

The times they are a changin' – parliamentary elections 2016

Parliamentary elections will be held in Iceland this coming Saturday, October 29 and it is safe to say, in the words of the newly announced Nobel laureate Bob Dylan, that the times they are a changin'. Despite an impressive turnaround of the economy, opinion polls indicate that the standing two party coalition government will lose its majority and a center-left coalition of at least four parties seems like the likeliest outcome. A three party center-right coalition of the government parties along with newcomer Viðreisn could also be possible.

Next step in removal of capital controls implemented

On October 21 the first of two steps introduced on August 16, 2016 towards removal of capital controls was implemented. In this step, outward foreign direct investment and investment in financial instruments issued in foreign currency was authorized up to a certain amount, amongst other things. The Icelandic króna has appreciated considerably in the last few months, while the Central Bank of Iceland has continued to intervene in the FX market by selling Icelandic krónur. Even with capital outflows now allowed to a certain extent, the króna has kept appreciating and the CBI continued its FX interventions.

Analysts

Elvar Ingi Möller

+354-444-6981

elvar.moller@arionbanki.is

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

Stefán Broddi Guðjónsson

+354-444-6959

stefan.gudjonsson@arionbanki.is

Þorsteinn Andri Haraldsson

+354-444-6988

thorsteinn.haraldsson@arionbanki.is

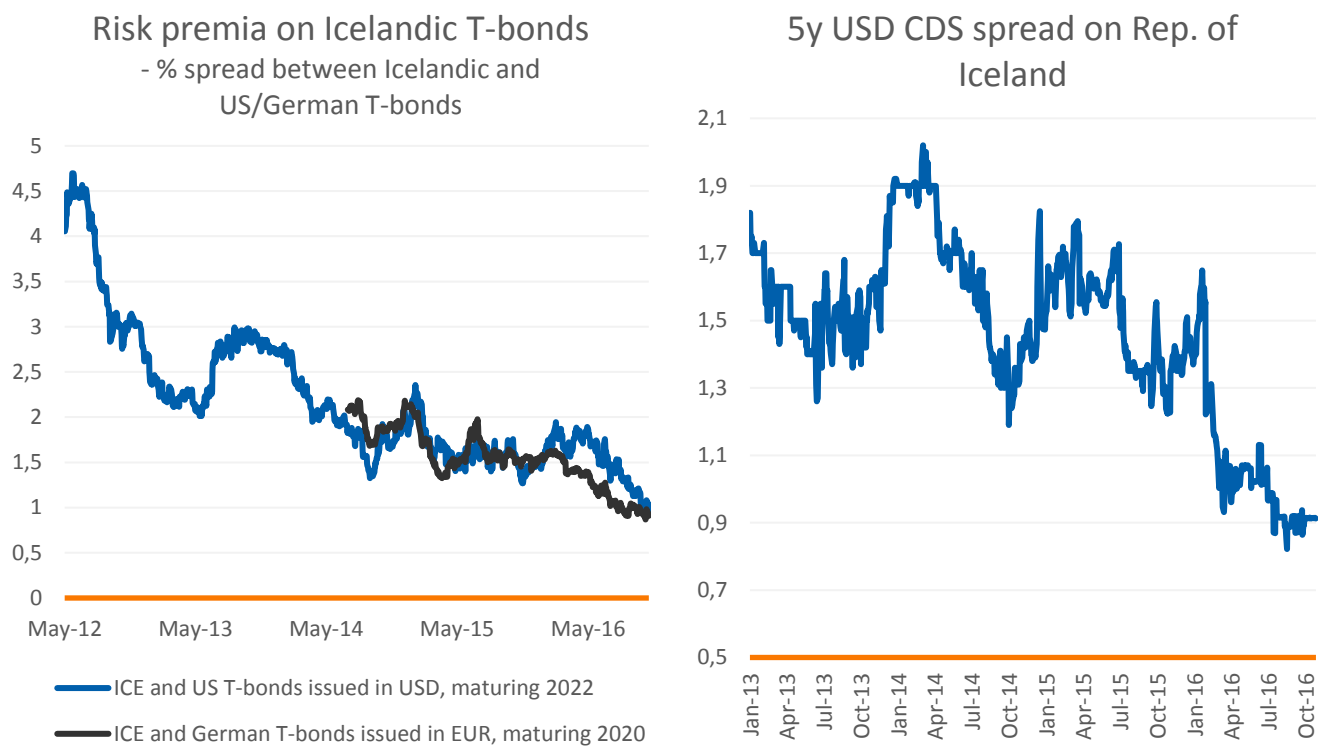
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The times they are a changin' – parliamentary elections 2016

