

The króna outlook

The króna has been exceptionally stable over the past years under the protective wings of capital controls. What should we expect when controls are lifted? Macroeconomic factors, such as the current account balance, terms of trade, FX denominated debt service and improved ratings mostly point towards a stronger króna in the near-term. In addition, the Central Bank claims to be committed to maintaining strong reserves and minimizing currency volatility. However, as always, downside risk remains.

Expected flows in domestic financial markets in 2016

At the beginning of each year we like to try to map out what the main determinants will be regarding supply and demand in financial markets in Iceland. The outlook is always uncertain, but with the capital control removal process and government ownership of two of the three major banks this year is rife with uncertainties. Indicators point to plenty of new supply, However, whether the banks will be sold this year and what kind of exemptions the pension funds will receive will have a large effect on flows in domestic financial markets in 2016.

Analysts

Anna Hrefna Ingimundardóttir
+354-444-6997
anna.ingimundardottir@arionbanki.is

Hrafn Steinarsson
+354-444-6910
hrafn.steinarsson@arionbanki.is

Konráð S. Guðjónsson
+354-444-6991
konrad.gudjonsson@arionbanki.is

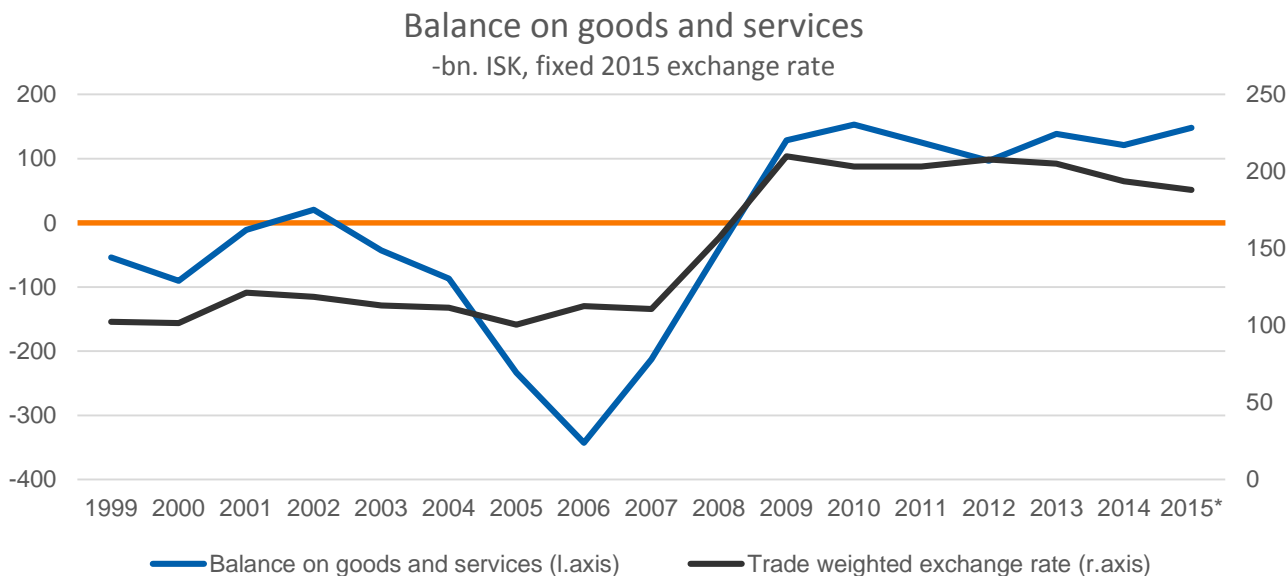
Provisional release:

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.

