

Political storm hits Iceland

Following the revelations contained in the “Panama Papers”, which linked three ministers to offshore companies, a political storm swept over Iceland, carrying away the Prime Minister Sigmundur Davíð Gunnlaugsson. The unrest had short-lived effects on markets, with equities markets bouncing back within days and turnover in the króna interbank market picking up soon after with the CBI at the forefront. The biggest uncertainty is whether, and then how much, the cabinet reshuffle might have pushed back the intended date for the offshore króna auction.

Private consumption: Up, up, up we go!

Icelanders’ payment card turnover grew at an annual rate of 11.4% in the first quarter of 2016, indicating a strong growth in private consumption. Other indicators, such as the retail index and sentiment index, point in the same direction. In addition, the labor market is going from strength to strength, with unemployment trending down and labor force participation on the rise. Put together, this might indicate that our forecast of 6.8% consumption growth in 2016, first thought to be fairly ambitious, might perhaps end up being a moderate one.

Appreciating króna keeping the lid on inflation

Recently published paper shows that the currency of invoicing in international trade can have a significant impact on price stability. If trade is invoiced in foreign currencies as in Iceland, price levels are more vulnerable to exchange rate shocks. In other words, that causes high degree of exchange rate pass-through in Iceland. Since 2011 it is quite clear that inflation might have remained significantly higher hadn’t the króna appreciated over that period. Combining different scenarios with Arion Research inflation forecast indicates that if the króna continues to appreciate it might keep inflation near the 2.5% inflation target.

Analysts

Erna Björg Sverrisdóttir

+354-444-6993

erna.sverrisdottir@arionbanki.is

Hrafn Steinarsson

+354-444-6910

hrafn.steinarsson@arionbanki.is

Konráð S. Guðjónsson

+354-444-6991

konrad.gudjonsson@arionbanki.is

Provisional release:

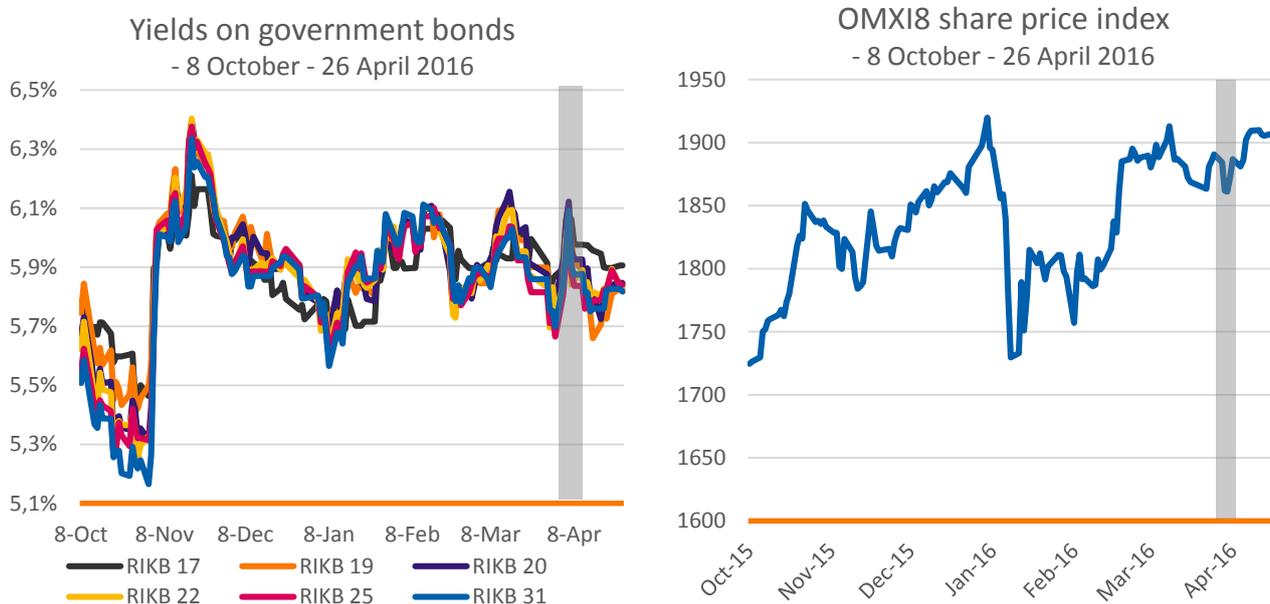
The content of this release has been prepared by the Research Division of Arion Bank hf. The Research Division bases its information on data information services and news services, both foreign and domestic, which it considers reliable, along with its own interpretations and evaluations of public information. Arion Bank hf. accepts no responsibility for the accuracy of this information nor any liability for transactions based on this information. In relation to this it should be noted that any of the Research Division's discussion may be an abridged version of more extensive analysis and research and conditions of financial markets change rapidly. For these reasons the recommendations and forecasts of the Research Division can change without notice, but they do reflect the opinions of the Research Division's employees at the time that they are expressed. Those parties who are interested in initiating transactions are advised to contact an expert at Arion Bank hf. before any decision is made. It should also be noted that Arion Bank hf., its employees and other parties associated with the Bank may have vested interests concerning particular organizations, which the Research Division's published material may pertain to at any given time.

