

Bill on offshore króna passed into law

A bill on offshore króna assets was passed into law right before midnight May 22. With the law, offshore króna assets have been more properly defined and segregated to a greater extent. However, the bill does not discuss the upcoming offshore króna currency auction, aimed to be held in mid-June. Offshore krónur continue to be subject to special restrictions and owners are obliged to move their assets to restricted accounts before September 1, 2016. Those who will not participate in the auction will be authorized to exchange their krónur for euros on the reference rate 220 until November 1, 2016.

The CBI keeps key rate unchanged

On May 11 the Monetary Policy Committee (MPC) of the Central Bank of Iceland decided to keep its key rate unchanged. A strengthening króna and favorable global price developments keep relieving domestic inflationary pressure. However, the MPC's tone has become more hawkish, as it expects a tighter monetary stance will probably be needed in the coming quarters. Alongside the interest rate decision the CBI released its *Monetary Bulletin*, where it revised both its GDP growth and inflation forecasts upwards.

Payment card turnover on the rise

Payment card turnover continued to grow in April after having risen markedly in Q1/2016, both foreign and domestic. Growth in Icelanders' card turnover is relatively higher than forecasts on private consumption growth. Foreign payment card turnover growth outpaced growth in tourism in Q1, which could be explained, amongst other things, by very positive summer bookings and more spending per tourist.

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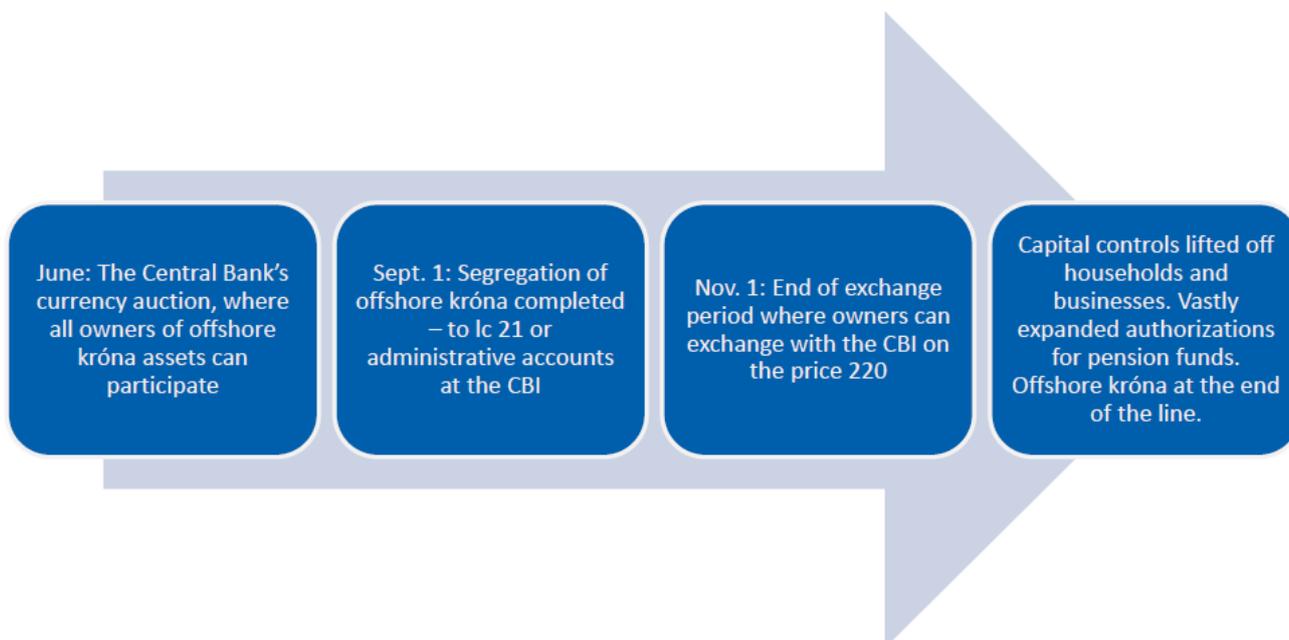
Provisional release:

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Bill on offshore króna passed into law

After closing of markets on May 20, 2016, the Minister of Finance and Economic Affairs, Mr. Bjarni Benediktsson, presented before Parliament [a bill of legislation](#) as the [next steps towards capital account liberalization](#). The bill regarded the treatment of specified króna-denominated assets, referred to as *offshore króna assets*, and was passed into law shortly before midnight on May 22.

