ICELANDIC ECONOMIC UPDATE

Arion Bank

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Growth in Q3 disappoints

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Legal Developments

In November there were two major legal developments relating to Icelandic financial markets. The Supreme Court of Iceland ruled that if a bankrupt estate owns assets in foreign currency at the time of distribution, the law neither prohibits nor obliges payments to occur in foreign currency, but that the exchange rate must be the official one at the date of payment. In addition the EFTA court issued its advisory opinion regarding price indexed loans.

The CBI grants LBI an exemption from capital controls

In early December the CBI, in consultation with the Ministry of Finance and Economic affairs, granted LBI exemptions from capital controls in order to distribute 400 bn.ISK to priority claimants. This should lift pressure off Iceland‘s BoP profile and facilitate the abolition of capital controls.

Balance of Payments in Q3

On December 2 the CBI published data on the balance of payments in Q3. Overall there was a surplus in the current account, which is not unusual for Q3 since exported services tend to be strong in that quarter due to the tourist season. The surplus is nevertheless somewhat smaller than in Q3 2013.

The CBI cuts interest rates by 50 basis points

On December 10 the Monetary Policy Committee of the Central Bank of Iceland decided to lower its interest rates by 50 basis points, citing slower growth in both GDP and domestic demand than previously expected.

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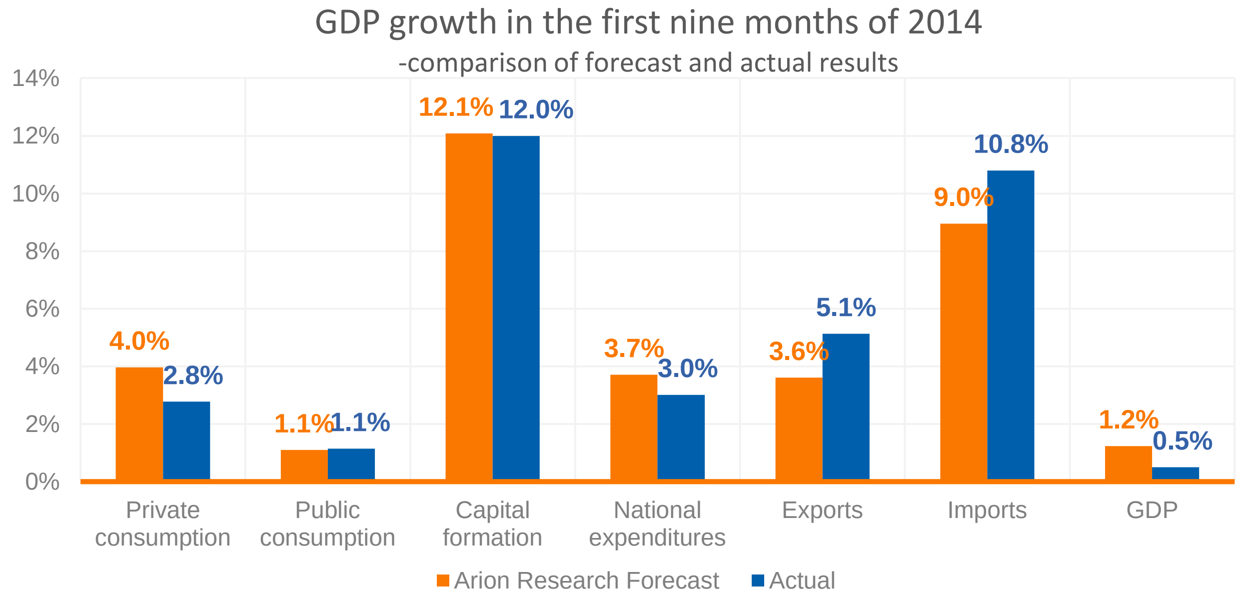
Growth in Q3 disappoints