Political storm hits Iceland

On April 3 the so called “Panama Papers” made headlines across the globe. The leaked documents revealed that three Icelandic ministers, most notably the then-prime minister Sigmundur Davíð Gunnlaugsson, were linked to offshore companies. The revelations, first made public in a special TV broadcast, caused an uproar, starting a chain of events that ultimately led to Mr. Gunnlaugsson’ resignation and a cabinet reshuffle. At present time the coalition between the Progressive and Independence Parties still stands with Sigurdur Ingi Jóhannsson, former Minister of Agriculture and Fisheries, as PM. With elections scheduled for this autumn the government intends to push forward in order to finish as many priorities as possible, the króna auction and further steps to lifting capital controls there among.

The date of the offshore króna auction has yet to be announced although both Mr. Benediktsson, the Minister of Finance, and Mr. Guðmundsson, the Governor of CBI, have emphasized that the auction will take place in the first half of the year despite the political turmoil. However, Mr. Guðmundsson has implied that before the capital controls are lifted certain legislations have to be passed into law. As of now it is still unclear what those legislations entail.

The unrest on the political scene had short-lived effects on markets, with both the bond and stock markets bouncing back within a few days. Furthermore, historically the fluctuations were minor: Yields on government bonds rose on average by 0.3% over three days while the OMXI8 share price index fell by 1.6%.

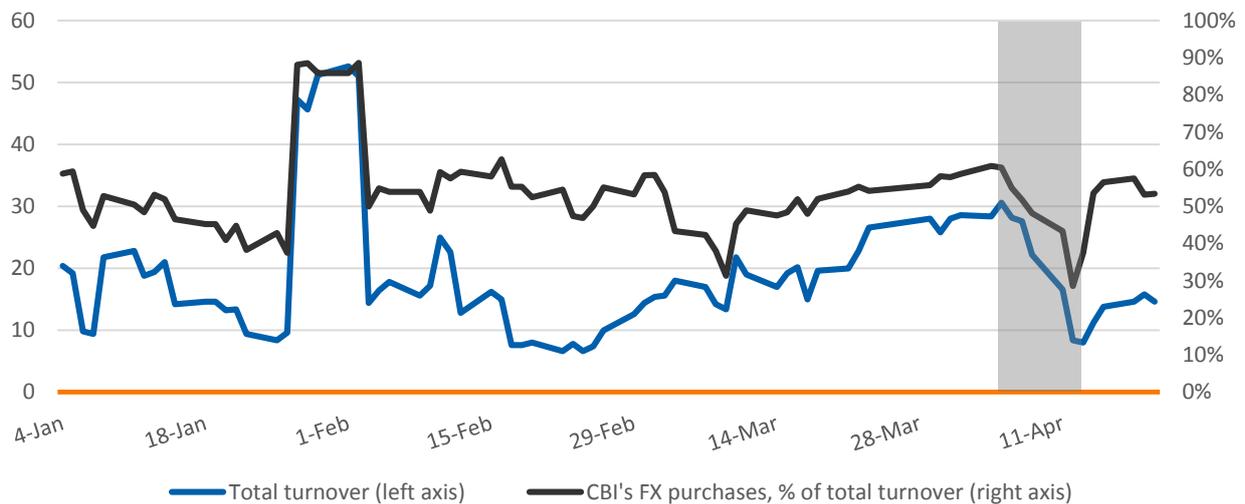


Sources: Kodiak, Nasdaq

At first glance the foreign exchange market seems to have also been affected by the political turbulence, however briefly, with daily turnover slowing down in the two weeks following the Panama Papers revelations. This posed the question whether capital inflows had dwindled or if this was simply a coincidence, for one must keep in mind that the turnover has tended to fluctuate greatly, often going well below the average with no apparent reason. Furthermore, it might be somewhat farfetched to place the blame on a temporary political uncertainty as it hardly affects the influx of tourists which has been the biggest source of capital inflows so far. Whatever the case may be, whether it is because the political storm has subsided or not, the turnover seems to have picked up again.

