ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | October 2015

Economic Outlook 2015-2018: Full Speed Ahead

In October, Arion Research published a new economic forecast. We expect GDP growth this year to be 5.4% and 4.1% in 2016. The growth outlook in Iceland is very favorable compared to other developed economies. We expect growth in the coming years to be mainly driven by investment and private consumption. Although inlfation risk looms, we are not yet seeing the effects of recent wage increases. Imported prices are keeping inflation at bay, the question is: for how long?

Monetary Policy: Transmission Breakdown?

The Central Bank‘s Monetary Policy Committee has raised rates by 100 bps since June. What effect has that had on the economy and the inflation outlook? Inflation is still low, but is that thanks to the CBI‘s rate hikes? When examining the various transmission channels of monetary policy it looks like recent rate hikes are not having the intended effect. A strengthening króna and low inflation abroad has helped keep inflation below target, but there is no guarantee that will last. Perhaps the CBI‘s MPC will have to look for some other tools in its tool chest to restrain domestic inflation in the coming quarters.

Stability Proposals: The Central Bank Gives the Green Light

The Central Bank of Iceland has published its assessment of the failed bank estates‘ updated stability proposals. In short, the CBI believes the proposed measures will not jeopardize monetary, exchange rate or financial stability. The proposals are valued as counterbalancing potential outflows in the amount of ISK 856 bn. In addition, any legal risk is greatly mitigated.