The króna outlook

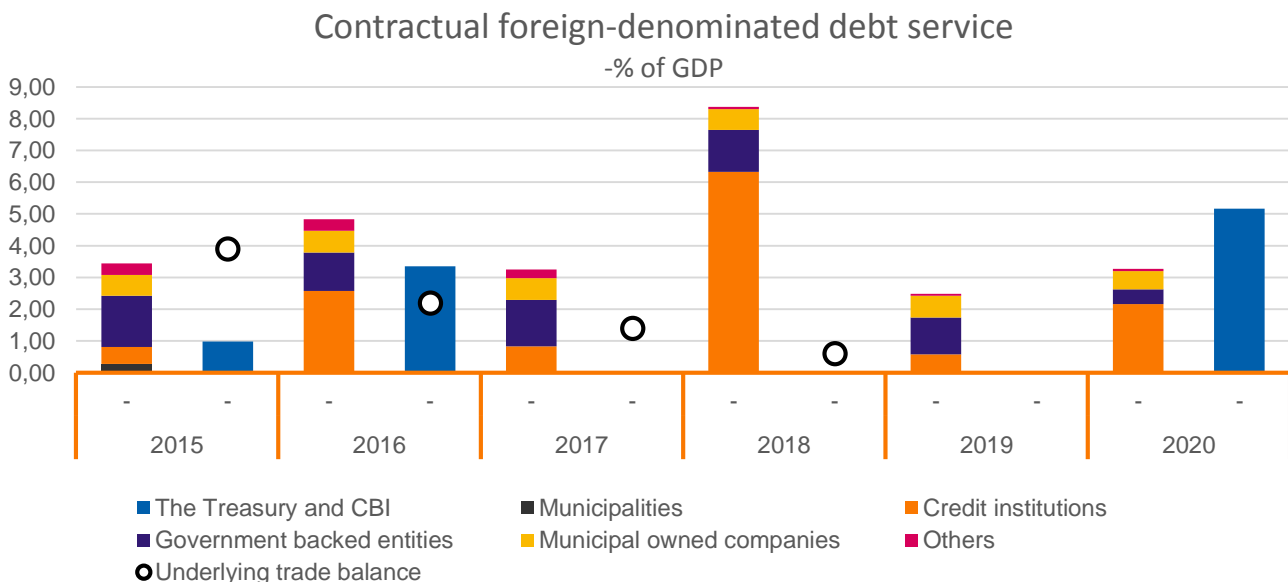
The Icelandic króna has been unusually stable over the past few years under the “protection” of capital controls. The general assumption is that controls will be mostly lifted this year. What will that mean in relation to exchange rate volatility and the outlook for the króna?

Foreign trade: In the years leading up to the financial crisis Iceland had a sizeable trade deficit and a strong currency. Ever since the króna collapsed in 2008 there has been a rather consistent trade surplus, even after the króna started strengthening in 2014. The balance on goods and services in the first 9 months of 2015 was positive by 148 b.kr., mostly due to exported services related to the tourism industry. Numbers for the balance on services are not yet available for Q4 2015. Over the whole year, however, the balance on traded goods was negative by 30 b.kr.

