ICELANDIC ECONOMIC UPDATE

Arion Bank

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Coming up: wage negotiations

The labor market has been showing signs of improvement recently, but an imminent threat looms. Centralized wage negotiations are coming up and many labor unions have already put forth very strong demands. Will high wage increases actually increase purchasing power? If history in Iceland is any indicator, the answer is: probably not.

Tourist arrivals keep growing at a record pace

The rate of increase in tourist arrivals is as high as ever. Given the fact that major investments are taking place in the tourism industry and that airlines are increasing their flight frequency to and from Iceland we thought we should update our forecast for tourist arrivals through Keflavik International Airport for 2015-2017. We are now predicting a 20% increase in arrivals this year and 1.5 million tourists in 2017. Not too bad for a country of 330,000.

The lifting of controls – what will the next steps be?

In March, the Central Bank of Iceland changed its government bond foreign investment exemption lists so they now only include RIKB 15 0408 and Treasury bills. It remains to be seen what other investment options will be made available in the near future to those foreign investors who hold ISK or government bonds, but we expect that an exit tax and/or a longer term euro bond will be in the cards.
The CBI issued its annual report last week. In his speech, the Minister of Finance sounded hopeful that important steps in the pressing matter of capital account liberalization would be taken in the first half of 2015.

Dividends keep growing

Listed Icelandic companies will pay handsome dividends this year - in the case of some companies, even higher amounts than last year's profits. While these companies operate in an environment of capital controls they are likely to pay out higher dividends than they otherwise might. Companies in the transport and fishing industries are undertaking large scale investments in the coming years and will most likely not be returning cash to shareholders quite yet.

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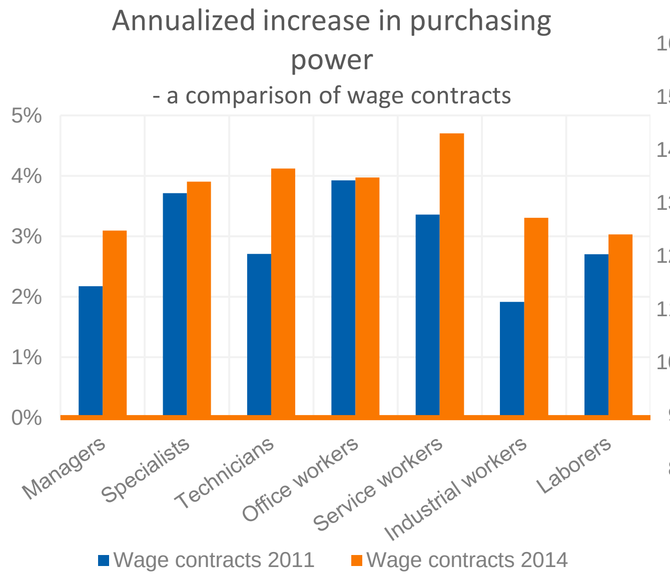
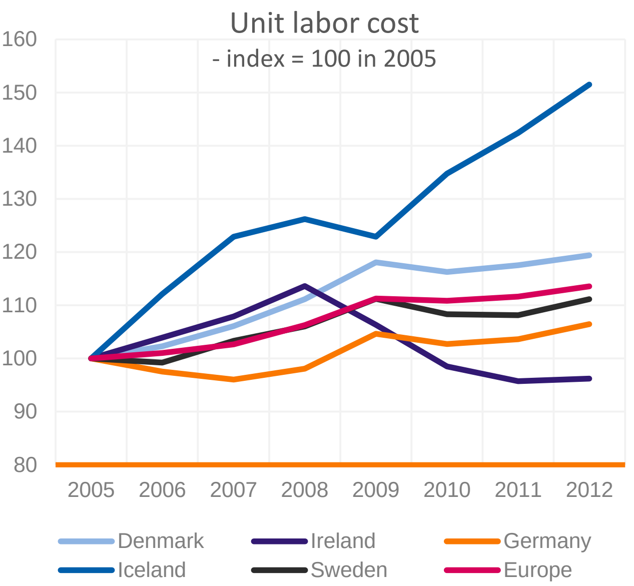
Coming up: Wage negotiations

The main concern these days regarding the Icelandic economy seems to be upcoming wage negotiations – perhaps understandably. Wage contracts of some of the country's largest labor unions recently expired and we are already hearing a very harsh tone on both sides of the table. Groups such as teachers, pilots and medical doctors negotiated a hefty wage increases last year which only served to increase the demands of those who have yet to talk terms. When most of the labor market belongs to a labor union, as is the case in Iceland, and wage negotiations are very centralized, this can have a noticeable effect on the overall price level in the economy. With wage negotiations beyond productivity increases, in addition to the CBI's inflation target, we have generally seen inflation pick up, ultimately reducing purchasing power – which is quite contrary to the wage increases' intended purpose.

