ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | June 2015

Finally, a map for the road ahead

On June 8 the Icelandic government announced its plan to lift capital controls. The plan is threefold; the failed banks‘ estates will need to fulfil certain stability conditions, either by making a voluntary contribution by year-end or paying a 39% tax on all assets, offshore ISK holders will be offered to exit in the fall via a product-mix auction held by the Central Bank and ultimately controls will be lifted on the domestic market, when conditions allow.

The CBI hikes rates by 50 basis points

The CBI‘s monetary policy committee decided to hike interest rates by 50 basis points in June, citing high nominal wage increases as the main culprit. The MPC also voiced concerns over public finances, given recently announced measures taken by the government in order to facilitate wage negotiations. The measures entail looser fiscal policy.

Capital account liberalization – what does it mean for the Treasury and the CBI?

The Treasury and the Central Bank will receive considerable amounts of krónur (as well as foreign currency) if the failed banks‘ estates proposals for stability contributions are accepted as submitted. The total amount could end up anywhere in the range of ISK 400-600bn. The proceeds will supposedly be used to pay up some of the government‘s debt. As sensible as that sounds, the execution could pose problems as far as price stability is concerned.

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Finally, a map for the road ahead

On June 8 the Icelandic government announced its plan to remove capital controls. According to a statement issued by the Ministry of Finance and Economic Affairs the solution involves a three-pronged plan:

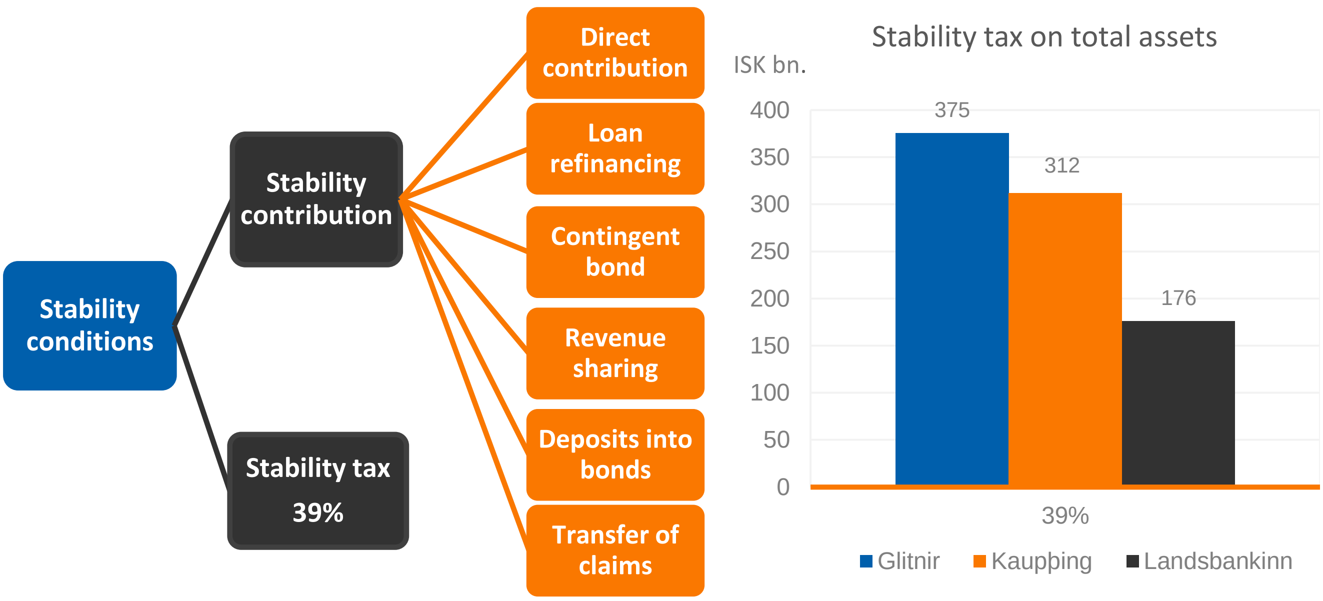
1. **The failed banks' estates** will be subject to certain „stability conditions". They can either choose to fulfil them voluntarily by year-end by making various contributions, or they will be forced to pay a so-called „stability tax".
2. **Foreign holders of ISK** denominated deposits or government bonds will be offered a product-mix auction in the fall.
3. Subsequently, controls will gradually be lifted on the **domestic economy**.