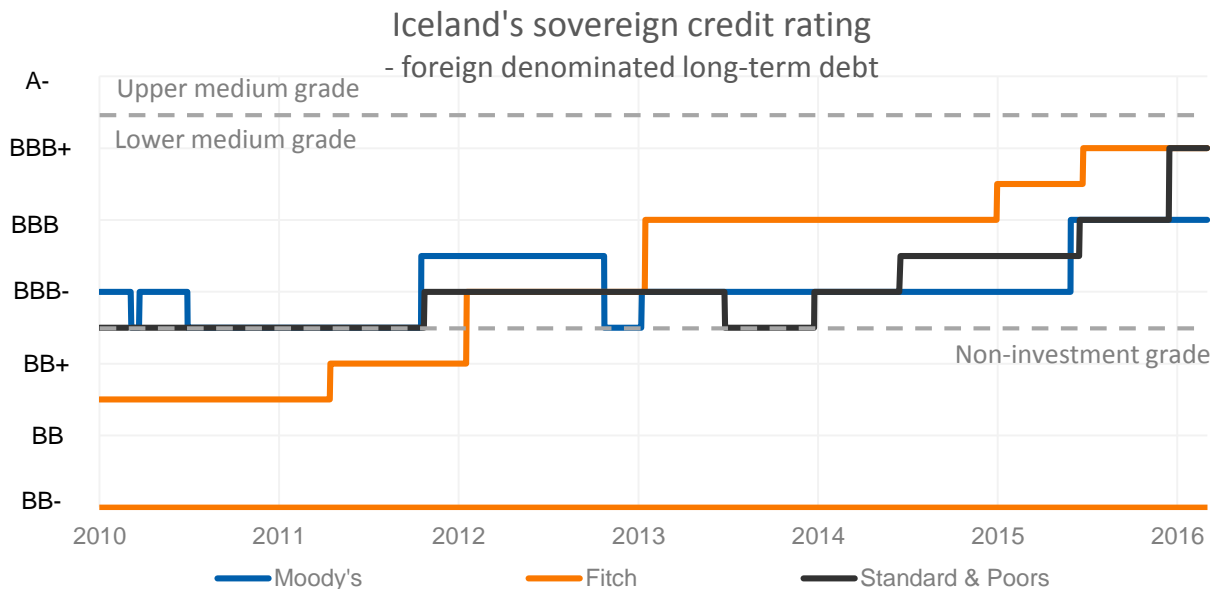


The terms of trade: The terms of trade improved by approximately 5% in 2015 according to CBI estimates, thanks to rising marine prices and falling prices of raw materials, such as oil. They are expected to improve slightly further this year. Oil prices have fallen considerably since the Central Bank published its latest forecast in November so the terms of trade could improve more than expected in 2016, all else equal.

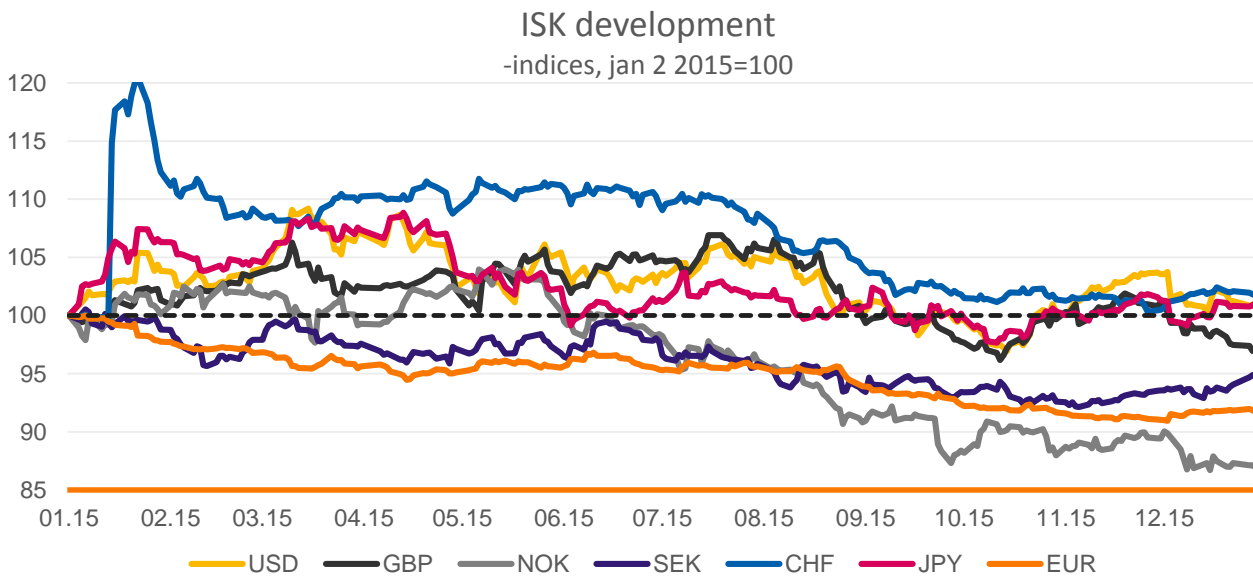
Foreign debt service: According to the Central Bank’s latest [Financial Stability](#) report, Iceland’s contractual foreign-denominated debt service has declined as a positive current account balance has allowed domestic entities to reduce their foreign debt. The estimated average FX debt payments to be made by resident entities other than the CBI and Treasury in 2016-2020 amount to approximately 4.4% of GDP. The CBI’s latest estimate for the underlying trade balance in 2016 is 2.2% of GDP, 1.4% in 2017 and 0.6% in 2018, but a portion of the foreign debt due is expected to be refinanced at improved terms so foreign debt service is not likely to be a major concern in the coming years.



