

### Ch-Ch-Ch-Changes... Our thoughts on the Election Results

- As expected the left wing government of Iceland lost its majority in the parliamentary elections on Saturday, realising the collapse of its approval rating in the preceding months and leaving other parties to, in the words of David Bowie, *turn and face the strain*. The outgoing government was a coalition of Social Democrats and the Left-Green Party. Following Saturday's election the two largest opposition parties, the Independence Party and the Progressive Party, will together hold a large majority of seats in the Althing when it convenes. We put together our thoughts on how major policy areas might shift in the coming months if a coalition is formed by the two largest parties.

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As expected the left wing government of Iceland lost its majority in the parliamentary elections on Saturday, realising the collapse of its approval rating in the preceding months. The outgoing government was a coalition of Social Democrats and the Left-Green Party. It came to power in 2009 in the midst of turmoil and social unrest following the collapse of the majority of the banking sector less than a year before.

Following Saturday's election the two largest opposition parties, the Independence Party and the Progressive Party, will together hold a large majority of seats in the Althing when it convenes. Iceland has a long history of coalition governments and at this moment it is most likely that a centre-right coalition government of the two parties will be formed. Other options should not be ruled out, though, since both of the largest parties could form three party coalitions, e.g. with the Social Democrats and newcomer liberal-democrat party Bright Future or Left-Greens. In any case a new government is likely to adopt a very different policy on many economic matters. The lyrics of David Bowie therefore come to mind as we expect changes to lie ahead once a new government turns and faces the strain - of running Iceland.

### The result of Saturday's parliamentary elections

Party	Of votes	Seats 2013	Seats 2009
Independence Party (IP)	26,7%	19	16
Progressive Party (PP)	24,4%	19	9
Social Democrats	12,9%	9	20
Left-Greens	10,9%	7	14
Bright Future	8,2%	6	
Pirate Party	5,1%	3	
Others	11,8%	0	4
<b>Total</b>	<b>100,0%</b>	<b>63</b>	<b>63</b>

In line with tradition the President of Iceland, Mr. Ólafur Ragnar Grímsson, will spend today meeting with Icelandic leaders one by one at the presidential residence before making a decision on whom to trust with a mandate to form a government. To secure a majority the government needs support from at least 32 MPs. As can be seen from the table a majority support of the two largest parties could be easily secured but three party coalition would also be an option.

The Progressive Party is the clear winner of the elections and will probably be awarded the mandate to form government, gaining 10 MPs since 2009. Its main platform in the elections was almost universal household debt relief to be funded by taxing foreign creditors of the old bank estates, though the details of the party's plan were left somewhat ambiguous throughout the campaign.

Given what we believe to be the most probable government formation, i.e. a coalition of the Independence Party and Progressive Party, there might be some changes in store for vital policy areas.

### Iceland's bid to join the EU

Both the Independence Party and the Progressive Party have been against Iceland joining the EU. There is, however, a large minority keen on joining the EU among the parties' voters, especially within the IP which it needs to reconcile with. According to polls majority of Icelanders would vote against joining the EU, but at the same time they want to finish the accession talks before making the decision not to join. We believe the next government is likely to host a referendum as soon as possible on whether to continue with the talks as that has the parties official position on the matter. If results of the referendum would be in favour of continuing with the talks then the parties would expedite the process and have the resulting agreement put up for vote. For both the IP and PP the EU talks will be a low priority. Regarding the future of the Icelandic Krona, both parties have discussed the openly discussed the possibility of adopting the Canadian Dollar or the Norwegian Krona either unilaterally or preferably bilaterally.

## The Capital Restrictions

Both the IP and PP have put abolishing the Capital Controls on the top of their agenda, although neither party has put forward detailed agenda on how it should take place. The single issue that was most discussed during the run up to the elections was PP's proposal that indexed linked housing loans will be lowered significantly, funded by the foreign creditors forgiving their claims on ISK denominated assets of the old banks estates. Giving the importance of this issue and the weight put on it by PP it is highly unlikely that any major steps will be taken towards lifting the controls before that issue has been negotiated. In any case, substantial write downs of foreign creditors claims will probably be an essential part of any capital account liberalisation strategy (see below).

