of payment pressures consists of simply comparing forecasted current account surpluses with known contractual maturities of foreign debt. If the foreign repayment schedule exceeds foreseeable currency generation via the current account, it is considered a risk factor that could either put pressure on the ISK exchange rate or drain central bank reserves.

The economy's collective foreign debt repayment schedule remains both heavy and frontloaded, not least because of maturities on bonds issued by Landsbankinn to its predecessor, LBI, to settle a transfer of domestic assets from the failed bank following the crash of 2008. The bonds' first maturity falls on 2014, but repayments become increasingly burdensome from 2015 onwards.

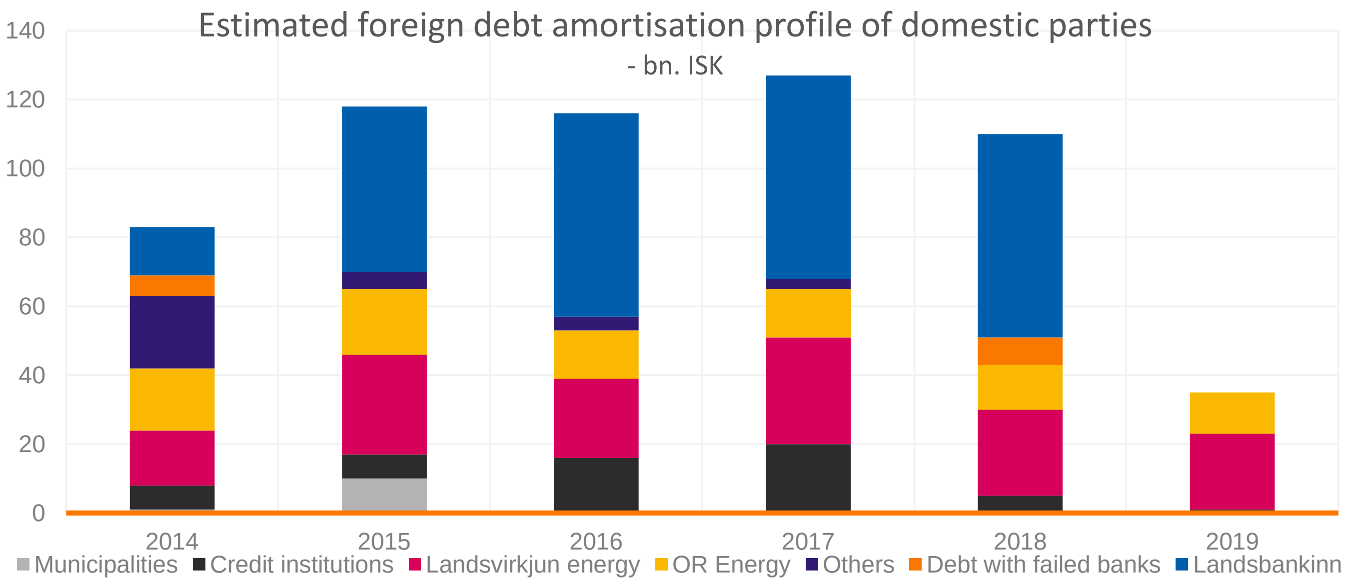


Fig. 3

Source: CBI

It might seem puzzling that the previous figure overlooks foreign debt maturities of both the Treasury and the Central Bank of Iceland. There are two reasons for this. The first is that the CBI is holding enough reserves to cover every foreign sovereign maturity in the next decade, leaving no gap to bridge; the second is that the Treasury has affirmed its ability to borrow abroad by issuing fresh USD denominated debt twice since 2011, using the proceeds to give back IMF bail-out loans received during the crisis of 2008. Additionally, credit spreads have come down substantially in the last 2-3 years, so the Treasury appears to be in a position to continue refinancing its foreign maturities going forward, placing no pressure on the economy's balance of payments in the process.