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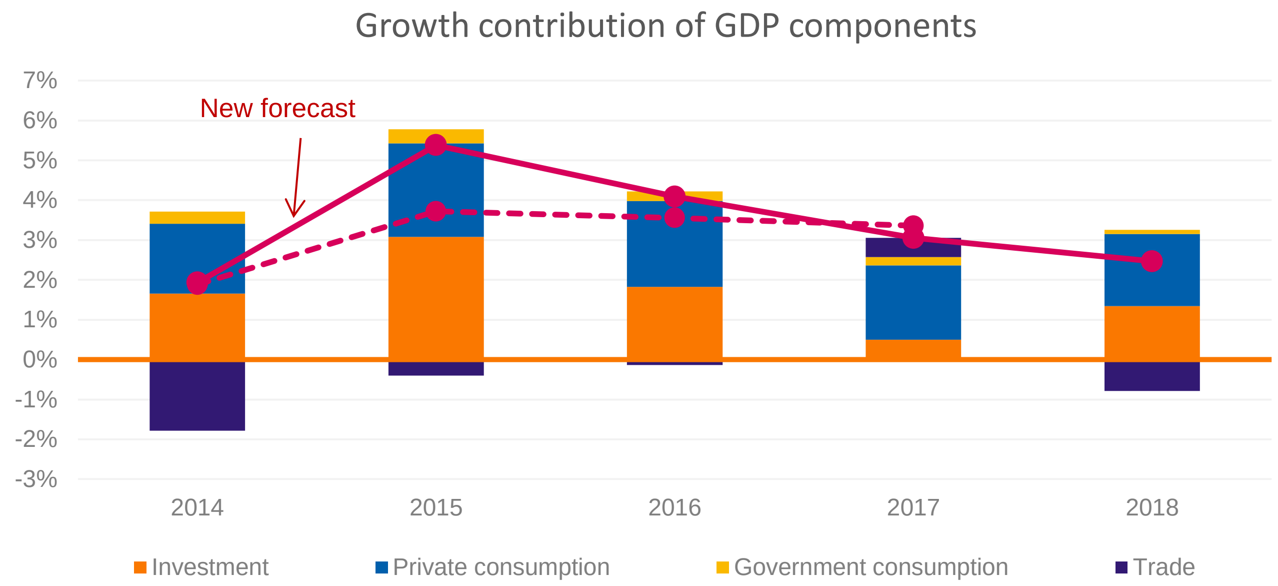
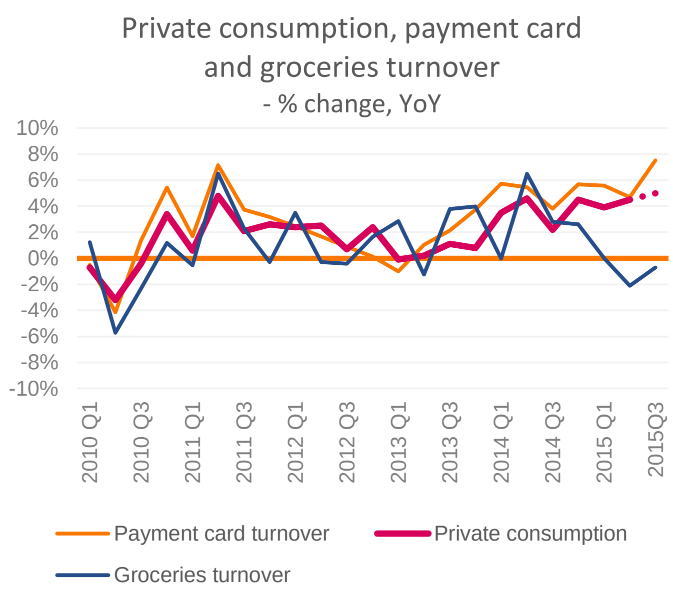
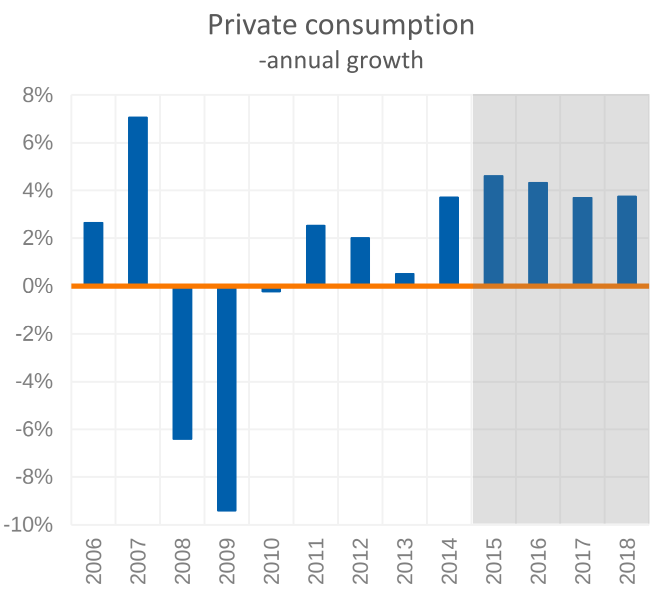
In October, Arion Research published a new economic forecast for 2015-2018, titled: Full Speed Ahead. We expect higher growth than in our June forecast (5.4% GDP growth this year, 4.1% in 2016), which will be driven mainly by private consumption and investment. National accounts showed a strong pick-up in growth in Q2 and high frequency indicators in Q3 are pointing in the same direction. The growth outlook in Iceland remains one of the best among developed nations, according to the IMF's October forecast.



Sources: Statistics Iceland, Arion Research

This spring, it looked like wage disputes and impending strikes were hampering growth in private consumption. According to high frequency indicators, such as groceries- and payment card turnover in Q3, it seems like consumption has picked up again, most likely resulting from decreased uncertainty in the labor market and high wage increases. We believe there will be robust growth in private consumption throughout the forecast horizon, supported by wage increases, an improved equity position of households, low unemployment and increased optimism regarding future economic conditions.

