

Economic growth 4.2% in Q1 2016

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Offshore owners stay put

On June 16 the Central Bank of Iceland held a currency auction where owners of offshore króna assets were invited to purchase foreign currency. The amount of the accepted offers totaled just over 83 b.kr., out of nearly 188 b.kr. submitted in the auction. As a result, the impact on the CBI's foreign reserves will be smaller than many had expected beforehand, as they will merely be reduced by 54 b.kr., an amount that is roughly 10% of the non-borrowed FX reserves. It is clear that only a small part of the so called “overhang”, a total of 320 b.kr., will exit the economy through this auction.

Soccernomics of Iceland

Football has more aspects than a pitch, 22 players and a ball. Soccernomics, a book first published in 2009, covers football from the economics and business perspective. Right now, everything in Iceland is about the Euro in France: Volume of trade is low in the stock market, roads are empty during games and nothing else seems to be on the news. Therefore we thought it appropriate to take a closer look at some aspects of soccernomics, i.e. relative football interest in Iceland, effects on happiness and Euro impact on Iceland's balance of payments.

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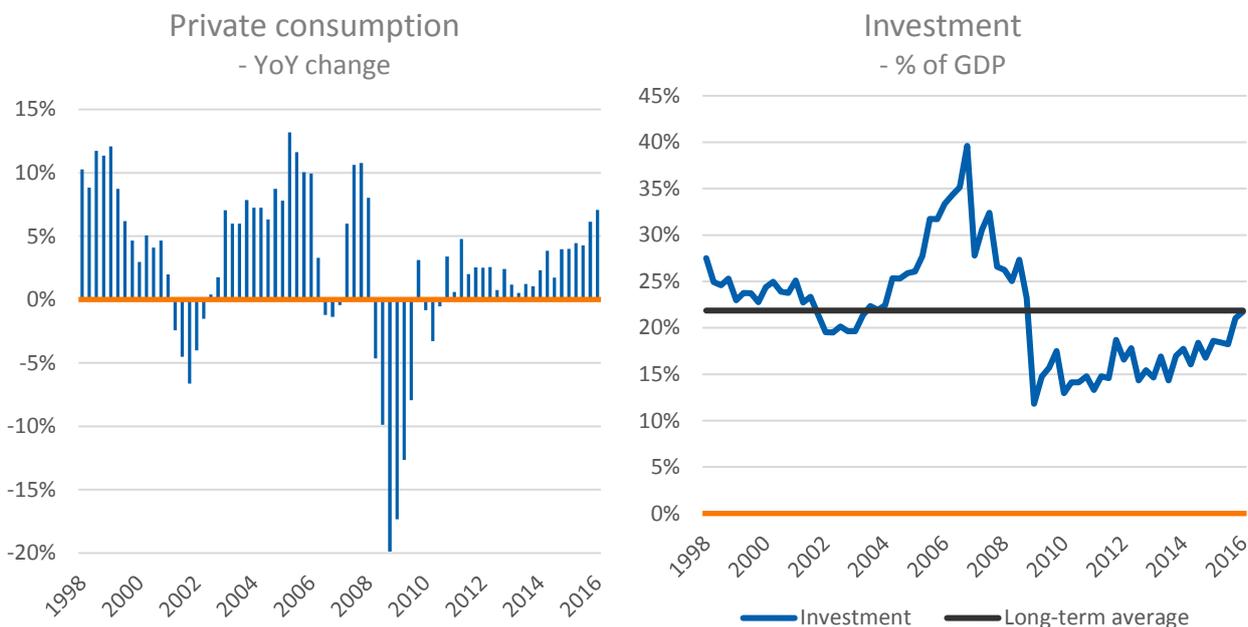
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Economic growth 4,2% in Q1 2016

Gross domestic product increased at a 4.2% annual rate in this year's first quarter, the strongest economic growth in Q1 since 2008. In fact, the description "since 2008" fits the growth numbers quite well: Record growth in consumption since 2008 and investment as a share of GDP has not been higher since year-end 2008. Although the economic growth is slightly below our forecast, mainly due to aircraft imports in March and less growth in public consumption, it appears that we somewhat underestimated the strength of the economy.