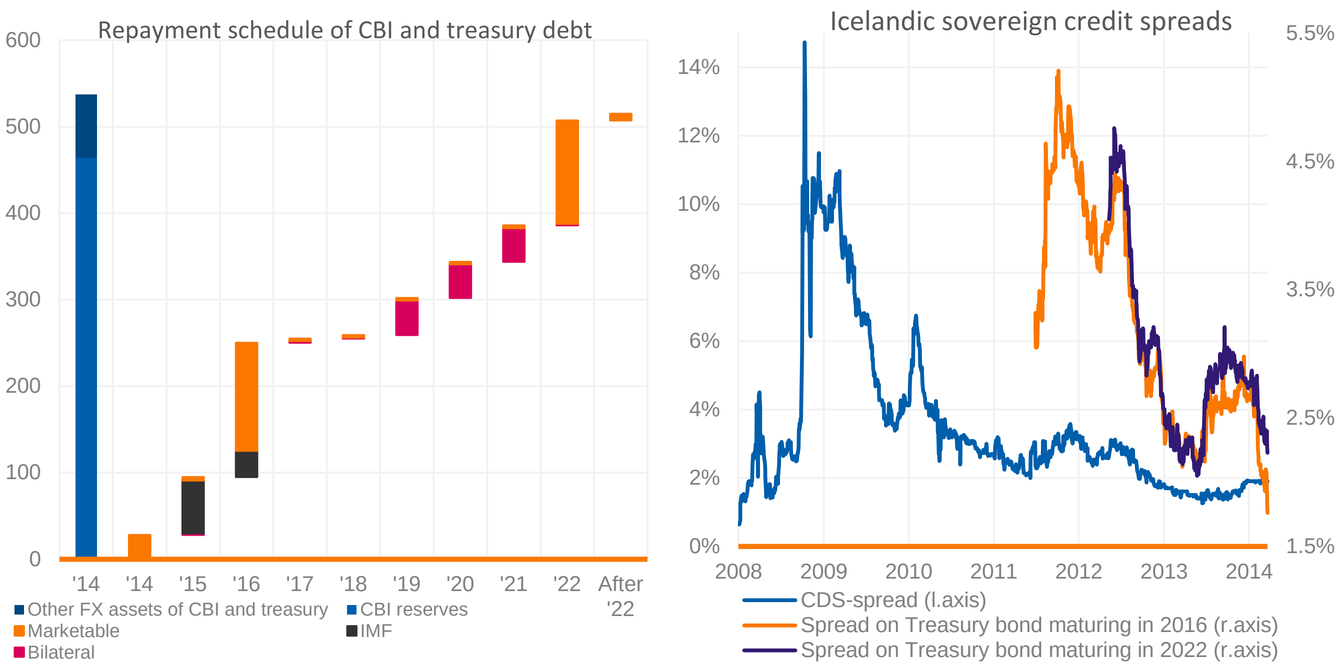


Fig. 4
Source: CBI

When the heavy repayment schedule in figure 3 is contrasted with our forecast of the current account surplus in figure 1, it seems that the economy's capacity for currency generation won't be able to cover foreign contractual obligations. We label the difference between the two as a balance of payments gap, which will strain central bank reserves, the ISK exchange rate or both absent foreign investment inflows, refinancing or foreign asset liquidation. Nevertheless, the gap appears smaller than it's sometimes made out to be, accumulating to roughly 100 bn. ISK over the course of the next six years.