Daily turnover in the Icelandic FX market

- m.EUR, 5 day MA



Sources: The Central Bank of Iceland, Arion Research

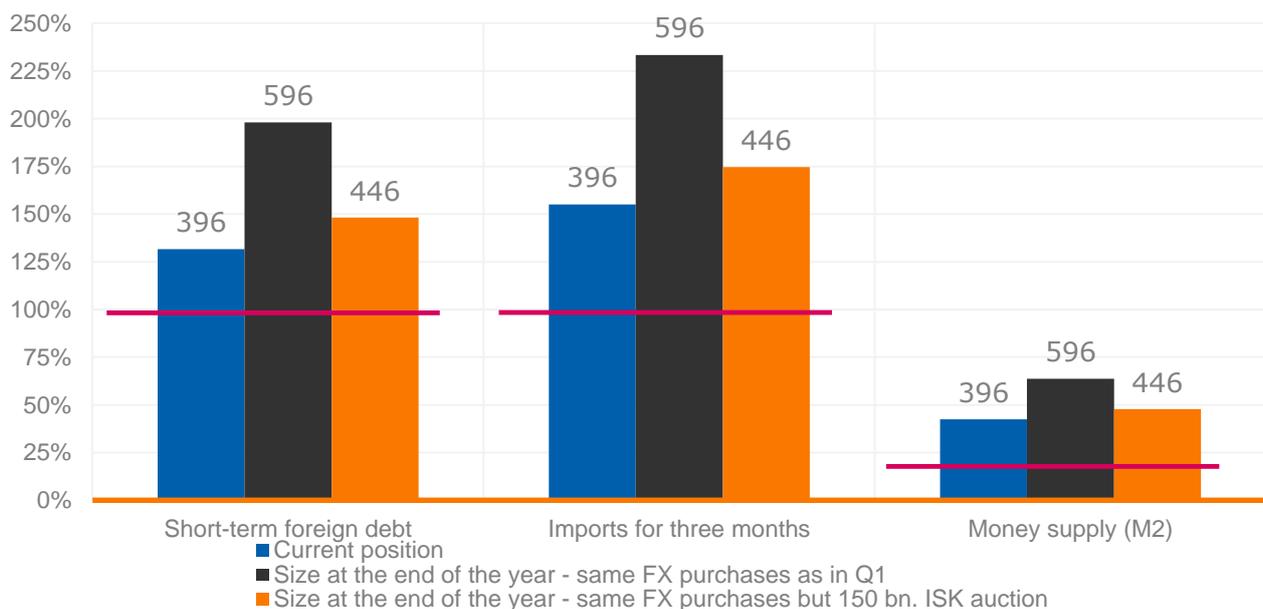
The CBI hoarding foreign currency

Despite the relative calm on the FX market in the first weeks of April, the CBI has certainly not been idle as the Bank has bought foreign currency for 114 bn.kr. in 2016¹, opposed to 38 bn.kr. during the same time last year. The Bank has iterated that its main goal in the FX market has been to accumulate reserves and smooth out fluctuations, not directly affect the króna exchange rate². So far the Bank has had considerable scope to build reserves, owing to the increase in foreign tourists as well as increased purchases of securities by foreign investors. From 2013 the net FX reserves have grown from non-existing to 400 bn.kr., a strong position in historical context as well as according to several common measures. Thus, by all accounts, it looks like the CBI should be well equipped to handle the capital account liberalization.

This leads to a question we have pondered before: When are the net FX reserves large enough?

According to the IMF's "reserve adequacy metric" for Iceland the adequate size of the total FX reserves is around 500 – 700 bn.kr. With reserves totaling at 735 bn.kr. at the end of March the CBI seems by most measures to have more than adequate size of FX reserves for the purposes described above. Combined with the cost of the FX reserves, which was close to 23% of the CBI's equity based on the end-2015 position, the likelihood of the CBI cutting back on its FX market interventions and allowing the exchange rate to appreciate is rising.