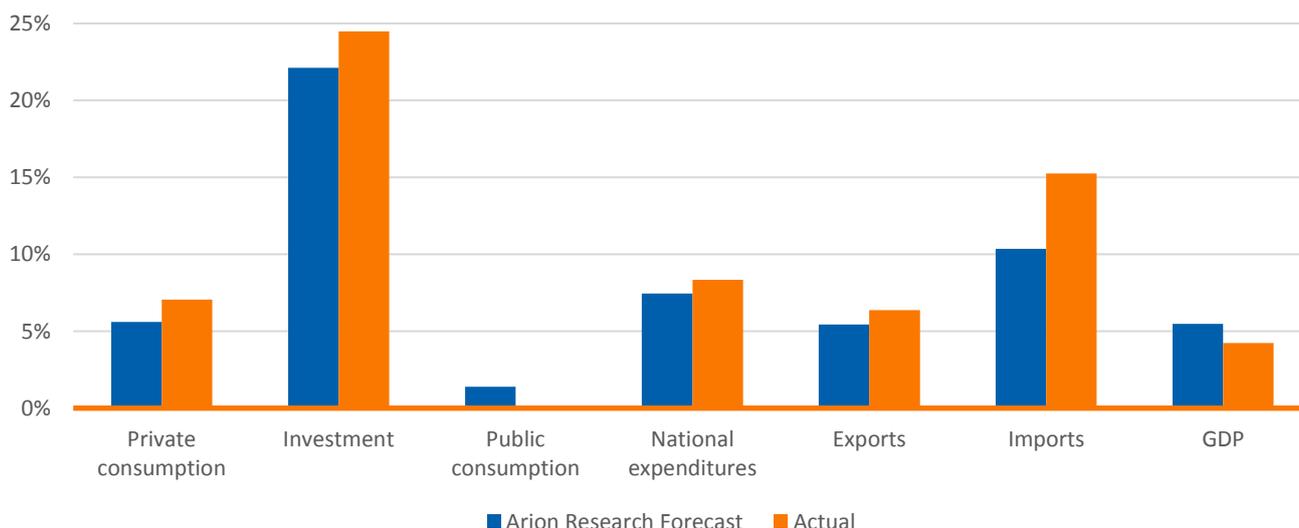


Sources: Statistics Iceland, Arion Research

As in previous years, growth was driven by investment and private consumption. Domestic demand grew by 8.3% in Q1 2016. Private consumption growth measured 7.1% and was considerably stronger than we anticipated (5.6%). We estimate that stronger purchasing power, job creation and improved net household wealth will support significant growth of private consumption. Furthermore, high-frequency indicators, such as payment card turnover, consumer confidence and imports suggest that domestic demand is gaining momentum. It is possible that our forecast from March, which amounted to just over 6.8% growth in private consumption in 2016, was too modest.

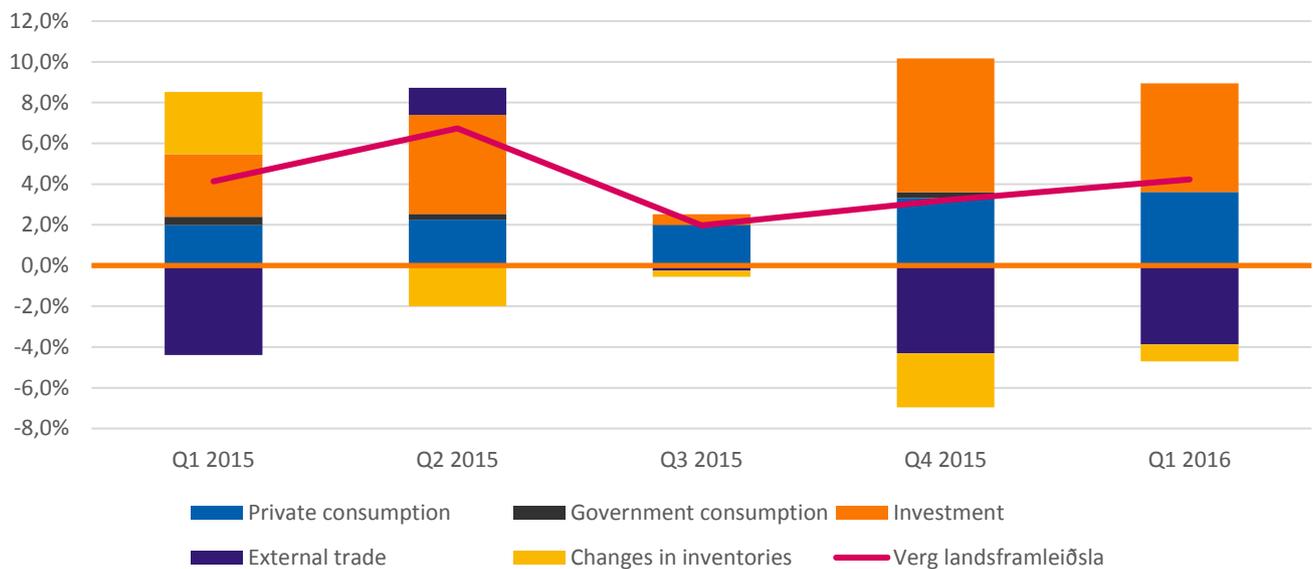
Investment continued to grow sharply and the investment level is reaching the long-term average. As before, it was business investment that was the driving force, as it grew by 32.4% in the first quarter. If the volatile investment in ships and aircrafts is excluded, business investment rose by no less than 45% and total investment by 31.4%. Housing investment increased by 10%, the second consecutive quarter, which is a positive sign in light of the growing demand for housing. Public investment however, dropped in the quarter. A Deloitte survey among the CFOs of the 300 largest Icelandic firms shows that about 75% of respondents said they will invest this year, which indicates that business investment growth is not losing pace.

GDP growth in the first quarter of 2016 - comparison of forecast and actual results



Export growth was somewhat above our forecast, increasing by 6.4% YOY. Just as before, service exports was the driving force, with the tourist industry in the forefront. One of the most surprising factors was the strong growth in imports, as they grew by 15.2% or well above our forecast (10.4%). The import of aircrafts in March explains largely the deviation from our forecast. Due to the rapid growth of imports, the contribution of external trade to growth was negative.