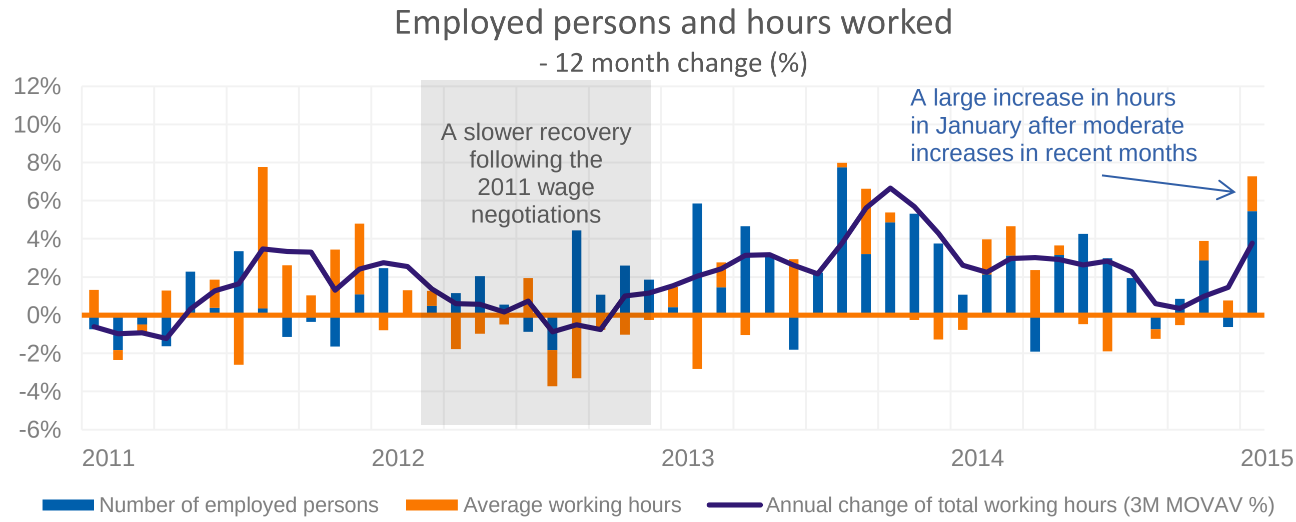




Sources: OECD, Central Bank of Iceland, Arion Research

The wage negotiations that were made in 2011 involved a general wage increase of 11.4% over a three year period, while the contracts in 2014 were for a 2.8% wage increase over a one year period. An annualized comparison shows that purchasing power increased by 2.9% on average between 2011 and 2013 while it increased by at least 3.9% in 2014[1]. High wage increases are therefore not guaranteed to increase purchasing power since they are quite likely to result in higher inflation, interest rate increases and a stronger real exchange rate. From 2005-2012 cumulative wage increases in Iceland have amounted to approximately 51% while they have been about 13% in Europe as a whole, as can be seen in the graph above to the right.

In addition to fueling inflation high wage increases can lead to increased unemployment. Although the numbers at the beginning of the year indicate increased demand for labor, very high wage increases over the coming months might make many employers reconsider, possibly impeding the recovery in the labor market.