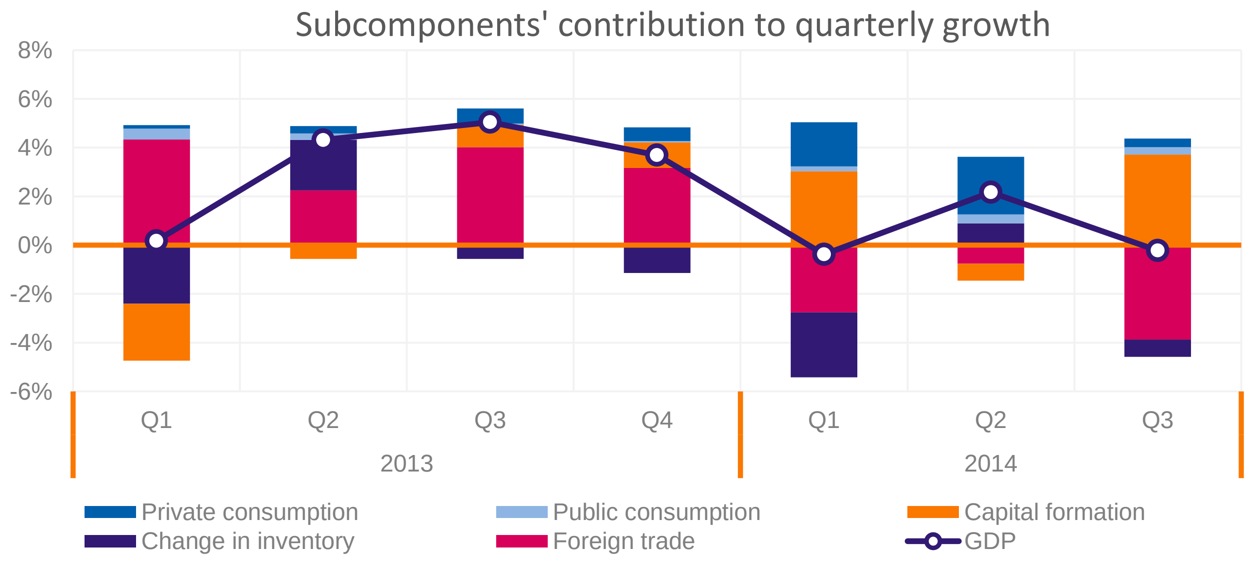
GDP growth numbers for Q3 missed expectations by a substantial margin and it looks like growth for the year as a whole will be under analyst projections. GDP grew by a mere 0.5% in the first nine months of the year while Arion Research had projected growth of 1.2%. The main reason for the deviation seems to be low growth in private consumption, especially in the third quarter, as well as higher than expected growth in imports throughout the year.



Sources: Statistics Iceland, Arion Research

Investment is growing considerably, in line with our projections, largely due to purchases of ships and aircraft. When excluding such investments both imports and capital formation are not growing nearly as rapidly. A single ship or aircraft has a relatively large effect on Icelandic GDP numbers given the small size of the economy.

Last year's growth was mostly driven by exports while this year private consumption and investments have been the main pillars of growth. The Central Bank of Iceland had predicted GDP growth of 2.9% for 2014 and a 4.3% growth in private consumption. In order for that to materialize we would need to see GDP growth of around 10% in Q4 and private consumption to grow by approximately 8% so it looks like predictions about feisty domestic demands might not be coming to fruition and that the output gap might not be closing just yet.



Sources: Statistics Iceland, Arion Research

One possible explanation for slow consumption growth in Q3 is hesitance to spend just before the results of the debt relief scheme were made known. That should then result in stronger growth in private consumption in Q4. Another possible explanation is a spillover effect from what appears to be a slowdown in global markets, especially in the eurozone.

Payments from failed entities may occur in foreign currency

In November the Supreme Court confirmed a District Court ruling in favor of Kaupthing's creditors regarding payments from the estate in foreign currency. The ruling states that if the failed entity owns assets in foreign currency at the time of distribution, the law neither prohibits nor obliges payments to occur in foreign currency. The ruling also states that the currency in which the payment takes place is up to the trustee of the estate to determine. The *value* of any asset or payment shall be officially determined in ISK using the official exchange rate at each point in time.

However, the law does not prohibit the trustee of the estate from facilitating payment in foreign currency as long as it is determined by the exchange rate *at the time of payment*. In addition, the trustee may assist foreign creditors in purchasing foreign currency for ISK even if the estate has no foreign assets. Such a purchase would take place at the official exchange rate of that currency *at the date of payment*. No law states that the exchange rate should be determined at the date of the winding up order.