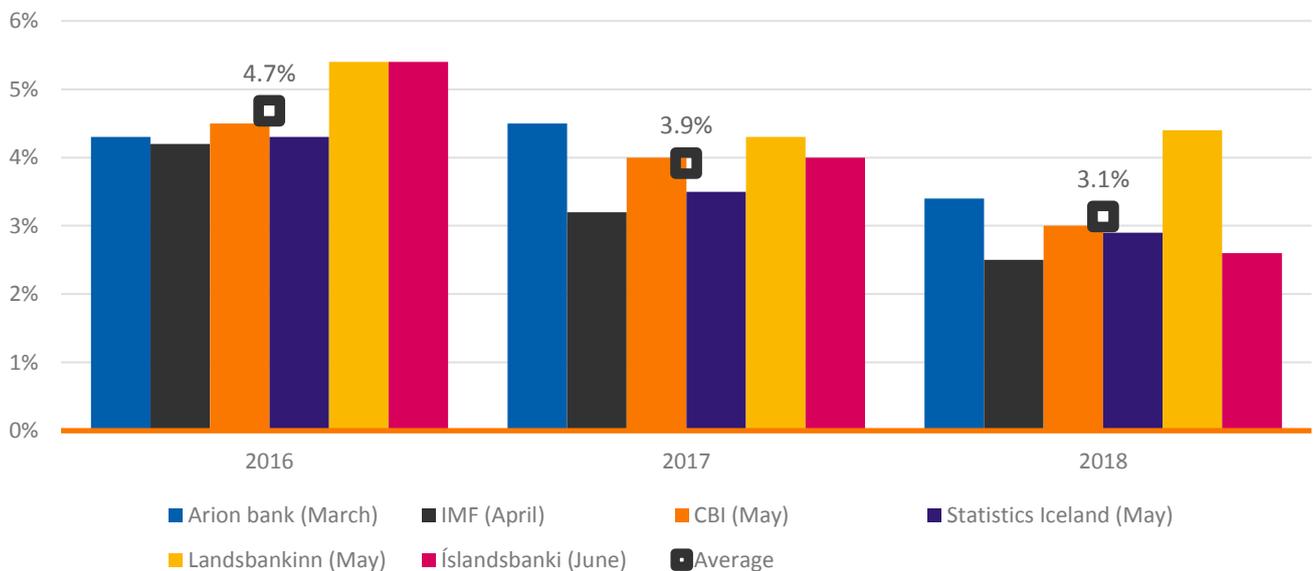
Growth contribution of GDP components



Sources: Statistics Iceland, Arion Research

Analysts have been busy in the last few weeks updating their forecasts. The Central Bank, Statistics Iceland, Landsbanki and Íslandsbanki all published new forecasts in May and June. All analysts shifted their forecasts for economic growth in 2016 upwards. In March, when we introduced our forecast, analysts were predicting just over 4% economic growth this year, now the average has risen to 4.7%.

Growth forecasts 2016-2018



Sources: Analysts' forecasts

Offshore owners stay put

On June 16 the Central Bank of Iceland held a currency auction where owners of offshore króna assets were invited to purchase foreign currency. The highly anticipated auction, which is an important step towards full capital controls liberalization, was the last in a series of twenty-three auctions. A total number of 1,715 offers were submitted, of which 1,688 were accepted. All offers submitted at an exchange rate of 190 krónur per euro or lower were accepted. The amount of the accepted offers totaled just over 83 b.kr., out of nearly 188 b.kr. submitted for sale¹. As a result, the impact on the CBI's foreign reserves will be smaller than many had expected beforehand, as they will merely be reduced by 54 b.kr. (meaning that the CBI pays 54 b.kr. for the 83 b.kr. because of the exchange rate difference), an amount that is roughly 10% of the non-borrowed FX reserves.

It is clear that only a small part of the so called "overhang", a total of 320 b.kr., will exit the economy through this auction. The offshore assets that remain in Iceland will be transferred to restricted accounts, or as the Governor of the Central Bank, Mr. Mar Gudmundsson put it: "They will go to the back of the line ... and someday it will be their turn again." For now, there is nothing that indicates that the poor participation in the auction should hinder the next steps towards lifting capital controls on resident entities.

Limited effects on the bond market

It appears that participation in the auction among owners of State-guaranteed securities was poor. According to an announcement from the CBI, the bank only bought securities for the nominal amount of 22 b.kr., which is around 12% of the total amount offshore owners owned in State-guaranteed securities.