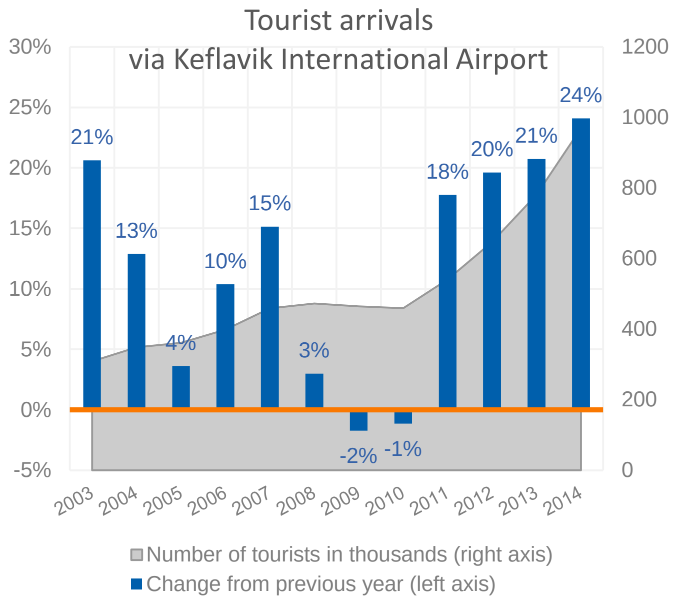
Source: Statistics Iceland

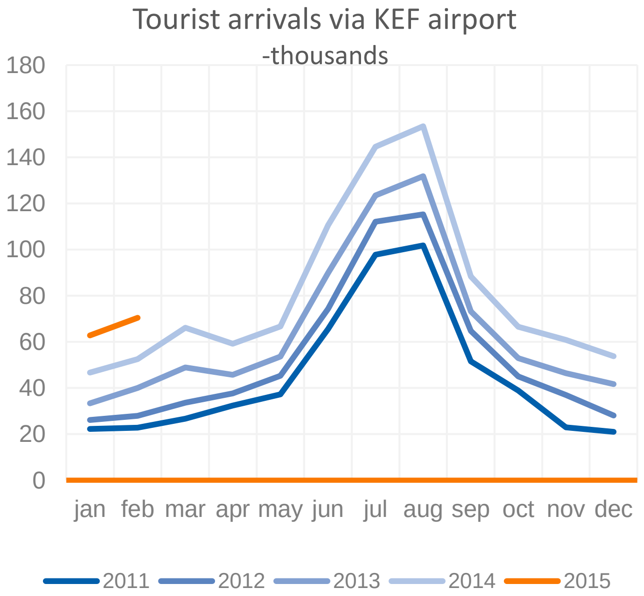
[1] Looking at the period from Q3 2013 to Q3 2014. The increase in purchasing power was 5.8% when looking at 2014 as a whole.

Tourist arrivals keep growing at a record pace

The rate of increase in tourist arrivals does not seem to be slowing down if numbers for January and February are any indicators. Despite an unusually brutal winter in Iceland as far as weather goes tourist arrivals through Keflavik International Airport increased by over 34% in January and February. Last summer Arion research felt quite optimistic predicting an increase of 25% in Q1 2015 in tourist arrivals through Keflavik airport. It looks like that may have been an underestimate.

Most forecasters have been underestimating tourist arrivals since 2010. Last year there was a 24% increase in tourist arrivals via Keflavik Airport following two strong growth years. In fact, since 2011 there has been an increase in tourist arrivals every single month from the same month in the previous year. How long can we expect this trend to continue?