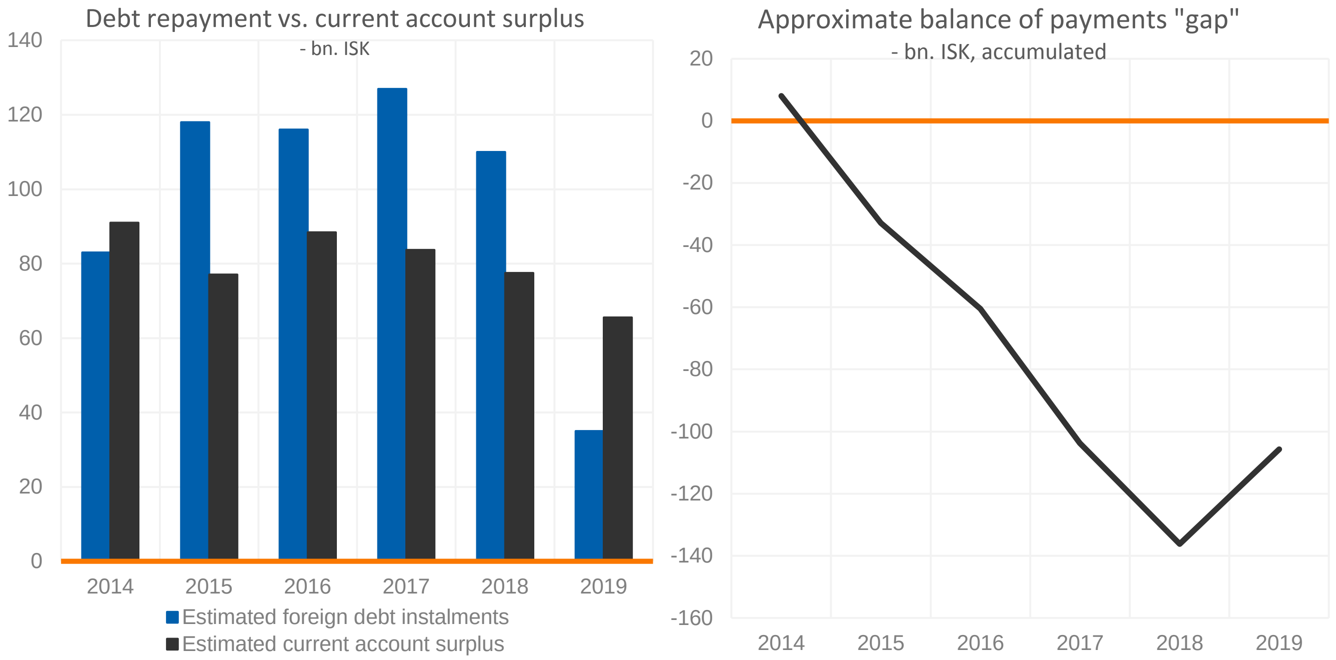


Fig. 5
Source: CBI, Arion Research calculations

Landsbanki bond extension would mitigate risk greatly

Although the balance of payments pressures we're forecasting are far from insurmountable, we acknowledge that authorities wish to mitigate risks from outflows on foreign debt repayment. Additionally, spreading out maturities would free up currency to provide a buffer for lifting controls. A straightforward measure advocated by a number of analysts (including us) to achieve just that would be to extend the Landsbanki bonds. The CBI has emphasised this point on numerous occasions. In its 2013/2 Financial Stability report it further maintains that "[…] if the bonds are not lengthened through negotiation, the capital controls will prevent the payment of recoveries on the bonds to the old bank's creditors from destabilizing the economy." We take this to be an ultimatum; if the bond isn't negotiated, no payouts from the estates will happen.

The extension can be achieved via either refinancing by issuing new debt abroad (like both Arion and Íslandsbanki have already done at declining yields over the last 12 months) or by renegotiating the bonds' terms with the LBI. We're putting our money on some combination of these factors happening. In figure 6, we've tried to estimate the impact a ten year extension of the Landsbanki bond would have on the economy's collective foreign repayment schedule.