It is safe to say that the bill lays the groundwork for capital account liberalization and a timeline for upcoming events, with the currency auction of the Central Bank next in line where offshore króna owners can exchange their króna assets for euros.



Sources: Alþingi, Arion Research

However, the bill does not address the terms in the upcoming offshore krónur currency auction. Those terms have yet to be released, but both the CBI and the Minister of Finance have indicated that the auction will be held in mid-June. The bill rather aims to define offshore króna assets and segregate them more completely. According to the definition, offshore króna assets amount to 319 b.kr. and are listed in the table below.

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

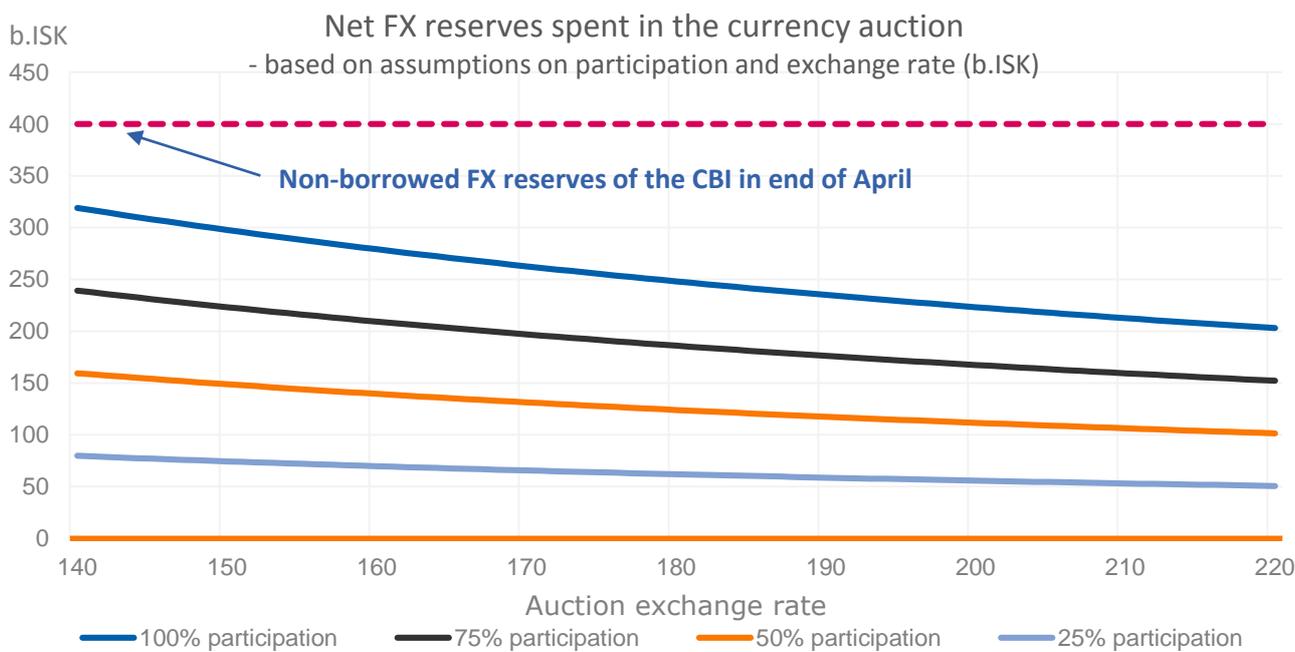
Sources: Alþingi, Arion Research. *Detailed definitions can be found under section 6.4 in the bill's explanatory notes

Custodians of offshore krónur will be obliged to segregate the offshore krónur that will not be used in the CBI's proposed currency auction. Offshore krónur held as deposits shall be transferred to restricted accounts, either with domestic banks or the Central Bank, while electronically registered securities shall be transferred to administrative accounts with the CBI. In both cases custodians of offshore krónur are required to complete the transfer no later than September 1, 2016. Deposit institutions are then required to allocate an amount equal to the total balance of restricted accounts to certificates of deposit issued by the CBI (reserve requirement). The certificates bear 0.5% interest (reviewed annually) which is paid once a year.

Offshore króna owners who will not participate in the currency auction can exchange their króna for euros with the CBI before November 1, 2016 on the reference rate 220 (average price in the CBI's previous currency auctions). Hence, there will be a window of opportunity for offshore króna owners to free their assets if they decide not to participate in the currency auction. Nevertheless, it is highly likely that the November reference rate will be unfavorable compared to the auction exchange rate.

But what will the effect be on the FX reserves of the Central Bank?