In 1964 Bob Dylan sang that *the times they are a changin'*. The newly crowned Nobel laureate's words seem fitting now as parliamentary elections will be held in Iceland this coming Saturday and polls show the coalition government losing its majority. It remains to be seen whether the new government will be on the right or left wing of the political spectrum, but everything points towards a coalition of at least three parties.

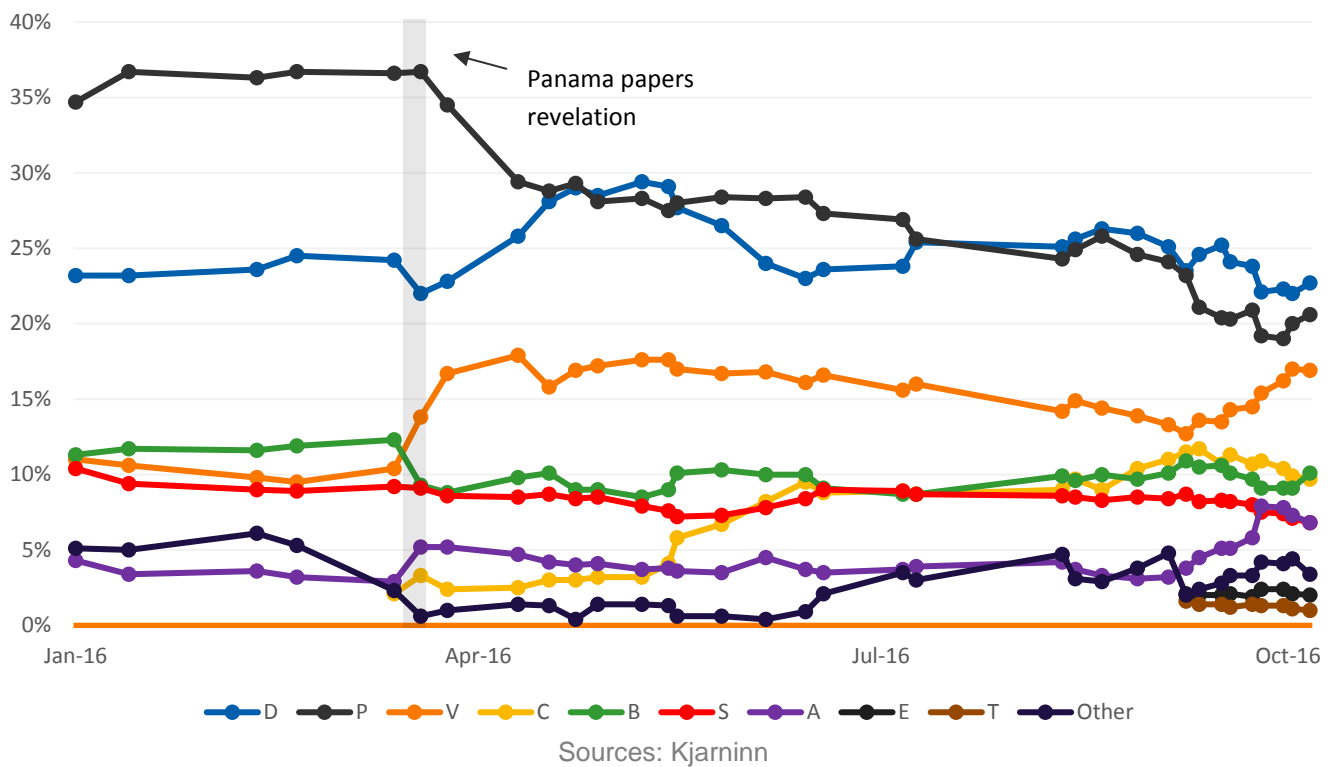
The incumbent center-right coalition government of the Independence Party (D) and the Progressive party (B) came to power in 2013 after the collapse of the former coalition government of Social Democrats (S) and Left-Greens (VG). Now, three years later considerable progress has been made in recovering from the economic collapse of 2008. Major steps have been taken towards removal of capital controls, the economy is flourishing, inflation has remained below the set 2.5% target rate of the Central Bank since February 2014 despite considerable wage hikes, and government debt has been reduced substantially. The government is projected to turn in a 408.8 billion surplus in 2016 (with stability contributions), compared to an accumulated deficit of 387.8 bn. ISK from 2009-2013. Moreover, risk premia on Icelandic Treasury bonds denominated in EUR and USD and five year USD CDS spreads have come down markedly in recent years.