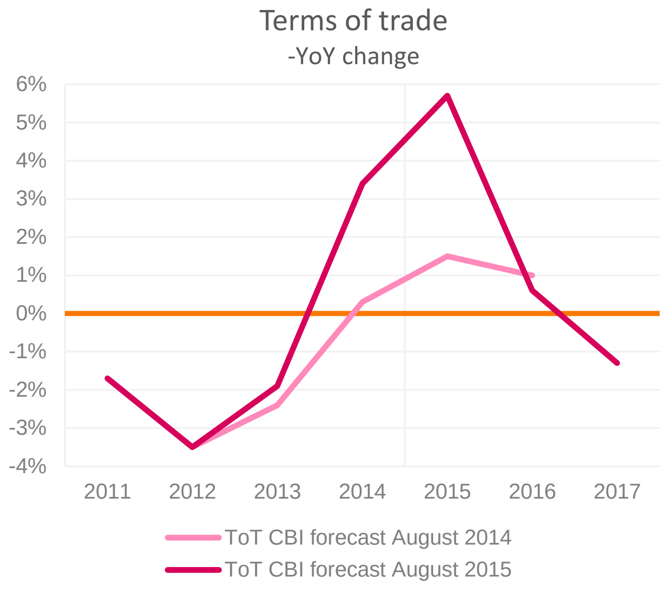


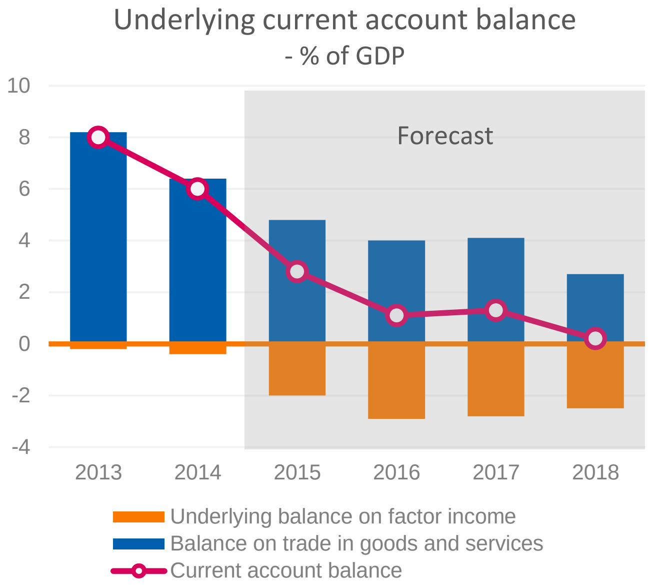


Sources: Statistics Iceland, Central Bank of Iceland, The Centre for Retail Studies, Arion Research

We still believe growth in investment will mainly be driven by industrial investment, such as hotel construction and silicon smelters. We also expect considerable investment in ships and aircraft, as well as increased investment in housing, which has been disappointing so far this year. A likely explanation for slow growth in housing investment in Q1 was unusually bad weather, with another possible culprit being competition from hotel builders as far as labor, funding and other resources go.

The tourism industry is expected to continue contributing generously to growth via an increase in exported services. We also expect imports to grow considerably along with increased consumption and investment. We nevertheless expect a current account surplus over the forecast horizon, given a constant exchange rate, supported by a vast improvement in the terms of trade this year.