Different measures to estimate the size of the net FX reserves



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

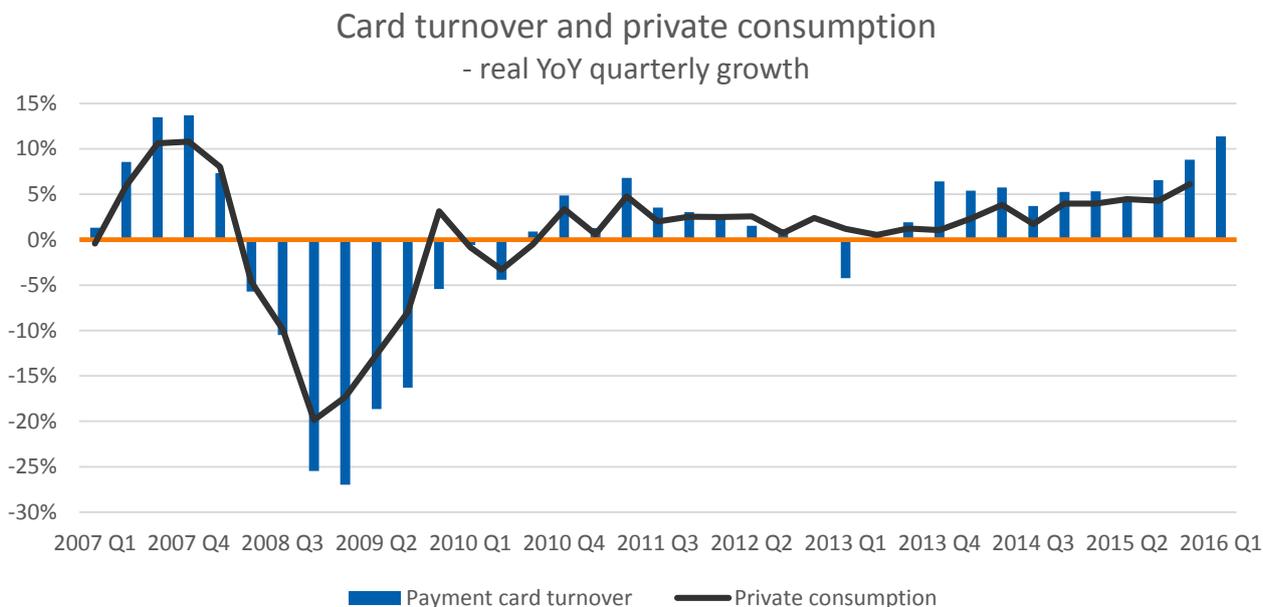
¹ As of April 22.

² Considering this it is interesting to see so bluntly stated in the recently published Financial Stability Report that "the purpose of the currency purchases **was to offset the appreciation of the króna** due to strong foreign exchange inflows and to build up the foreign reserves."

Private consumption: Up, up, up we go!

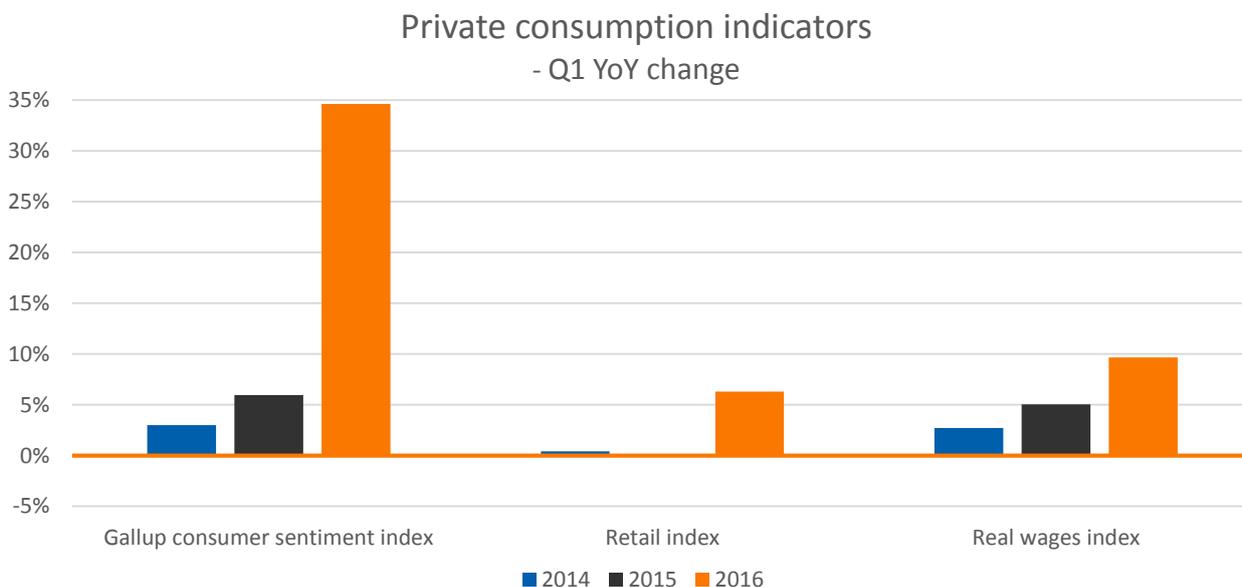
Icelanders' payment card turnover grew at an annual rate of 11.4% in the first quarter of 2016, the highest growth in one quarter since 2007. The card turnover is split into domestic turnover, which grew by 8.7% in Q1, and card turnover abroad, which grew by whopping 35.8% at the same time. Despite the surge in spending abroad, the payment card balance was positive by 9 bn.kr. in January and February thanks to an even greater increase in foreign tourists' card turnover. In addition, it seems that foreign card turnover per tourist has increased as well, indicating that the average tourist is spending more in his home currency.