The balance of payments problem involves assets totalling 1,200bn:

- ISK 500bn in the failed banks' estates
- The estates' foreign denominated claims against domestic residents, ISK 400bn
- Offshore ISK held by non-residents in the amount of ISK 300bn

The failed banks' estates (ISK 900bn)

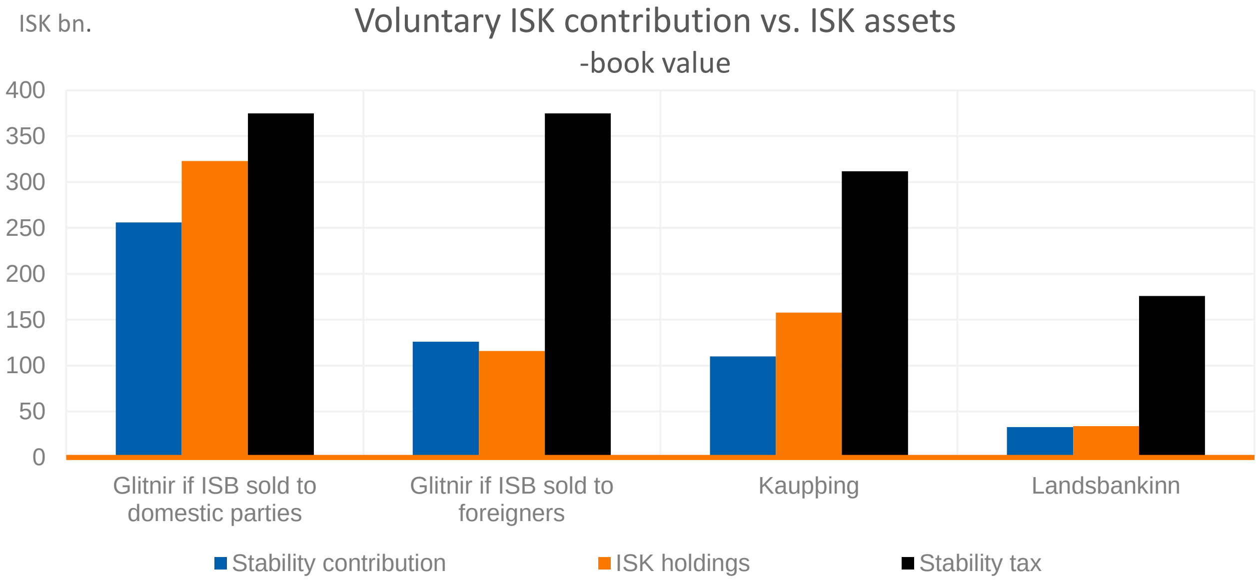
The failed banks' estates have been in discussions with the government regarding conditions which must be fulfilled in order to maintain stability in the Icelandic economy. The estates will have two options; sign composition agreements that fulfil the six stability contributions by year-end, or pay a stability tax of 39% on all assets. Each and every condition must be fulfilled in order to avoid the hefty tax. According to the estates' financial statements as of year-end 2014 the total amount collected from the tax would be around ISK 850bn, or (more likely) 682bn when accounting for allowable deductions.



Sources: The Ministry of Finance and Economic Affairs, financial statements of Glitnir, Kaupthing and Landsbankinn 2014, Arion Research

It seems quite likely that the estates will be able to avoid the tax by making stability contributions fulfilling each of the conditions listed above. Representatives of a large share of the creditors of each estate have already put forth proposals for stability contributions which will most likely be accepted by the authorities (see the proposals of each of the estates here: Glitnir, Kaupthing, LBI).

Although our estimates for the stability contribution totals for each estate are quite rough it looks like there is a strong incentive for the estates to fulfil the conditions instead of paying the tax. The ISK assets are approximately what the stability contribution amounts seem to be targeted towards when you look at the total proposed contribution for each estate in relation to its ISK holdings. Although the final amount of the stability contribution remains uncertain, so is the market value of the estates' ISK assets. In fact, the contribution proposals are structured in such a way that the risks related to Iceland's external position are reduced in the event of large value changes in the estates' portfolios.



