ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | August 2016

Central Bank lowers key interest rate

On August 24, the Monetary Policy Committee (MPC) of Central Bank of Iceland decided to lower its key interest rate by 50 bp, down to 5.25%. The decision came as a surprise, as the general consensus was towards unchanged rates. Moreover, the MPC changed its tone from hawkish to neutral. Markets reacted well to the decision as inflation premium on 5 and 10 year bonds yields fell by roughly 50 bp in two days. Alongside the rate decision the Central Bank published its third Monetary Bulletin, where the Bank revised its inflation forecast downwards.

Government announces next steps in liberalization of capital controls

On August 16, the government introduced its next step in removal of the capital controls. A bill of legislation was presented before parliament on the following day. If the bill passes into law unchanged, a considerable step will be taken towards capital account liberalization immediately upon passage, while the second step will be taken on January 1, 2017. According to the Ministry of Finance and Economic Affairs, the bill will cause a roughly 50-65% reduction in exemption requests from the Foreign Exchange Act.

The Icelandic housing market – an overview

Housing prices in Iceland have been rising rapidly over the last quarters. Residential housing prices are 12.4% higher than one year ago, with the price of three bedroom apartments rising by 13.6% in the last twelve months while single-family dwellings prices have risen by 9.3%. Demand will continue to be strong going forward and we estimate that 8-10,000 extra houses will be needed before 2020.

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Central Bank lowers key interest rate

On August 24, 2016, the Monetary Policy Committee (MPC) of the Central Bank of Iceland decided to lower the Bank's key interest rate by 50 bp. This is the first rate change since November 2015 and the first time rates have been lowered since November 2014.The Bank's key interest rate now stands at 5.25%. It is safe to say that the announcement came as a surprise, as the general consensus before the decision was that the MPC would keep interest rates unchanged. Moreover, the MPC changed its tone from hawkish to neutral.

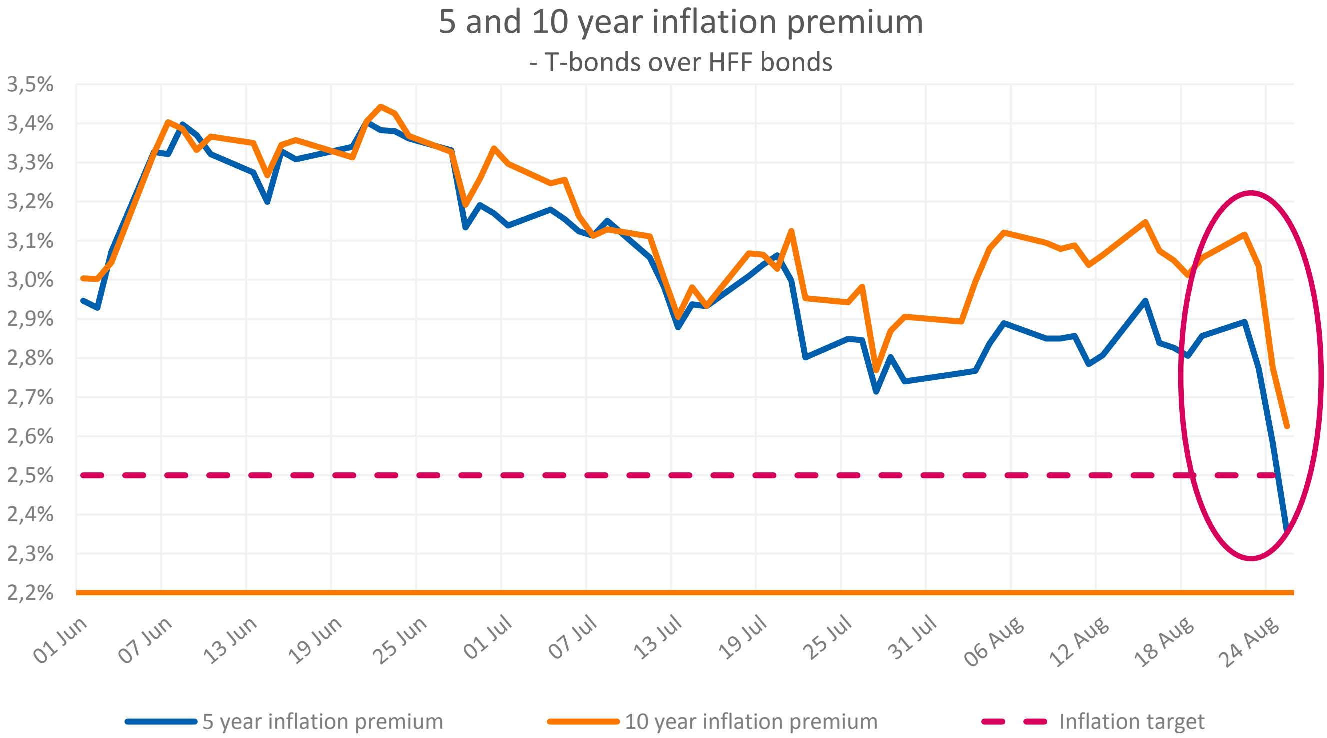
Since its November decision, the MPC line of argument has been:

"A stronger króna and more favourable global price developments have provided the scope to raise interest rates more slowly than was previously considered necessary. **However, this does not change the need for a tighter monetary stance in the coming term, in view of growing domestic inflationary pressures.** How much and how quickly the monetary stance must be tightened will depend on future developments and on how the current economic uncertainty plays out."

The statement following the rate cut in August read:

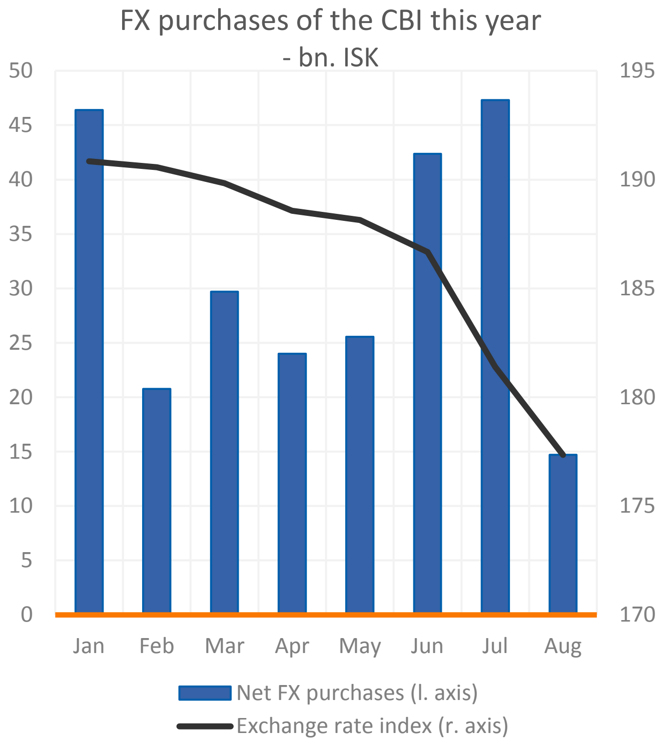
"There are indications that monetary policy has been more successful than was expected earlier this year. As a result, it appears that it will be possible to keep inflation at target over the medium term with a lower interest rate than was previously considered necessary. The likelihood of increased macroeconomic imbalances and the uncertainty associated with capital account liberalisation argue for caution in interest rate setting, however. **Whether interest rates will be lowered further or need to be raised again will depend on economic developments and on the success of the capital account liberalisation process.**"