Historically, payment card turnover has been a good indicator for assessing private consumption. In March Arion Research forecast a rapid growth in private consumption, or 6.8% growth in 2016. The payment card turnover year-to-date numbers indicate that this forecast, at first thought fairly ambitious, might not be far off, perhaps even ending up as a moderate one.



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

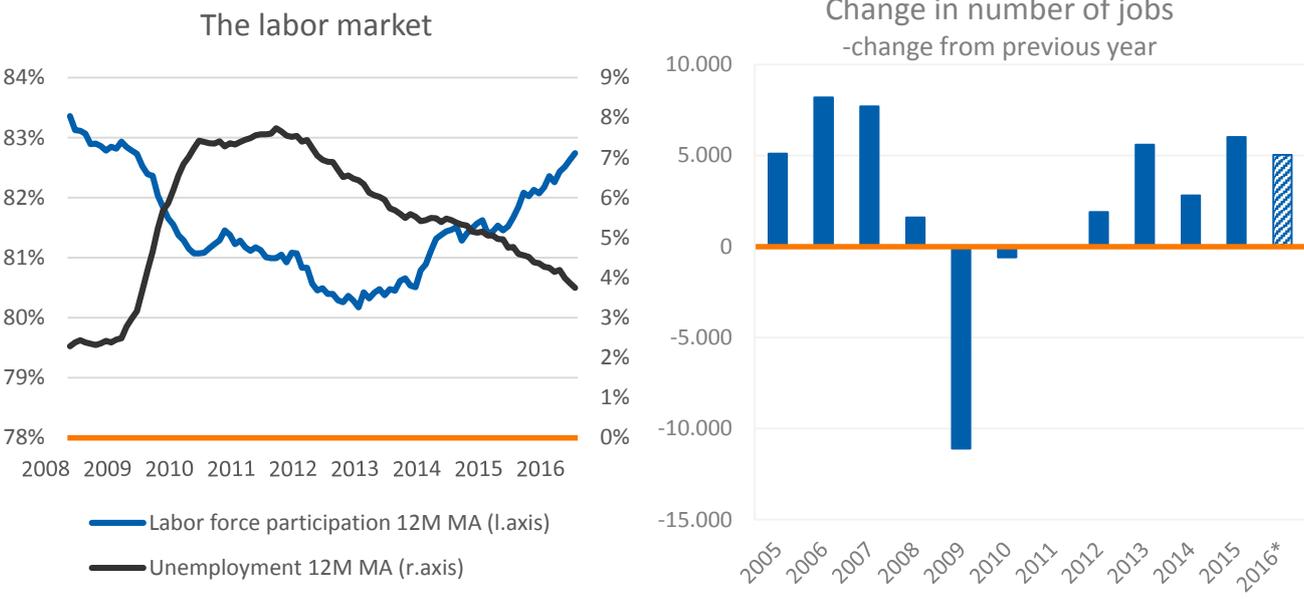
Other indicators point to the same direction as illustrated in the graph below. The sizable increase in consumers' sentiment reflects the optimism in the economy which will likely fuel further growth in private consumption. Furthermore, the retail index picked up considerably in the first quarter compared to the same time year before, even when adjusting for the effects of Easters. A possible explanation for the "spending spree" is the wage hike that took place in February with the so called SALEK-agreement, adding on even larger wage increases mid-year 2015.