The effects on the FX reserves will depend on the participation rate in the auction on one hand and the auction exchange rate on the other. The picture below shows the amount of FX reserves the Central Bank will need to spend based on certain participation and auction exchange rates. The Bank's gross official reserves at the end of April amounted to 760 b.kr. while non-borrowed reserves, i.e. financed in krónur, amounted to nearly 400 b.kr, due to considerable FX market interventions by the Central Bank in the past two years.

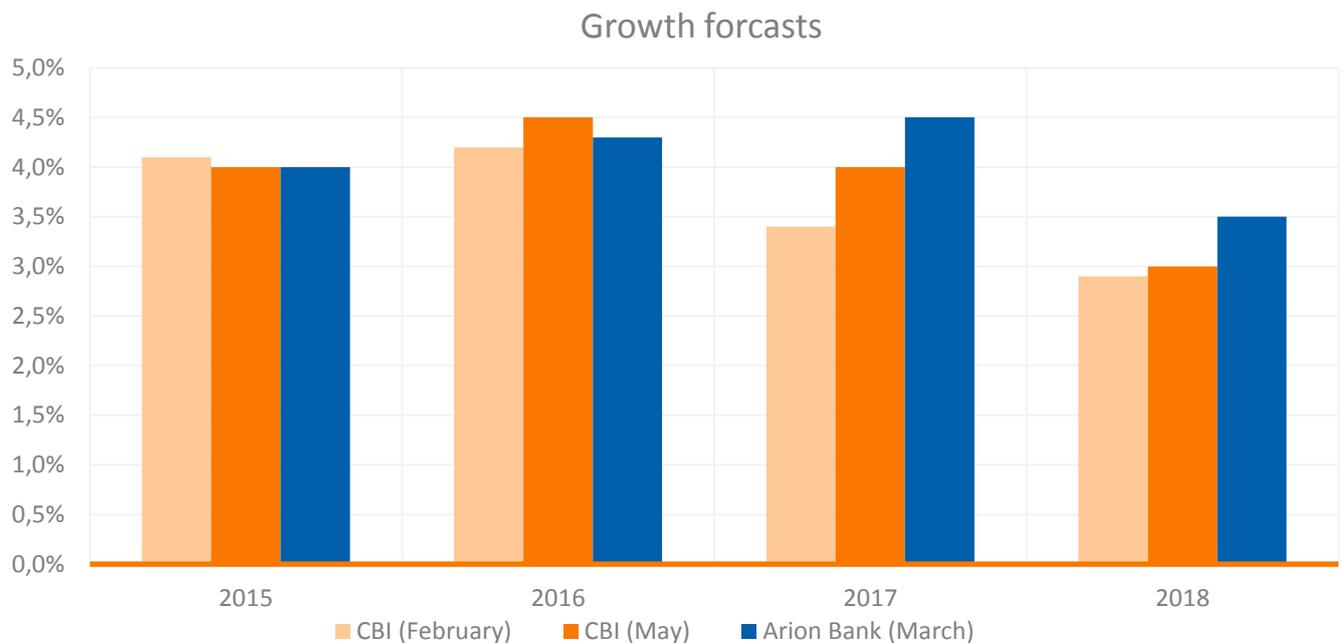


The Bank has iterated the need for vast FX reserves, owing to uncertainties regarding capital account liberalization. As stated in the notes on the bill: "While liberalisation is underway, the size of the foreign exchange reserves will be determined through a cautious approach in accordance with guidelines issued by the International Monetary Fund (IMF)." In that sense the Bank has earmarked a portion of its reserves for the currency auction. While probably wanting to rid the economy of as many offshore krónur as possible, the Bank will keep in mind that it will want to own some amount of non-borrowed reserves to be able to smooth out fluctuations during the liberalization process.

The CBI keeps key rate unchanged - revises growth forecast upwards

On May 11 the Monetary Policy Committee (MPC) of the Central Bank of Iceland (CBI) decided to keep its key rate unchanged, in line with forecasts. Inflation measured at 1.6% in April, slightly higher than in April 2015, and remains well below the set target rate of 2.5%. A strengthening króna and improved terms of trade have managed to offset the inflationary pressure of recent wage hikes and a widening positive output gap. However, the MPC's tone has become more hawkish as it points out that favorable global price developments could reverse and domestic inflationary pressures remain strong. Furthermore, it is yet to be seen whether firms will keep meeting increased wage costs without raising prices.