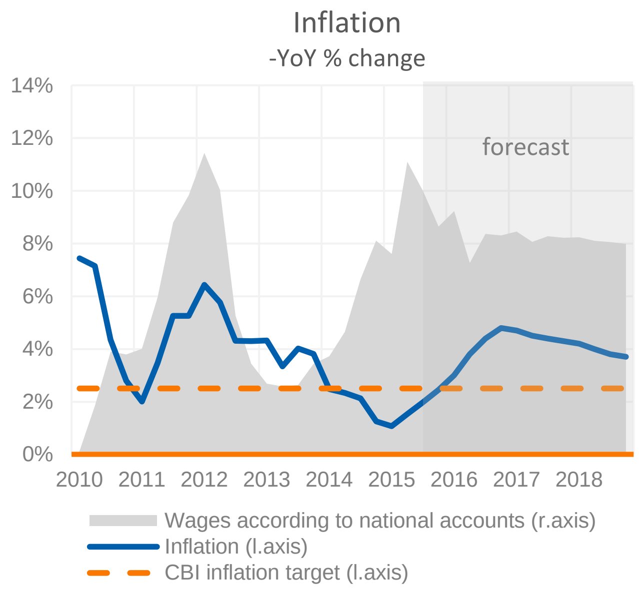


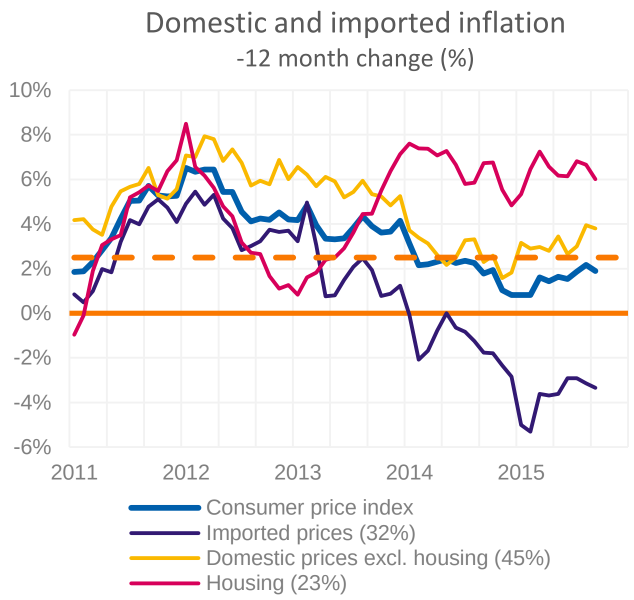


Sources: Statistics Iceland, Central Bank of Iceland, Arion Research

The Central Bank expected to raise rates due to medium-term inflation pressure

Although inflation is currently below the CBI's 2.5% target at 1.8%, inflation pressure remains over the medium term. Tension is starting to build up in the labor market as we are operating at near full employment and the output gap is estimated to have already closed. Wage agreements of certain groups could possibly be rescinded in February due to other groups receiving higher wage increases. We therefore expect the Central Bank to raise its key rate in the coming quarters, barring material changes in the inflation outlook. What the Central Bank views as the key rate could change over this period, however. Currently, the key rate is the rate for 7 day term deposits, but if the new banks' cash positions decreases substantially after the winding up of the failed bank estates the CBI could start viewing its 7 day collateralized lending rate as its key interest rate.





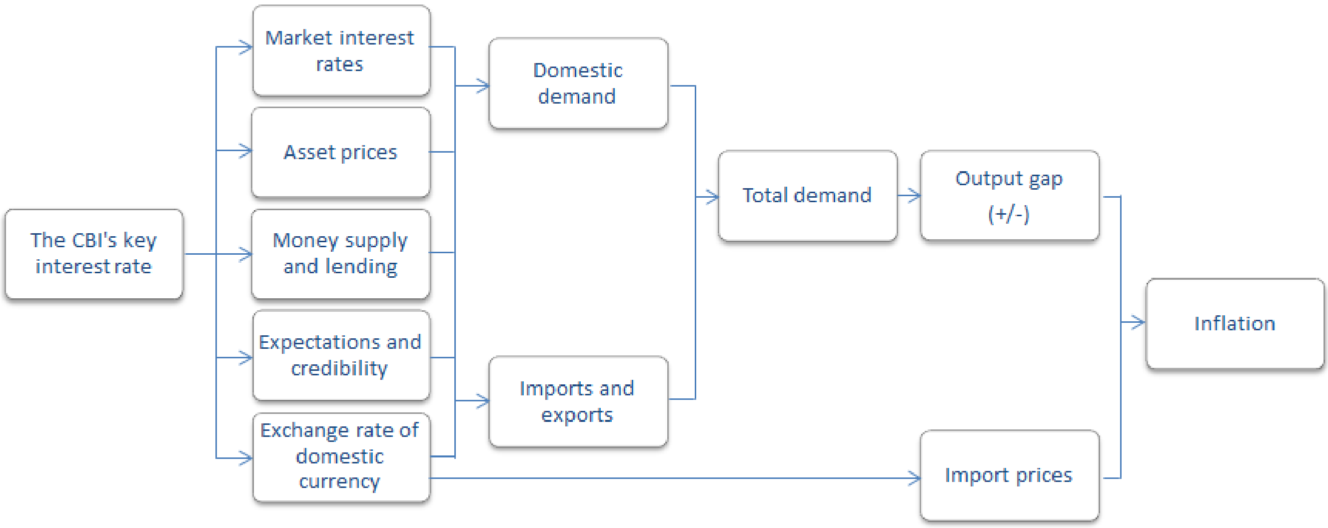
Sources: Statistics Iceland, Central Bank of Iceland, Arion Research

The main driving factor behind inflation since the beginning of 2014 has been the price of housing. Since investment in housing has been below expectations and purchasing power is increasing, we expect real estate prices to keep rising throughout the forecast horizon, although we do not believe prices will reach the previous heights of 2007 in real terms.