Sources: Bloomberg, Arion Research

However, the elected period of four years was cut short following scandals related to three members of the government, revealed in the Panama papers. Not only did the revelation have an immediate impact on the approval ratings of the government but also led to the ultimate resignation of Prime Minister Sigmundur Davíð Gunnlaugsson. Although the ratings of the government rebounded quickly, the emergence of the Pirate Party has excluded the standing government from regaining a majority in parliament. In the beginning of the year opinion polls measured the Pirate Party's (P) approval ratings at 36.7% although their ratings have come down substantially since then. The latest polls measure the Pirate Party at 20.6%, slightly behind the Independence Party.

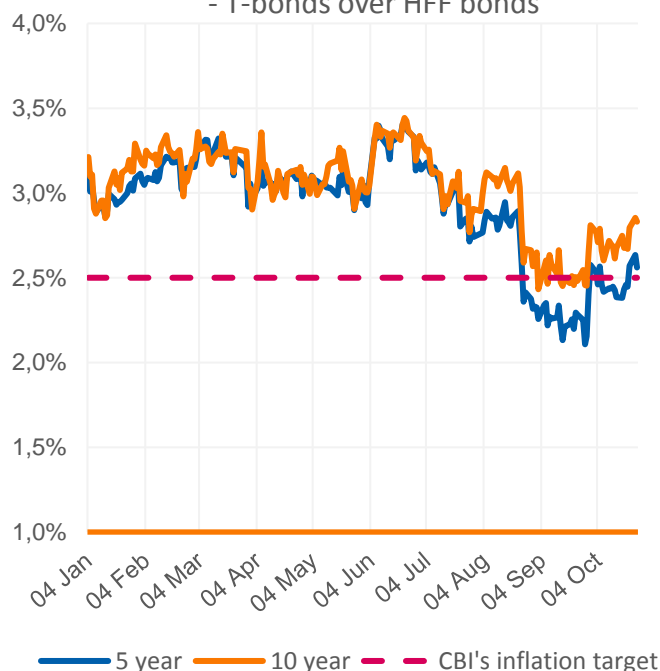
Approval ratings in 2016



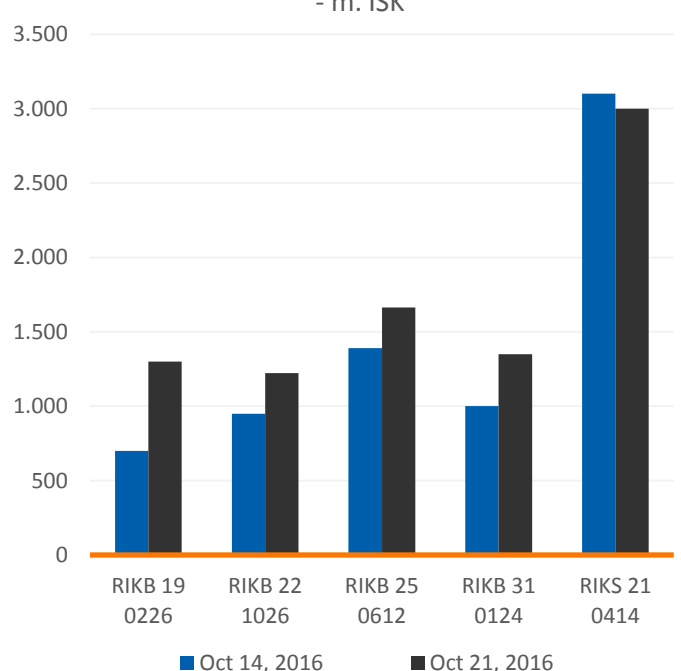
According to local media Kjarninn there is a 61% chance that the Pirate Party will spearhead the next coalition government of P, VG, A (Bright Future), and S. The newcomer Viðreisn (Revival (C)) might be needed to attain a majority. A coalition of the aforementioned parties would most likely be regarded to be on the left side of the political spectrum, but there are still plenty of questions where to base the Pirates on the spectrum. Moreover, C is a center-right party split from the Independence party, which further complicates matters. The other possible solution would be a center-right coalition of D, B and C.