In the CBI's latest [Monetary Bulletin](#), also published on May 11, the Bank revised both its forecasts for GDP growth and inflation upwards from its February forecast. GDP growth this year is expected to rise to 4.5%, compared to a 4% estimate in February, while GDP growth for 2017 is now projected at 4% instead of a 3.4% forecast in February.

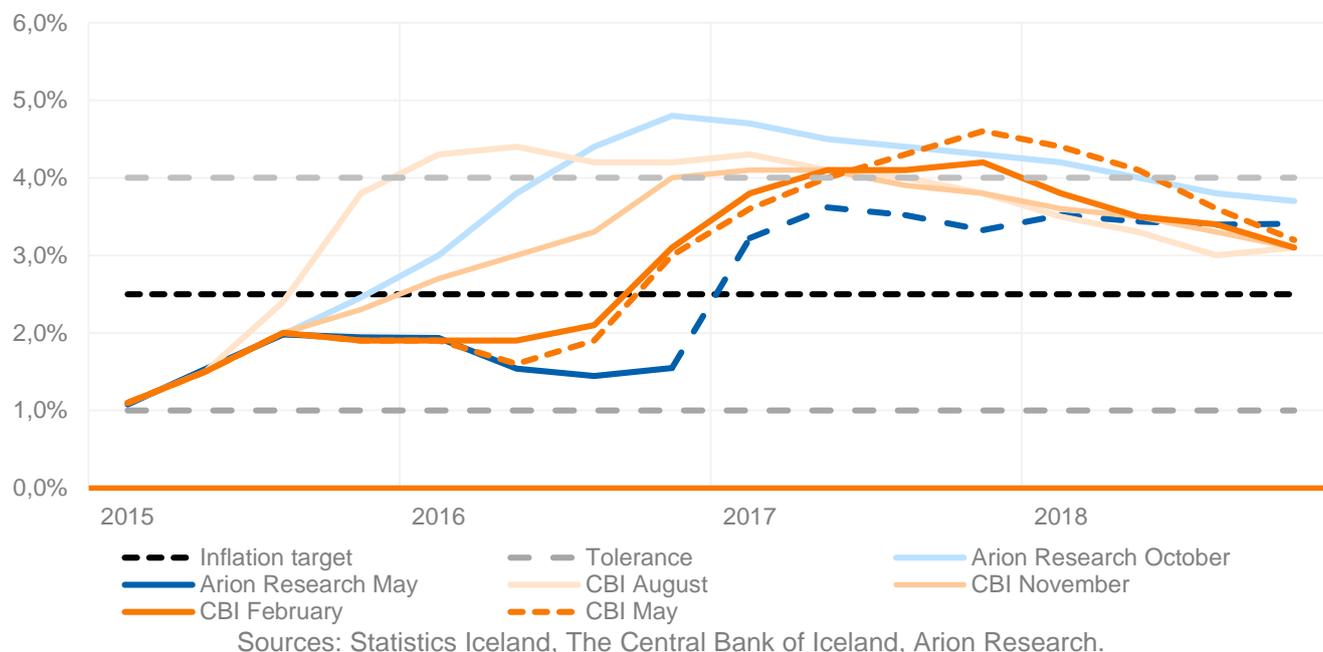


Sources: The Central Bank of Iceland, Arion Research.

The revised inflation forecast is somewhat higher than the February forecast and measures inflation at 3% at the end of 2016. Although inflation is expected to remain below the target rate well into 2016, and that signs show that the monetary policy has managed to anchor inflation expectations, the MPC reiterates that a tighter monetary stance will probably be needed in the coming quarters as uncertainties surrounding growing domestic inflationary pressures are mounting.