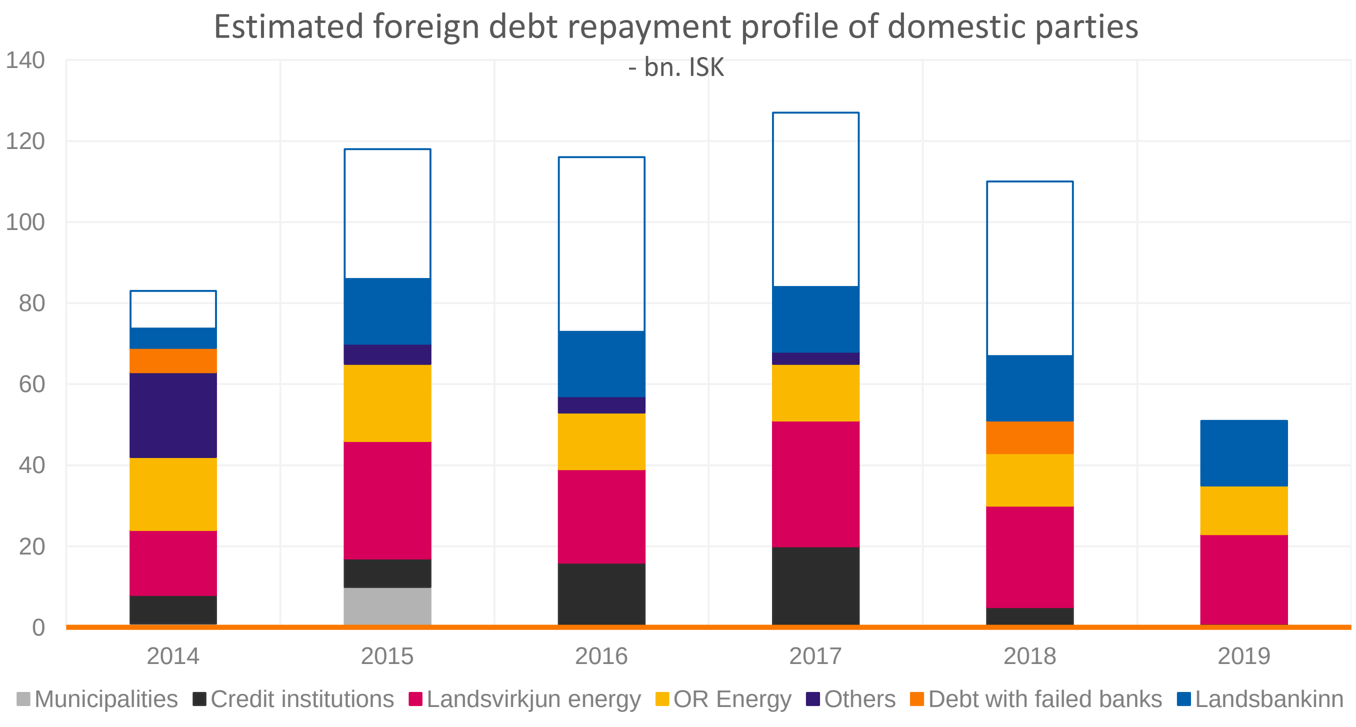
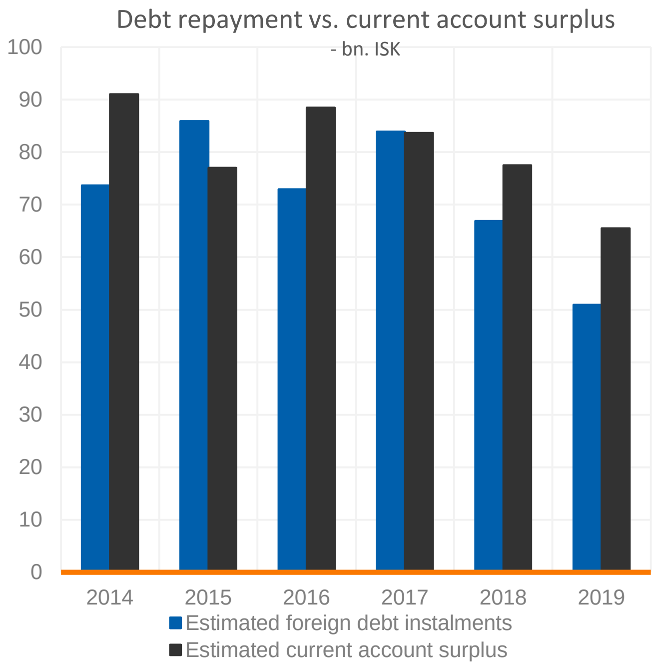


Fig. 6
Source: CBI, Arion Research calculations

If we now proceed to compare this new repayment schedule to our current account forecast from figure 1, it turns out that the Landsbanki extension alone would instantly make outflows on contractual foreign maturities manageable enough not to pose a significant threat to stability. In fact, the balance of payments gap observed in figure 5 would actually turn from deficit to surplus – meaning the CBI could either accumulate reserves or the ISK would appreciate absent repatriation of other ISK assets.