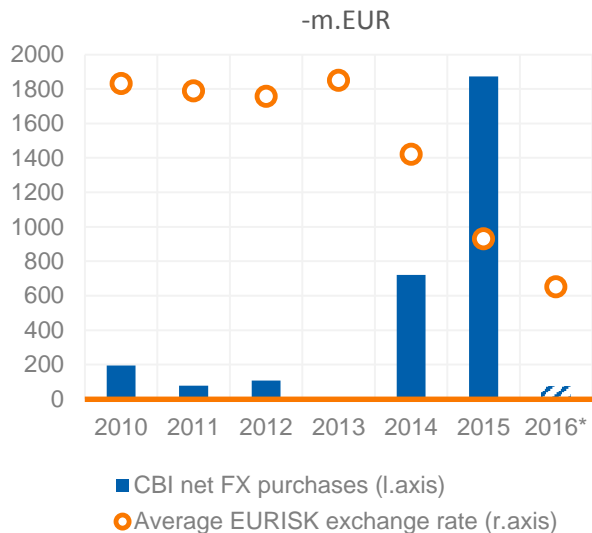
On January 15 [Standard and Poor's upgraded Iceland's credit rating to BBB+](#) while affirming short-term ratings at A-2, citing progress in lifting capital controls as well as declining debt levels as the main determining factors. Gross government debt declined by approximately 15% of GDP in 2015 and is expected to decline further in the coming years regardless of the failed banks' estates stability contributions.



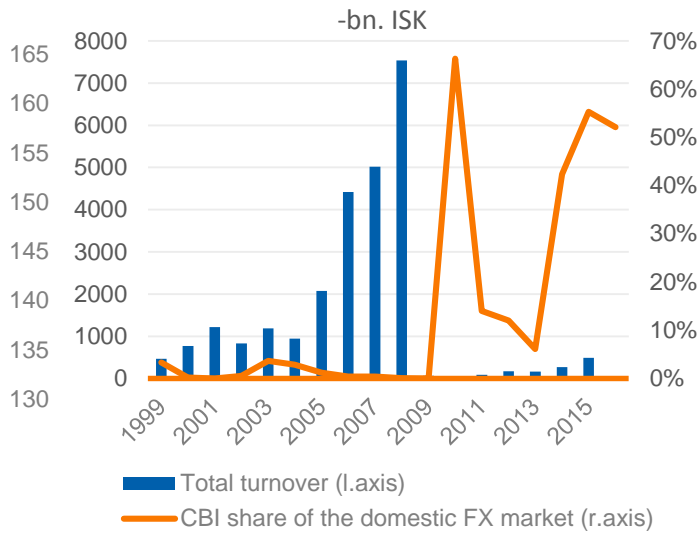
CBI intervention in the FX market: The króna strengthened considerably in 2015 (by 8.4% against the euro) even though the Central Bank purchased close to 1.9 bn euros worth of FX (over 50% of total turnover) in the interbank market last year.