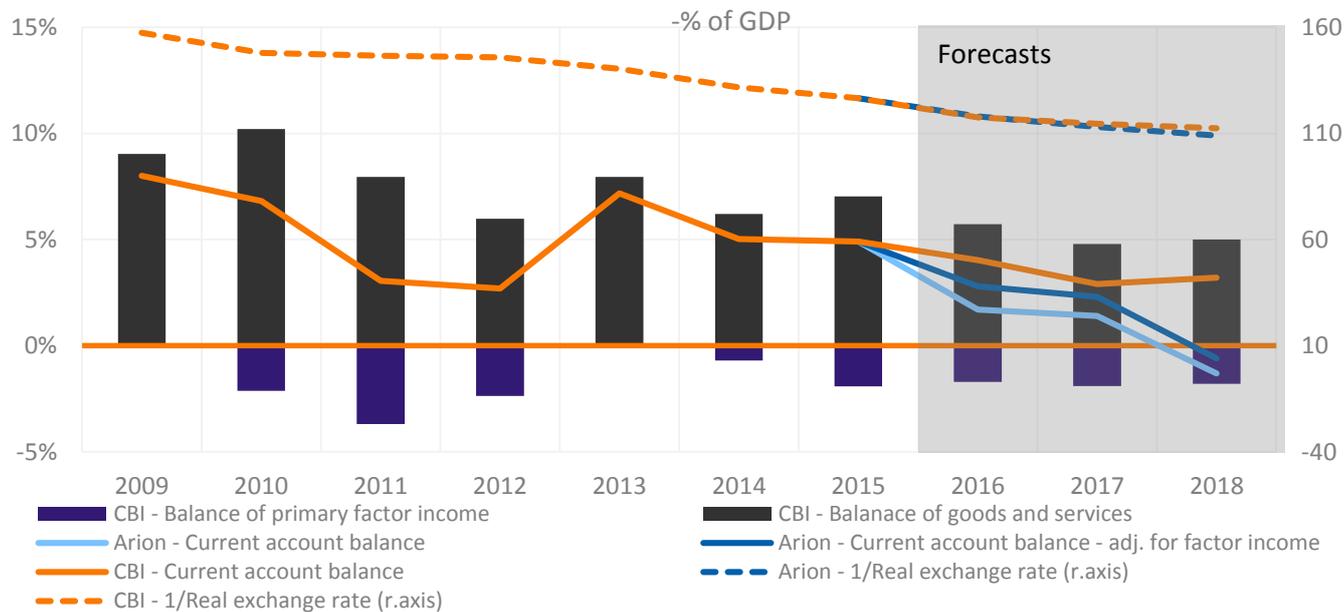
The main uncertainties surround an underestimation of the demand-side effects and cost increases of recent wages settlements, an eased fiscal stance, underestimation of rising housing prices and a depreciating króna. However, most indicators point to a strengthening króna in the coming quarters, as capital inflow is expected to increase with continued growth in tourism alongside improving terms of trade. Moreover, considering the current size of FX reserves and how rapidly the Bank's reserves have expanded in the first half of 2016, the CBI is expected to cut back on its FX market interventions, [as we have recently pointed out](#).

Inflation forecasts



It drew our attention that the CBI projects a current account surplus throughout the forecast horizon. This is surprising as the real exchange rate of the króna is anticipated to continue to strengthen due to expected growth in domestic demand and even further growth in imports. In fact, in [March Arion Research forecast](#) that the current account balance will turn slightly negative in 2018. Historically, the real exchange rate and current account balance usually go hand in hand, e.g. there is a very strong correlation between imported goods, less ships, aircraft and aluminum production, and real exchange rate. That is not a coincidence as a stronger real exchange rate leads to lower import prices and thus increased demand.