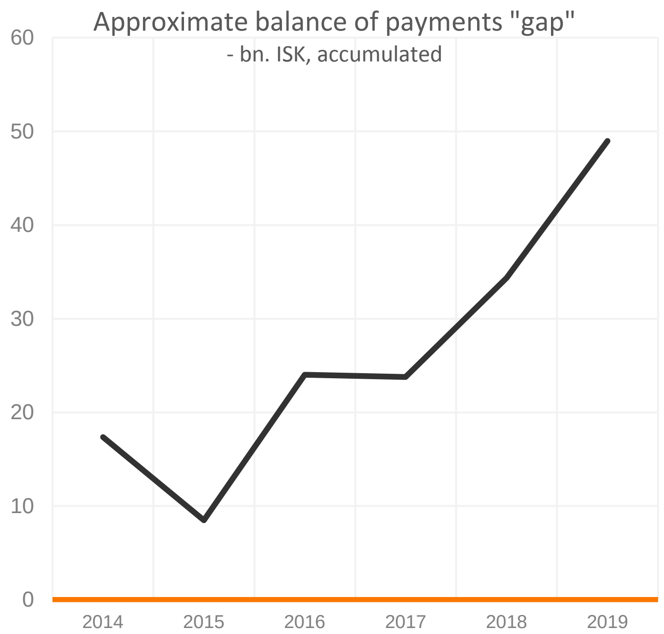


Fig. 7
Source: CBI, Arion Research calculations

Again, let us stress that so far, we've assumed no foreign investment inflows, no refinancing by other parties than Landsbankinn and no foreign asset liquidation. All these factors provide pure upside potential to the scenario we've outlined; for instance, we haven't even taken account of the substantial foreign assets Landsbankinn has on its books, which will likely suffice to cover all its maturities in 2014 and 2015, even in the absence of any extension.

The balance of payments crisis (you probably missed) in 2009-2013

At the risk of sounding paradoxical, we have a number of reservations about the widely employed method of analysis used above. While we fully acknowledge that comparing forecasts of the current account with outflows due to maturing debt is a quick, intuitive and convenient approach to identifying potential balance of payments pressures, it has several deficiencies which make it unsuitable as a definitive indicator of impending crises.

The method's main drawback is the same as its appeal; how simplistic it is. By assuming that current account surpluses must always match debt repayments, it presupposes that net exports are the economy's only source of FX, while contractual debt repayments are the only source of outflows. This is simply not the case, even in the current situation of significantly constrained capital movement. The approach therefore ignores both foreign assets that debtors might be holding on their balance sheets and other sources of FX, such as offsetting foreign investment inflows via the economy's financial account.

Additionally, the current account is not recorded on a cash flow basis, so it includes various calculated items which do not involve any FX actually changing hands, such as asset revaluation, retained earnings on FDI etc., and therefore provides an inaccurate depiction of contemporaneous balance of payments pressures, either positive and negative.

The latest Financial Stability report issued by the CBI provides an excellent example of just how misguided the current account vs. debt repayment approach to identify balance of payments pressures can be by compiling data on actual debt repayment in the years 2009-2013. In individual years, the repayments were actually much heavier than the maturities causing policy makers concern in the coming years. In the figure below, actual repayments in 2009-2013 are contrasted with the estimated repayment schedule used in the preceding analysis.