Overall, the outlook is quite positive for the coming years. If the liberalization of the capital account is successful and if the government stays on a path of fiscal restraint and debt reduction we could well be headed into a period of robust, sustainable growth. Of course, those are big "ifs".

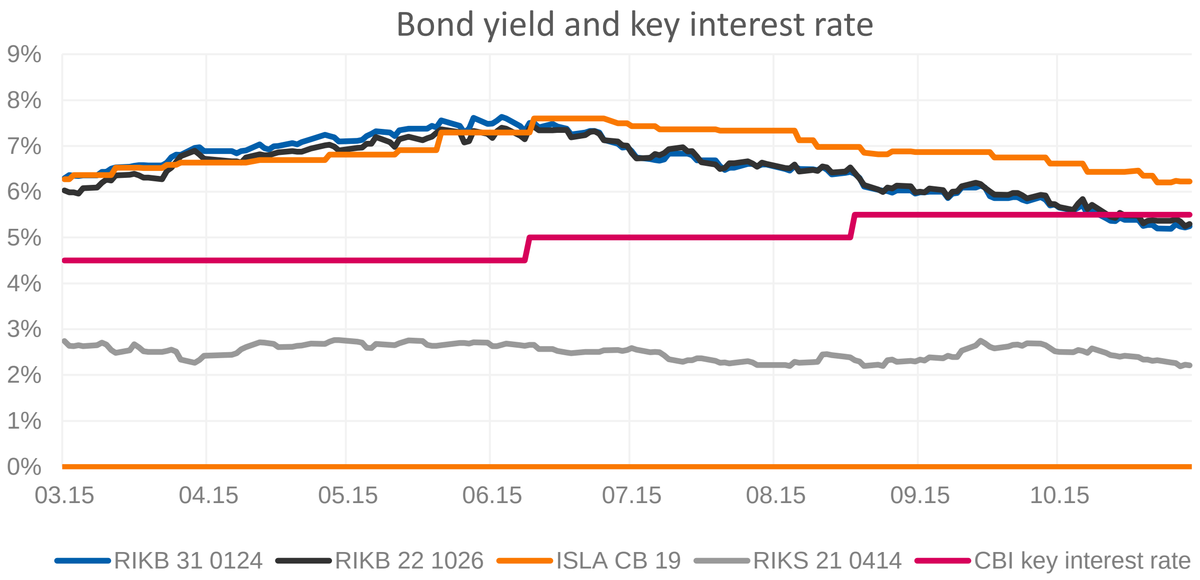
Monetary Policy: Transmission Breakdown?

The Central Bank's Monetary Policy Committee has raised rates by 100 bps since June, due to a worsening inflation outlook following the latest collective bargaining round. Given the MPC's forward guidance it looks like rates will be raised further still in the coming quarters. According to theory, the Central Bank's key interest rate has an effect on the economy and inflation through various channels as can be seen in the picture below.



Sources: Central Bank of Iceland, Arion Research

One of the channels of monetary policy is through market interest rates, but bond market yields have come down markedly since the Central Bank started raising rates in June. In fact, most government bonds, including longer term bonds, now have a lower yield than the Central Bank's key rate. Lower yields on government bonds usually also means lower cost of debt for companies such as financial firms, who have been seeing the interest rate on covered bonds for instance coming down recently. That in turn leads to lower interest rates on mortgages, contrary to what the MPC is trying to achieve.

