ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | January 2014

Robust growth in Q3 takes forecasters by surprise

StatIce released national accounts for the third quarter of 2013 in December. The numbers were stronger than expected, with GDP rising 4.9% from the previous year on strong exports and weak imports. Growth for the first three quarters was measured at 3.1%, beating forecasters' expectations by a substantial margin.

ESÍ asset sale set to deflate stock of money, curb inflation

In December, ESÍ, a subsidiary of the Central Bank of Iceland, announced a sale of indexed bonds from its portfolio to the tune of 100 bn. ISK, evenly spread over the next five years. ESÍ is a holding company whose assets consist of collateral posted by financial institutions that defaulted on pre-crisis repurchase agreements with the CBI. As the bond sale will come to reduce money in circulation, it is tantamount to tapering. We expect rising indexed rates on tighter liquidity conditions, but dropping nominal rates on improved inflation outlook.

ISK less vulnerable to depreciation pressures in 2014

The ISK has seen a hefty appreciation since late November (EURISK -4.6%; USDISK -4.9%). The CBI has used the chance to intervene heavily in the interbank market, thereby accumulating unleveraged reserves. A balance of payments analysis suggests that depreciation pressures will subside in 2014, making way for further CBI FX purchases. We predict a steady exchange rate in the near term, although risks from terms of trade deterioration, weaknesses in the fisheries and aluminium sectors and a potential rebound of imports remain.

Housing prices on the rise

Arion Research published a report on the Icelandic housing market in December. 2013 saw a continuing rebound in housing prices from post-crisis lows, with comparatively robust increases during the last months of the year. We project further rises still.

A million tourists in 2015?

Icelandic tourism had yet another record year in 2013, with more than 780,000 tourist arrivals; a 70% increase since 2010. We're projecting further growth, albeit at a slightly slower rate. If our forecast proves accurate, tourist arrivals will break one million in 2015.

Non-residents' ISK assets down by 67 bn. in 2013

Non-residents' liquid ISK assets, a key part of the overhang necessitating capital controls in Iceland, dropped by 67 bn. in 2013, mostly due to currency auctions designed to stem outflow pressures. At the current rate, the entire stock will have been wound down by year end 2018.

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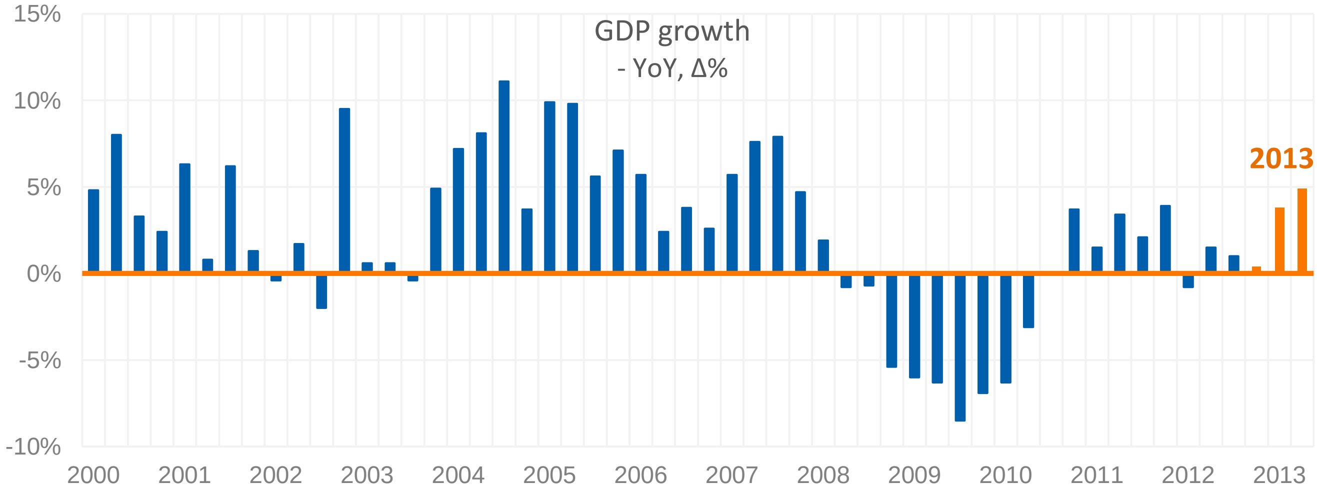
Robust growth in Q3 takes forecasters by surprise

StatIce released national accounts for the third quarter of 2013 in December. The economy grew by 3.1% during the first three quarters of 2013, compared with 2012.

Components of GDP	*Volume change from previous year, %*	
	Q3	Q1-Q3
Private final consumption	2.4	1.3
Government final consumption	0.9	1.4
Gross fixed capital formation	5.3	-7.1
Changes in inventories	-1.5	…
Gross domestic final expenditure	**0.6**	**-0.5**
Exports of goods and services	8.3	4.2
Imports of goods and services	1.6	-1.9
GDP	**4.9**	**3.1**

Source: StatIce

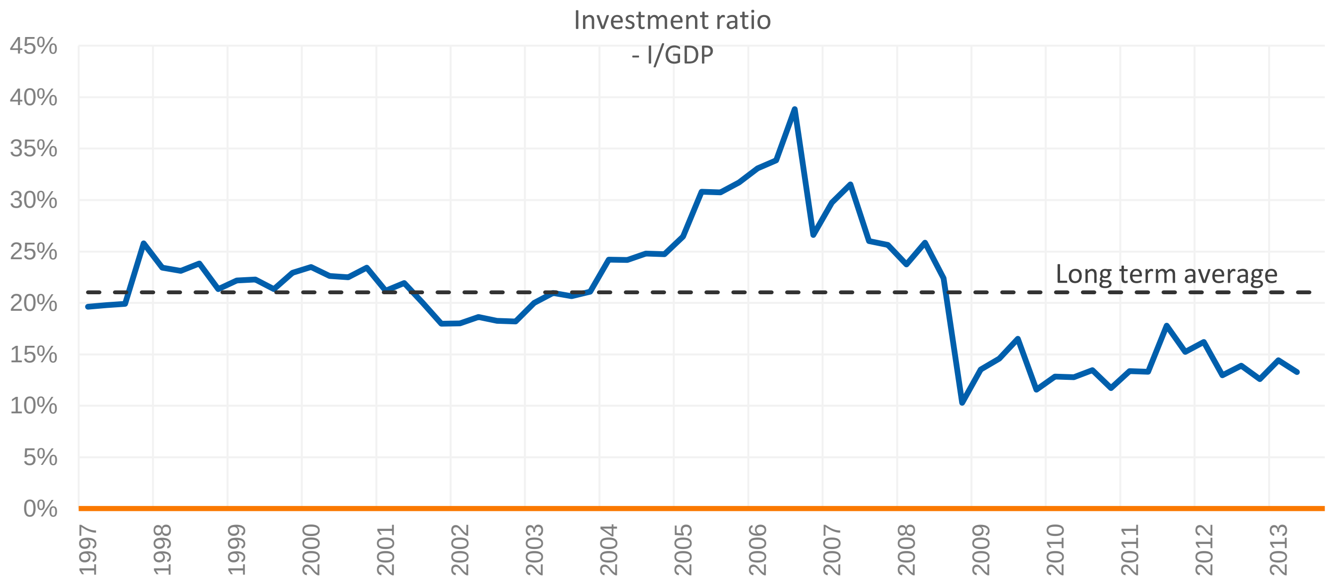
We were really pleasantly surprised when the numbers were published; our original forecast since last spring assumed 1.5% growth in 2013 after the slowdown witnessed in the second half of 2012. Even our updated forecast since last summer assumed 2.4% growth – so the growth so far is beating even our most recently revised expectations substantially.