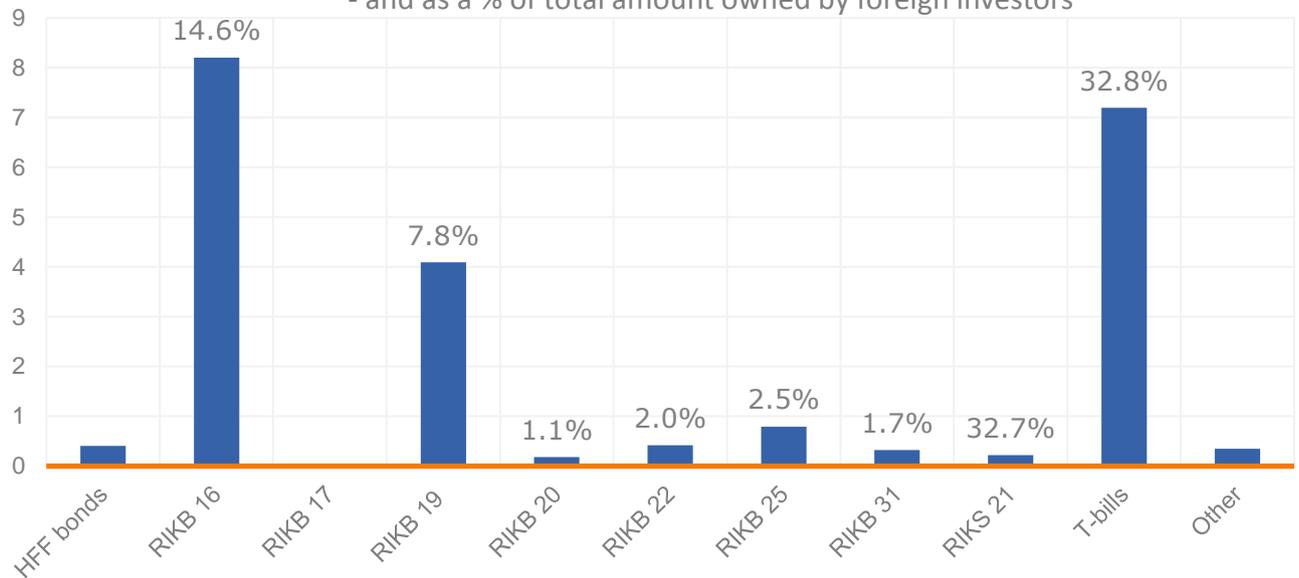
Brief asset definition*	Amount, b.ISK.
Deposits owned or in custody of financial institutions	74
Assets on custodial accounts	20
Bonds and bills	177
Unit share certificates	1
Shares, bonds, and other securities that underwent restructuring agreement after Nov. 28, 2008. The same applies to reinvestment of the proceeds of such assets	20
Shares, bonds, and other securities issued after Nov. 28, 2008 by withdrawal in ISK with a foreign financial institution	28
Total	319

Source: Central Bank of Iceland, Arion Research, *Detailed definitions can be found under section 6.4 in the bill's explanatory notes

The picture below shows the participation in the auction by T-bills and T-bond series. Of the nominal amount of 22 b.kr. offered as financing for foreign currency purchases in the auction, 8 b.kr. were in the form of T-bond series RIKB 16, or 14.6% of the total amount owned by foreign investors in that series. Foreign owners of T-bond series RIKB 19 sold 4 b.kr while 7 b.kr. of T-bills were sold. Smaller amounts were sold of other State-guaranteed securities.

¹ These are the final results of the 16 June auction, including transactions taking place on the basis of the Bank's tender offer of 21 June.

B.kr. Participation in the currency auction by T-bills and T-bond series - and as a % of total amount owned by foreign investors

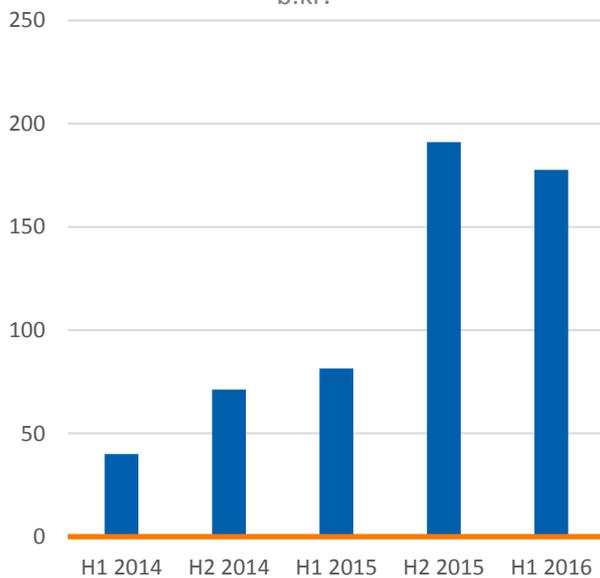


Source: Central Bank of Iceland

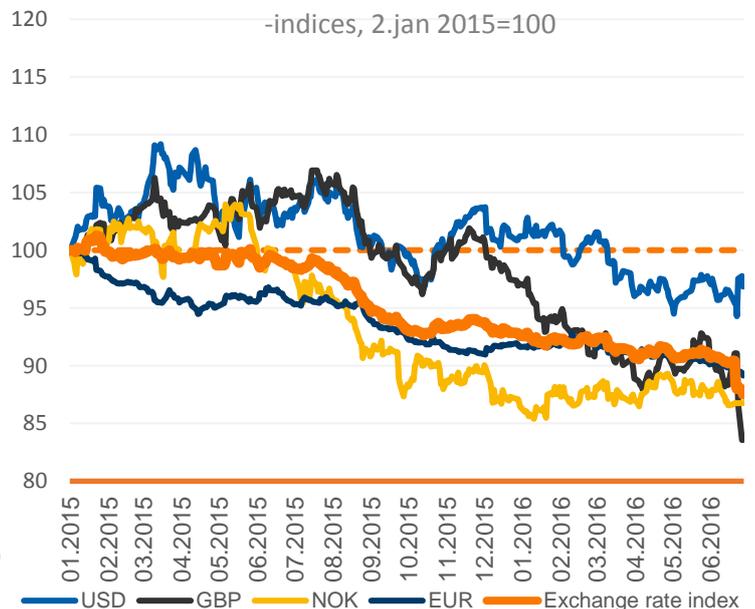
What does the auction mean for the foreign reserves?