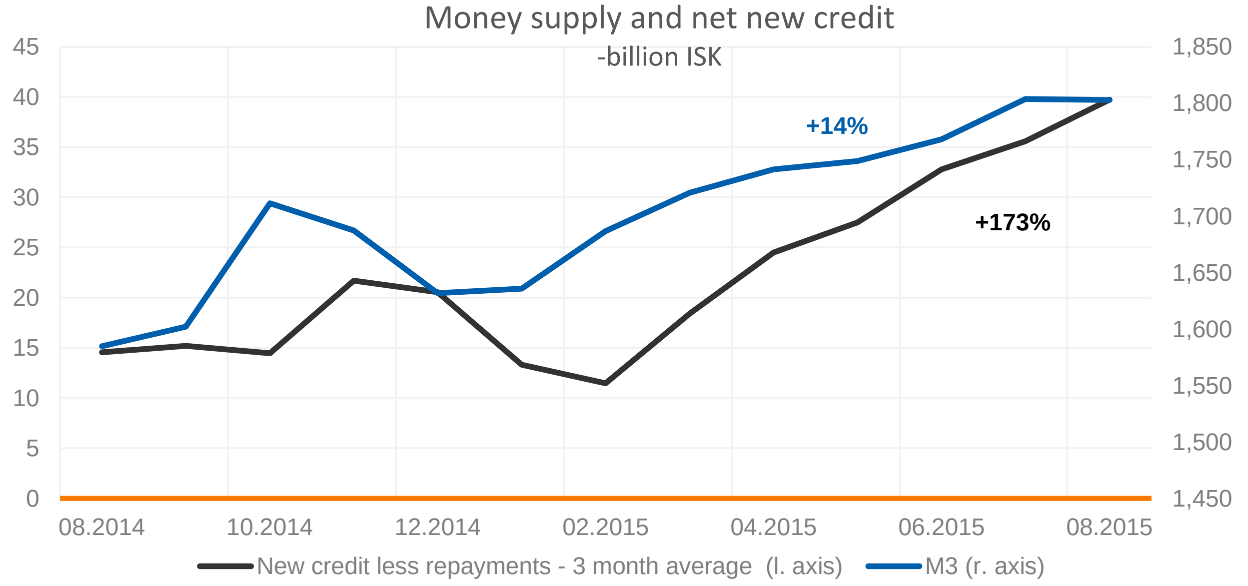


Sources: Kodiak, Central Bank of Iceland, Arion Research

What is causing the decline in market yields? Higher credit ratings, an improved economic outlook and a credible plan to lift capital controls are most likely a part of the explanation. Additionally, an increasing interest rate differential between Iceland and other countries fuels demand for domestic bonds and if the Central Bank keeps raising rates in the coming quarters, as is expected by most analysts, the differential will probably increase further. In that sense, higher Central Bank rates have the opposite effect of what they are intended to do, at least when looking at the market rate channel of monetary policy. Massive inflow of capital could encourage increased lending and therefore have expansionary effects which could threaten price stability. On the other hand, capital inflow, if large enough to strengthen the exchange rate, could constrain inflation through lower imported prices.

Asset prices are rising and lending is picking up

Another channel of monetary policy is through asset prices, which have been rising quite rapidly in recent months so it looks like monetary policy is not having a major impact there, not yet at least. The Nasdaq OMXI8 index has risen close to 36% over the last six months and real estate prices keep rising heftily as well, although rising housing prices may be attributed to lack of supply rather than an expansion of credit in the mortgage market. However, net new bank lending to firms and households has been picking up recently and it doesn't look like the recent interest rate hikes have slowed that development down. The money supply (M3) has also been increasing.



Sources: Central Bank of Iceland, Arion Research

Inflation expectations have not increased much following wage agreements. The exchange rate of the króna might play a part as it has been strengthening recently and is mostly expected to strengthen further in the coming quarters due to a trade surplus and capital inflow.

One positive development regarding the inflation outlook is the agreement recently made between major labor unions and employers in both the private and public sector. The agreement states that a common wage policy be formed until 2018 to prevent the game of leap-frog that has historically characterized wage negotiations in Iceland. In the meantime, an economic council with representatives from the labor market, the Central Bank and the government will be established to design a new framework for wage agreements that will take effect in 2018. The emphasis will be on letting the export sector lead wage bargaining as is customary in other Scandinavian countries, therefore taking international competitiveness into account.