Source: StatIce

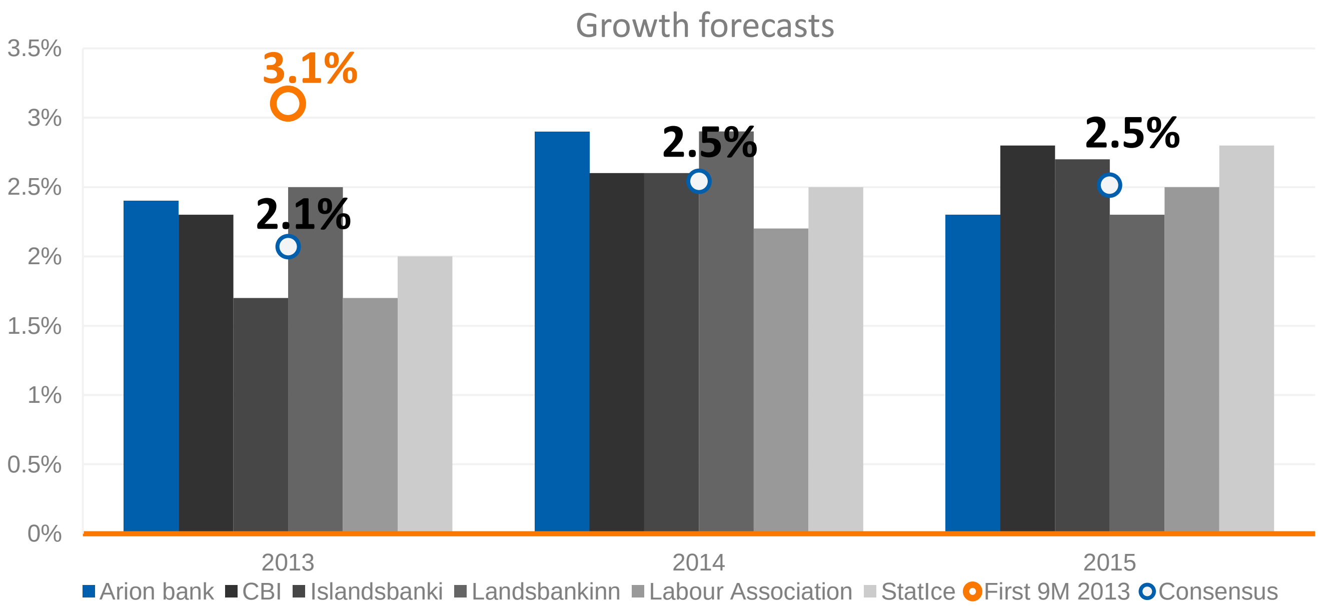
The growth is mainly driven by very strong exports and weak imports. We think this is a good sign; net exports tend to be a more sustainable growth driver than consumption.

We're still worried about investment, since it is still way below historical average. But the investment climate isn't all doom and gloom; even though investment dropped over the first three quarters, it's still dropping by less than we assumed and even seems to be picking up a bit in Q3 (note that the investment drop in 2013 is due to a large one off investment in ships/aeroplanes during the first half of 2012).



Source: StatIce

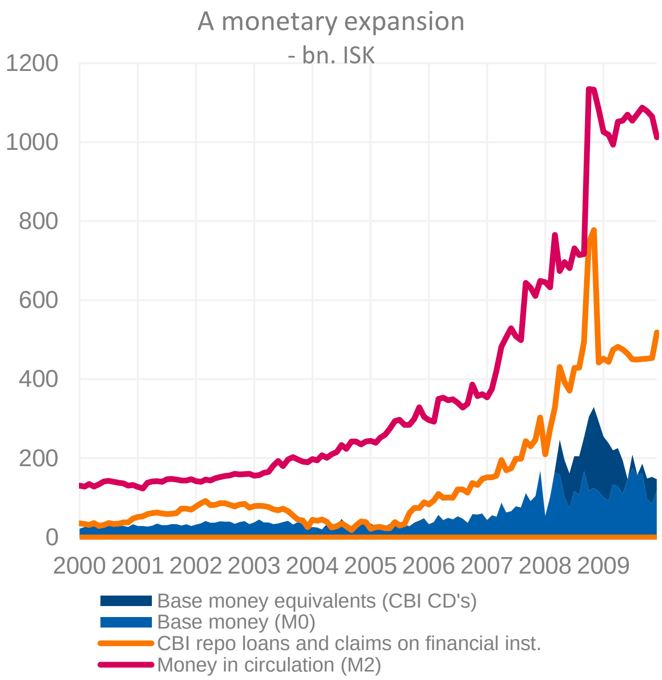
It appears we aren‘t the only ones taken by surprise by the numbers – a consensus forecast of 2013 puts overall annual growth at 2.1%. Unless we see a substantial slowdown in Q4, 2013 is going to beat all analysts‘ forecasts. Considering that high frequency indicators such as credit- and debit card turnover indicate continuing growth in both consumption and exports of services in Q4, a slowdown shouldn‘t be the most immediate concern.

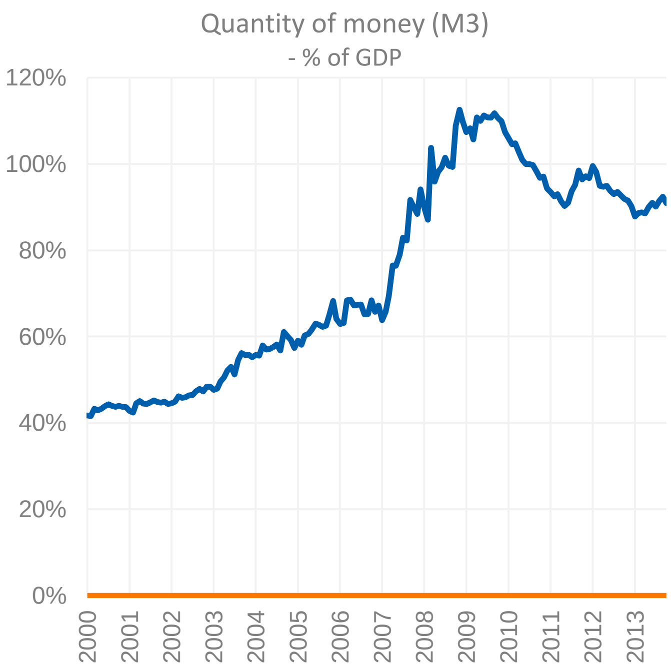


Source: Various forecasts, StatIce

ESÍ asset sale set to deflate stock of money, curb inflation

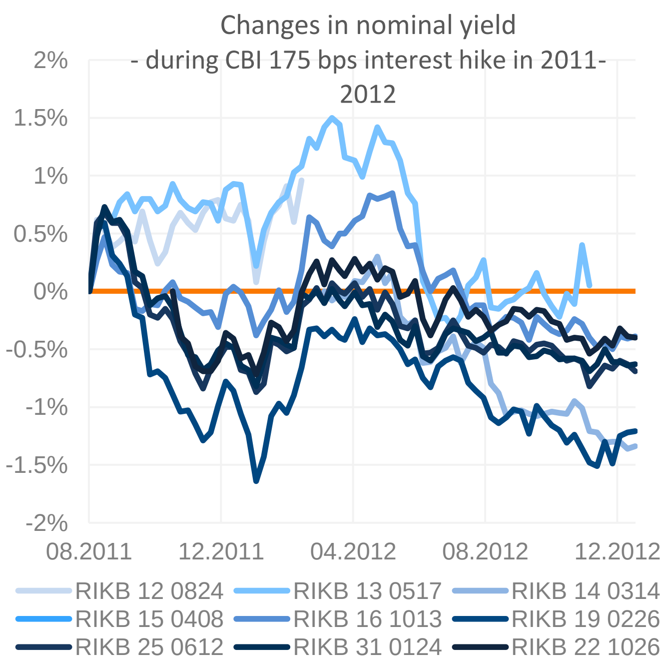
In the run up to the bank failures of 2008, the CBI entered into huge repurchase agreements with the financial system (i.e. provisioned loans against collateral). It thereby acted as a lender of last resort by pumping liquidity into the banks when credit became scarce, enabling a tremendous monetary expansion. The CBI accepted various bond issues as collateral, including unsecured bonds issued by the banks themselves. When the banks failed, they were unable to repay these loans to the Central Bank and much of the collateral turned out to be worthless.