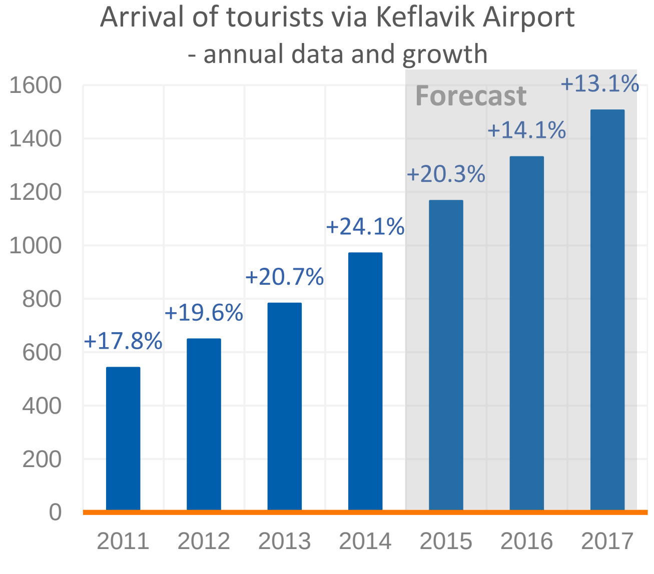


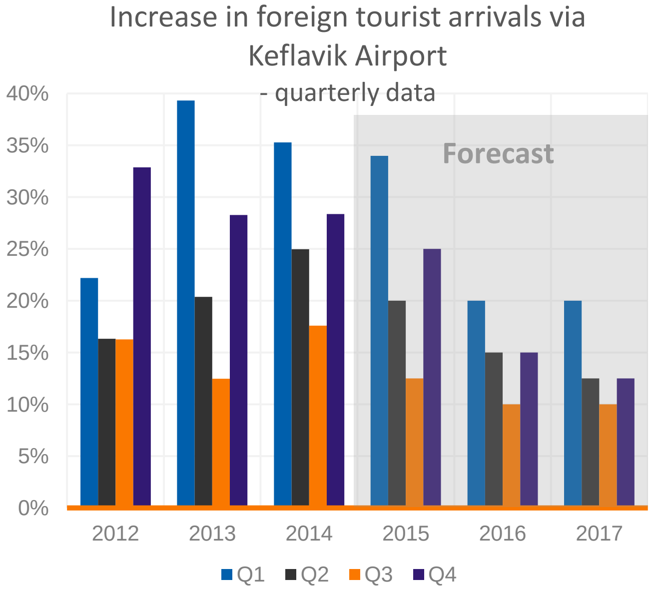
Source: Icelandic Tourist Board

Hotel investment eases accommodation limitations

Arion research was quite cautious when it came to predicting tourist arrivals over the summer months in 2014 due to a shortage of hotel rooms. Occupancy rates in July and August of last year were around 90% countrywide so increasing the number of tourist during those months by a large percentage would be practically impossible without new hotel rooms. Occupancy rates in the city were also very high throughout last year and even stood at 97.5% in the whole capital area in March, which is partly explained by the fact that winter tourist tend to stay within the city limits when visiting. We expect at least 700 new hotel rooms to come onstream this year in Reykjavík, easing these limitations.

Given the large scale investments now taking place in tourism, an increased frequency of flights to and from the country and the latest tourist arrival numbers we thought we should update our tourist arrivals forecast for the coming years.



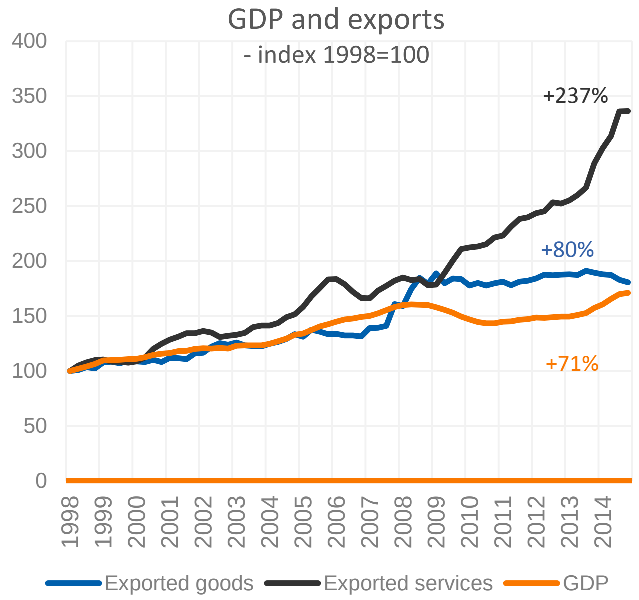


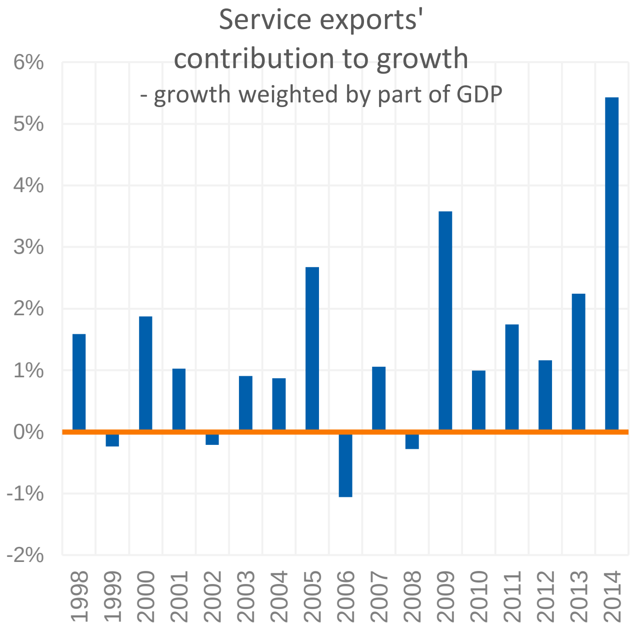
Sources: Icelandic Tourist Board, Central Bank of Iceland, Arion Research

We are now forecasting that the total rate of increase this year will be 20%, 14% in 2016 and 13% in 2017. This means that the number of tourists visiting Iceland via Keflavik airport will be approximately 1,166,000 this year and a million and a half in 2017. As before we assume that the increase will be relatively slower over the high season summer months.