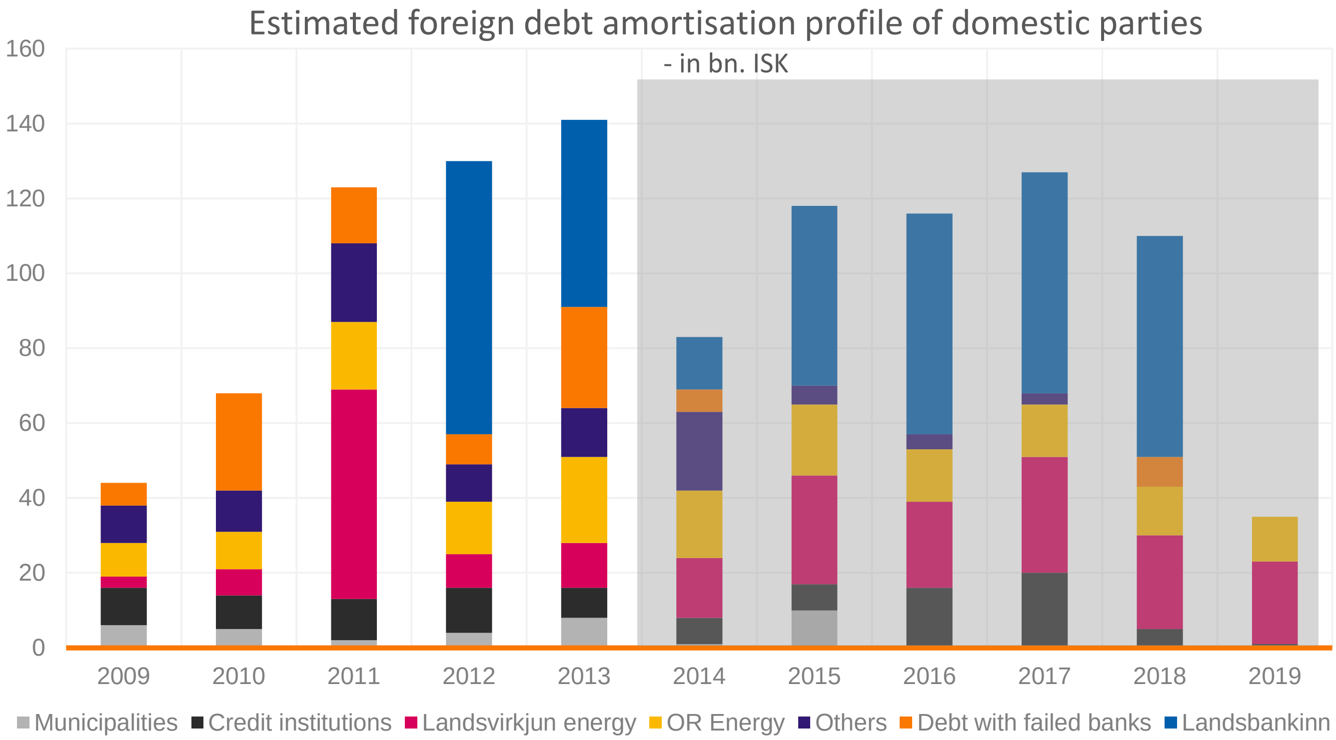


Fig. 8
Source: CBI

Additionally, the repayments exceeded the accumulated current account surpluses recorded during the period by a substantial margin, leaving a balance of payments gap of 80 bn. ISK – which, incidentally, isn't that much smaller than the payment deficit we're projecting considering no extension of the Landsbanki bonds.