The Central Bank's net FX purchases



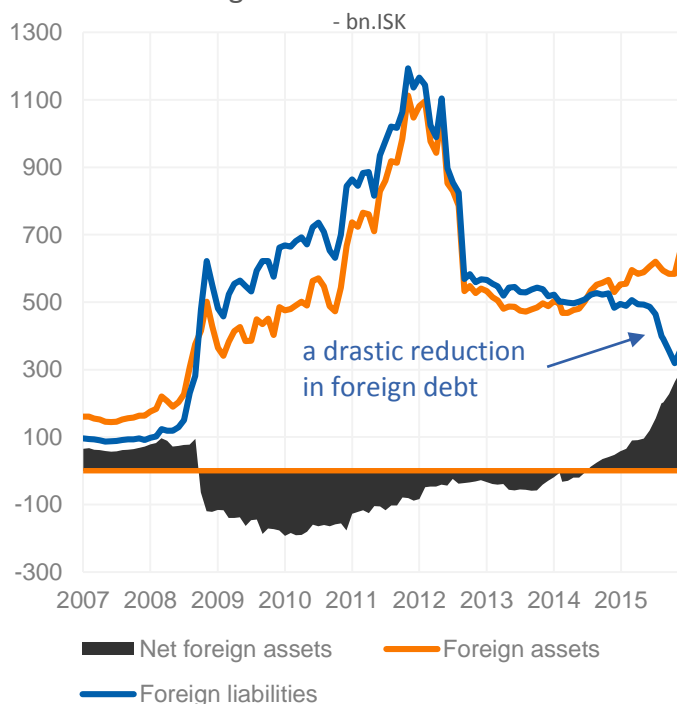
FX turnover in the interbank market



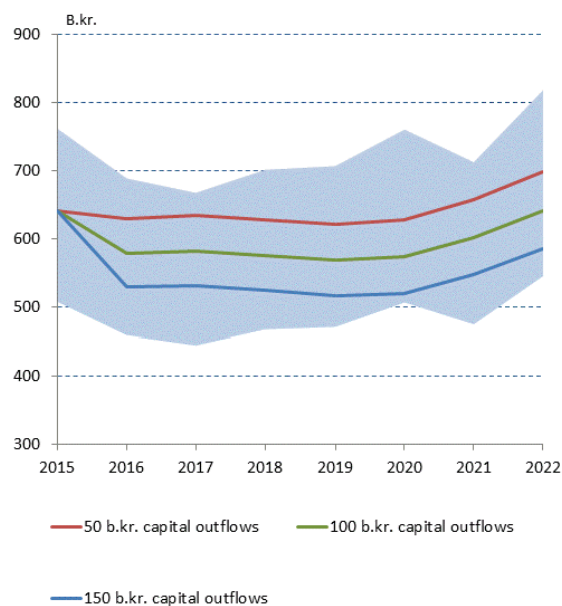
Sources: Statistics Iceland, The Central Bank of Iceland, Bloomberg, Arion Research

According to the CBI, its main goal this year in the FX market has been to accumulate reserves, not to directly affect the króna exchange rate. But will the CBI keep adding to reserves at the same pace in 2016 as it did in 2015? Looking at the IMF's "reserve adequacy metric" the Central Bank seems to be in a reasonable place when looking at gross reserves, which stood at 650 b.kr. at the end of 2015. Even when assuming capital outflows of 150 b.kr. the bank should be able to maintain adequate reserves, as estimated by the IMF, in the coming years. However, given the fact that the offshore króna auction has not yet taken place, the current account balance is projected to decline and the outflow of residents is expected to increase we can assume that the CBI will keep purchasing reserves to some degree while they have the chance.

Net foreign assets on CBI balance sheet



Reserves¹



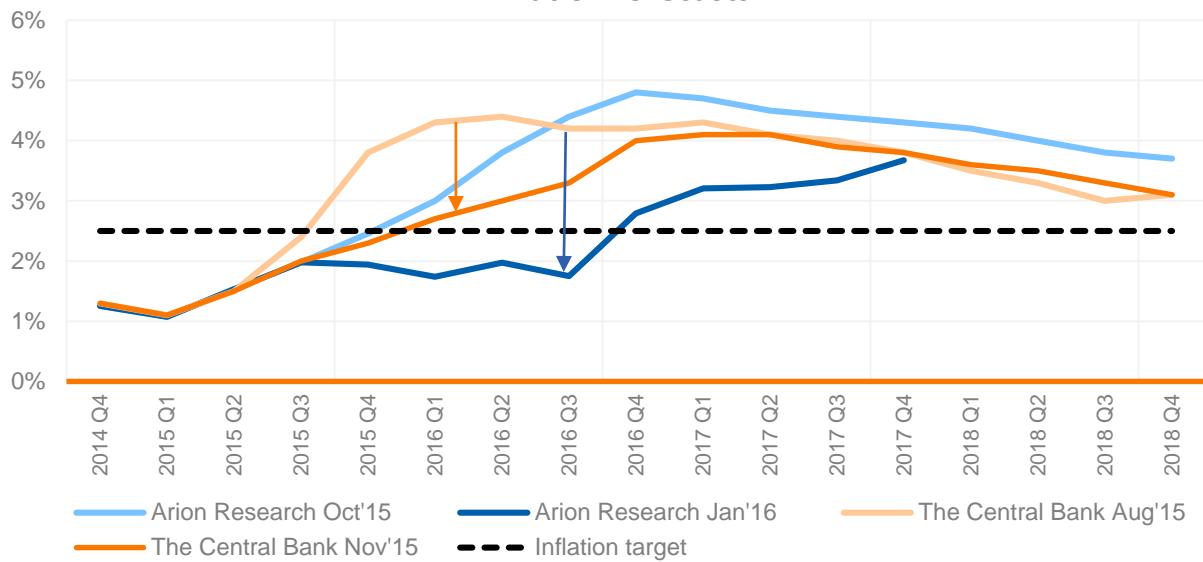
1. The shaded area shows the interval of adequate reserves size based on a 100-150% reserve adequacy metrics as developed by the IMF.

Sources: The Central Bank of Iceland, Arion Research

So where is the króna headed?