Inflation premium in recent months has been close to the set target rate of the Central Bank, but has been trending upwards in recent weeks, just as yields on the USD and EUR denominated bonds covered above. Yields on nominal T-bonds have grown by over 30 basis points in the past month while yields on indexed (HFF) bonds have changed little to nothing.

5 and 10 year inflation premium - T-bonds over HFF bonds



Outstanding Security Lending - m. ISK



Sources: Kodiak, Government Debt Management, Arion Research

It is possible that the upcoming elections might be causing these growing inflation expectations, as campaign promises of the left-wing coalition indicate increased government spending which might in turn fuel demand in the near future. Increased demand for indexed bonds can also be observed when looking at the outstanding

amount in securities lending, which could indicate increased short positions in nominal securities. It remains to be seen whether or not markets calm down again after the elections, but that most likely depends on the ensuing coalition discussions.

Next step in removal of capital controls implemented

On August 16, the government introduced the [next major step towards liberalization of the capital controls](#). The bill, prepared in accordance with recommendation from the IMF, was presented before parliament on August 17 and eventually passed into law on October 11. The first step of the next two towards lifting the capital controls (listed below) came into effect on October 21.

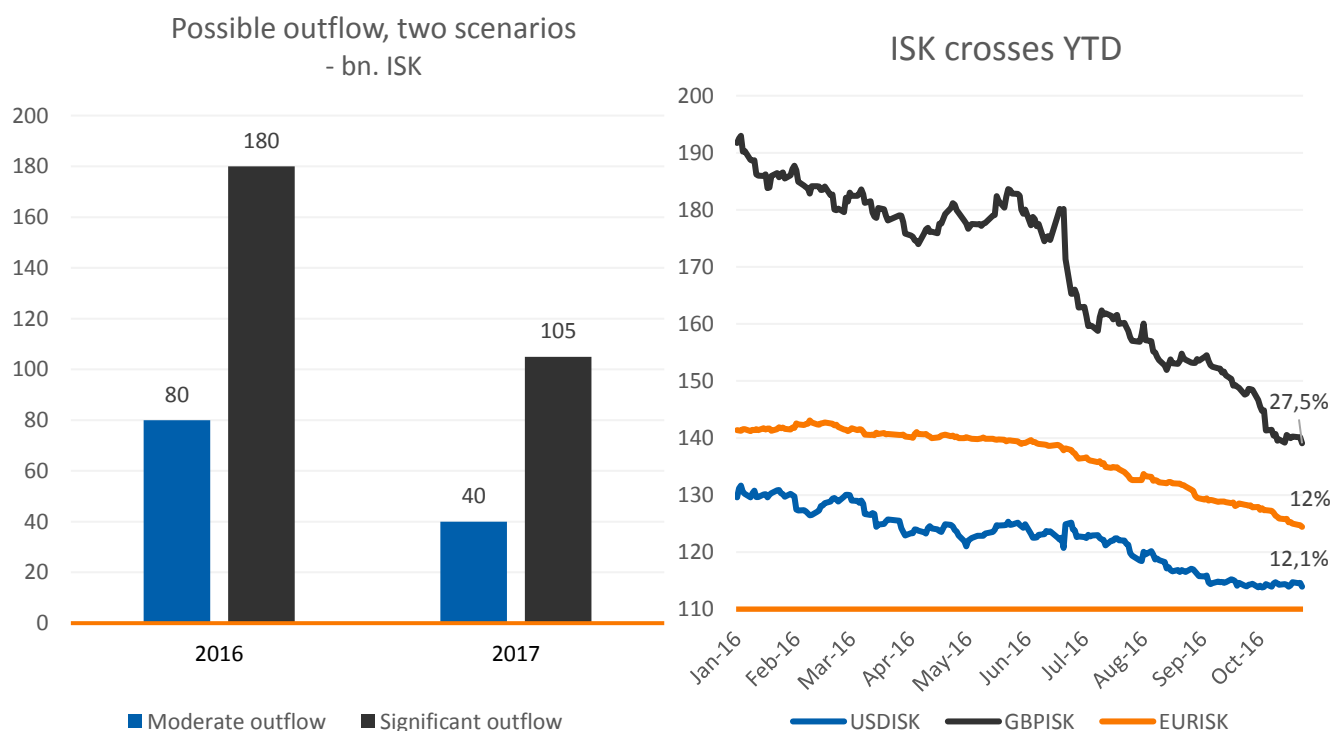
Step 1 (October 21, 2016)