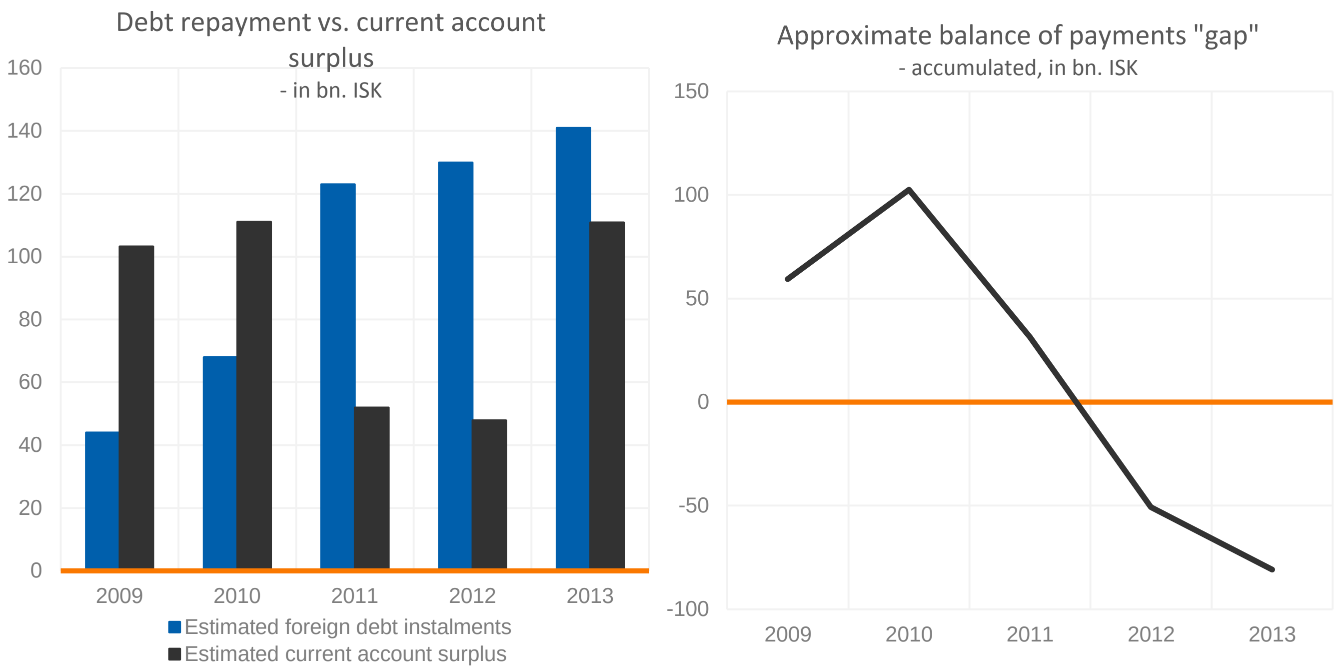


Fig. 9

Source: CBI, Arion Research calculations

But hold on a minute. According to this, the Icelandic economy should've been undergoing at least a mild balance of payments crisis, with mounting depreciation pressures on the ISK, drainage of CBI reserves or a combination of both. Interestingly, nothing of the sort happened. On the contrary, the ISK appreciated handsomely during 2010 after taking a wild hit in 2009, remaining relatively stable in the following years, displaying no directional drift what so ever.

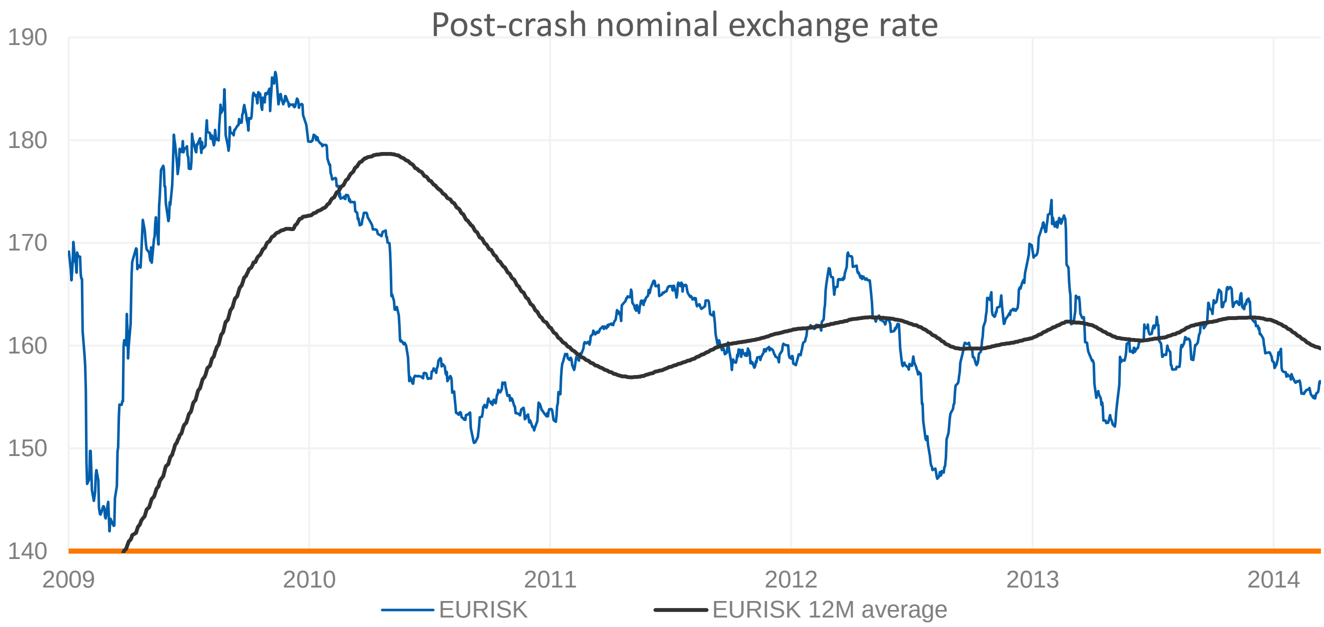


Fig. 10

Source: CBI, Arion Research calculations

At the same time, the CBI managed to accumulate roughly 400 m. EUR of unleveraged reserves via a mixture of one-off purchases from the books of banks with disproportionately large uncovered FX risk, its regular intervention programme in 2010-2012 and consequent discretionary interventions. Still, there can't have been much room for other investors to exit any ISK positions – right? Again to the contrary, the stock of non-residents ISK assets was wound down by roughly 280 bn. during the period, via both one-off transactions (such as the Avens-agreement) and [regular currency auctions hosted by the CBI](#).