For the last two years the CBI has had considerable scope to build reserves. The bank has certainly not failed to grasp that chance and has been buying foreign currency like never before. Last year the bank bought foreign currency for an amount of 272 b.kr, a 145% increase from 2014's 111 b.kr. So far this year the CBI has bought foreign currency for 176 b.kr., which is a considerable increase from the same time last year, and a hefty accumulation of reserves considering the high season for tourism has only just started. The króna exchange rate has been relatively unfazed by the racket on the FX market and has slowly continued to appreciate.

CBI's net FX purchases - b.kr.



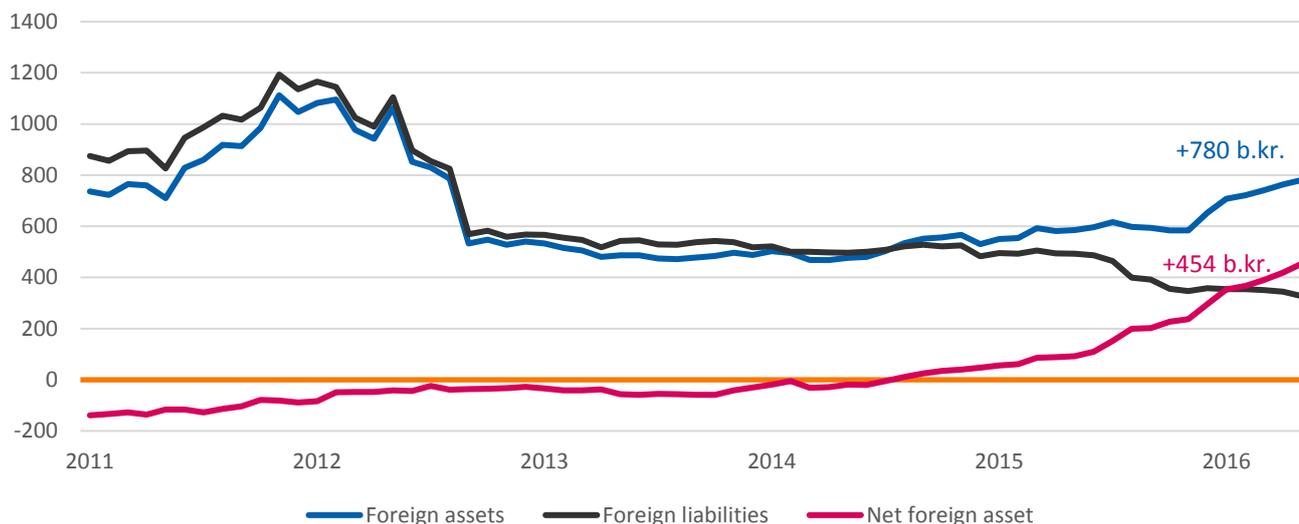
Exchange rate against the króna - indices, 2.jan 2015=100



Source: Central Bank of Iceland, Arion Research

In the wake of the CBI's substantial foreign currency purchases, the bank's non-borrowed reserves, i.e. the part of the reserves that is financed domestically, have gone from non-existent to approximately 454 b.kr. at the end of May. This development has mostly taken place in the last twelve months, as according to a rough estimate the non-borrowed reserves have increased by 360 b.kr. in that time. The CBI has often stated that building up foreign reserves is necessary for two reasons. Firstly, due to uncertainties surrounding the capital account liberalization and secondly, in order to mitigate exchange rate volatility. How large the non-borrowed reserves should be is a question we have often pondered, as the CBI has been reluctant to give a clear guidance. However, as stated in the recently passed Act on the treatment of króna-denominated assets subject to special restrictions "While liberalization is underway, the size of the foreign exchange reserves will be determined through a cautious approach in accordance with guidelines issued by the International Monetary Fund (IMF)."

