



Icelandic Economic Update

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Net debt position never better

- Iceland's net external debt position has not been as strong since the Central Bank of Iceland first began taking measurements in 1989. The position at the end of the third quarter was "only" negative by 24% of GDP once the effects of the collapsed banks have been eliminated. The situation is likely to change for the worse in the medium term. Approving the Icesave bill will only depress the net debt position by 3-4% provided that the assumptions of the Icelandic negotiating team are reasonably accurate. However, when the shareholdings of the banks' resolution committees are transferred to non-resident creditors, the debt position will increase by approximately 20% of GDP according to calculations by the IMF. The net external debt position will therefore be negative by 50-60% of GDP if both the above scenarios are taken into account. This would be a similar figure to the norm before the growth of the banking system in 2000-2008.

Why aren't foreign investors interested in HFF14?

- Indexed ISK-denominated assets owned by foreign investors totaled ISK 20 billion out of their total assets of ISK 400 billion in the autumn of 2010. This may seem strange as foreigners are allowed to sell ISK generated by payments on HFF bonds (which are indexed and guaranteed by the Icelandic State) irrespective of whether such payments are instalments or interest payments. This is not the case with other bonds as foreigners are only allowed to sell ISK generated by interest payments. Foreigners can buy HFF14 which matures on 15 September 2014 and thereby escaping in only 1,8 years (duration of the bond). Foreign financial institutions can use offshore ISK in this transaction, thereby capitalizing on the exchange rate differential between the offshore and the official exchange rate which is currently more than 60%.

Calendar

Date	Title	Period
17 February 2011	Auction Treasury Bonds	February 2011
24 February 2011	Consumer Price Index	

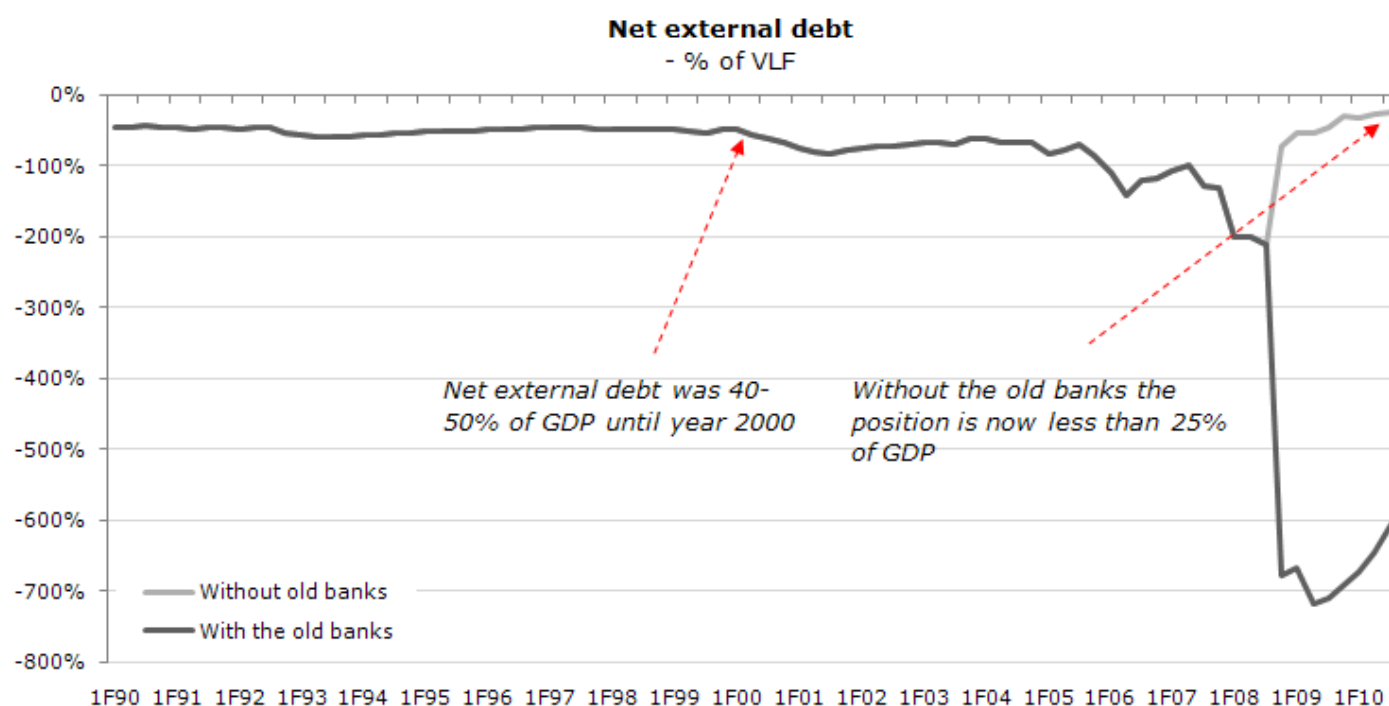
Net debt position never better

Iceland's net external debt position has not been as strong since the Central Bank of Iceland first began taking measurements in 1989. The position at the end of the third quarter was "only" negative by **24% of GDP** once the effects of the collapsed banks have been eliminated (see figure).