- Outward FDI 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.

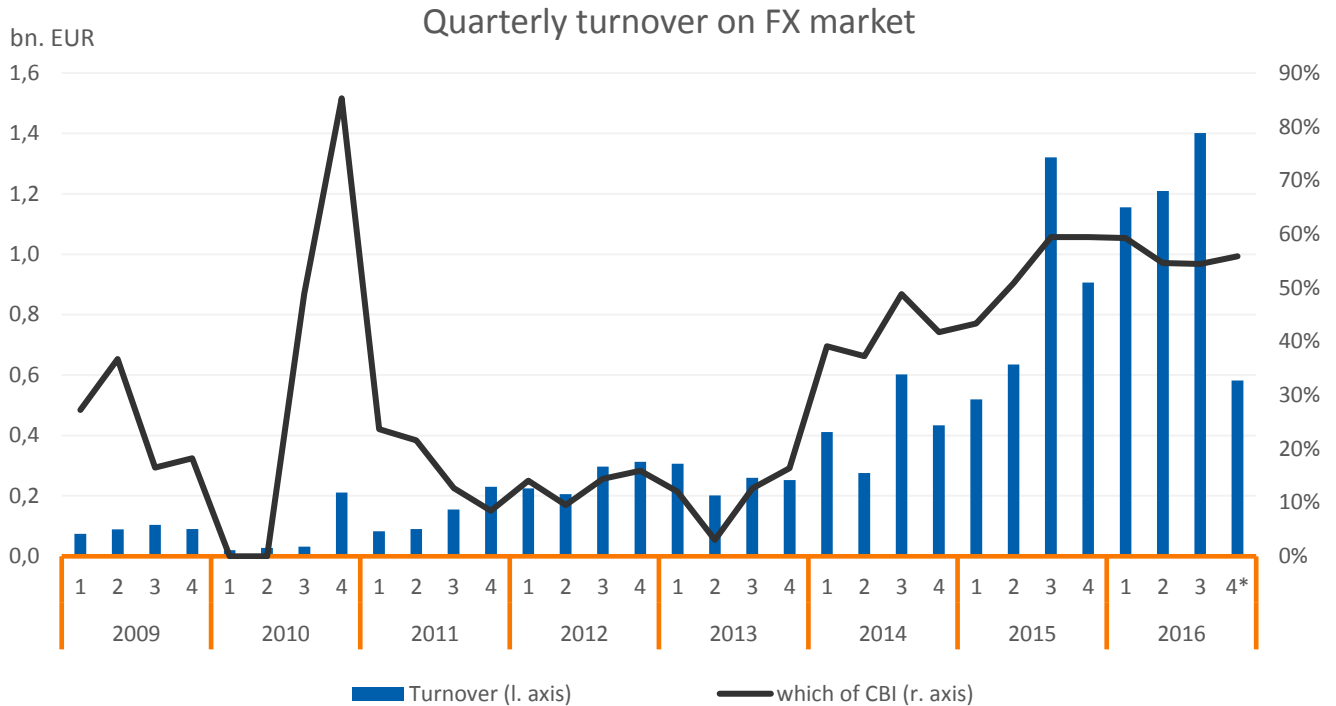
Step 2 (January 1, 2017)

- 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.