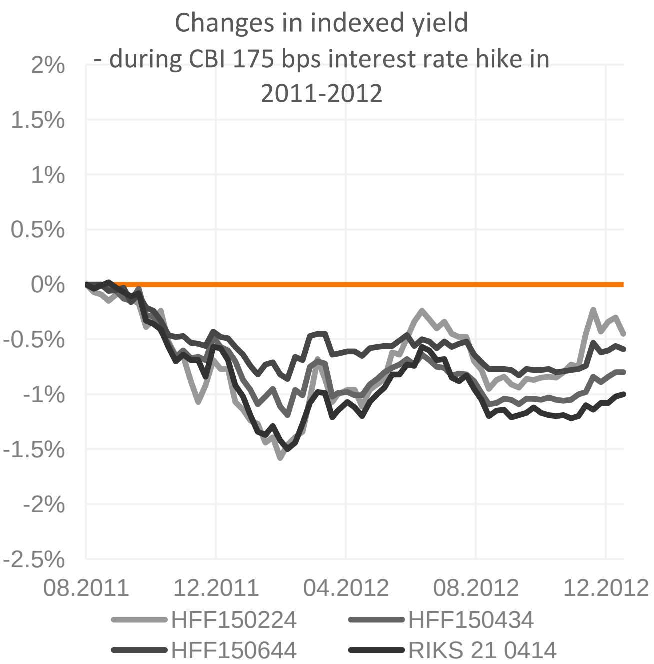




Source: CBI, Arion Research calculations

Some of the collateral, however, was covered by sound portfolios. The issues in question were placed in a holding company called ESÍ, to be sold off at a later date, thereby winding down some of the excess liquidity left in the financial system by the repurchase agreements (the same excess liquidity that‘s causing bond yields to drop despite rate hikes and the REIBOR to hug the floor of the interest rate corridor).



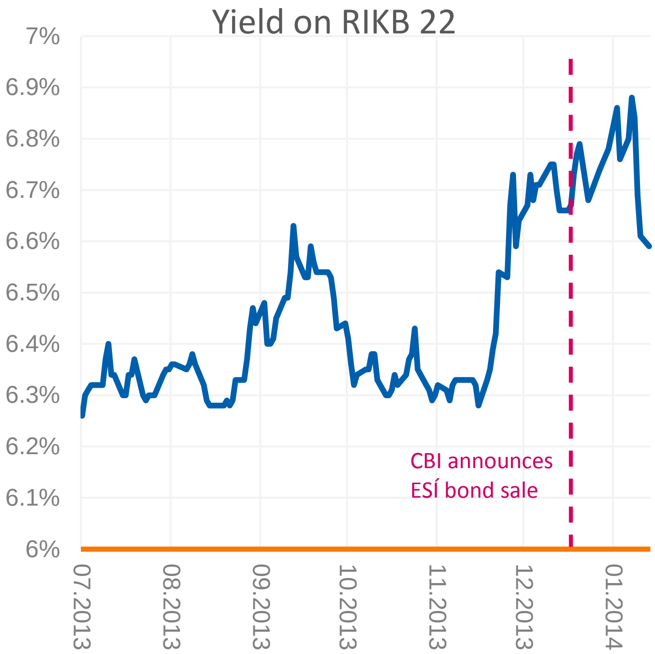


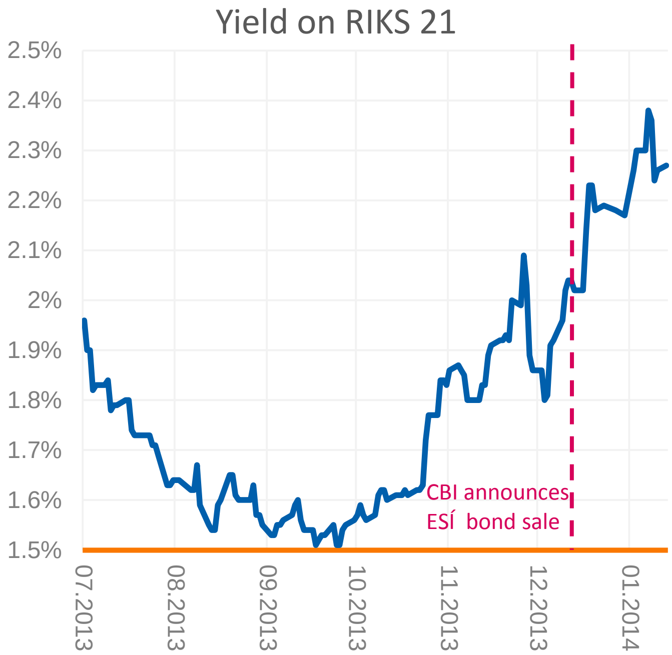
Source: CBI

So that‘s what‘s happening now – a de facto tapering. The CBI intends to vacuum up some of the liquidity that its pre-crisis lending against unsecure collateral left lying around in the financial system. Everyone knew it was going to happen at some point, so this shouldn‘t come as a total shock to anyone - but now the ‘when’s and ‘how’s are finally clear.

A covered bond issued by Kaupthing (now on the books of Arion) worth 100 bn., or a third of ESÍ‘s total assets, will be placed in an SPV of sorts. The SPV will then issue marketable bonds that the CBI will list on the NASDAQ OMX in equal sized chunks of 20 bn. over the period 2014-2018.

Yields on the bond market were already pricing the possibility of ESI starting to unwind in the coming years, which is why the announcement of the bond sale didn't lead to any huge changes in yield (it should also be considered that both the nominal and indexed curves had shifted substantially on jitters due to the government debt relief scheme announced in November). We‘ve seen a moderate and gradual shift upwards on HFF‘s and RIKS since the announcement, so the supply of indexed bonds via the ESI bond sale seems to be a bit greater (or maybe it's starting sooner?) than markets were expecting.





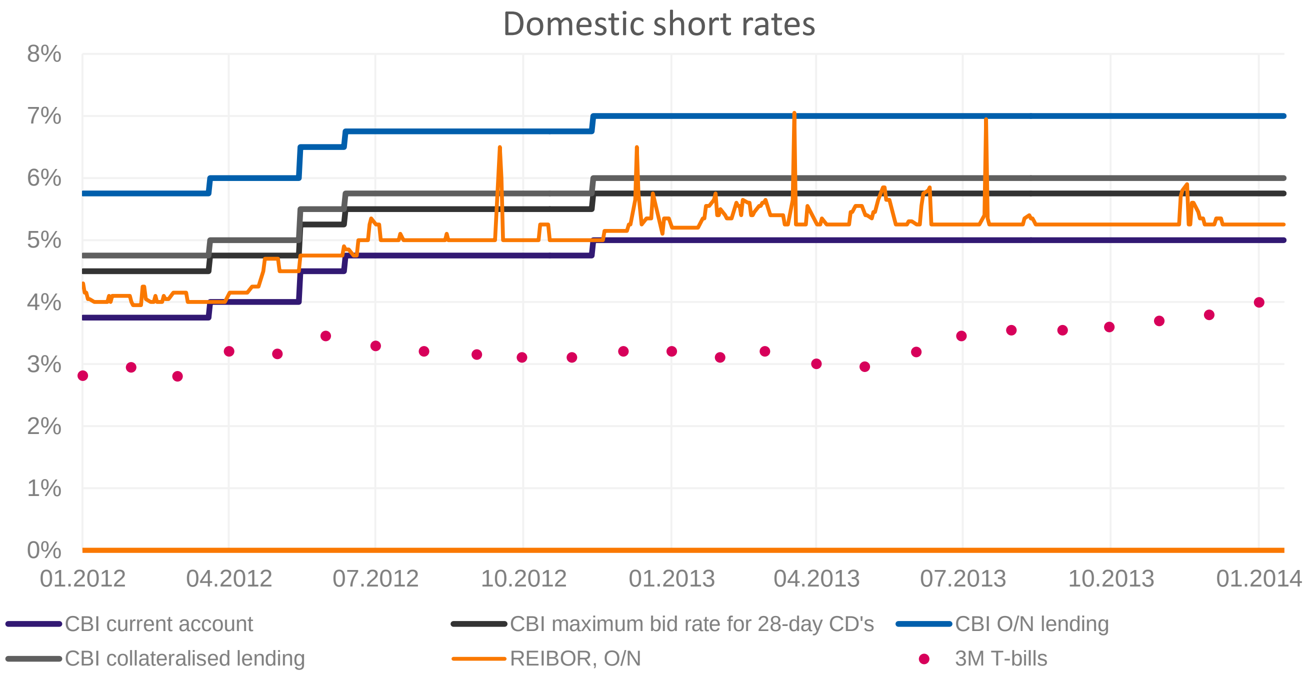
Source: Kodiak

The yield on RIKB‘s also went up temporarily, but it has been coming down over the last few days, so the inflation premium has been dropping. We think this trend makes sense. It‘s key to consider the monetary implications of the bond sale; it is effectively an open market operation to reduce the stock of money, so it is the equivalent of monetary tightening.