The bad news is that the situation is likely to change for the worse in the medium term. For example, the holdings of the banks' resolution committees (currently defined as residents) will eventually be transferred to non-resident creditors, which will lead to an increase in external debt. Should the Icesave deal pass into law then the net position will deteriorate even further.

The good news is that even if we factor the two above scenarios into the equation, the position is not that bad in a historical context. Approving the Icesave bill will only **depress the net debt position by 3-4%** provided that the assumptions of the Icelandic negotiating team are reasonably accurate. However, when the shareholdings of the banks' resolution committees are transferred to non-resident creditors, the debt position will increase by approximately 20% of GDP according to calculations by the IMF (ISK 89 billion in Arion Bank, ISK 100 billion in Íslandsbanki, and 50% of a bond in new Landsbanki to the old bank). **The net external debt position will therefore be negative by 50-60% of GDP** if both the above scenarios are taken into account. This would be a similar figure to the norm before the growth of the banking system in 2000-2008.

These figures must be treated with a certain amount of caution however as there is considerable uncertainty over factors such as the assets and liabilities of Icelandic companies overseas.



Source: Central Bank of Iceland

While the liabilities are a known quantity, there is less certainty over the assets

In order to provide some insight into the figures on the net position (assuming that the real net position is 50-60% of GDP) here is an overview of the key factors.

Liabilities at the end of the third quarter of 2010:

- External debt of the government was approximately ISK 900 billion. The majority relates to the currency reserves loans.
- The power utilities had debts of ISK 570 billion.

- Investments by non-residents in deposits amounted to more than ISK 230 billion and investments in government bonds and bills came to approximately ISK 230 billion.
- Although not included in the Central Bank's official figures we are adding the debts relating to Icesave and the holdings of non-residents in the new banks. We assume a figure of ISK 60 billion for Icesave and ISK 189 billion for the holdings in the new banks and ISK 150 billion relating to new Landsbanki's bond to the old bank (Iceland has a 51.4% claim on the bond).
- The remaining sum of approximately ISK 1,000 billion refers to the holdings of non-residents, such as holdings in aluminium plants, and debts of Icelandic companies overseas. Until now holdings in Actavis have been responsible for a large proportion of these figures.

Assets at the end of the third quarter of 2010:

The assets contained in the Central Bank's figures are more difficult to quantify:

- At the end of the third quarter the currency reserve totalled almost ISK 500 billion. The figure is now up to ISK 700 billion but the net position has not improved to the same degree (because external debts counter this increase in the reserve to some extent).
- The pension funds had foreign assets of ISK 500 billion.
- There is a big question mark hanging over the value of Icelandic companies abroad (and also over their debts). The same is true of private Icelandic investors and it is impossible to say with any degree of accuracy how much is tied up in international equities or funds.

Why aren't foreign investors interested in HFF14?

Indexed bonds have not featured prominently in the asset portfolios of foreign investors (owning ISK). It was estimated that such bonds only made up 5% of such portfolios in the autumn of 2010. Indexed ISK-denominated assets owned by foreign investors totalled ISK 20 billion out of their total assets of ISK 400 billion. HFF14 is a bond issued by the Housing Financing Fund and matures in 2014. The bond carries a deficiency guarantee from the Icelandic State. Payments are twice a year.

ISK-denominated assets owned by non-residents are considered to be one of the reasons hindering the lifting of the capital controls. These investors are considered "impatient" and thought likely to try to sell their assets immediately even though the exchange rate of the ISK is considered low by many metrics. **The yield on HFF14 does not appear to reflect this situation** as foreign investors (i.e. international financial institutions) are permitted and able to exit their positions in Iceland in just a few short years by investing in HFF14 (i.e. they can take out contractual payments and interest).

HFF14 is an annuity bond linked to the Icelandic CPI with payments divided into instalments and interest payments. It is permitted to sell ISK generated by payments on HFF bonds, irrespective of whether such payments are instalments or interest payments. This also applies to HFF14 bought with offshore ISK (if the owner is a foreign financial institution). **As it is not long until HFF14 matures, foreign investors can "escape" in 1.8 years (duration of the bond) but the last payment is on 15 September 2014.**

Given the above, it's worth asking why foreign investors haven't already driven down the yield on HFF14? The reasons could be:

- Foreign investors still cling to hope that capital controls will be lifted sooner.
- Market value of HFF14 is only ISK 32 billion (end of 2010) which means that foreign investors could only bring a small proportion of their ISK-denominated assets out of the country in this way. The next HFF bond classes after HFF14 are so long that they hold little appeal for foreign investors.
- Foreign investors are still not aware of this option?

The offshore exchange rate of the euro is ISK 260/280 (buy/sell) today. The exchange rate (offshore) has depreciated significantly recently after reaching a low of EURISK 200 during the summer of 2010. We won't go into how reliable the offshore exchange rate is or whether you can do business at this exchange rate. But a foreign financial institution who buys offshore ISK at the exchange rate of 260 against the euro is permitted to buy Icelandic treasury bonds – via a foreign bank. The current official exchange rate for EURISK is 158. An investor who buys ISK at the offshore exchange rate and sells it at the official exchange rate (via buying HFF14) will make a handsome return, just over 60% if the official exchange rate will remain stable.

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