## Creditors of the failed banks

An overhang of more than 800 bn. ISK worth of foreign claims on domestic assets of the failed banks is the main reason why abolishing capital controls is troublesome. A large issue is therefore how to negotiate those claims as to expedite capital account liberalisation, and minimise the risk of a currency crisis repeating itself via imbalances on foreign payments.

Both of the parties were more outspoken towards creditors of the failed banks than the outgoing government, and their rhetoric harsher. While the leader of the Social Democrats frequently testified to the creditors' constitutional rights to their assets during the campaign, the winners of the election have clearly indicated that creditors must accept substantial write downs on their claims, while stressing that they don't mean to expropriate their assets. They will, however, utilise what bargaining position the capital controls and sovereignty of the state allow them to the fullest extent during negotiations regarding foreign claims.

They have also stressed that write downs are effectively what would be necessary if there were no capital controls – it would be impossible under current projections of FX inflows for all creditors to leave the country at once without the exchange rate falling substantially.

It has been left ambiguous how exactly creditors might have to accept writedowns. There are several options. Some of these might include:

1. Foreign creditors might be induced to forgive claims on domestic assets, on condition they will receive the full amount of FX denominated assets held by the failed bank estates.
2. Foreign creditors might be induced to sell off claims on domestic assets against FX, at a substantial discount from the onshore exchange rate.
3. Foreign creditors might be allowed free exit at a penalty of a substantial exit levy, collected by the Treasury.

## Energy sector

A government of IP and PP will approach the utilisation of Iceland's energy resources very differently from its predecessor. Both IP and PP see further utilisation of hydro and geothermal energy as a key to increase Icelandic exports. The new government is thus likely to push forward with some of the power plants and energy intensive projects that are already on the drawing board but have lacked support from the outgoing government. This might include changes to the government Master Plan for energy resources that would make further harnessing of hydro power possible. We see the new government being more interested in Landsvirkjun's work on an energy cable to Europe. The new government is much more likely to embrace private sector involvement in energy production in Iceland either by welcoming private investment in new projects or by selling some of the its holdings in the energy sector (see Privatisation for some further thoughts on the subject).

## Taxes

Tax reform was the main platform of the Independence Party during their campaign. We therefore predict that any number of changes to the tax system might come into effect during the next fiscal year, and some of them even during this fiscal year. These include:

- Lower payroll taxes, aimed at stimulating employment.
- Abolishment of wealth taxes, a property tax considered to be unfair double taxation of income.

- Lower income taxes and a return to a two bracket tax system, instead of a three bracket one, aimed at increasing disposable household income, simplifying collection and reducing evasion.
- Lower gasoline taxes, with the goal of lowering gas prices.
- Lower resource levies, aimed at stimulating investment in fisheries and energy intensive industries and reducing uncertainty in the export sector.
- Lower tariffs and duties, aimed at lowering import prices and stimulating competition.
- Introduction of tax credit for household deleveraging, effectively giving breaks to people paying down mortgages, with the goal of speeding up asset formation. This would also give households the choice of saving by buying back their own debt, rather than buying someone else's debt via their pension funds' bond purchases.

The Independence Party has been Reaganesque in its rhetoric regarding changes to the tax system, insisting that lower taxes will stimulate the economy enough in the long run to make up for lost revenue. If all of the changes above were to be made, we would be inclined to predict at least modest fiscal deficits in the short run.

### **Privatisation**

The outgoing government held quite negative views towards privatisation of large state held companies, even suggesting that the state would become a permanent stakeholder in the largest Icelandic bank, Landsbankinn, acquired by an equity injection during bailouts in 2008.

A government formed by the Independence Party and Progressive Party will almost surely be willing to privatise Landsbankinn, thereby recouping at least some of the costs incurred during the financial collapse and improving government finances.

Furthermore, it might be willing to consider a partial privatisation of Landsvirkjun Energy, the largest energy corporation in Iceland, which is wholly owned by the Icelandic state. It's privatisation was a frequent topic of discussion during the last term. Although no party has any intention of selling a majority stake in the company, these parties might contemplate offering a minority stake in the company (up to 30-40%), either by auctioning off a part of the state's stock or offering new equity.

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