It just so happens that the profile of the bond sale offsets the profile of the household debt relief strategy exactly (household debt is expected to be written down by 20 bn. per year over the next four years), so it constitutes a perfect sterilisation of the relief program, thereby reducing greatly the need for direct interest rate hikes. Potential inflationary pressures stemming from the combination of a bloated money stock and debt relief will thereby be dampened somewhat by the asset sale, without the need for direct rate hikes. This should be good news for the nominal issues.

All in all, the strategy outlined by the CBI and ESÍ looks pretty good to us. It means the Bank is finally taking control of its own monetary policy by using more policy levers than just interest rates. It also means that the unsustainably large stock of money left in the financial system by the pre-crisis repurchase agreements will be wound down – and therefore reduce the danger of asset price bubbles building up.

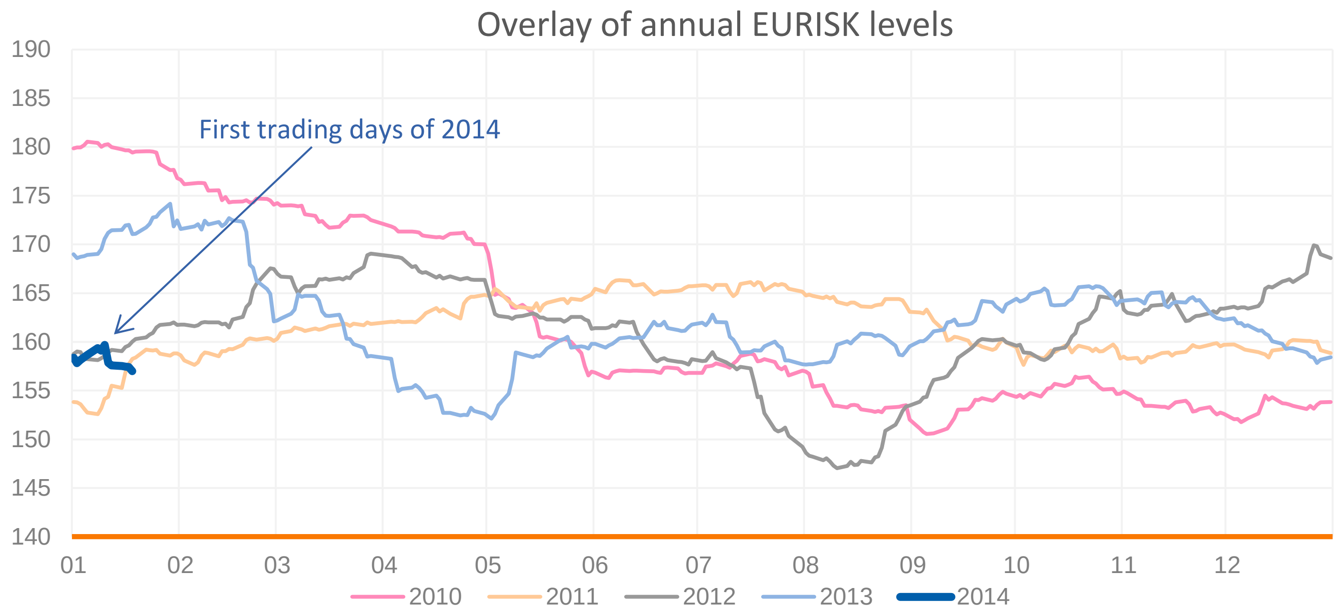
We‘re also less worried about any adverse effects of the government debt relief scheme because of the bond sale, since it should sterilise the scheme. And it will hopefully help to contain inflation without the CBI having to resort to rate hikes, although we expect the REIBOR to maybe drift closer to the centre of the interest rate corridor in the coming years.


Domestic short rates
8%
7%
6%
5%
4%
3%
2%
1%
0%
01.2012
04.2012
07.2012
10.2012
01.2013
04.2013
07.2013
10.2013
01.2014
CBI current account
CBI maximum bid rate for 28-day CD's
CBI O/N lending
CBI collateralised lending
REIBOR, O/N
3M T-bills

Source: CBI

ISK less vulnerable to depreciation pressures in 2014

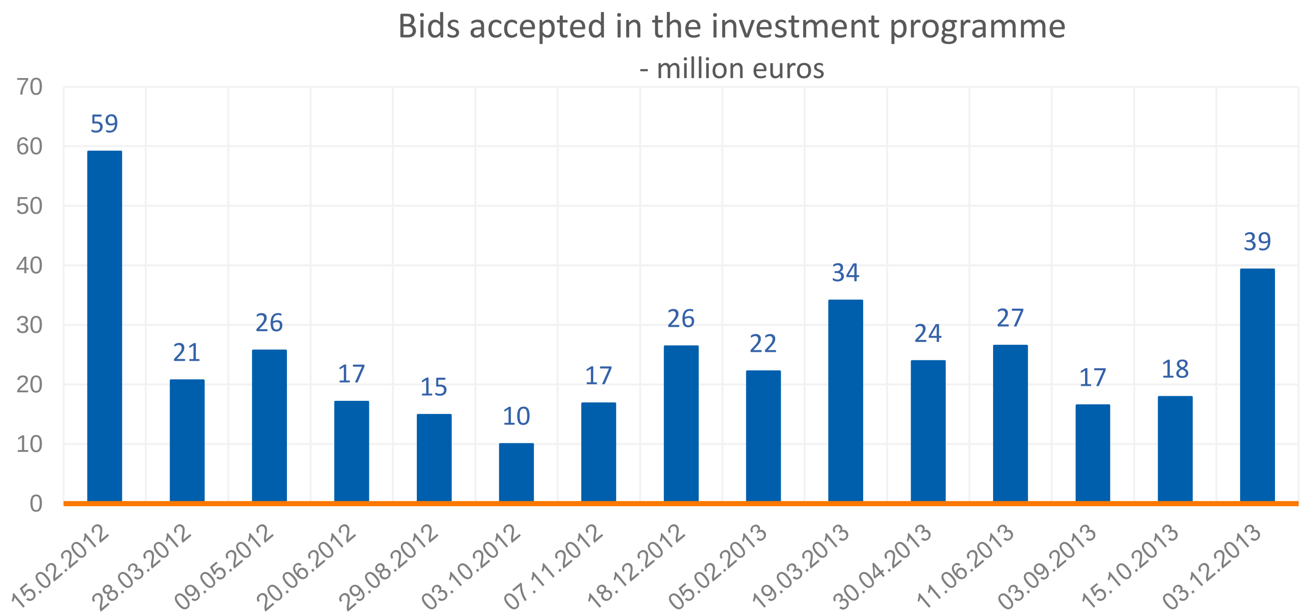
The ISK saw a sharp appreciation during the last month of 2013 that's been continuing during the first month of 2014. The EURISK cross is at a pretty low level at the moment, compared with recent post-crisis development.