Steinunn Guðbjartsdóttir of Glitnir's winding-up board said in an interview with RÚV that she believes this ruling confirms that the failed bank estates may pay creditors in FX, whether it be following a composition agreement or bankruptcy. This is what the estates have been doing thus far and according to Steinunn it's a relief to get confirmation of its legality. Many who have advocated the bankruptcy route believed that it meant that the creditors would have to be paid in ISK – this ruling confirms that is not the case.

EFTA deems 0% inflation benchmark in violation of EU directive

Later in the month the EFTA court issued its advisory opinion in the case of Sævar Jón Gunnarsson vs. Landsbankinn. The court found that a 0% inflation benchmark was not in accordance with an EU directive regarding consumer loans, if inflation was not 0% at the time of the loan agreement, and that the directive did apply to indexed loans.

The Court also found that it was up to Icelandic courts to determine the consequences of the violation. Icelandic laws have already been clarified on the matter of indexation and currently lenders must use the known level of inflation at the time of the signing of the contract.

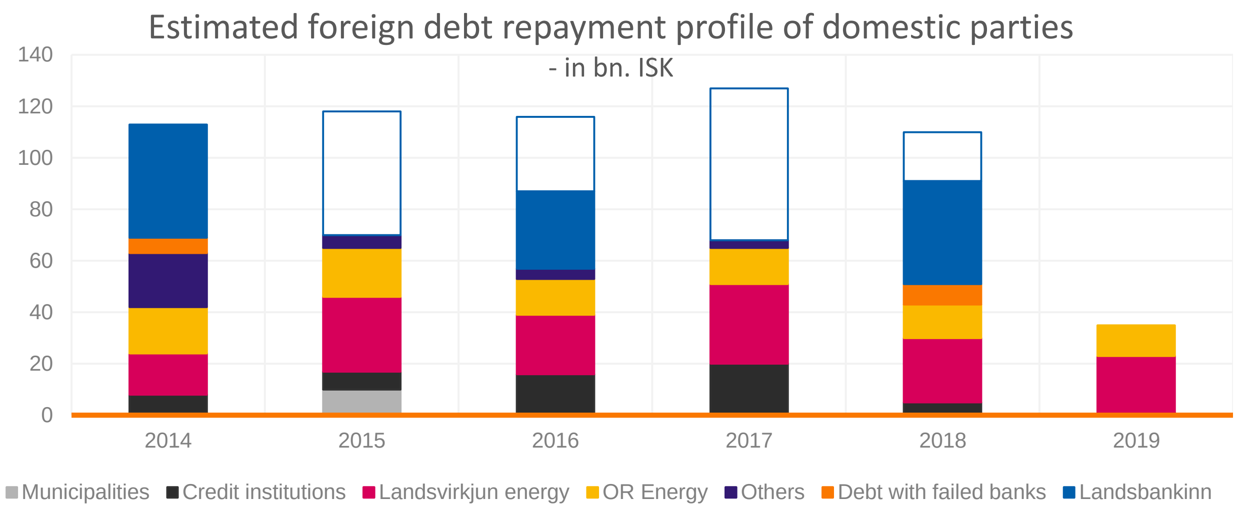
The Icelandic government could possibly be liable for incorrectly introducing the directive into Icelandic law. While the EU directive did not specifically mention price levels the Icelandic law stated that loan agreements should assume „a constant price level", which, as we now know, may be interpreted in various ways.

Már Guðmundsson, governor of the Central Bank of Iceland, stated that total outstanding value of the loans this applied to was only 66 bn.ISK, since mortgages did not fall into this category of consumer loans. Consumer loans in Iceland are generally non-indexed.

Following the EFTA court opinion the Icelandic banks issued statements saying that they would be affected financially if Icelandic courts find the indexation clause in the contracts to be illegal. They also stated that high equity ratios made them more than equipped to handle any blow resulting from such a ruling.