Sources: Financial statements of Glitnir, Kaupthing and Landsbankinn (year-end 2014), Arion Research

Offshore krónur (ISK 300bn)

The so-called „old overhang", or offshore ISK, totals approximately ISK 300bn and is almost entirely made up of deposits and Icelandic goverment bonds. These foreign investors have been locked within capital controls for the past seven years, although they have been allowed to exit via multiple currency auctions held by the Central Bank since 2011. In the fall, these investors will be offered to participate in another auction, a so-called product-mix auction. Then, they will be able to choose between exiting the economy by purchasing foreign currency (at a significant premium), or swapping their current bond holdings for a long-term investment in a 20-year government bond (in either ISK or EUR). Should offshore ISK holders choose neither option they will be diverted into non-interest bearing accounts, blocked for „a long time". More information will become available regarding these actions in the fall when we expect additional bills to be presented to Parliament.

We wonder whether these actions are perhaps unnecessarily hostile. The authorities claim that if these investors are indeed here for the long haul they can prove it by swapping their current holdings for long-term bonds. However, the original purchaser of the bonds will be obligated to pay an exit levy for the first seven years and the bonds will in all likelihood be at much less favorable terms than the Icelandic government bonds these investors are currently holding. Should they choose to hold their current bonds, coupon and principal payments will be deposited into blocked accounts, making holding them a less desirable option than otherwise. In that case they will most likely only be offered to invest in the instruments on the CBI's exemption list, currently only T-bills.

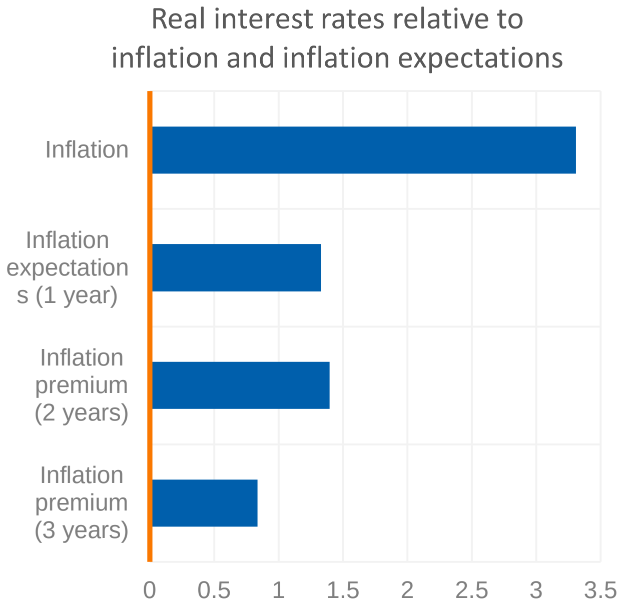
Offshore ISK holders have already been invested in Iceland for seven years and those who remain have chosen to do so by not participating in the CBI's multiple auctions. Therefore, we believe that a more amicable solution could have been found for this particular group of investors than the one that has been presented by the government. Any actions construed as unnecessarily harsh could raise the risk premium required by foreign investors and serve as a deterrent for potential future investors.

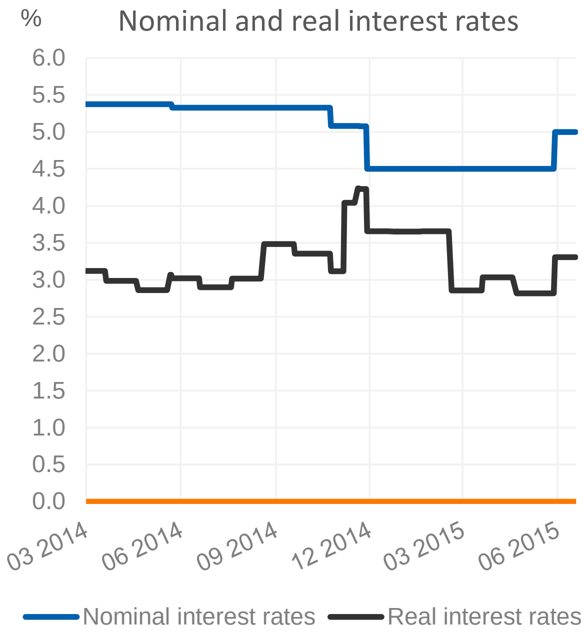
The domestic economy

Following the resolution of the issues described above, Icelanders will gradually be freed from the constraints of capital controls. Individuals will receive further authorizations and restrictions will be nearly completely removed, except for very large flows of capital. Pension funds will be allowed to invest abroad for (at least) ISK 10bn per year, which is approximately 25% of their net inflows. This will allow them to maintain the current proportion of foreign assets in their portfolios. If conditions allow, the limit will be raised. Domestic businesses will also be allowed to invest directly abroad.