The outlook in the Icelandic economy has improved vastly over the past year although concerns about possible overheating and deteriorating external conditions remain valid. As far as the króna goes, most indicators do point to a strengthening in the quarters ahead. Inflation prospects have been a major concern recently, but inflation has yet to materialize and the short-term outlook has improved considerably. Growth in tourism is expected to continue which, along with improving terms of trade, is forecast to result in a positive (but declining) current account balance. Additionally, foreign debt has been drastically reduced and with credit ratings on the rise investor interest from abroad is likely to increase, with the resulting inflow of capital. Foreign investors have already increased their holdings considerably in the bond market following the Central Bank's interest rate hikes and the announcement of the government's plans to lift controls.

Inflation forecasts



Sources: The Central Bank of Iceland

How much outflow the Central Bank will allow this year on the other hand is of course a major determinant as far as how the exchange rate will develop. Pension funds, who received exemptions for 10 b.kr. in the latter half of 2015, have already received exemptions for 20 b.kr. for the first four months of this year. The amounts allowed for the remainder of the year will most likely depend on the development of the CBI's reserves as well as international trade conditions. The Central Bank will in all likelihood make sure they have belt and suspenders on before opening up the gates for the rest of the domestic economy.

In a recent [speech](#) the governor of the Central Bank of Iceland said:

“Before lifting capital controls on domestic residents, we will have to finalise the necessary adaption of monetary policy and financial stability frameworks to the potentially rough seas of unrestricted capital movements. For monetary policy, it means what we call IT+, where IT is coupled with a managed float, supported by macroprudential policies and possibly on-and-off capital flow management tools to deal with excessive inflows related to carry trade that greatly complicate the conduct of monetary policy, as indeed happened in Iceland last summer and autumn... A flexible exchange rate can be both part of the problem and the solution. Capital controls in some form are here to stay as part of the toolbox, but comprehensive capital controls should not be imposed lightly.”

It appears the Central Bank will remain committed to keeping volatility in the ISK at a minimum with inflation targeting+. How exactly that policy will be implemented and whether it will work remains to be seen.

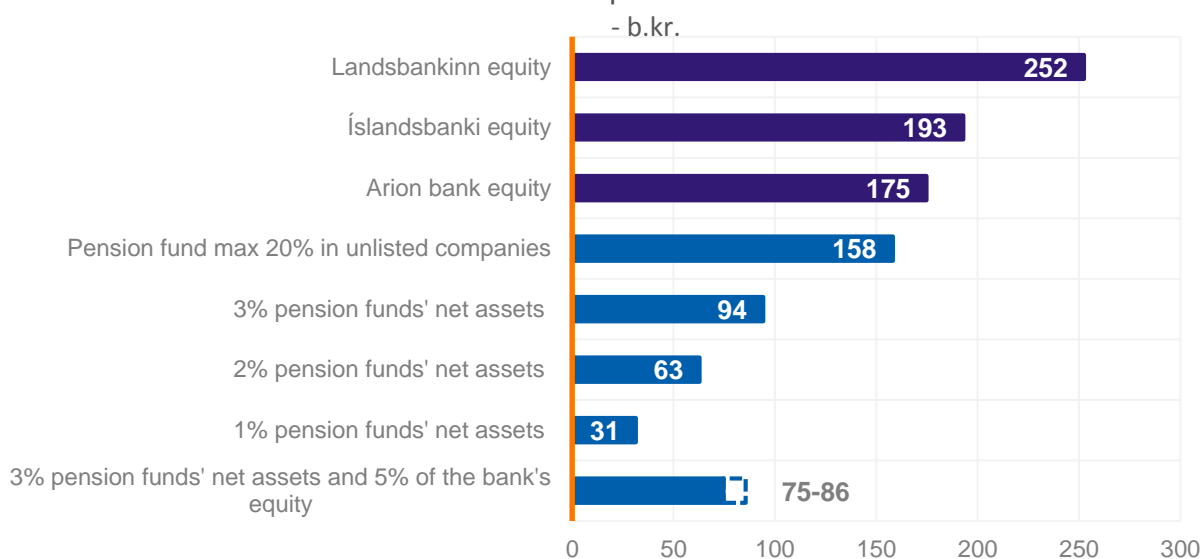
Although there does not seem to be too much downside risk as far as the króna goes in the near term, the Central Bank's stance on monetary policy as well as the progress on the removal on capital controls will be something to watch in the coming weeks and months.