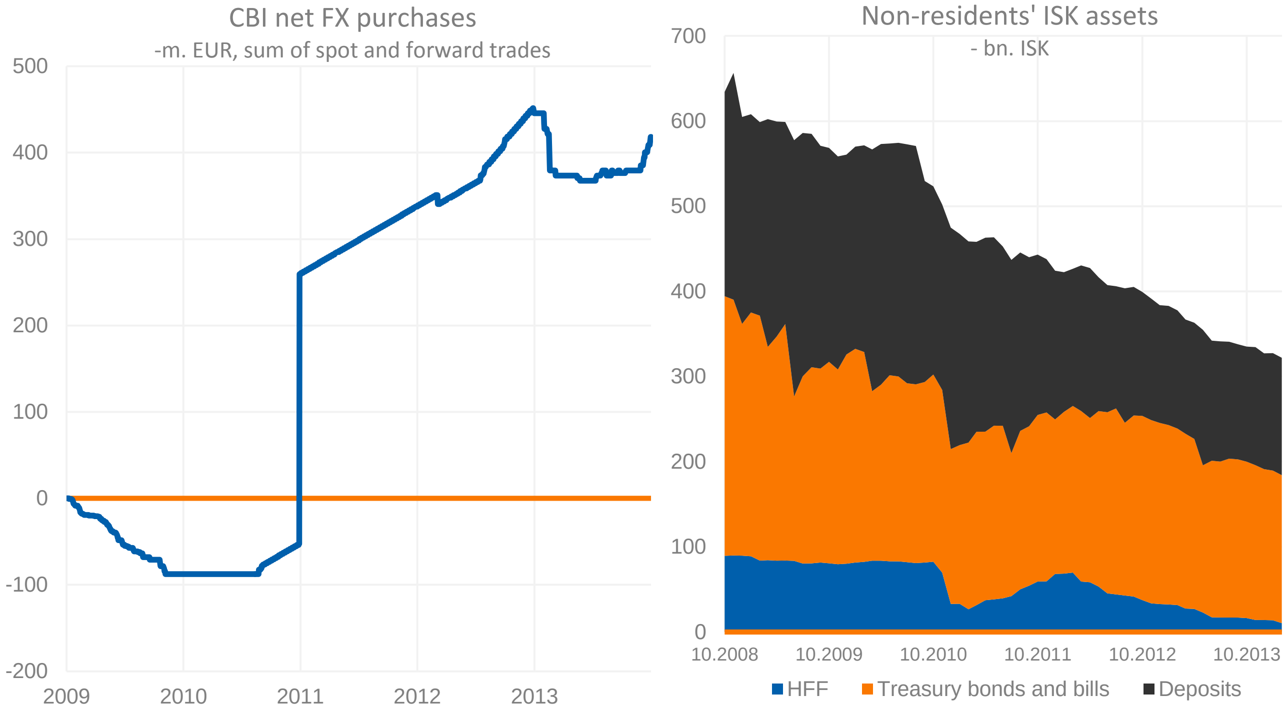


Fig. 11
Source: CBI, Arion Research calculations

According to the Financial Stability report, the discrepancy stems from a number of factors:

> Because the current account surplus exceeded debt service early in the period, there was scope to purchase foreign currency to cover future payments, some of which were paid in the latter half of the period. […] For example, the Central Bank's foreign currency auctions have generated inflows, both through the auctions themselves and through the foreign exchange market, in the amount of 210 b.kr., while releasing offshore krónur in the amount of 128 b.kr. Resident entities have been able to use the difference, 80 b.kr., to pay down foreign debt. Furthermore, based on a conservative estimate, it can be assumed that they sold foreign assets or collected loans owed by non-residents for some 20-80 b.kr. during the period. This excludes any possible asset sales to cover interest expense on the foreign exchange reserves. The remainder is other net inflows, excluding the foreign currency auctions. The amount involved totals a few dozen billion krónur. In addition, the foreign exchange market transactions by the Central Bank and the commercial banks have some impact.

We therefore stress that despite the usefulness of the current account vs. debt repayment approach to identifying possible risks, its users must realise inherent limitations to the method of analysis as such. It should not be considered a definitive quantification of the economy's payment deficit or surplus or a completely accurate predictor of crisis. Recent experience suggests that both foreign trade and movement of capital are elusive enough to make accurate projections of FX inflows and outflows a formidable task when peering years into the future.