Tourism remains a positive contribution to economic growth

Along with the increase in tourist arrivals we expect a continued boom in exported services and a positive effect on economic growth. The production of goods, such as marine products and aluminium, depends on various supply restrictions that do not apply to the tourism sector to the same extent. We therefore expect tourism to remain a pillar of economic growth in Iceland over the coming years.

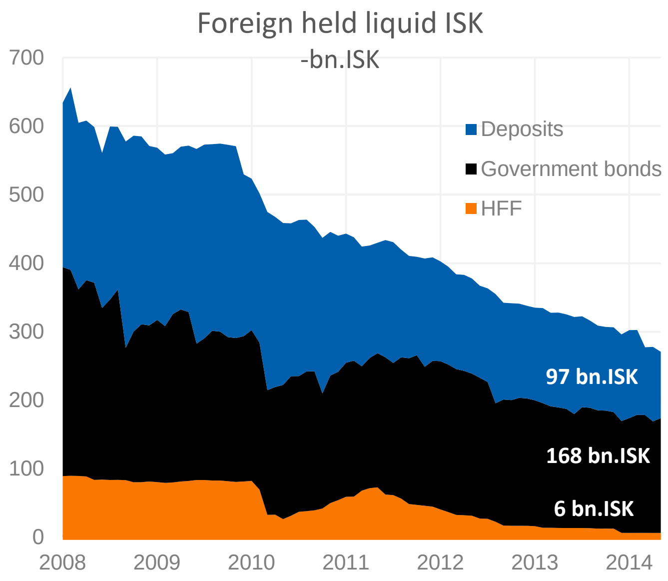


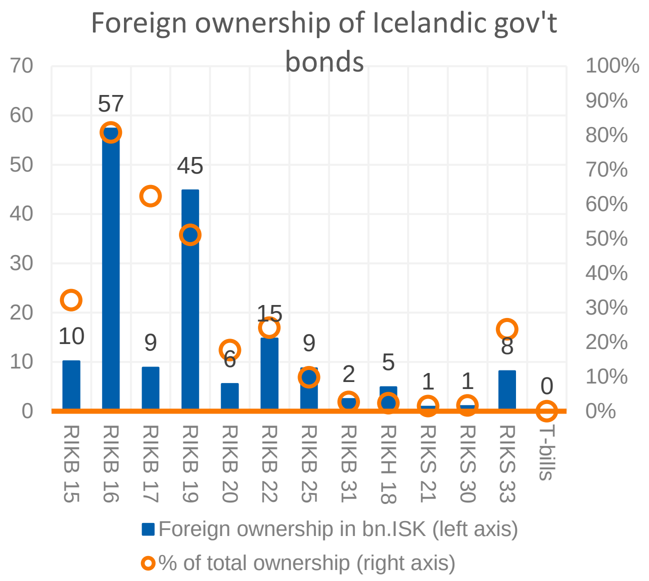


Sources: Statistics Iceland, Arion Research

The lifting of controls – what will the next steps be?

At the beginning of March the CBI announced a change to its rules on foreign exchange and government bond foreign investment exemption lists. The exemption lists are now limited to Treasury bills and one Treasury bond, RIKB 15 0408, which will mature on 8 April. This limits the investment options of foreign investors substantially as the previous list included exemptions for RIKV, RIKB, HFF, LSS 24, RVK 09 and LAND 05. Foreigners own a substantial part of the Icelandic bond market, especially the shorter end, so these changes are bound to affect the markets in one way or another. One could expect, for instance, that demand for T-bills would increase in the near future since RIKB 15 is maturing very shortly and no other options are currently available as a reinvestment.





Sources: CBI, The Government Debt Management, Arion Research

According to the CBI's statement these changes were made to prepare for further steps in the lifting of capital controls and it was also stated that the owners of these króna assets will be offered another investment option which is meant to decrease the risk of instability in the currency market once controls are lifted.