The transmission of monetary policy takes time and its effects on domestic demand might not be seen until about six to twelve months later. It is also possible that bond market yields were even lower had it not been for the CBI's rate hikes, but overall we are still not seeing the effects of tighter monetary policy. The reserve requirement has already been raised. Some sort of restrictions on large inflows of foreign capital have been mentioned although they don't seem to be right around the corner. The question is: will the Central Bank's MPC accelerate planned hikes in the coming quarters to fight these developments or turn to other tools?

Stability Proposals: The Central Bank Gives the Green Light

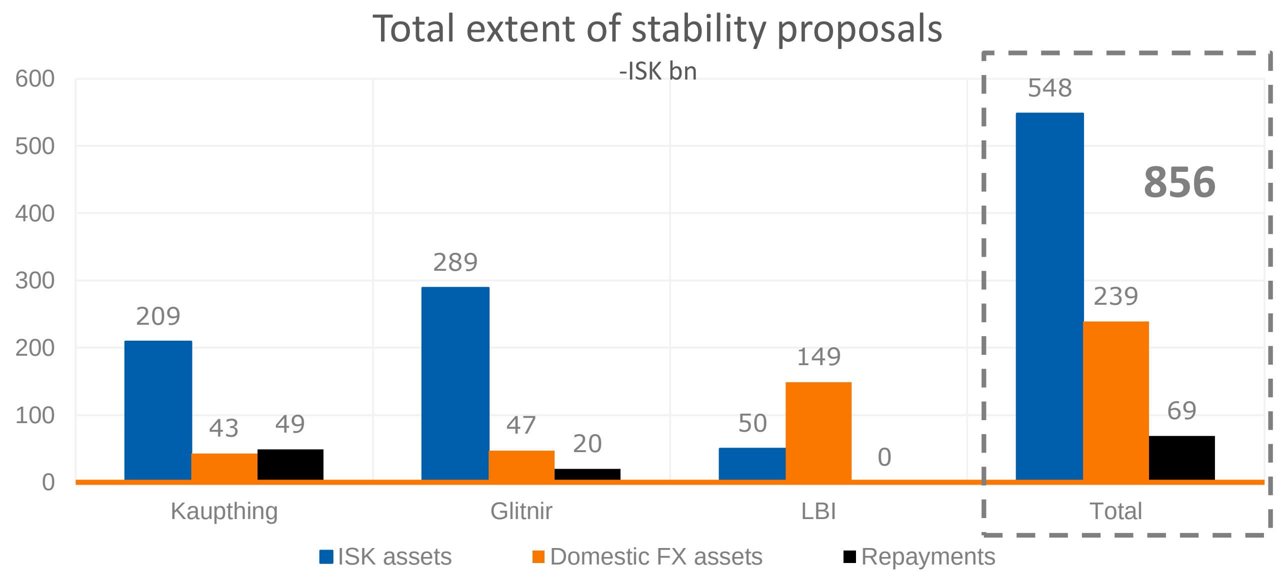
The Central Bank of Iceland published its assessment of the failed bank estates' stability proposals and concluded that "the fulfilment of the composition agreements together with the proposed countervailing measures will not jeapordise monetary, exchange rate, or financial stability." Among the proposals of the estates were various measures:

- The conversion of FX deposits to medium-term loans
- Prepayment of loans granted by the Treasury and CBI to Arion Bank and Íslandsbanki
- Payment of a direct stability contribution that factors in the uncertainty regarding the future value of the assets handed over, ensuring that any possible BoP (Balance of Payments) risk is eliminated
- A portion of ISK assets will go towards taxes, expenses and reserves and will therefore stay in Iceland, posing no threat to the BoP
- The CBI's Asset Management Company's (ESÍ) FX denominated recoveries from the estates will counteract any negative BoP impact
- The handover of Glitnir's share in Íslandsbanki to the authorities all but eliminates any BoP risk which could otherwise have resulted from the sale of the bank

Total extent of proposals ISK 856 bn	Payments to the authorities ISK 491 bn	Prepayment of loans ISK 74 bn
Medium-term financing of the banking system ISK 226 bn	Positive effect on FX reserves ISK 41 bn	Positive effect on Iceland's external position ISK 360 bn