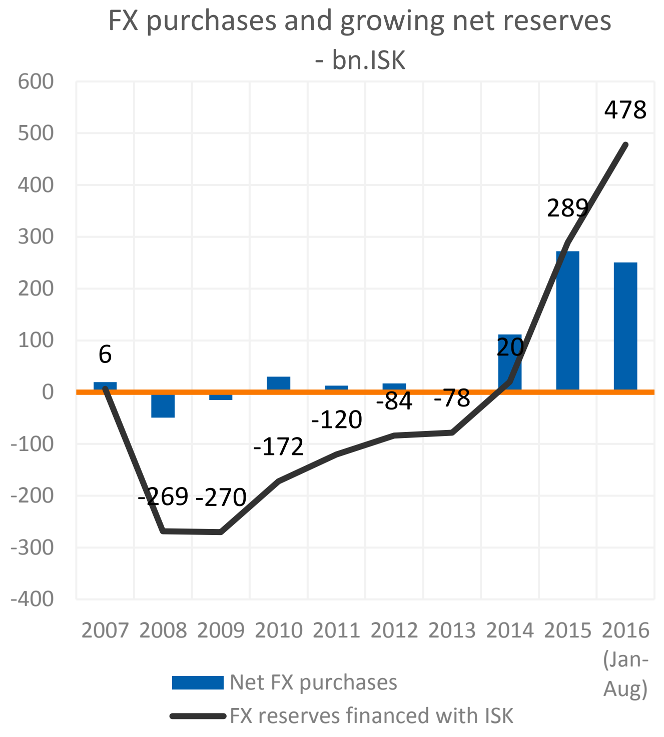
Markets reacted well to the announcement with the OMXI 8 stock index rising 2.98% on the day of announcement and yields on bond markets falling by 10-50 bp. Moreover, inflation premium fell drastically following the decision with the five year inflation premium target creeping below the inflation target set by the Central Bank before the end of the week.



Sources: KODIAK, Central Bank of Iceland, Arion Research

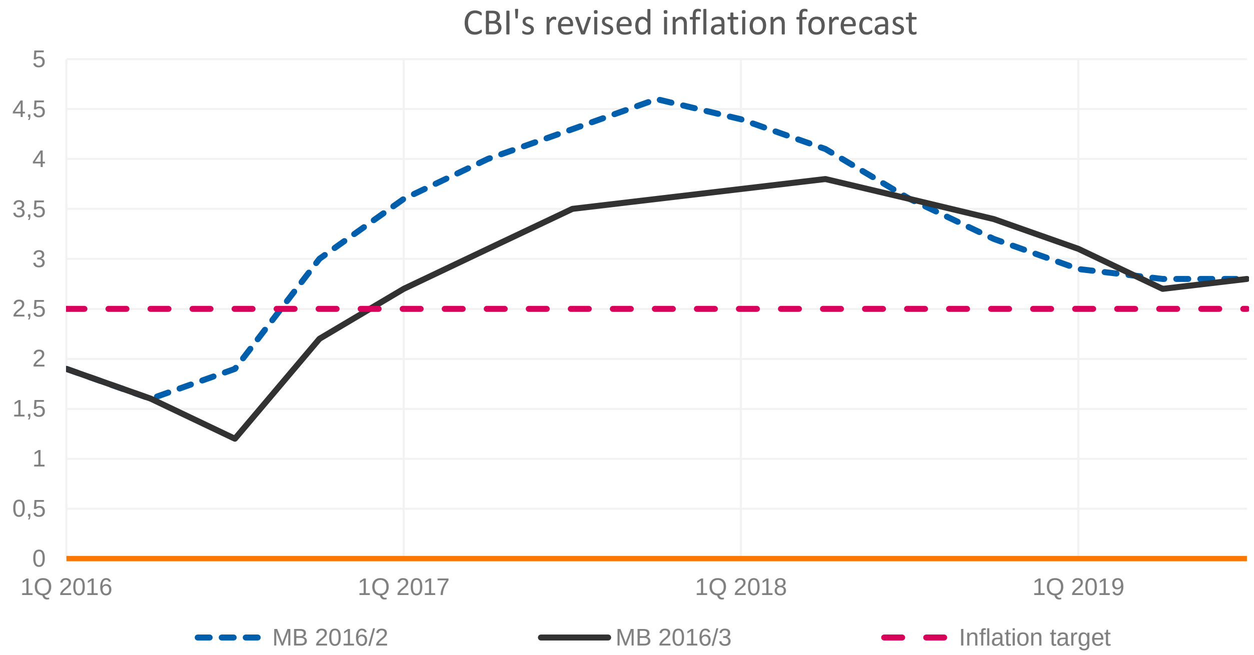
Alongside its interest rate decision, the Central Bank published its third Monetary Bulletin of 2016. The outlook is for somewhat stronger growth this year than the Bank had previously forecast in May. Moreover, in spite of extensive FX interventions by the Central Bank in recent months the exchange rate of the króna has strengthened considerably. According to the MPC the appreciation of the króna had considerable weight in the decision to lower rates. The net FX reserves of the Central Bank now amount to 478 bn. ISK.