Current account balance and real exchange rate

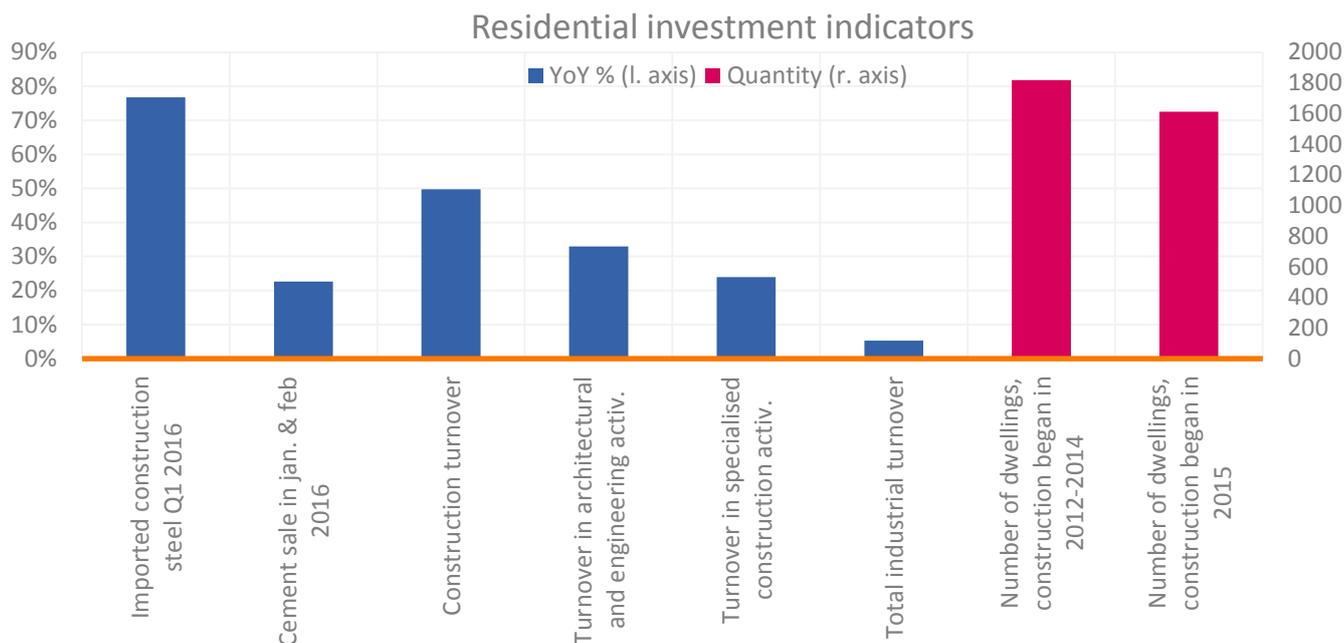


As a counter-argument the Bank states that the “equilibrium real exchange rate” has risen, which we agree with. However, we question whether the real exchange rate at the end of the forecast horizon, which measures only 10% weaker than in 2007, will hold in the long run without the current account balance and exchange rate of the króna giving in. Considerable uncertainty surrounds this, and just as the Governor of the CBI has pointed out the uncertainty is even more with the economy in midst of capital account liberalization, where capital inflow is open but outflow restricted.

Another thing that caught our attention in the Bank’s forecast is that it projects 6% growth in residential investment this year, while our forecast from March measures the growth at 13%. All ready we see signs that growth will possibly exceed our prediction.

Firstly, housing prices have risen substantially in the last few years – roughly 5% on an annual basis in the capital area in February. That, along with expectations of further price increases induces residential investment. Secondly, Building Code regulations are currently being loosened and a scheduled government intervention to support the housing market has been announced, both of which will probably stimulate

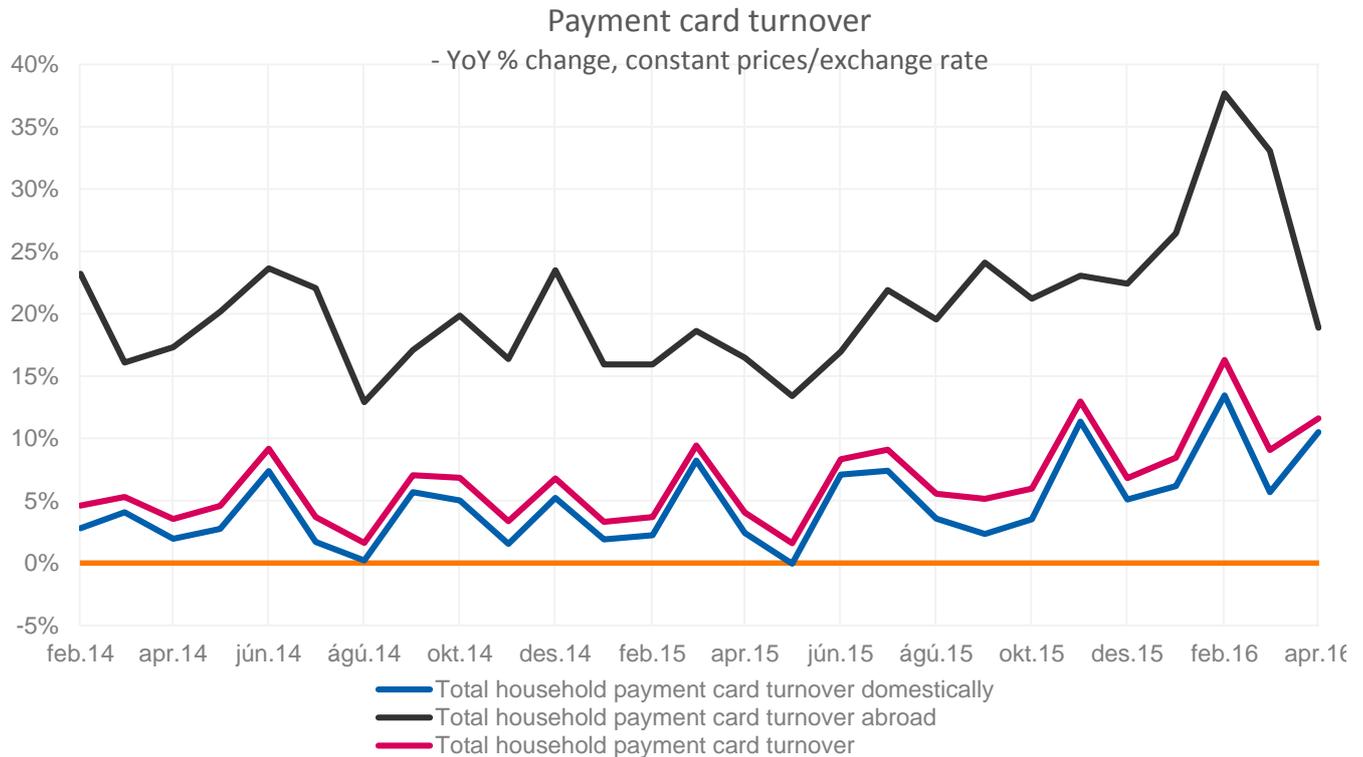
construction. Thirdly, residential investment was far below expectations last year, and shrank by 3% in fact, despite an accumulating need for investment. This suggests that residential investment might have been postponed. Investment picked up in Q4/2015 and increased by 9.7% year-on-year, showing good promise for this year. The fourth sign is that various economic indicators, such as the ones below, suggest that the construction sector, and likely residential investment, is picking up rapidly.