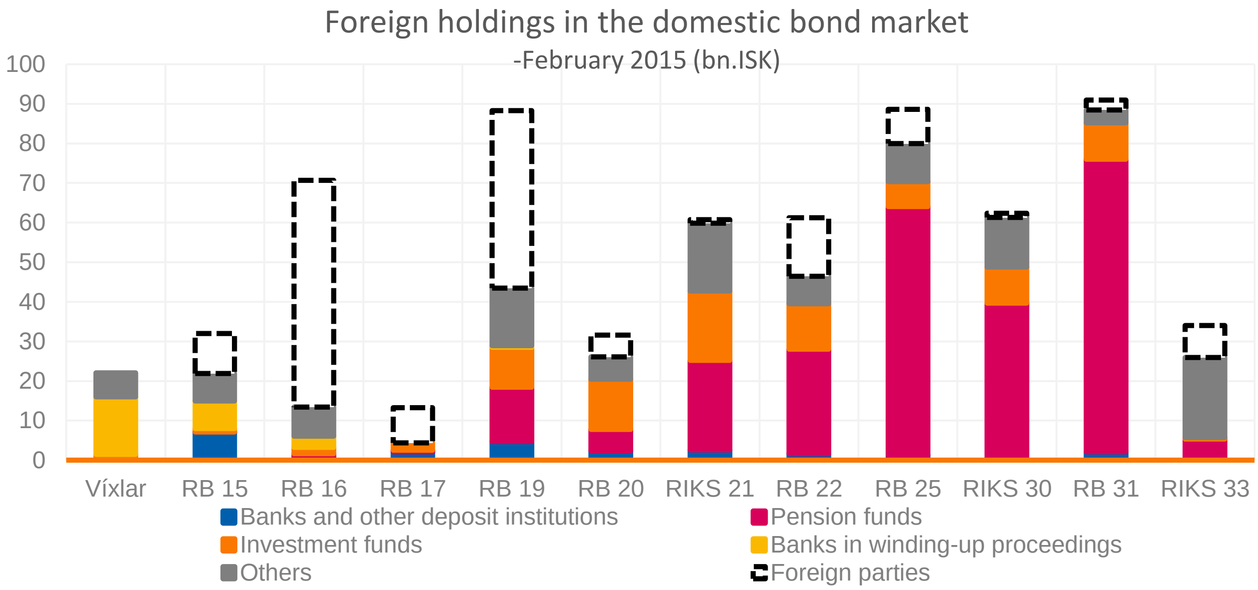
Which investment options will be offered?

In an IMF report published in July 2014 two possible routes (also mentioned in the CBI's report on the lifting of controls from 2011) were mentioned to minimize risks related to foreign held ISK. One of them was to offer long term euro denominated debt in exchange for their ISK assets, whether it be domestic bonds or deposits. The question is: what would the terms be and when would such a bond mature? The other option would be some form of an exit tax. In his report on the progress of plans to remove capital controls the Minister of Finance and Economic Affairs affirmed the belief that these would indeed be the next steps by indicating two possible ways to deal with balance of payments problems:

i) By imposing a haircut on domestic assets when exchanged for FX (an exit tax?)
ii) By ensuring that volatile assets are transferred to long term assets, the terms of which must be such that they cannot be accelerated or reverted to their former status (a long euro bond?)

What effect could these changes have on the domestic bond market?

If foreign holders of domestic bonds were to swap their short-term holdings for a long euro bond, for instance, the debt repayment profile of the government would lengthen and the shorter term issues would shrink quite a bit in size. The issues RIKB 16, 19 and 20 would all be under 50 bn.ISK while the longer term bonds would be closer to 80-90 bn.ISK in size. The refinancing need of the government in the coming years would be very little and new debt issued would most likely be more focused toward the shorter end. It should be stated, however, that it has not yet been disclosed what kind of options will be made available for foreign investors and whether they will even seek exit remains unknown.