Sources: Central Bank of Iceland, Arion Research

In the Bulletin, the Central Bank also revised its inflation forecast downwards. Inflation is expected to remain below the set inflation target into early 2017, but will then pick up when import prices stop declining and effects of currency appreciation diminish. However, the Bank does state that if the exchange rate continues to appreciate in the coming months, the baseline inflation forecast will be lower, ceteris paribus.



Sources: Central Bank of Iceland, Arion Research

Government announces next steps in liberalization of capital controls

On August 16, the government introduced the next major step towards liberalization of the capital controls. A bill of legislation, prepared in accordance with recommendation from the IMF, was presented before parliament on August 17 and now awaits review from the Economic Affairs and Trade Committee. The committee is expected to present their review before September 1.

The main elements of the bill, which consists of two steps, are summarized below. If the bill passes unchanged into law the first step will take effect immediately upon passage while step two takes effect as of January 1, 2017. According to the Ministry of Finance and Economic Affairs, the bill will cause a vast reduction in exemption requests from the Foreign Exchange Act, or roughly 50-65%.

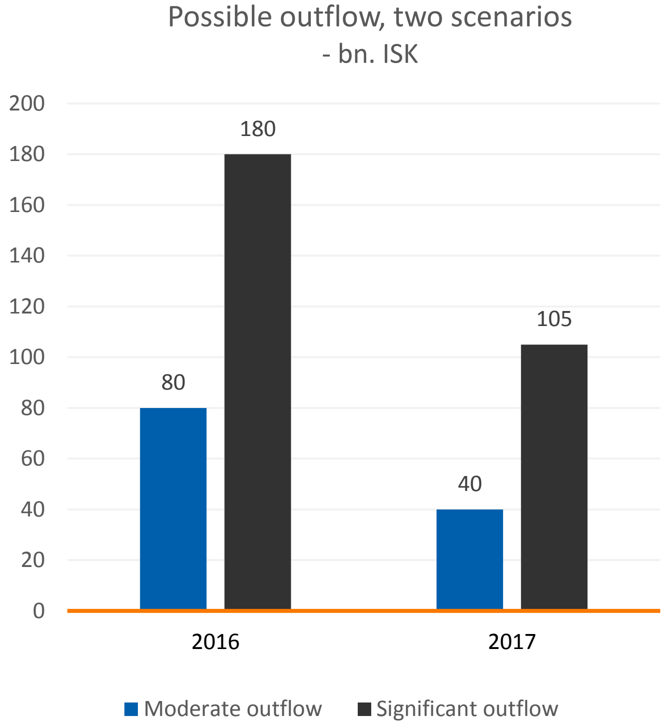
Step 1

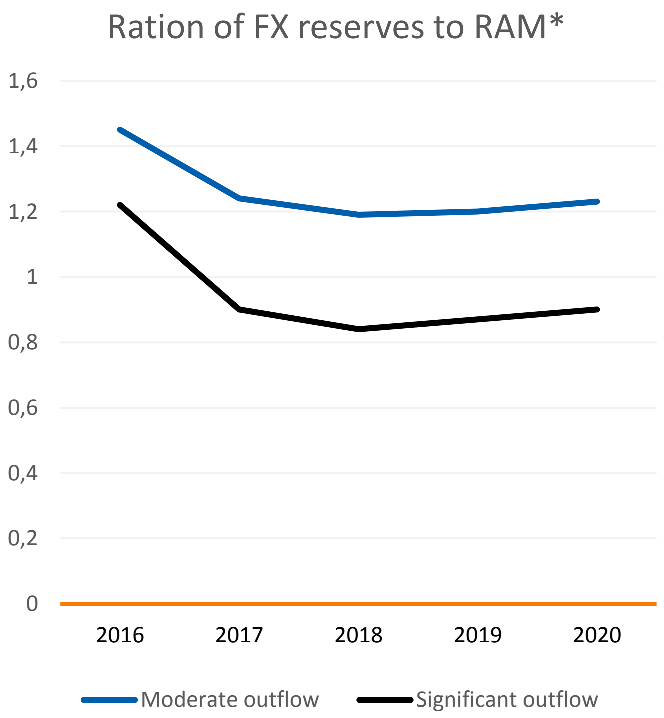
- Outward foreign direct investment unrestricted but subject to confirmation by the Central Bank of Iceland.
- Investment in financial instruments issued in foreign currency, other monetary claims in foreign currency, and prepayment and full payment (retirement) of foreign-denominated loans permissible up to 30 m. ISK, upon satisfaction of specified conditions.