Source: CBI

As the Icelandic economy is locked behind capital controls, the impact on exchange rate movements tends to be confined to flows relating to fundamentals. We've tried to identify the main reasons for the appreciation, the most important being:

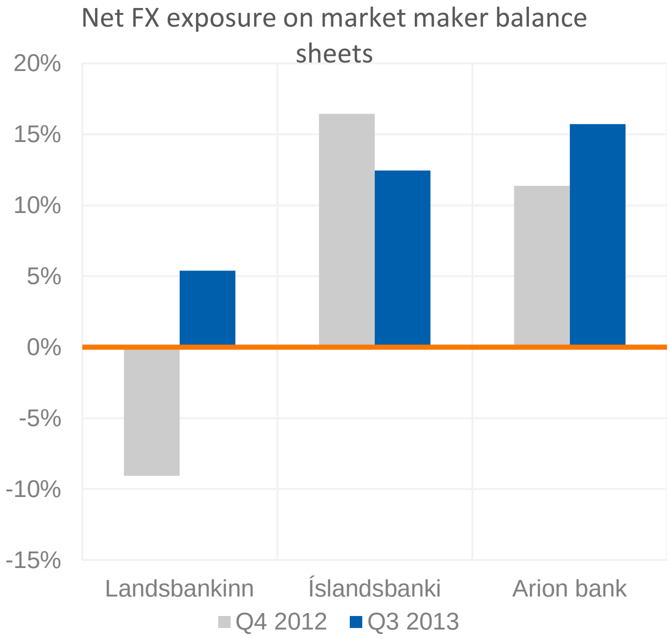
Handsome participation rate in early December CBI currency auction. Investors bid unusually large sums in the investment programme hosted by the Central Bank (if you're not sure what the auctions are about, you can read all about them in this micro primer we published a few months back). Participation in the auction is conditional; investors need to sell euros corresponding to their bid at the on-shore rate, hence, they effectively get a premium on half of the FX they eventually intend to invest in Iceland. High participation rates in the auctions, therefore, usually mean large sums of inflows in the following weeks.

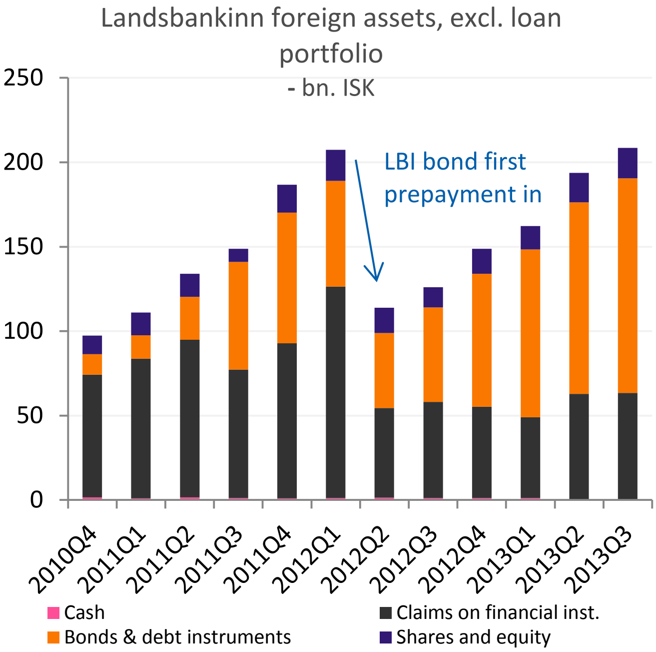


Source: CBI

Strong trade surplus during the final quarter of 2013. The Q4 surplus on goods was stronger than we expected according to StatIce's preliminary estimates, although it seems to have contracted slightly since 2012. The surplus was due to a recovery in seafood prices as well as weaker imports than expected. Although the balance of services for Q4 has still to be published, indicators such as credit and debit card turnover indicate a continuing growth in service exports toward year-end, amounting to +30% in December.

Large net FX exposures on market maker balance sheets. Icelandic regulation on FX exposure stipulates that no financial institution can take on FX denominated assets exceeding liabilites (or vice versa) by more than 15% of capital base. Q3 financial statements for the three large banks, which are all market makers on the FX interbank market, indicate that Arion bank and Islandsbanki are pushing the upper limit of their exposure, while Landsbankinn is probably nearing the limit, given that it has accumulated FX at the same pace in Q4 as it has throughout the previous quarters. This means that all of the banks need to dispose quickly of any fresh FX inflows, thereby prompting a swift appreciation lest they breach the FX exposure regulation.





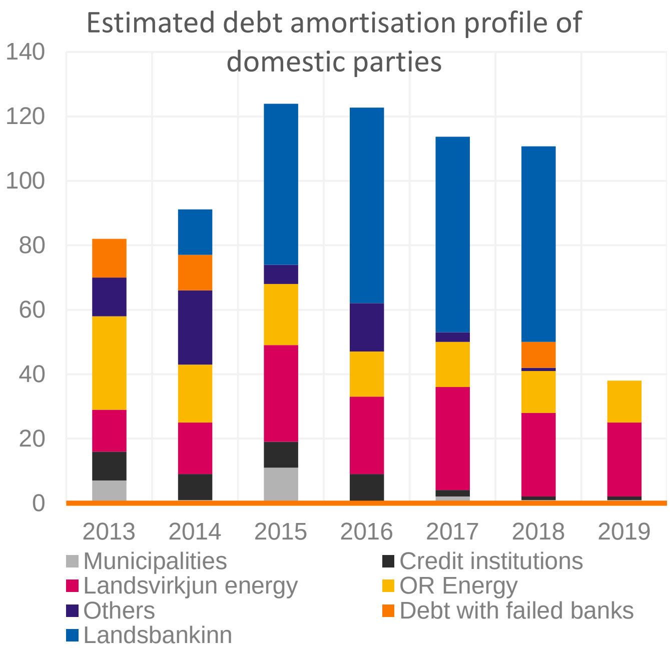
Source: Banks' financial statements

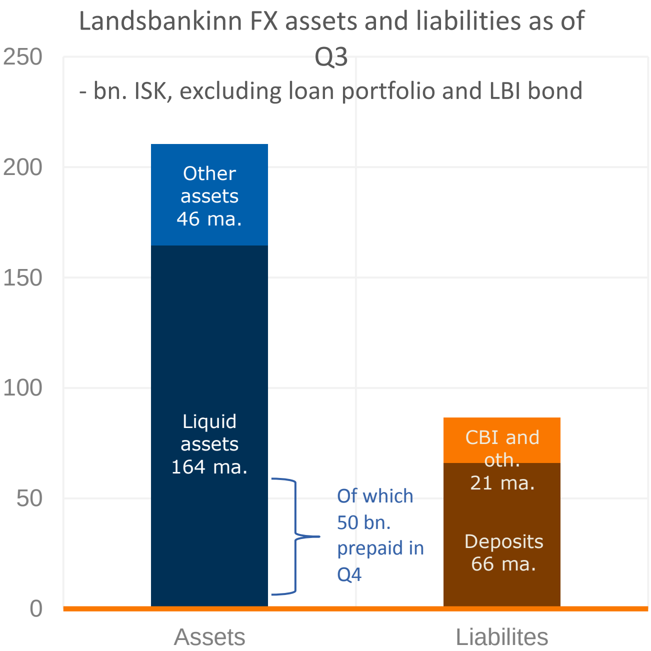
The outlook in 2014

It looks to us like we might witness a relatively strong and stable exchange rate in 2014. When assessing the long term exchange rate outlook, we've favoured the method of balance of payment analysis, i.e. trying to evaluate the stocks and flows that generate trading in the ISK.

One of the largest potential pressures to the exchange rate is the heavy and frontloaded repayment schedule of foreign debt being faced by various agents of the economy, many of whom have no foreign revenue. From 2015 onwards, the amortization profile looks rather bleak, although it should be noted that the largest chunk (i.e. repayments on bonds issued by new Landsbankinn to the old Landsbanki to settle a transfer of assets between the two) is being renegotiated with the aim of extending their maturities.