The CBI grants LBI an exemption from capital controls

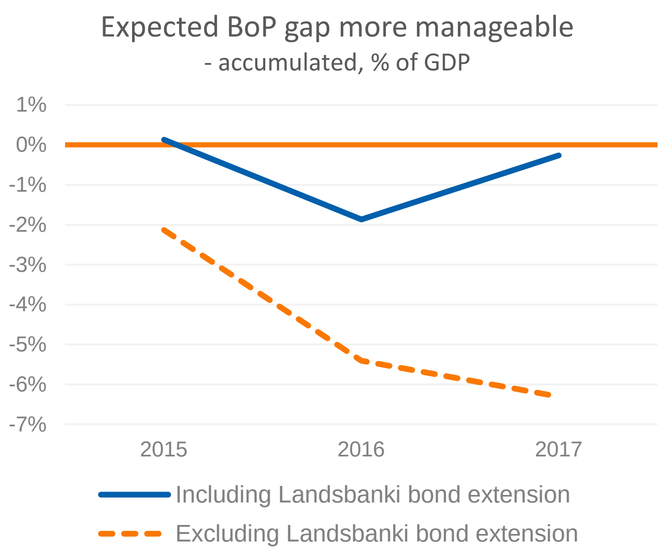
In early December the CBI, in consultation with the Ministry of Finance and Economic affairs, granted LBI exemptions from capital controls in order to distribute 400 bn.ISK to priority claimants, who will then have received 85% of their claims. The CBI also pledged to grant further exemptions for partial payments to priority creditors if the payments are deemed to not jeopardize the stability of the króna. This means that the bond extension agreed upon in May will take effect, with some changes.

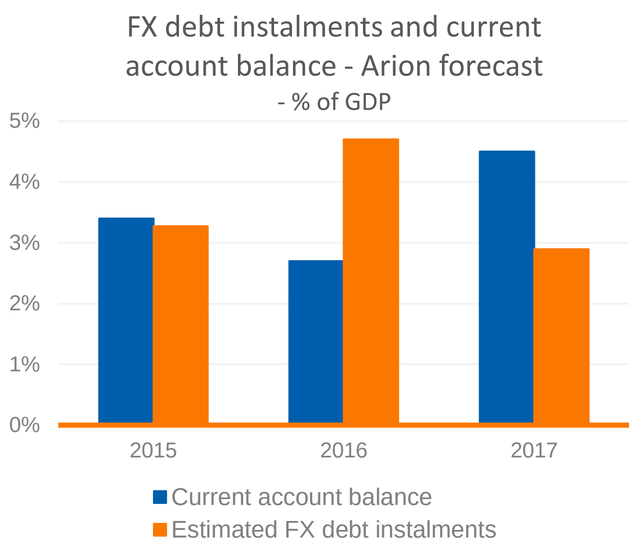


Sources: CBI, Arion Research

The new terms of the bond dictate that repayment of outstanding debt to LBI in the amount of approximately 196 bn.ISK will be met with ten bond issuances in EUR, GBP and USD maturing in 2016, 2018, 2020, 2024 and 2026.

As we have demonstrated in previous newsletters this will have a measurable positive impact on the BoP profile of Iceland and associated risks going forward and should therefore be a positive step as far as the lifting of capital controls is concerned.