Overall, Arion Research believes there is good reason to be optimistic about the plan as a whole, although some components, specifically the treatment of offshore ISK, have certainly raised eyebrows. The plan seems structured so that any side-effects on the exchange rate or the real economy will be minimized, but of course the goal of complete certainty is an unattainable one. At some point the cost to the domestic economy of maintaining capital controls becomes higher than the cost of the uncertainty related to lifting them. We believe we are already well beyond that point and therefore welcome the government's plan.

On June 10 the Central Bank of Iceland announced a 50 basis point rate hike. Even though the decision was in line with analyst expectations, the Bank‘s forward guidance was perhaps clearer than anticipated. The statement concludes: „it seems apparent that a sizeable rate increase will be necessary in August, followed by further rate hikes in the coming term.“ This unequivocal message most likely explains the 15-20 bp increase in bond market yields following the announcement.





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

From the MPC‘s May decision, several major developments have taken place:

- Wage negotiations have been signed, which entail wage increases well beyond what the Central Bank believes is consistent with its inflation target
- The government has announced measures to facilitate wage negotiations, which will lead to looser fiscal policy
- The government has announced a comprehensive plan to lift capital controls

As we expected, wage increases and the high growth in domestic demand were the main factors influencing the committee‘s decision and message this time. In order to prevent rate hikes in the committee‘s coming meetings the historical relationship between wage increases and prices in Iceland would simply have to break down. Barring such a development, we will most definitely be seeing further rate hikes in the MPC‘s upcoming meetings in August and September.

Már Guðmundsson, the Central Bank governor, said that the Bank would keep purchasing foreign currency in the interbank market, bolstering its reserves in advance of liberalizing capital flows. High nominal wage increases and higher inflation without the nominal weakening of the króna will result in a higher real exchange rate, which could lead to a smaller current account surplus or even a deficit. That would make matters more difficult for the Central Bank as far as accumulating reserves, in addition to damaging Iceland‘s competitiveness.