Source: The Government Debt Management

The CBI issued its annual report on 26 March. There was little in the report relating to progress on the liberalization of the capital account, but in their speeces the governor of the Central Bank, Már Guðmundsson as well as the Minister of Finance, Bjarni Benediktsson, sounded hopeful that this would be the year of action on that front. Már admitted that significant progress had been made and that economic conditions were ripe for the removal of controls while mentioning important risks:

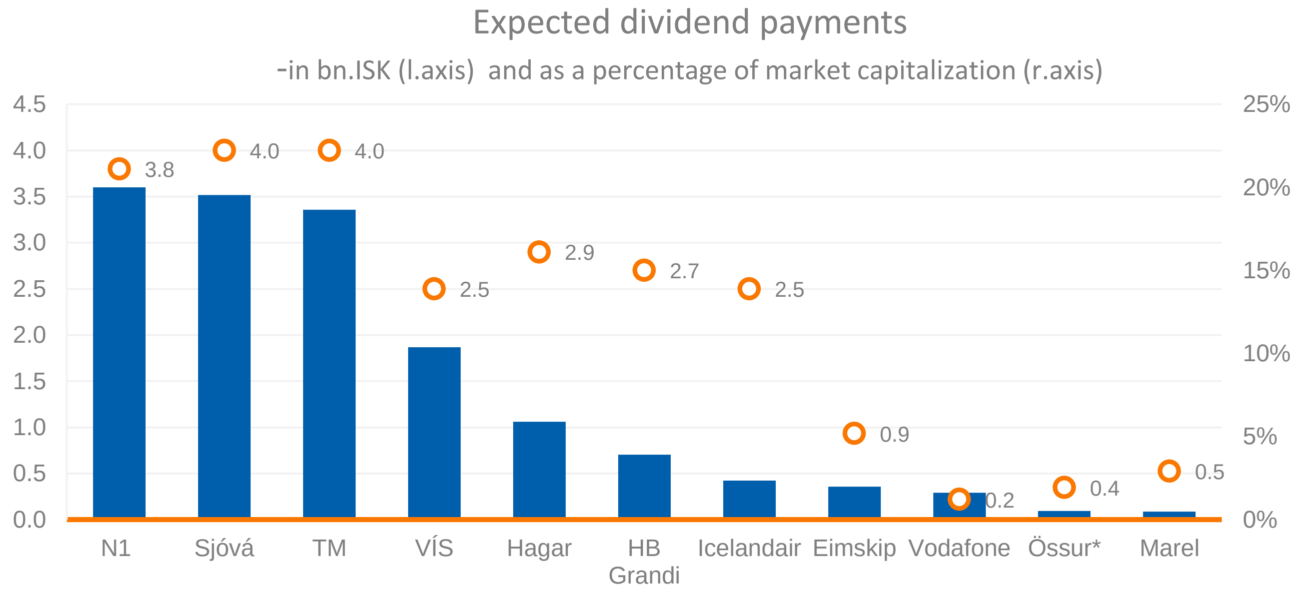
1) Labor market unrest could threaten price stability and turn the current account surplus into a deficit
2) The lifting of controls could fail with a negative effect on the exchange rate, inflation and stability in the financial system
3) Conditions in the global economy could turn against us.

Therefore we have to remain vigilant and avoid complacency according to the governor.

The Minister of Finance stated that he had reason to hope that major decisions would be taken, which would map out the path towards the lifting of controls, in the first half of this year and that 2015 would be a year of action. He also said: “slow and steady wins the race”. Let’s hope it won’t be too slow.

Dividends keep growing

Icelandic companies listed on Nasdaq OMX Iceland are likely to pay approximately 24 bn.ISK to shareholders in the coming months in the form of buybacks and dividends. That amounts to over 4% of these companies' market capitalization. Of these 24 billion about 12 bn.ISK will go to Icelandic pension funds who are among the largest owners of those companies intending to pay the highest dividend. This is an increase of 4 bn.ISK in dividend payments from last year.



*Össur is dually listed in Reykjavík and Copenhagen. Here, a third of Össur's market cap is counted as listed on Nasdaq OMX Iceland

Sources: Listed companies' annual reports, Arion Research

The largest dividend payments this year come from companies aiming for a higher debt ratio and companies that are not looking to invest or expand rapidly. The petrol company N1 and the insurance companies TM, VÍS and Sjóvá, for example, are planning to pay a dividend higher than last year's profit. Shareholders of those companies who are planning on investing quite heavily in the coming years should not, however, expect to receive a large share of last year's profits in the form of dividends. These include firms such as the transportation companies Icelandair and Eimskip and the seafood company HB Grandi.