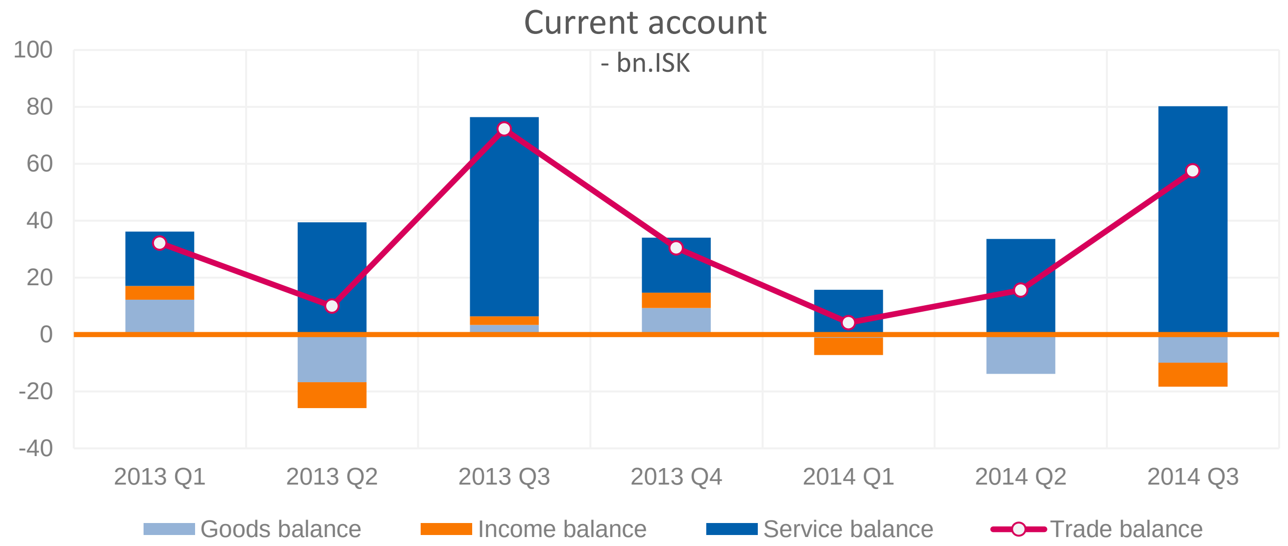


Sources: CBI, Arion Research

According to the CBI the debt repayment burden of domestic parties' foreign debt will be reduced by 124 bn.ISK through 2018. In addition to greatly improving the BoP outlook for Iceland, this arrangement should facilitate Landsbankinn's financing abroad on improved terms.

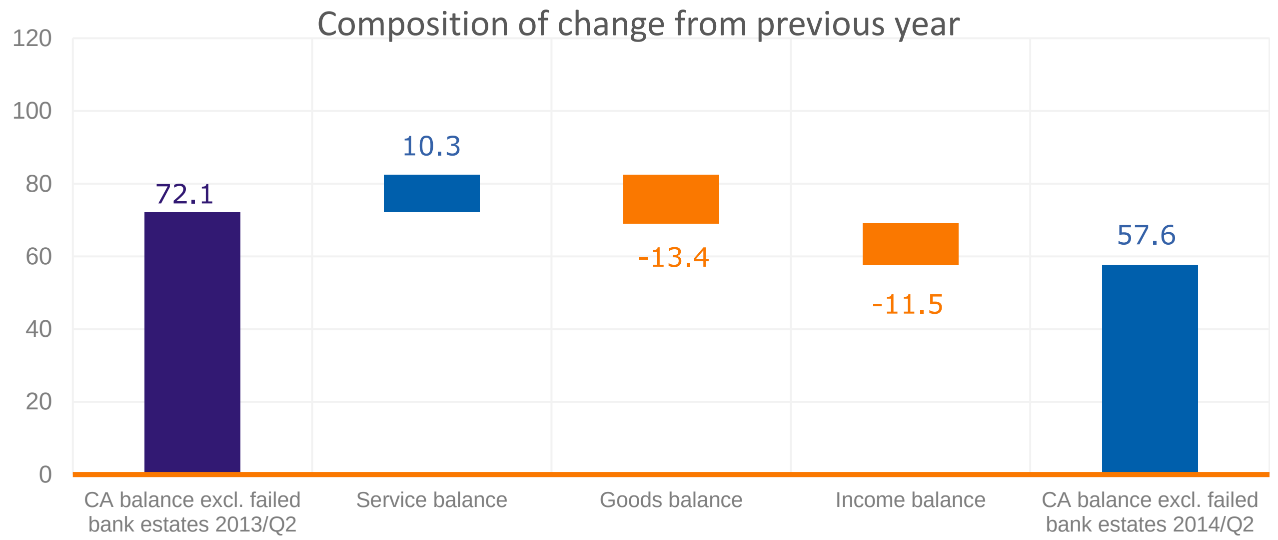
Balance of Payments in Q3

On December 2 the CBI published data on the balance of payments in Q3. Overall there was a surplus in the current account, which is not unusual for Q3 since exported services tend to be strong in that quarter due to the tourist season. The surplus is nevertheless somewhat smaller than in Q3 2013.



Source: CBI

Even though the current account surplus has been decent so far this year, the accumulated amount over the first nine months of the year is noticeably lower than it was at the same time last year or by 37 bn.ISK. The Arion Research current account forecast for the year as a whole assumes a surplus of approximately 100 bn.ISK. and we believe that will materialize. As can be seen in the graph below the balance on goods and on factor income caused a lower current account surplus in Q3 than at the same time last year, while a larger surplus in the balance on services provided a backstop.