In 2014, however, parties other than Landsbankinn have a lighter repayment profile than in 2013, while Landsbankinn itself has more than enough FX on hand to meet its 2014 maturities. A very conservative estimate of the bank's net liquid FX assets in Q3 would be somewhere in the region of 77 bn. ISK (counting only FX assets classified as liquid in the banks' Q3 financial statement net of all FX liabilities other than LBI bond). In Q4, the bank made a prepayment to the LBI bond to the tune of 50 bn., leaving at least 27 bn. to meet the roughly 14 bn. repayment scheduled for 2014.

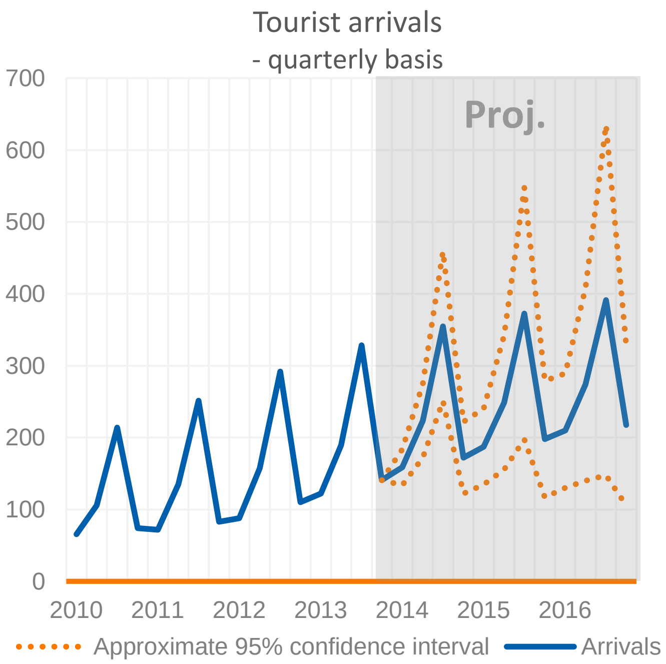


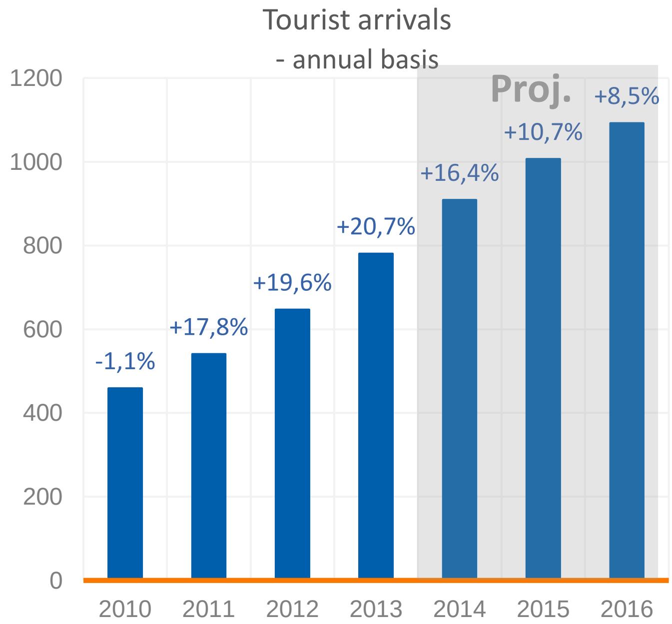


Source: CBI, Landsbankinn Q3 financial statement

Like mentioned earlier, the bank has probably accumulated further FX since its Q3 financials were published, making its net liquid FX position even more comfortable. We therefore aren't assuming Landsbankinn FX purchases to weigh heavily on the ISK for the next months.

Additionally, we're projecting relatively strong growth in tourist arrivals (see *A million tourists in 2013?*), that will hopefully contribute to a robust balance of trade in the face of challenges in other key exporting sectors.

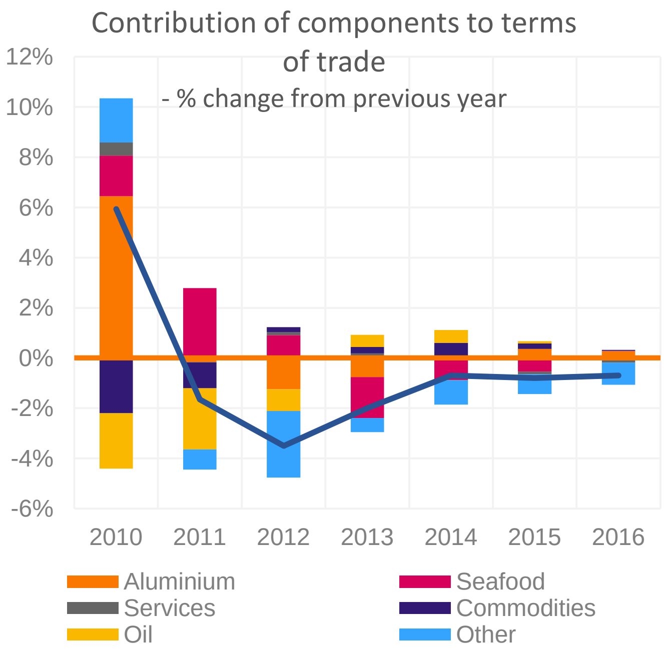


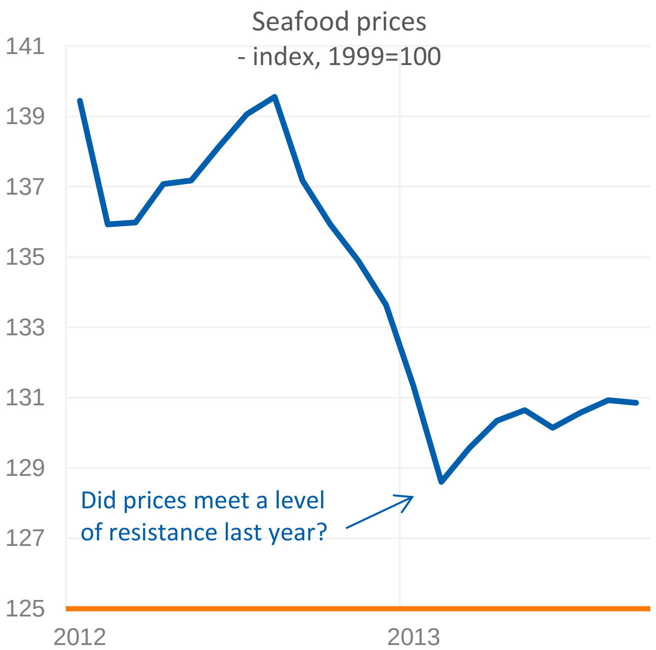


Source: Icelandic Tourist Board, Arion Research forecast

These challenges are mainly confined to the aluminium and fisheries sectors: Aluminium smelters might be forced to scale back production due to a possible 2% power supply reduction at Landsvirkjun Energy, since the company's water budget is poor after an unusually cold and dry winter. Capelin catches have been meagre in the first few weeks of the year; these tend to be very volatile, but have accounted for up to 10% of the total value of catch in recent years.

There's also considerable risk to the trade balance stemming from continuing weakness in the terms of trade, mostly weak aluminium and seafood prices. Aluminium forward curves are downward sloping while the CBI is forecasting a drop in seafood prices going forward, but it looks to us like there might be some upside to be found there, since seafood prices seem to have found a level of resistance last year and have been relatively stable since.