Alongside the presentation of the bill on August 16, the Central Bank of Iceland (CBI) presented two scenarios of capital outflow in each of the two steps listed above, assuming moderate and significant outflows. Considering that the Icelandic króna has strengthened considerably YTD against dollar, euro and pound, or 12.1%, 12%, and 27.5% respectively, one could have thought that the strengthening phase of the króna would subside with the implementation of step one. However, that has yet to materialize as the króna has appreciated even further against all three currencies since October 21.

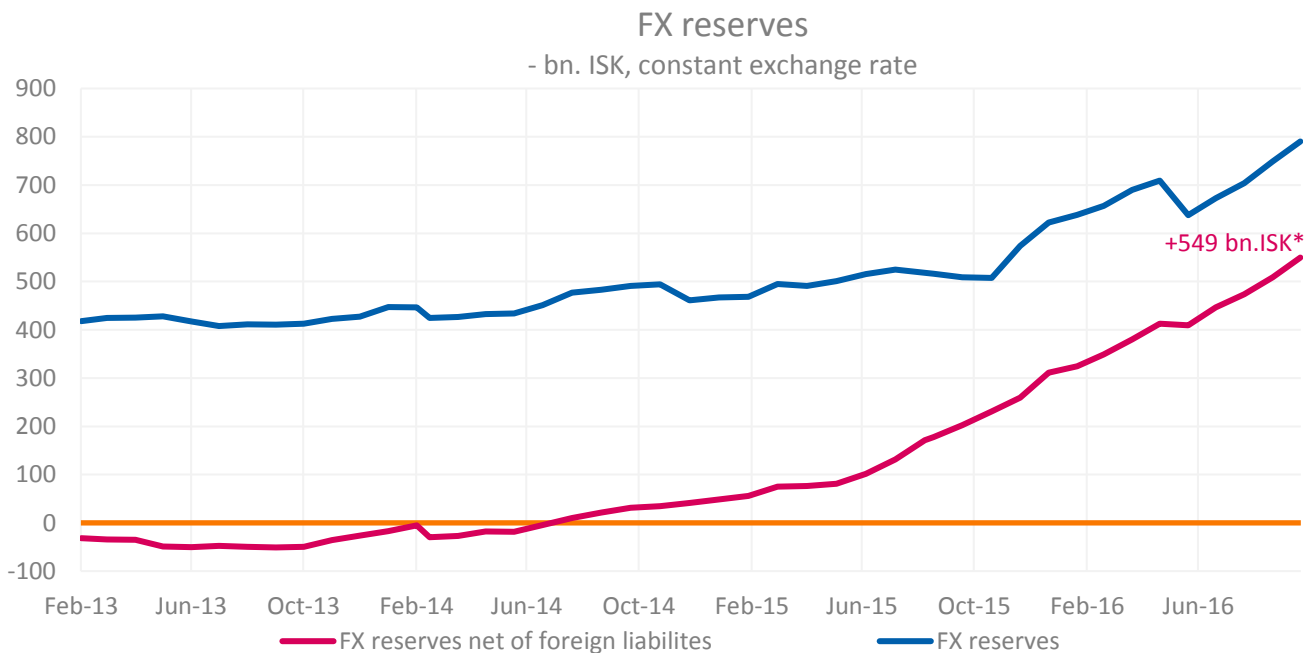


The CBI has also been increasing its intervention on the FX market in recent quarters in order to prevent the króna from over appreciating. For the past six quarters the CBI has been responsible for 56.4% of turnover on the FX market.



Sources: Central Bank of Iceland, Arion Research

At the same time the CBI is at a historical height of FX interventions, the FX reserves of the bank keep building up. In October alone net currency interventions by the have CBI amounted to 41 bn. ISK (as of October 25) and net FX reserves roughly stand at 549 bn. ISK. The CBI's next interest rate decision will be announced on November 16 and it will be interesting to see whether or not the Bank addresses its FX intervention strategy, like it hinted at in its last decision.



Sources: Central Bank of Iceland, Arion Research *October estimates