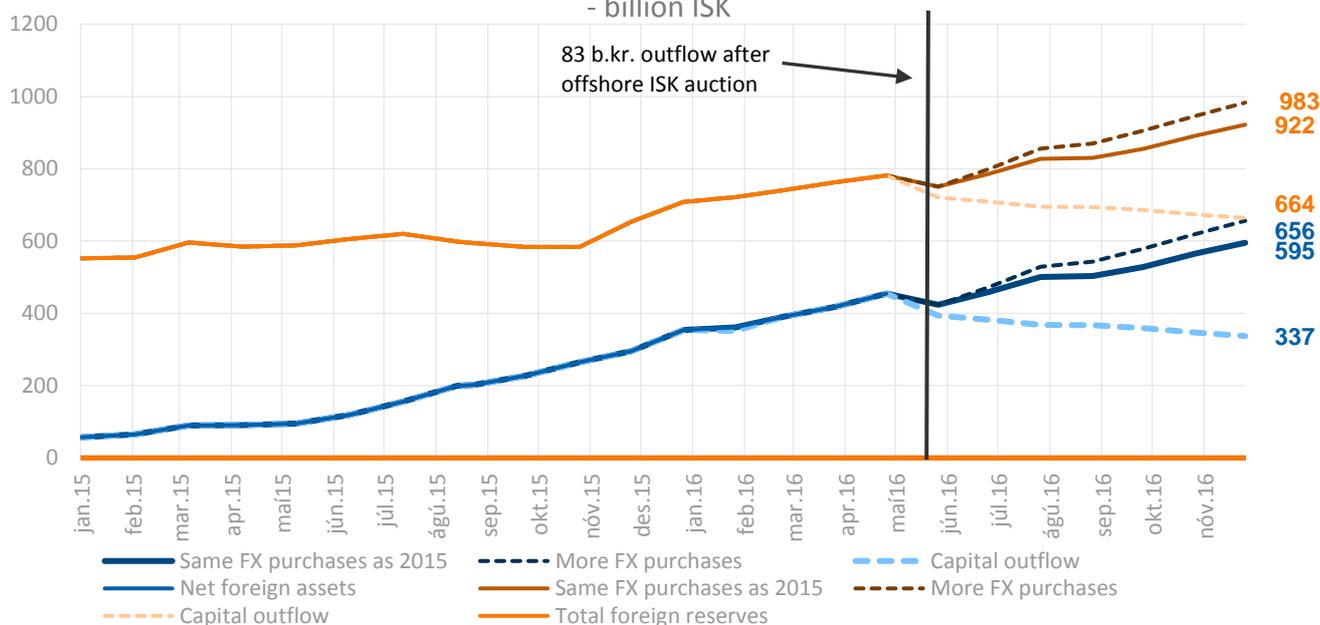
Net foreign assets on CBI balance sheet - b.kr.



Source: Central Bank of Iceland, Arion Research

On June 1 the Monetary Policy Committee (MPC) decided to keep its key rate unchanged. When asked at the following briefing Mr. Gudmundsson said the foreign reserves were suitably large (since then the CBI has bought FX for 31 b.kr.). He was also hopeful that after the currency auction the CBI would be quick to build up the foreign reserves again, definitely before the end of the year, preferably before autumn. However, now that the final results of the auction are available, it is clear that the reserves will be reduced by a much smaller amount than Mr. Gudmundsson probably first thought. Based on the speed the CBI has been building reserves for the past year it is highly probable that the, admittedly, small gap the auction left in the reserves will be filled in no time. At this time it is difficult to say what the bank will then do, as lifting of capital controls on residents is just around the corner. If the CBI continues in the same vein we could see non-borrowed reserves between 595 - 656 b.kr. at the end of the year. If however the CBI slows down its foreign currency accumulation, combined with yet another record-breaking year in the number of tourists visiting Iceland, it could clear the path for even further appreciation of the króna in the coming months.

FX reserves in different scenarios - billion ISK



Source: Central Bank of Iceland, Arion Research

Soccernomics of Iceland

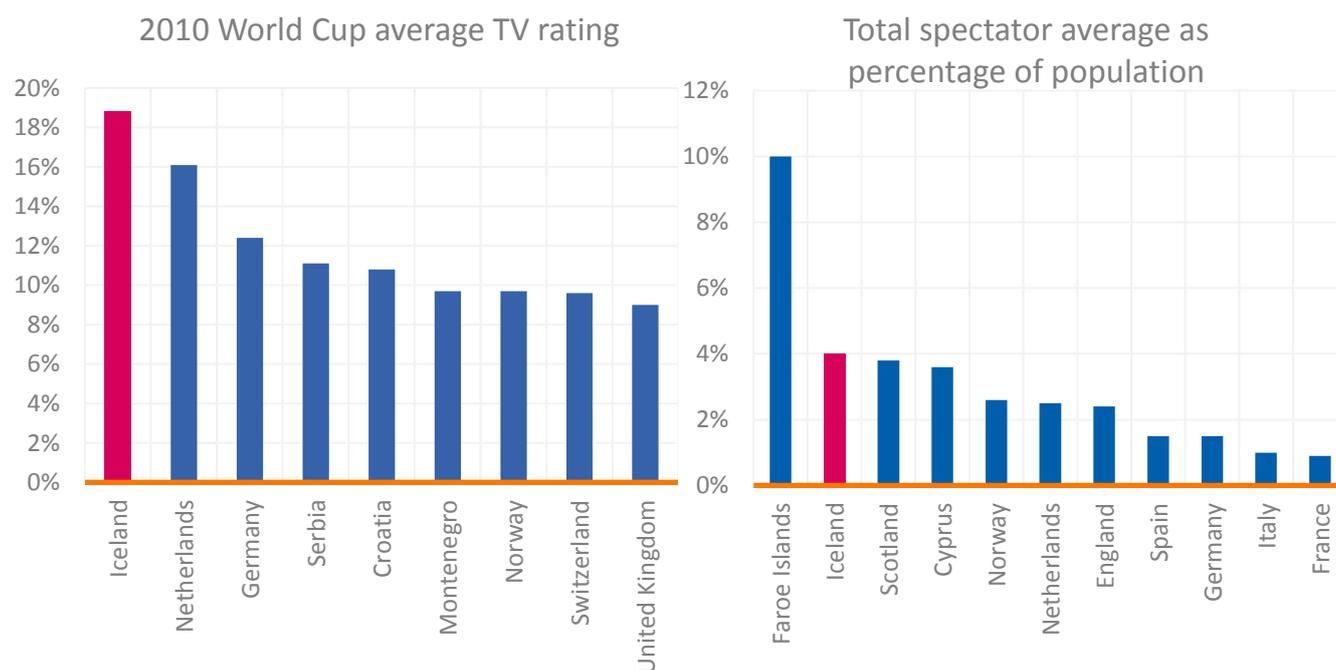
On Monday night Iceland shook the world but this time it wasn't a bank collapse or a volcanic eruption that shifted attention to our small country. Iceland's men national football team, against all odds, won 2-1 against England in the European Championship (Euro). Perhaps not all odds since Icelanders put enough money on Iceland's team to cause significant losses for Iceland's largest betting firm (their CEO however said that he doesn't care). Everything in Iceland is about the Euro in France: Volume of trade is low in the stock market, roads are empty during games and nothing else seems to be on the news.