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

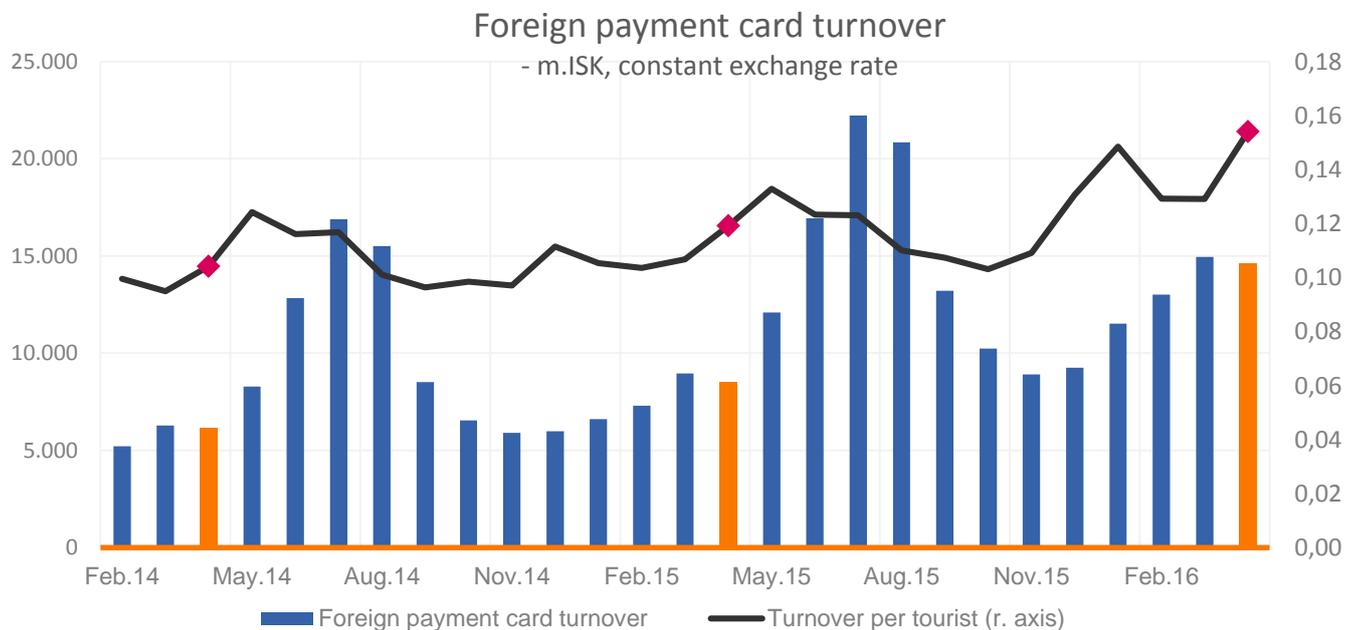
Payment card turnover on the rise

Icelanders' payment card turnover grew by 11.6% YoY in April, which is somewhat more than in the previous month but still in line with the development in the first half of 2016. Growth in card turnover abroad fell noticeably from 33% in March down to 19% in April, but the fact that the Easter holiday was in March this year probably played a substantial role in that decline. Additionally, the Easter holiday likely has an effect on domestic turnover to some extent, creating a bias in comparison between months.