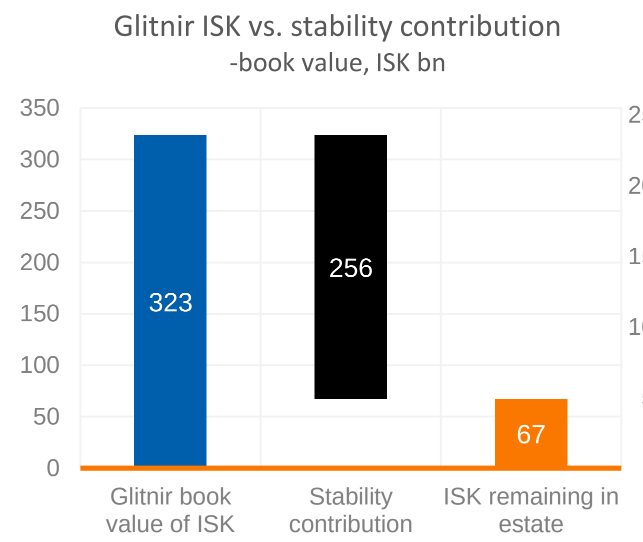
Public finances a cause for concern

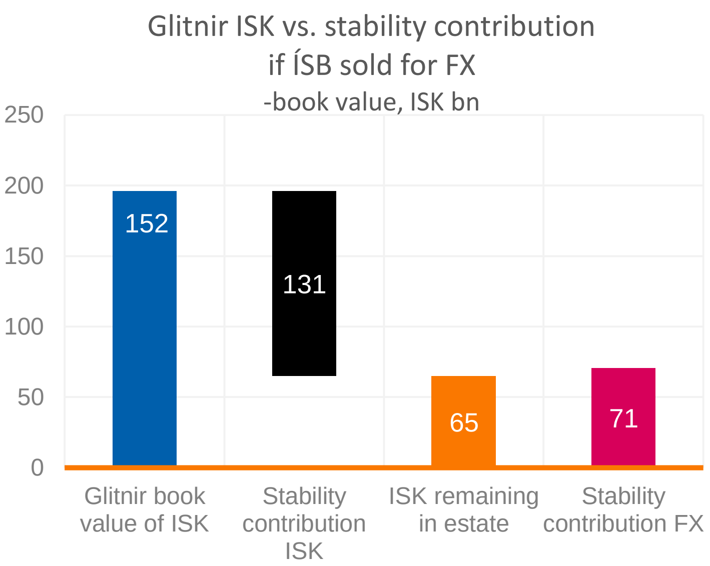
The MPC‘s statement indicated growing concerns over public finances. The government recently announced measures intended to facilitate the signing of wage agreements, the reasoning being that without such measures we would likely face prolonged strikes or even higher wages. These measures will in all likelihood result in reduced revenue for the government as well as increased expenditures on housing, for instance. It‘s important that the government shows restraint in next year‘s budget in order to prevent expansionary effects at the same time as the output gap is closing in the economy. It will be tempting to use the proceeds from the lifting of capital controls for increased expenditures or new investments, but fiscal and monetary policy must coincide this time around. The government therefore needs to use the proceeds responsibly, specifically to pay up debt, return a fiscal surplus and reduce money in circulation.

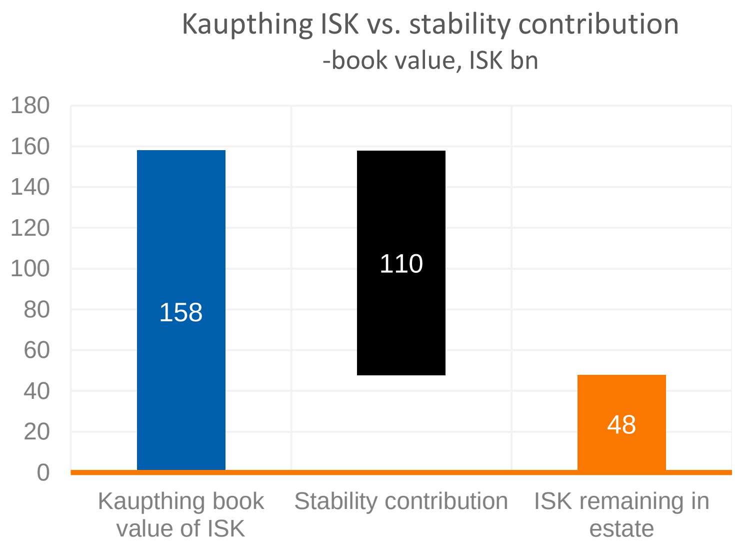
Capital account liberalization – what does it mean for the Treasury and CBI?

In all likelihood the Treasury and the Central Bank of Iceland will receive sizeable sums of krónur in relation to the lifting of capital controls. Should the estates be forced to pay the stability tax the amounts could be in the range of ISK 682-850bn. If, however, the estates‘ voluntary contributions are accepted the amounts are more likely to be somewhere in the ISK 400-600bn range, depending on whether the current proposals will be accepted as well as the value changes of the assets that are being handed over.

When looking at book value, Gitnir‘s contribution in Icelandic krónur could range anywhere from 126-256bn, depending on whether Íslandsbanki will be sold for FX or not (assuming P/B=1 for Íslandsbanki). Kaupthing‘s contribution will be closer to 110bn (assuming P/B=1 for Arion Bank). It‘s not unlikely that the value of some of the claims handed over to the authorities will end up being somewhat higher than book value and it is also quite possible that the banks will be sold for P/B>1, in which case the Treasury would receive a higher amount than book value, although a larger sum of ISK would be left in the estates as well in that case.