- Individuals are authorized to purchase one piece of real estate abroad per calendar year, irrespective of the purchase price and the reason for the purchase.
- That requirements that residents repatriate foreign currency be eased and that they be lifted entirely in connection with loans taken abroad by individuals for real estate or motor vehicle purchases abroad, or for investment abroad.
- Various special restrictions eased or lifted entirely, including individuals' authorization to purchase foreign currency for travel.
- Increased authorization for the Central Bank of Iceland to gather information so that the Bank can promote price stability and financial stability more effectively.

Step 2

- The ceiling on investment in financial instruments issued in foreign currency, other monetary claims in foreign currency, and prepayment and full payment (retirement) of foreign-denominated loans will be raised from 30 m. ISK to 100 m. ISK and further re-evaluated before 1. July 2017.
- Transfers of deposit balances allowed for amounts below 100 m. ISK. The requirement for domestic custody of foreign securities investments will be revoked. This will enable residents and non-residents to transfer deposits and securities to and from Iceland and to trade in securities abroad within the limits specified in the bill.
- Individuals' authorization to purchase foreign currency in cash will be expanded significantly.

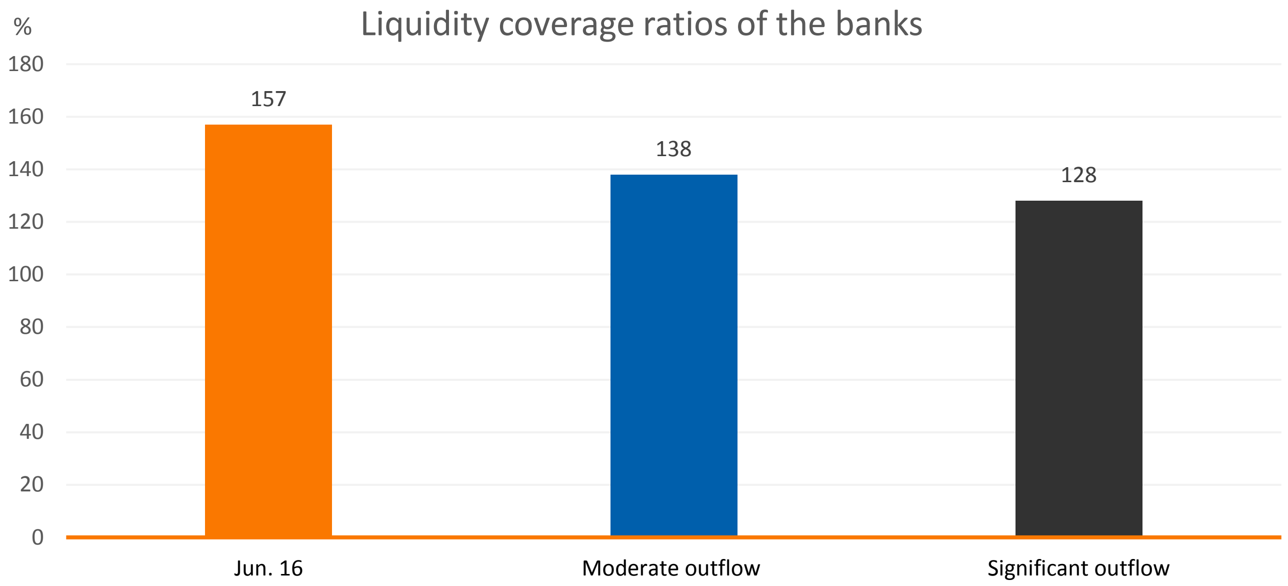
Along with the bill the Central Bank provided an assessment on the effect of the bill on possible capital outflows. The Central Bank argues that a wide interest rate differential, a stronger economy compared to trading partners, low inflation, and trade-related capital inflows attributed to a stronger króna will mitigate the risk of substantial capital outflows.