Sources: Statistics Iceland, Gallup, Centre for Retail Studies, Arion Research

Finally, the labor market has been going from strength to strength with unemployment trending down and labor force participation rising. The number of jobs has grown by leaps and bounds since the financial crisis hit, especially in the last year, and we expect that development to continue, especially in tourism and construction.

So far the hefty wage increases have not had any visible effects on labor demand. A recent survey among executives of the 400 largest firms in Iceland shows that labor demand is likely to keep growing, as more than a third of executives anticipate having to hire additional employees. That however might be easier said than done, with third of participants claiming shortage of labor force and surveyed unemployment at 3.8% in March (compared to 4% in March 2015 and 6.1% in March 2014).

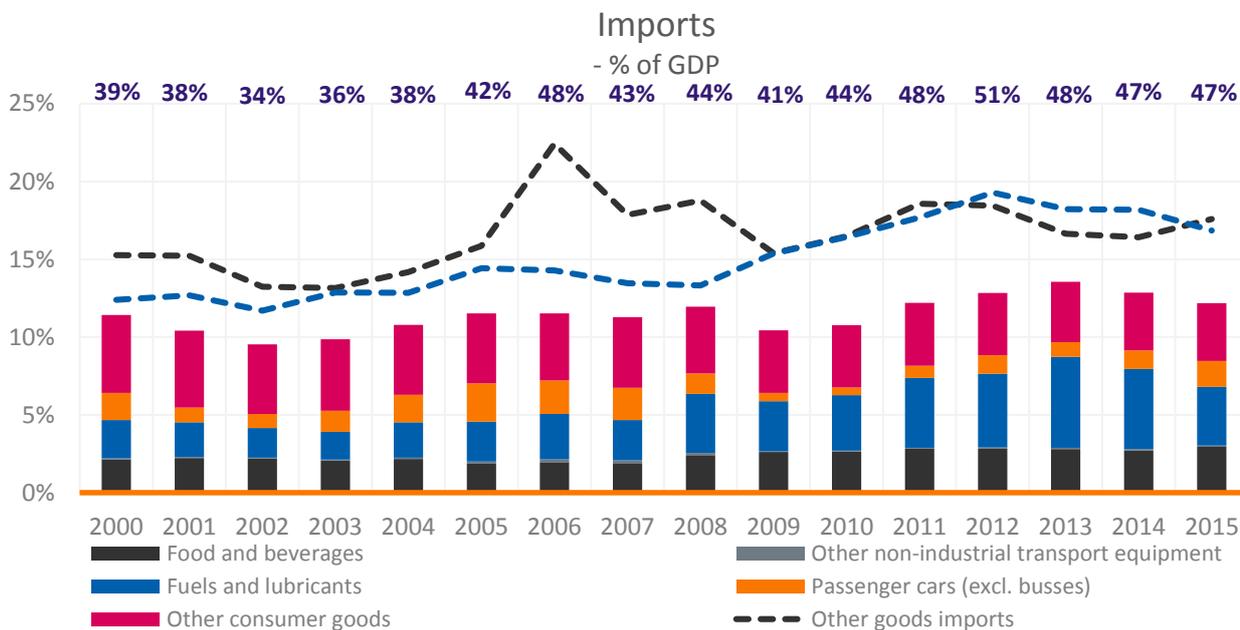


* First quarter of 2016.

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

Appreciating króna keeping the lid on inflation

Recently [published paper](#) by Harvard's Gita Gopinath shows that the currency of invoicing in international trade can have a significant impact on price stability. When trade is mostly invoiced in country's home currency, as is the case for the U.S., exchange rate fluctuations have limited impact on inflation. On the contrary, if trade is invoiced in foreign currencies as in Iceland, price levels are more vulnerable to exchange rate shocks. In other words, that causes high degree of exchange rate pass-through in Iceland. The experience of 2008 and 2009 is an uncomfortable reminder of that mechanism.