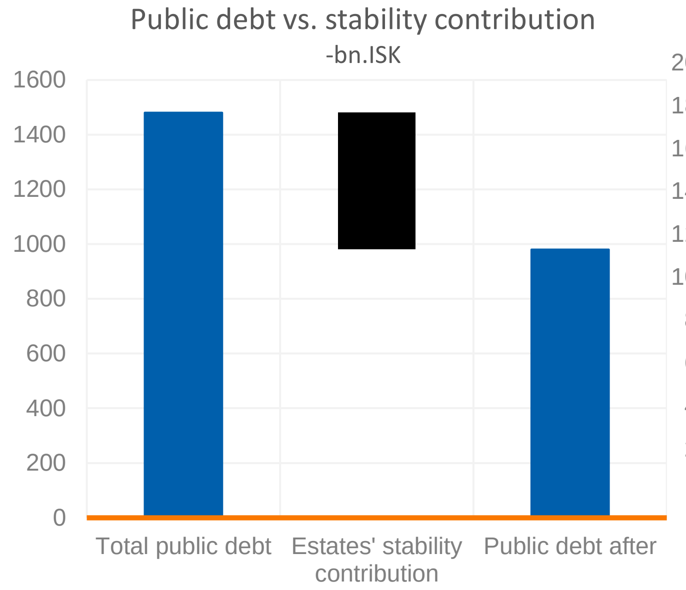


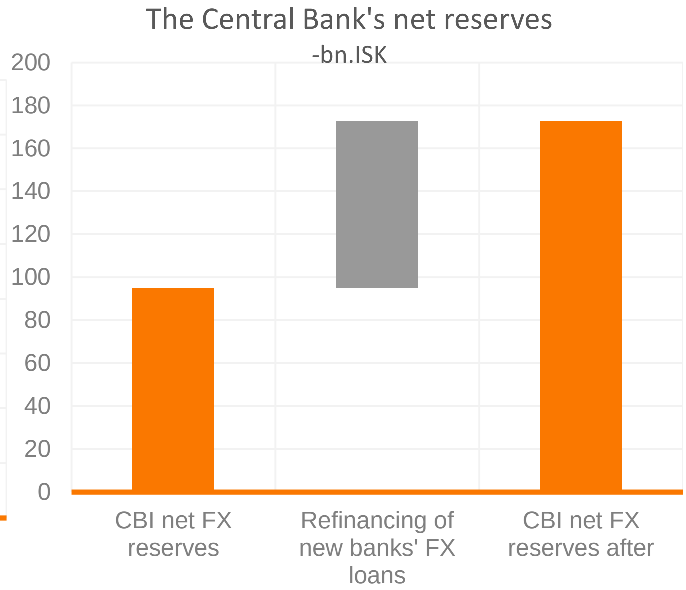
Sources: Glitnir and Kaupthing financial statements, estates‘ stability contribution proposals, Arion Research

It seems likely that the route of stability contributions will be chosen over the tax. Certainly the authorities see value in reducing the risk of extensive and extended litigation from the creditors of the estates, a real possibility in the event of the tax, but more unlikely if a voluntary agreement is reached.

Concerns have been raised regarding how the proceeds will be used. The stability tax bill indeed suggests that the entire amount collected will be used for debt repayment. However, there are some red flags nonetheless. Firstly, if the tax does not take effect and the estates end up making stability contributions instead of paying the tax there is nothing legally binding the government to use the proceeds to pay up debt. Even the law regarding the stability tax is not crystal clear on the matter of the use of the proceeds – it only states that economic stability must not be jeopardized and that the Finance Ministry must confer with the Central Bank regarding the use of the funds - a little on the vague side for our taste. Secondly, even if the authorities use every last króna to deleverage, poorly chosen or poorly timed debt repayments could potentially fuel inflation.

Of the total amount collected we can assume that ISK 40bn will be used to plug the hole in public finances over the next two years due to lost revenue from the bank tax, a sum already earmarked for the already implemented debt relief program of the government. Additionally, we expect the Treasury‘s debt to the Central Bank in the amount of ISK 145bn will be paid up. That could still potentially leave 200-400bn parked in a special deposit account at the Central Bank with a somewhat unclear purpose. As elections draw near it could be tempting to make promises about more exciting use of that cash than paying up debt.





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

Another side-effect of the stability contributions would be larger currency reserves for the Central Bank. The estates have suggested refinancing FX loans previously made to the new banks by the Treasury and the CBI. This would free up reserves and secure long-term financing (7-10 years) for the banks in foreign currency for approximately ISK 77bn. That, coupled with continuing inflow of currency from the booming tourism sector, should allow the Central Bank to build up strong reserves over the coming quarters - a much needed development in the capital account liberalization process.