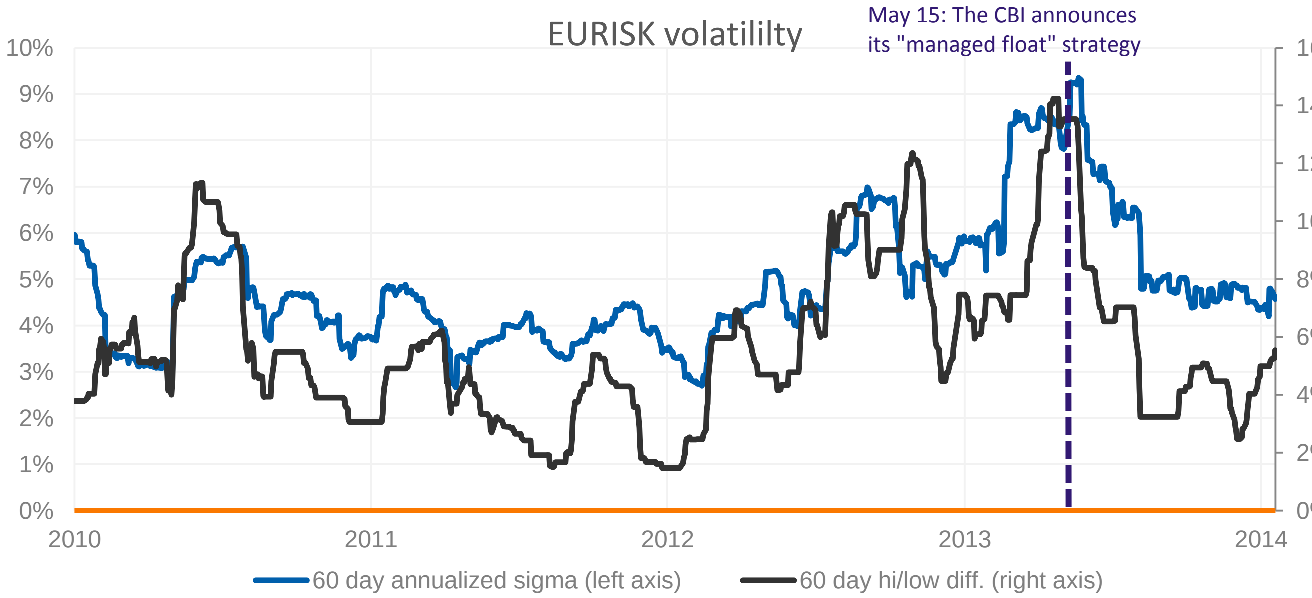
Source: CBI

Another potential risk stems from increased import demand in tandem with the ongoing economic recovery. Growth in imports might eat away at the current account balance, putting the ISK under pressure. Although this is definitely a factor to keep an eye on going forward, we're not overly worried that the magnitude of any rebound of imports will be sizeable enough to disrupt the exchange rate in the near term – especially since the CBI has been intervening to keep the ISK from appreciating too rapidly, thereby stymieing demand.

CBI accumulates reserves

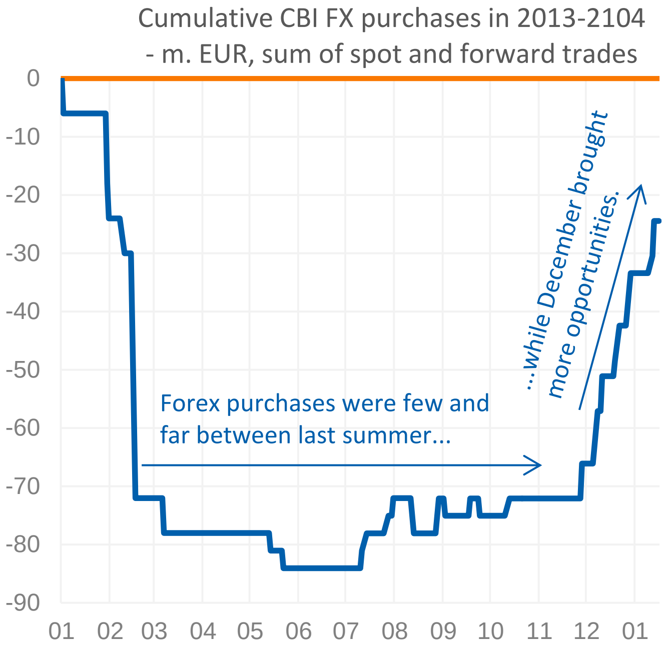
In fact, we are glad to see that the CBI has been taking advantage of recent currency inflows to strengthen its reserves by purchasing FX on the interbank market. This is a direct extension of the Bank's commitment to exchange rate stability, following its bid since May 2013 to run a "managed float" regime. It entails that the Bank leans against both FX inflows and outflows with currency interventions to reduce volatility and keep the ISK stable.

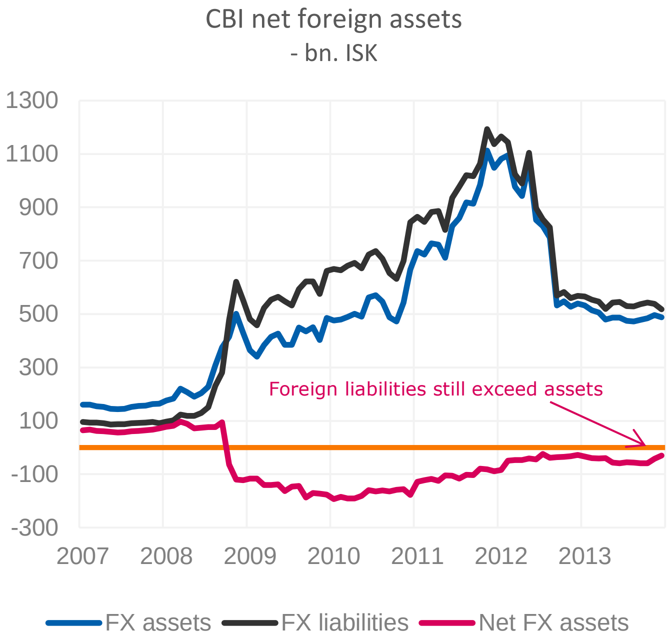
Like the figure below shows, the strategy has been successful as far as volatility goes; the ISK sigma went down markedly after the CBI announced its intention to follow a managed float strategy.



Source: CBI, Arion Research calculations

During the first half of 2013, we were worried that the price for stability might be too dearly paid; like the figure below shows, the CBI interventions were initially a one way street as it haemorrhaged reserves in a bid to support the exchange rate with aggressive FX market interventions. Fortunately, this trend has been reversed in the last 6 weeks, since the Bank has bought back a majority of the reserves it used in support of the exchange rate during the previous months.