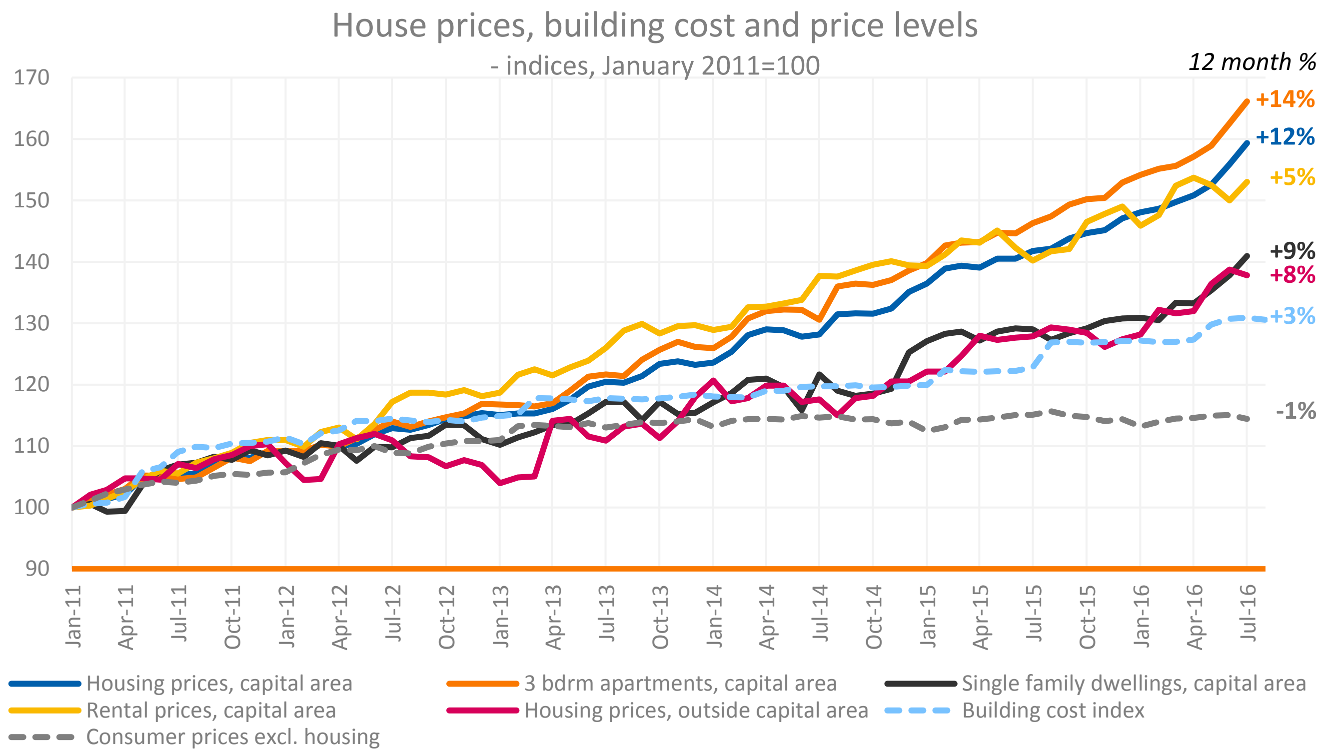
Sources: Central Bank of Iceland, Arion Research *Reserve Adequacy Metric of the IMF

The Bank additionally provided estimates on the effect on liquidity ratios of the four commerical banks. According to the Central Bank, liquid assets held by the four banks now amount to roughly 700 bn. ISK, of which 496 bn. being held in ISK and 200 bn. in FX. Stress tests carried out imply that the ratios will stay well above the regulatory mininum as shown in the graph below.