Expected flows in domestic financial markets in 2016

The flows in financial markets this year are, to some extent, characterized by the ongoing process of the lifting of capital controls. Stability contributions have been agreed upon by the old banks' estates and assets, such as a 95% share in Íslandsbanki, have been handed over to the Treasury. The next step will be selling the assets held by the Treasury and the main focus will be on privatizing the banks. The supply in financial markets will therefore depend largely on whether the banks will be sold this year.

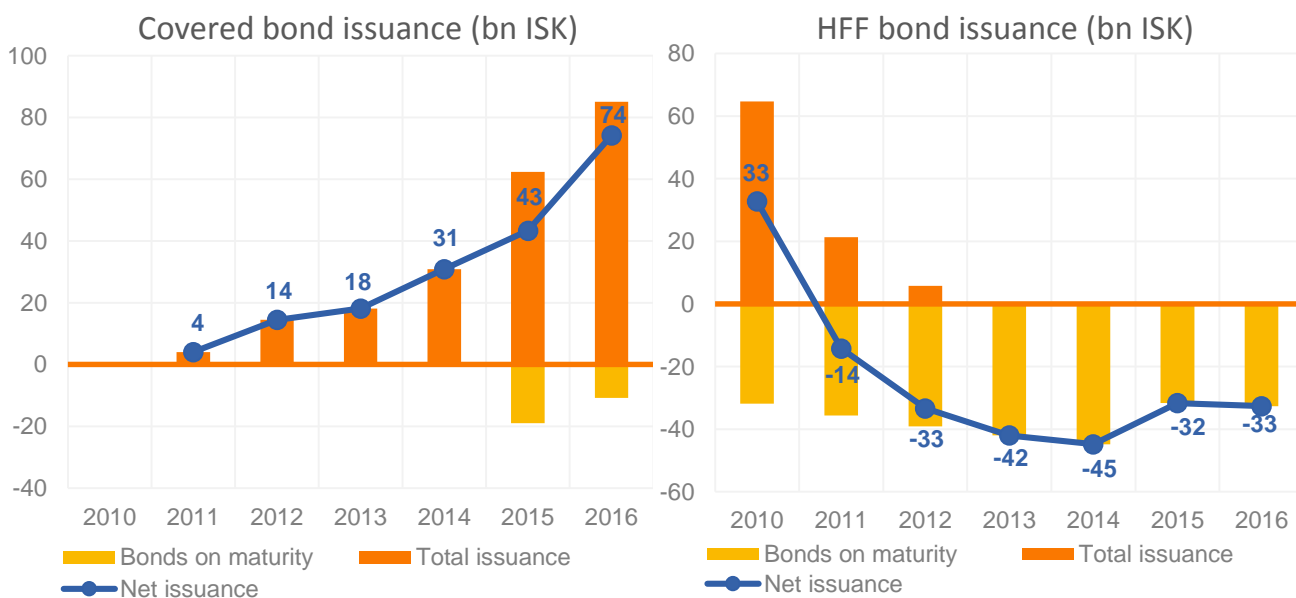
The graph below shows the equity in each bank in Q3 2015 as well as our estimate of the investment capacity of the pension funds. The analysis is based on a report issued by Icelandic State Financial Investments (ISFI), which is the Treasury's holding company and will hold the ownership of the banks on behalf of the Treasury. We agree with ISFI that the pension funds will probably be willing to invest 1-3% of their net assets in a financial institution. In addition, the pension funds will not hold more than 10% of a bank's equity, more likely closer to 5%. Finally, pension funds cannot invest more than 20% of their net asset in unlisted companies. The conclusion is that the investment capacity is likely around 31-94 b.kr., possibly up to 158 b.kr. However, the equity of the banks is valued at 175-252 b.kr. Therefore, potential supply seems to exceed domestic demand in financial markets if you look solely at the investment capacity of the pension funds. Other investors may show an interest in investing in the banks but their investment capacity is likely to be smaller.