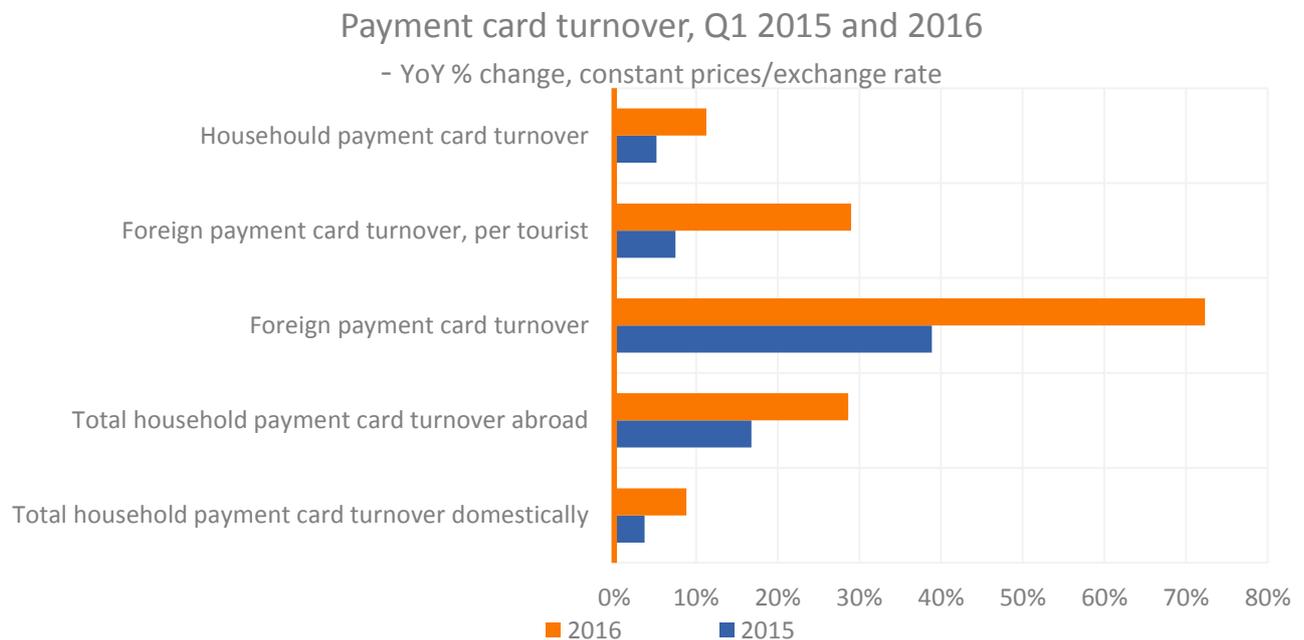


Sources: Statistics Iceland, The Central Bank of Iceland, Arion Research.

Foreign payment card turnover in Iceland amounted to 14.6 b.kr. in April, a 6 b. kr. increase from the previous year (+71%). This increase outpaced the 32.5% growth in visitors to the country. Payment card turnover per tourist therefore grew by 29% YoY and has never been as high in any one month when adjusted for exchange rate. However, increased passenger transport by domestic airlines shows up in domestic card acquirers' transactions which might inflate these numbers. Data from the Icelandic Centre for Retail Studies seems to support this as turnover per American tourist has increased rapidly this year, in line with WOW air's new North America flights. This extensive increase in turnover might also be explained by very positive summer bookings, since passenger transport (by air) transactions are essentially prepayments, suggesting a considerable increase in tourism for the summer ahead like analysts have predicted. Another possible explanation for increased foreign card turnover is that lower airfares have enabled tourists to spend relatively more of their disposable income on consumption of other goods and services.



Below we have compared the key changes of payment card turnover between Q1 of 2015 and 2016, and there is considerable growth in every aspect. Household card turnover e.g. increased by 11% in real terms while foreign card turnover increased by 72%. This development might be another indication of growing private consumption as well as an even further surge in tourism. That would be in line with the CBI's revised economic outlook where private consumption is measured at 6% for 2016, but previously Arion Research predicted 6.8% growth in consumption. These numbers, along with others such as imports in Q1, could even suggest that private consumption growth forecasts are modest at best.



Sources: Statistics Iceland, The Central Bank of Iceland, Icelandic Tourist Board, Arion Research