Football has more aspects than a pitch, 22 players and a ball. Soccernomics, a book first published in 2009, covers football from the economics and business perspective. Following are a few observations, inspired and based on Soccernomics.

The country that loves football the most (at least in Europe)

Even before Iceland's team guaranteed its ticket to the Euro in France foreign media, and frankly Icelanders themselves, started to look for explanations for this recent success. After all, the country's GDP is the 146th highest in the world and the country is the 180th most populous, yet the men's football team is ranked 34th by FIFA and the women's team is ranked number 20. The most common theories are firstly Iceland's disproportionate number of UEFA licensed coaches who work with children as young as six years old, and secondly, investments in facilities, including full-size indoor pitches. But why have Icelandic municipalities and the Football Association (KSÍ) invested so much?

Soccernomics might provide the answer. By aggregating three per capita measures of football interest, namely number of players, match attendances and TV ratings the book concludes that Iceland is the country in Europe who loves football the most. It can therefore easily be argued that the main reason for all of Iceland's recent football success is simply that very few nations care as much about the sport. Someone who has the interest is obviously more likely to become good, may that be in football or anything else in life. Also, it must be easier for politicians and KSÍ to push through investment in football infrastructure if the voters are avid football fans.



Sources: Kuper and Szymanski (2014) Soccernomics, European-football-statistics.co.uk

Major sporting events increase happiness

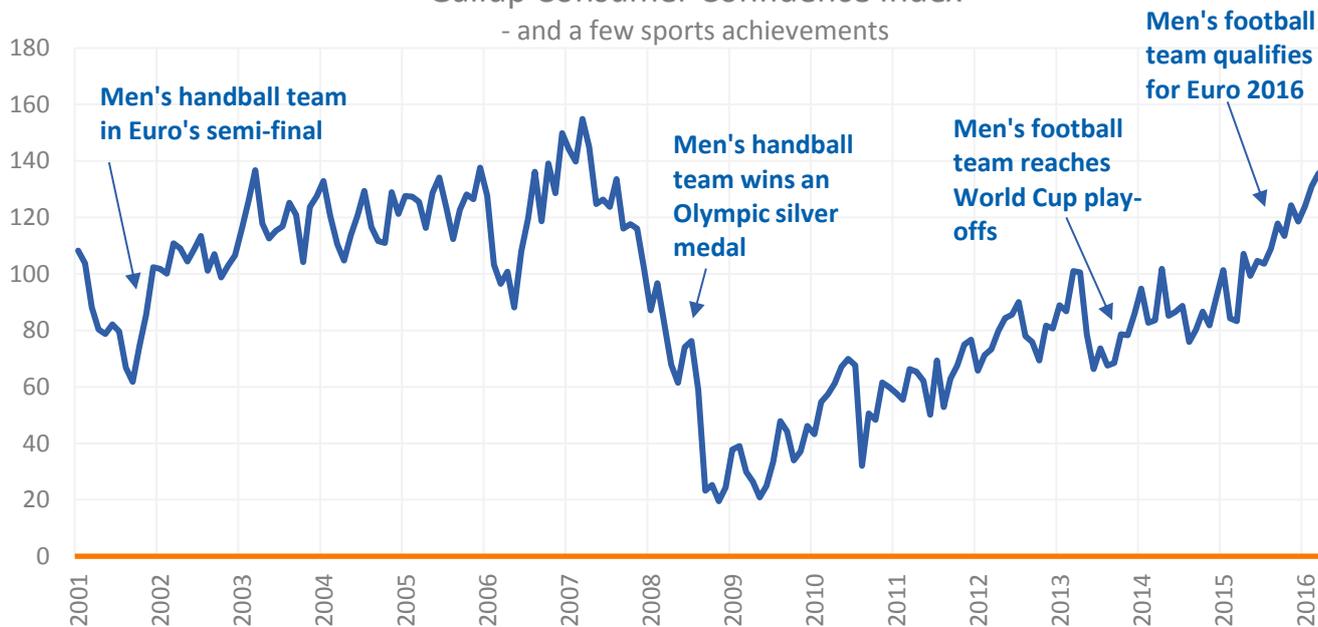
Despite claims that hosting a sporting event such as the World Cup or the Euro boosts the economy, there is overwhelming evidence that it's not the case. Brazil spent \$15 billion on the 2014 World Cup, which is 85% of Iceland's GDP, and yet most of the revenues went to FIFA. However, high cost doesn't necessarily mean that large sports events don't pay-off. There is research that suggests that hosting such events increases happiness and well-being, in the short run at least. There is also evidence that the same holds to a certain extent for participating countries, regardless of how well they do. Suicide rates drop significantly in European countries while they are participating in the Euros or the World Cup. Soccernomics claims that both of these phenomena stem from increased social cohesion during large tournaments.