Pension funds' investment potential in financial institutions



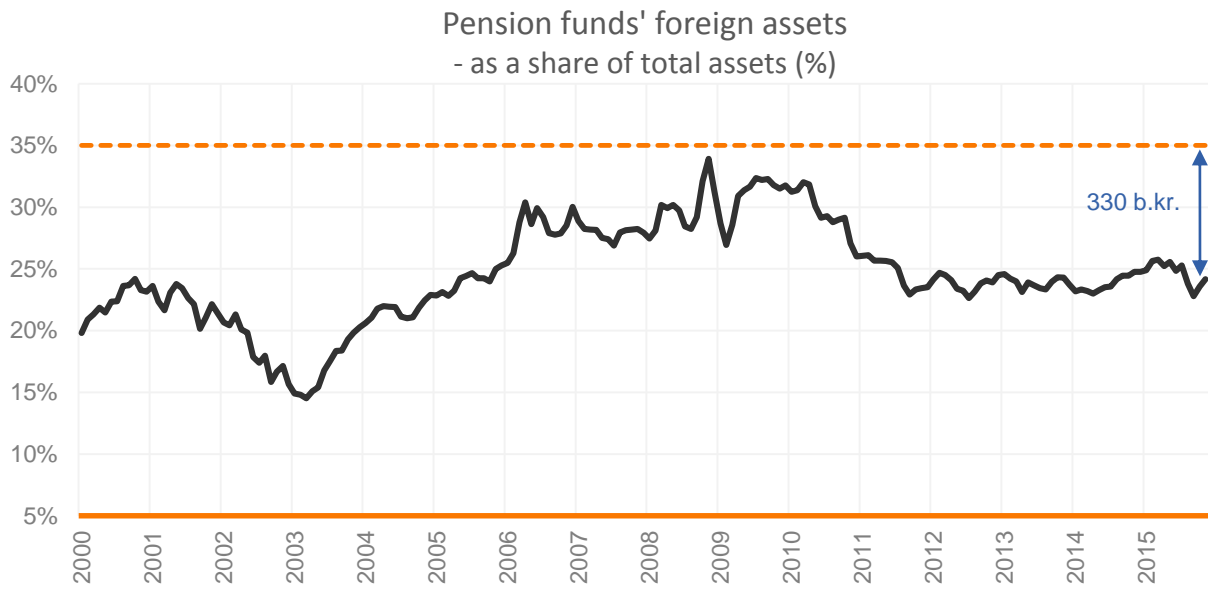
Sources: Financial Supervisory Authority, Arion Research

There will also be an increased supply, and in fact record issuance, of covered bonds. Total issuance will amount to 75-103 b.kr. according to issuing schedules released by the three largest banks. Our estimate is that total issuance will be around 85 b.kr., which equals a net issuance of 74 b.kr. At the same time, net issuance of HFF (Housing Financing Fund) bonds is negative for the sixth year in a row. We don't expect that to change in the near future so covered bonds will take over as a vehicle for funding domestic mortgages, which is in many ways a positive step and will decrease the amount of state guarantees in the long term.



Sources: The Housing Financing Fund, Kodiak, Arion Research

The third indicator that supply could exceed demand in Icelandic financial markets this year is the fact that pension funds are being authorized to invest abroad to a greater extent. We estimate that the pension funds will receive exemptions from capital controls to invest for at least 40 b.kr. abroad this year and if the lifting of capital controls is successful the amount may be closer to 60-80 b.kr. The pension funds would like to see the share of foreign assets in their portfolios increase from the current level of 24% to at least 35%. The ratio of foreign assets before the financial crisis in 2008 was around 33%. To reach a 35% ratio the pension funds would need to invest in international markets for roughly 330 b.kr. in the coming years. Therefore, we consider it likely that they will take advantage of the maximum allotted amounts in order to further diversify their portfolios.



Sources: The Central Bank of Iceland, Arion Research

It seems like there will be plenty of investment opportunities this year, perhaps more than resident entities will be able to handle. However, there is quite a bit of uncertainty regarding some of the main assumptions. Firstly, it is possible that none of the banks (Landsbankinn, Íslandsbanki and Arion Bank) will be sold this year. Additionally, covered bond issuance will take market circumstances into account so if yields rise in the bond market total issuance may be less than originally intended. Finally, the authorization for pension funds to invest abroad depends solely on the Central Bank and the process of authorization has been far from transparent. One of the factors that may change the demand side is inflow of foreign investors through the "yellow ticket" program. Last year, foreign investors purchased bonds for almost the equivalent of the Treasury's issuance of government bonds, about 50 b.kr. If that trend continues the picture already looks quite different.