Sources: Statistics Iceland, Arion Research

Exchange rate pass-through in Iceland

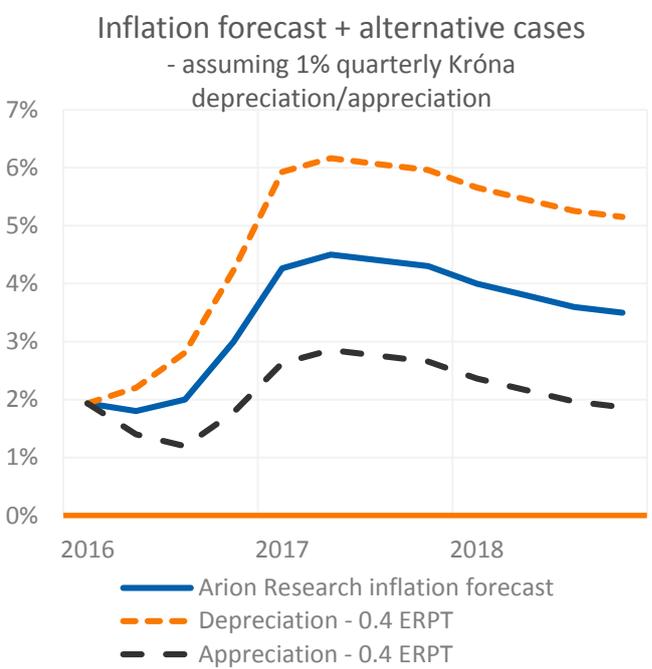
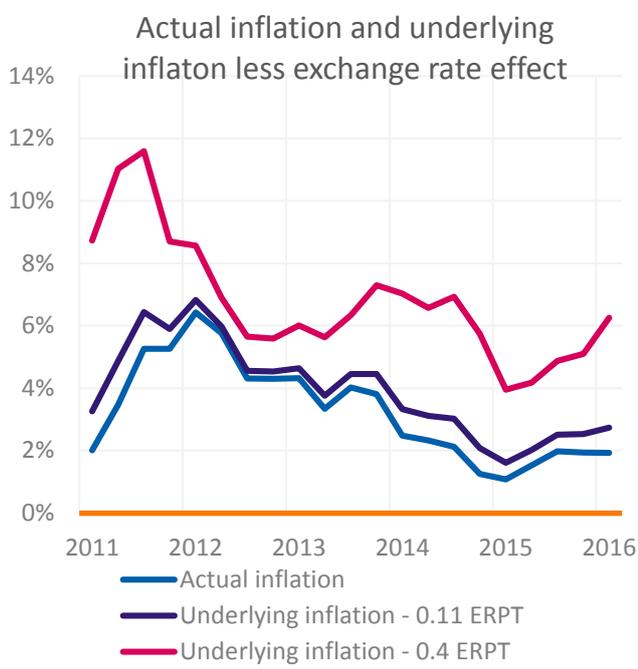
Although volatile exchange rate has more often than not caused inflation in Iceland, in the recent months and years it's been the opposite. Gradually appreciating króna has, with the help of low oil prices, low inflation globally, and lower inflation expectations, helped keeping inflation at bay, particularly after hefty wage increases last year. But to what extent? The answer lies in the degree of exchange rate pass-through (ERPT) – how much does the króna respond to a 1% change in the trade weighted exchange rate?

The answer is not simple, especially since there are evidence that suggest the pass-through to be asymmetrical and it's difficult to isolate the effect. The exchange rate pass-through in to the CPI in Iceland has been estimated to be anywhere between 0.1 and 0.4, which illustrates the difficulty in measurement.

How much has and can appreciating króna keep inflation down?

For the sake of simplicity and intuitive understanding we show below how inflation might have developed given different ERPT assumptions as well as what we can expect in the next couple of year.

On the left we see actual inflation and underlying inflation, which is not affected by exchange rates, assuming a different degree of and lagging effect of ERPT. Since 2011 it is quite clear that inflation might have remained significantly higher hadn't the króna appreciated over that period. On the right is Arion Research most recent inflation forecast, which assumes constant exchange rate, along with both cases of 1% quarterly exchange rate appreciation and 1% depreciation given high ERPT – 0.4. It should be noted that the alternative cases are not extracted from our model, yet they give evidence that if the króna continues to appreciate it might keep inflation near the 2.5% inflation target. We have previously argued that the króna is more likely than not appreciate further over the short term. Having said that, stronger króna might be fundamentally unsustainable which would inevitably lead to a depreciation. The picture below on the right also illustrates how inflation might quickly leave CBI's inflation target if the króna depreciates.



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