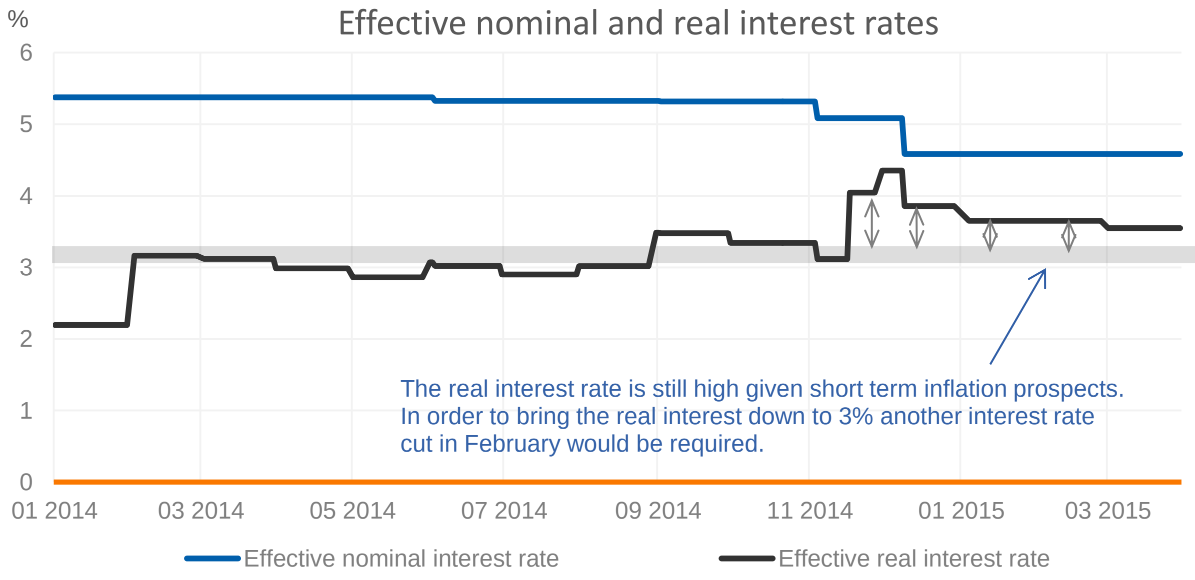
Sources: CBI, Arion Research

One noteworthy factor regarding the data for the quarter is that it does not quite explain the large FX inflow we witnessed in the fall. The balance on services was indeed higher than last year while the goods and income deficit more than wiped that difference out. Nevertheless, there was a large FX inflow in the quarter which allowed the Central Bank to increase their reserve by a substantial margin. There are various possible explanations for this apparent discrepancy. For instance, the FX repayment profile of domestic companies has not been very heavy, which means that few companies have been competing for currency over the past few months. It is also possible that the current account balance includes various components which do not directly affect the flow of FX, such as value reassessments through factor income, actions of companies with limited domestic operations or business related to the old bank estates, which are heavy enough in FX in order to purchase goods and services from abroad without having to go through the domestic FX market.

The CBI cuts interest rates by 50 basis points

On December 10 the Monetary Policy Committee of the Central Bank of Iceland decided to lower its interest rates by 50 basis points, citing slower growth in both GDP and domestic demand than previously expected. However, the governor stated in a press conference that the CBI looked at recently released GDP numbers from Statistics Iceland with reservations and expects them to be revised upwards - high frequency indicators all pointed to more rapid growth in domestic consumption.

According to the CBI governor the main reason for the interest rate cut this time was exceptionally low inflation numbers resulting in a real interest rate too high for current economic conditions in the opinion of the MPC. Additionally, labor market conditions have been improving at a slower pace than expected. The MPC’s statement indicates that more cuts can be expected in February barring high wage increases in upcoming negotiations or rapid growth in domestic demand.



Sources: CBI, Arion Research

When asked whether the impending abolition of capital controls factored into the MPC’s interest rate decision the governor was quick to dismiss that thought and stated that we were not quite there yet. Only one more FX auction has been announced by the CBI in February - the last auction offering the investment programme in its current form.