Does this hold true in Iceland? We used the consumer confidence index as a proxy to test this effect from major sporting events and when, for instance, the Icelandic men's handball team has done well and more recently our football team. We ran some regressions, adjusting for other factors such as unemployment, asset prices and purchasing power and found positive, but statistically insignificant effect. Admittedly, these analysis

are not yet very rigorous and frankly not on our list of priorities. Regardless, it will be interesting to see how the consumer confidence index will change in June and July.

Gallup Consumer Confidence Index

- and a few sports achievements

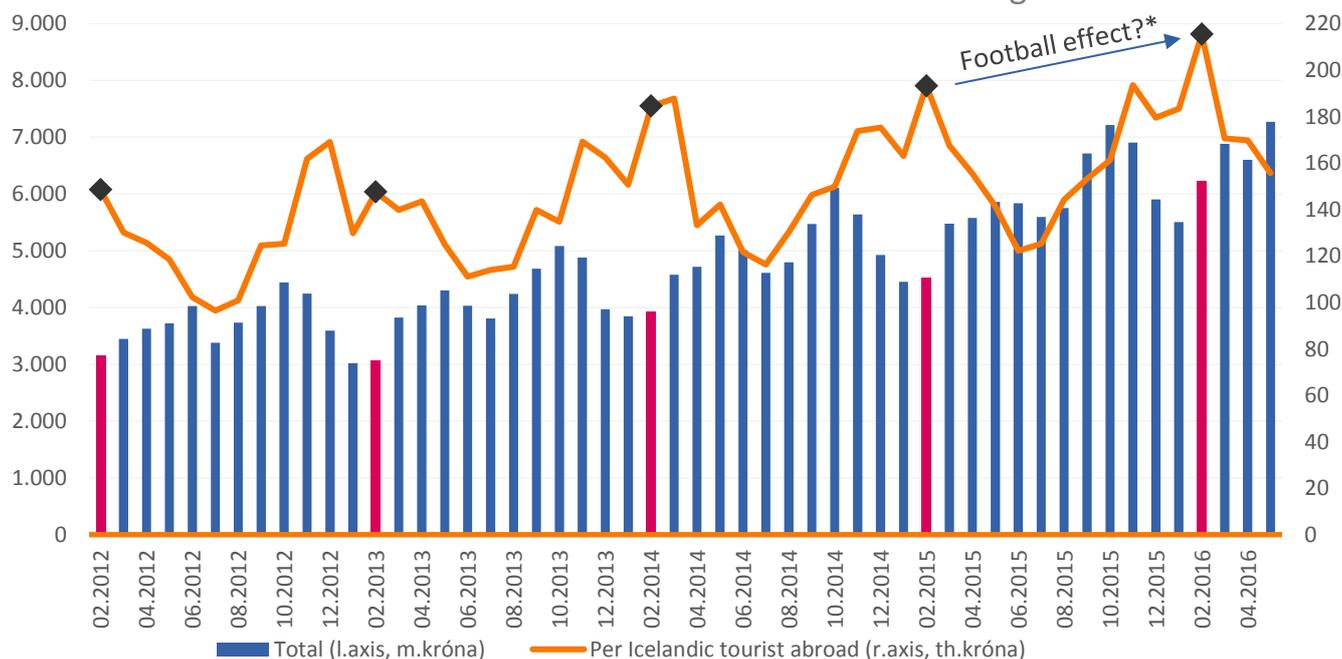


Source: Capacent, Arion Research

Insignificant but apparent Euro 2016 impact on Iceland's Balance of Payments

Before the competition it was announced that Icelanders bought 27.000 tickets for the Euro, which in theory means that over 8% of the population could see Iceland play in this year's tournament. A large proportion of the workforce has been on a holiday in June and Icelanders are spending a lot of their income on accommodation, tickets and other services in France. But how much? No data is available on that, but if we assume that the average supporter goes to two matches in category 3 and 4, respectively, and spends 150.000 ISK on accommodation, flights, etc. (which is probably a very conservative estimate) we end up with an amount of 2.2 billion krónur, which is 0.1% of GDP. If we assume that 5.000 more supporters spent and will spend similar amounts for the game against England and the quarter final against France the grand total becomes 3 billion krónur. Therefore we might see a hefty boost in travel services imports this quarter. On the other hand KSÍ, the Icelandic FA, has already received almost 2 billion krónur (14 million EUR) in prize money. If successful in Paris on Sunday, the FA will receive additional 4 m. EUR. A victory in the tournament would mean a total Euro revenue of 26 m. EUR for KSÍ, or 0.2% of GDP.

Icelandic credit card turnover at fixed exchange rate



Sources: Statistics Iceland, Icelandic Tourist Board, Arion Research. *Euro 2016 tickets were paid for in February.