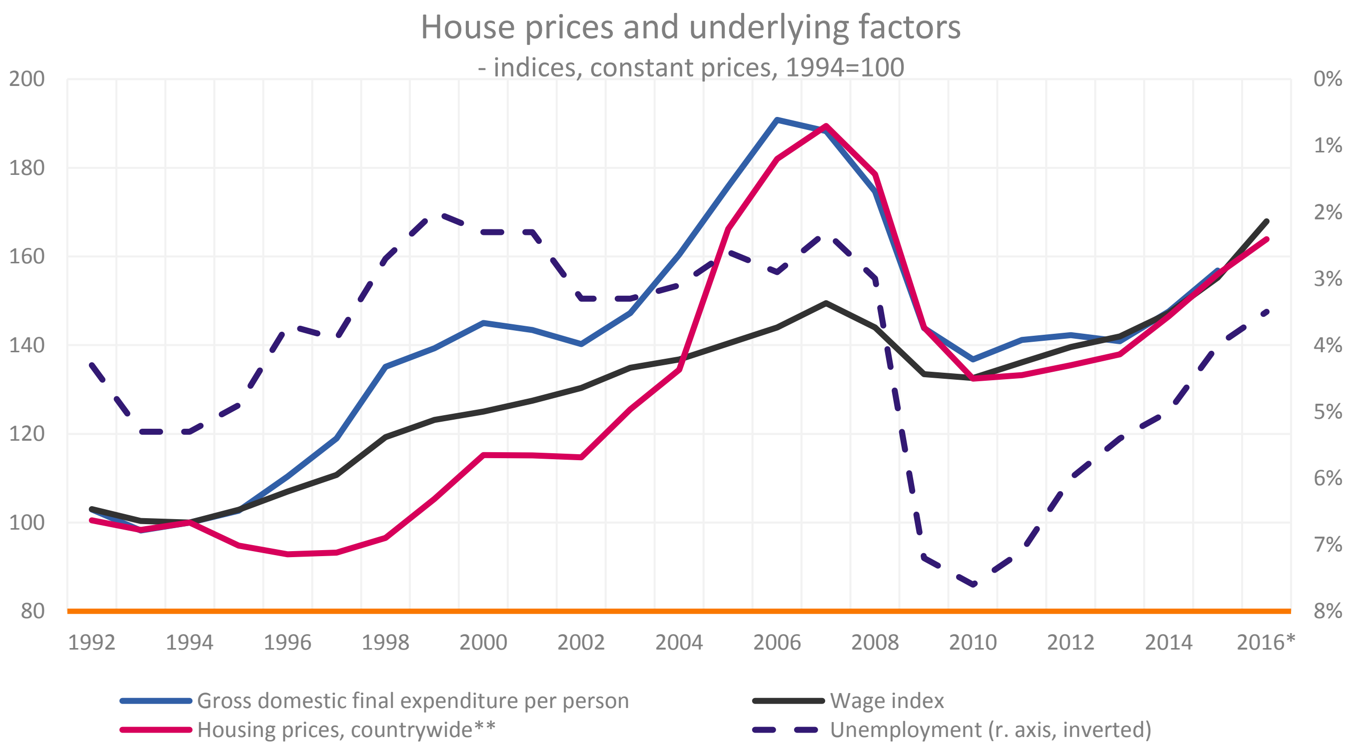
Sources: Central Bank of Iceland, Arion Research

In August, Arion Research published a report on the Icelandic housing market. Housing prices have risen quite rapidly over the last 12 months (July YoY), with single-dwelling residents growing by 9% and three bedroom apartments by 14%. Housing prices in the capital area have outpaced the rise outside the capital area, or 14% and 8% respectively. Over the same period consumer prices excluding housing have fallen by 1% while the building cost index has risen by 3%. However, rental prices in the capital area have only risen by 5% YoY despite considerable increase in tourism.