Source: Ministry of Finance

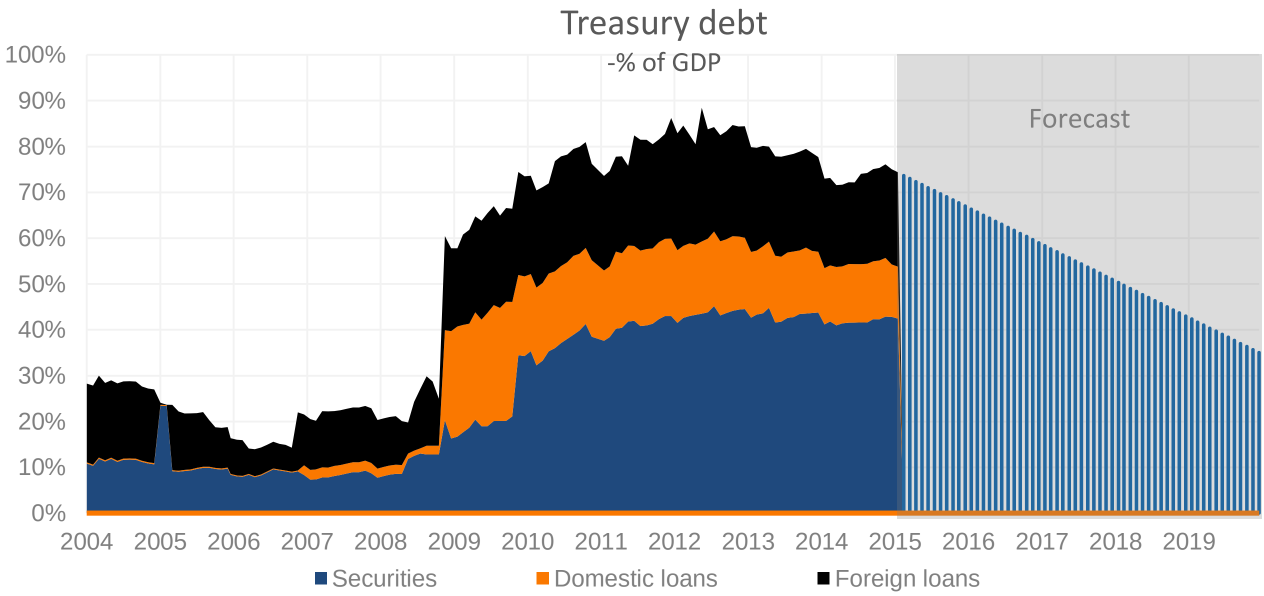
In addition to direct and indirect contributions, this solution entails greatly mitigated legal risk for the Icelandic State, further reducing BoP risks in the future as well as facilitating the removal of capital controls on residents. The Central Bank estimates these measures as counterbalancing potential outflows in the amount of ISK 856 bn., including domestic assets backed by foreign FX. For comparison, the GDP of Iceland in 2014 was ISK 1,989 bn.



Source: Ministry of Finance

The CBI estimates that Iceland's net external debt will decrease by ISK 3,740 bn and that the underlying international investment position (IIP) will improve by ISK 360 bn should the proposals be accepted by the courts as put forward. Iceland's external debt position is expected to improve from 1/3 of GDP to about 1/10 of GDP by year-end 2016, the country's most favorable external debt position in decades. Credit rating agencies are largely expected to upgrade Iceland's sovereign rating once the composition agreements have been approved.

What further supports an improved sovereign credit rating, besides reduced uncertainty and a greatly improved BoP outlook, is the fact that the stability contributions are to go towards the reduction of Treasury debt, including debt to the CBI, and that the allocation of the contributions is subject to the approval of the CBI to ensure financial stability. Paying down large chunks of marketable debt at the same time could have negative effects on stability in financial markets so the CBI will be consulted before any action is taken. However, since a large part of the assets handed over to the government is in the form of illiquid assets which will be put up for sale, their ultimate sale should at least partly counteract the monetary expansion resulting from any buyback of marketable debt.



Sources: Central Bank of Iceland, Ministry of Finance, Arion Research

The Icelandic courts will have until March to approve all composition agreements. If things go according to plan, and capital controls will finally be lifted after having been in place for seven years, the Icelandic economy will finally be out of its straitjacket.