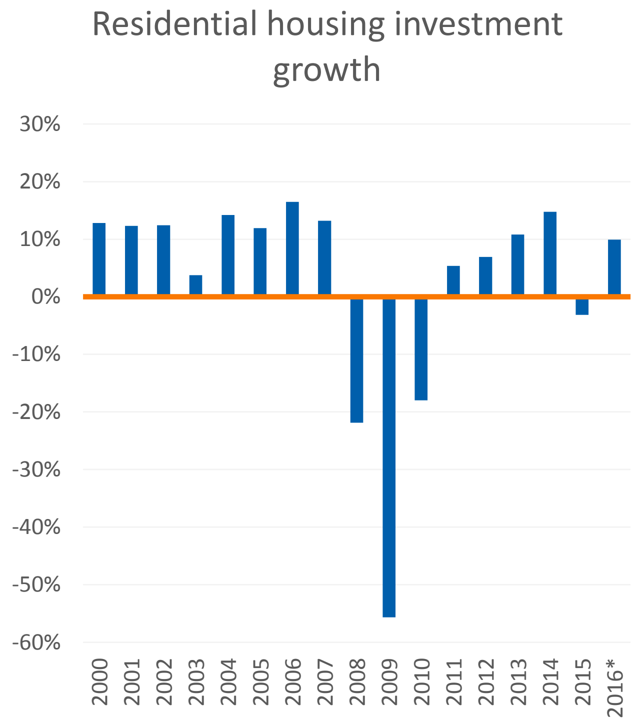
Sources: Statistics Iceland, Registers Iceland, Arion Research

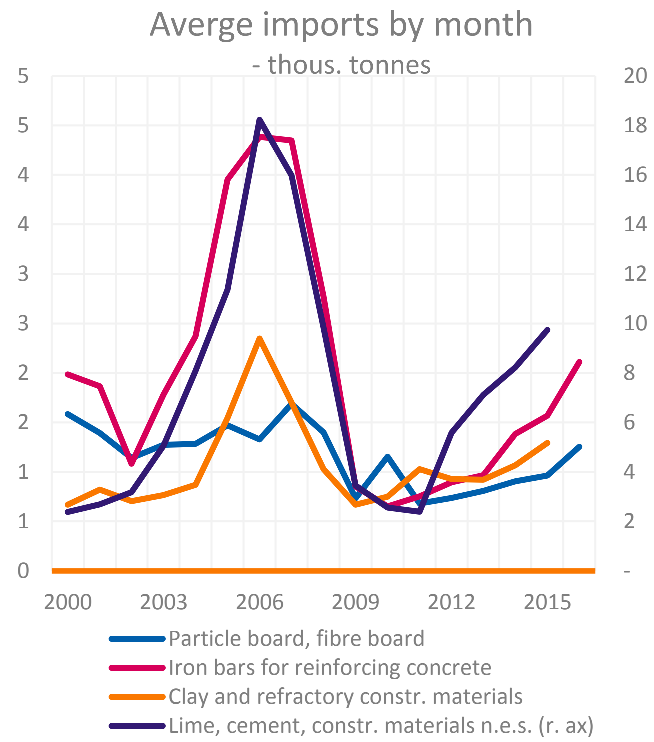
It can be seen when inspecting some underlying factors of housing prices that various indicators closely follow the development of housing prices. In that respect, there is a strong correlation between housing prices and unemployment (decreasing), gross domestic expenditure per person and wages.



Sources: Statistics Iceland, Registers Iceland, Arion Research * First six months **Residential property market price index from 2001, imputed rentals for housing from 1997, housing price index for the capital area from 1994, building cost index from 1992.

In spite of hefty price increases in the housing market in recent quarters there is still a lack of residential housing. After four years of continuous growth, residential housing investment contracted by 3% in 2015. According to Statistics Iceland the population of the country will grow by more than 19,000 over the next five years, which in turn increases demand for housing. Moreover, everything points towards even further increase in tourism which is an equivalent of a population increase for the housing market. With that in mind we estimate that around 8-10,000 extra houses will needed to be built before 2020. However, signs for the first half of this year show that investment is picking up steam.





Sources: Statistics Iceland, Registers Iceland, Arion Research *First quarter