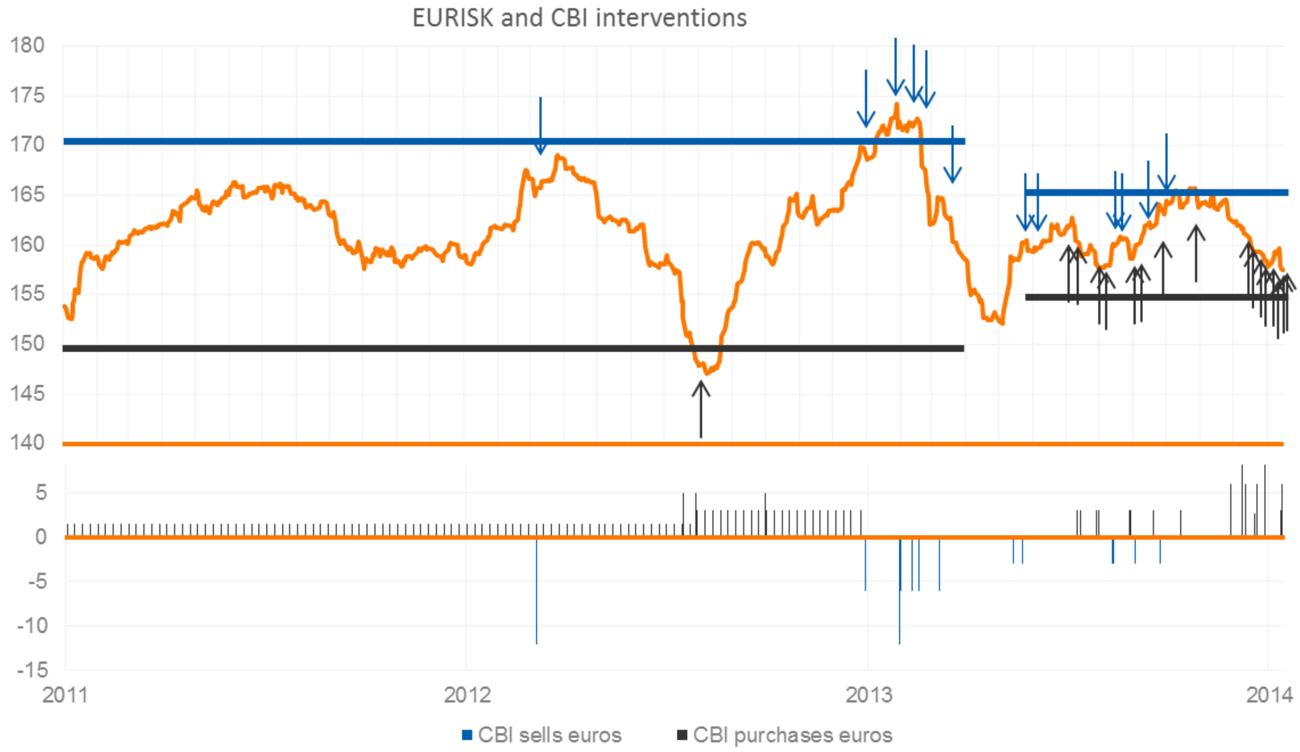




Source: CBI, Arion Research calculations

However, the CBI's net foreign position is still negative. This isn't an immediate concern, since the CBI and Treasury's repayment schedules are quite backloaded (the CBI has enough reserves on hand to meet foreign repayments for most of the next decade or so). Still, we expect the Bank to continue accumulating unleveraged reserves, which is why we predict it to continue relatively aggressive FX purchases well into 2014. This might mean that any underlying room for appreciation will simply manifest itself as reserve accumulation. In other words, the CBI might simply wolf up any currency inflows, thereby preventing a significant appreciation of the exchange rate.

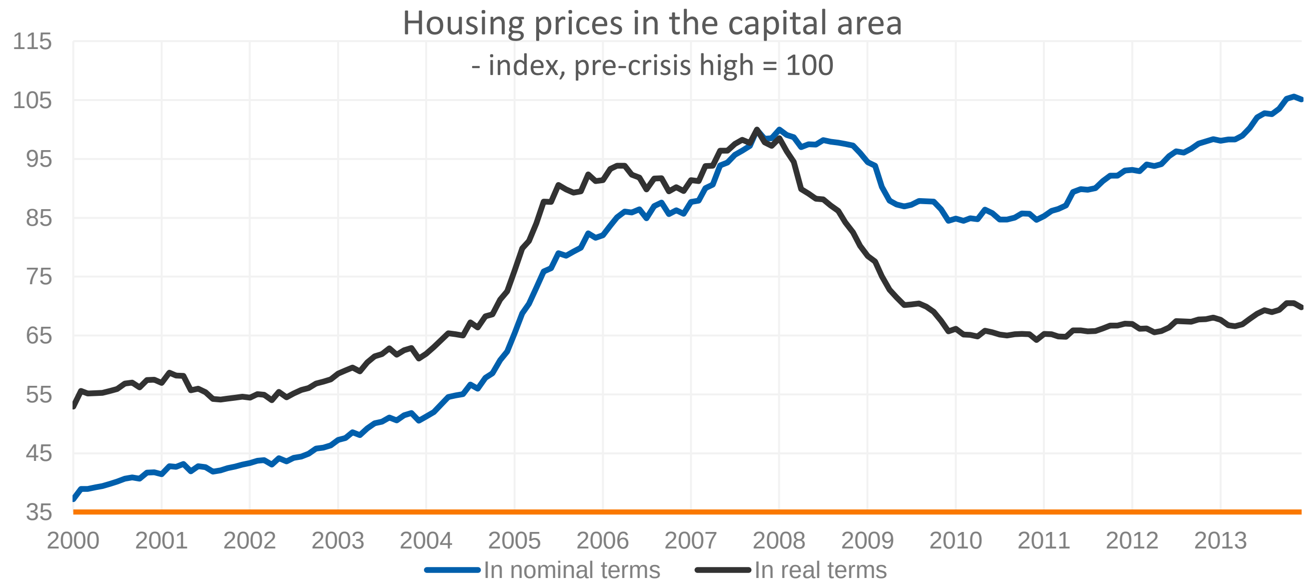
We've mapped out the bank's interventions to date in an attempt to locate a band where the CBI is comfortable with the exchange rate, and outside which it becomes more likely to intervene. Before the CBI instigated its managed float regime, it appeared to have a propensity to intervene once EURISK broke through a floor of 150 or a ceiling of 170. After its managed float announcement in May, this band seems to have tightened substantially, as the CBI intervenes much more frequently at levels close to either side of EURISK 160. We conclude that this band provides an adequate assumption for exchange rate developments going forward, and that any deviations from the band that might appear as time progresses will do so gradually.


EURISK and CBI interventions
180
175
170
165
160
155
150
145
140
5
0
-5
-10
-15
2011
2012
2013
2014
CBI sells euros
CBI purchases euros

Source: CBI

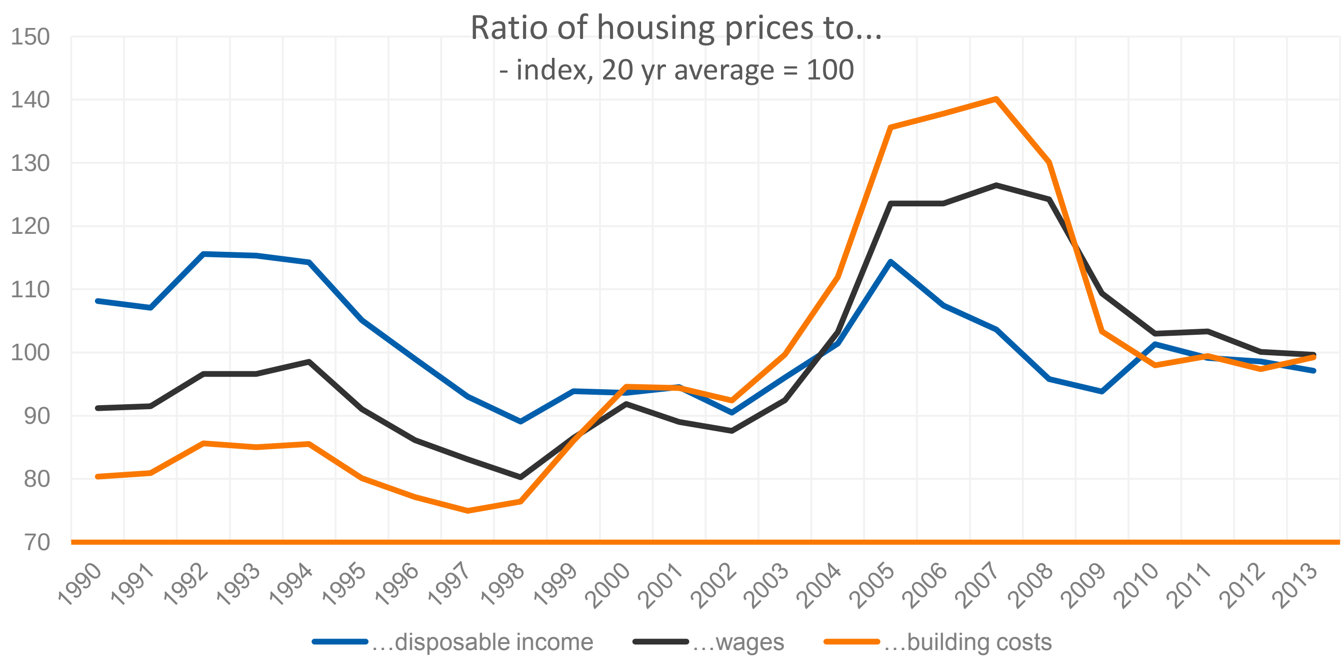
Housing prices on the rise

After taking a beating during 2008-2010, housing prices have rebounded slowly but surely over the last three years. In 2013, housing in the capital area rose by 6.8% in nominal terms and 2.6% in real terms.



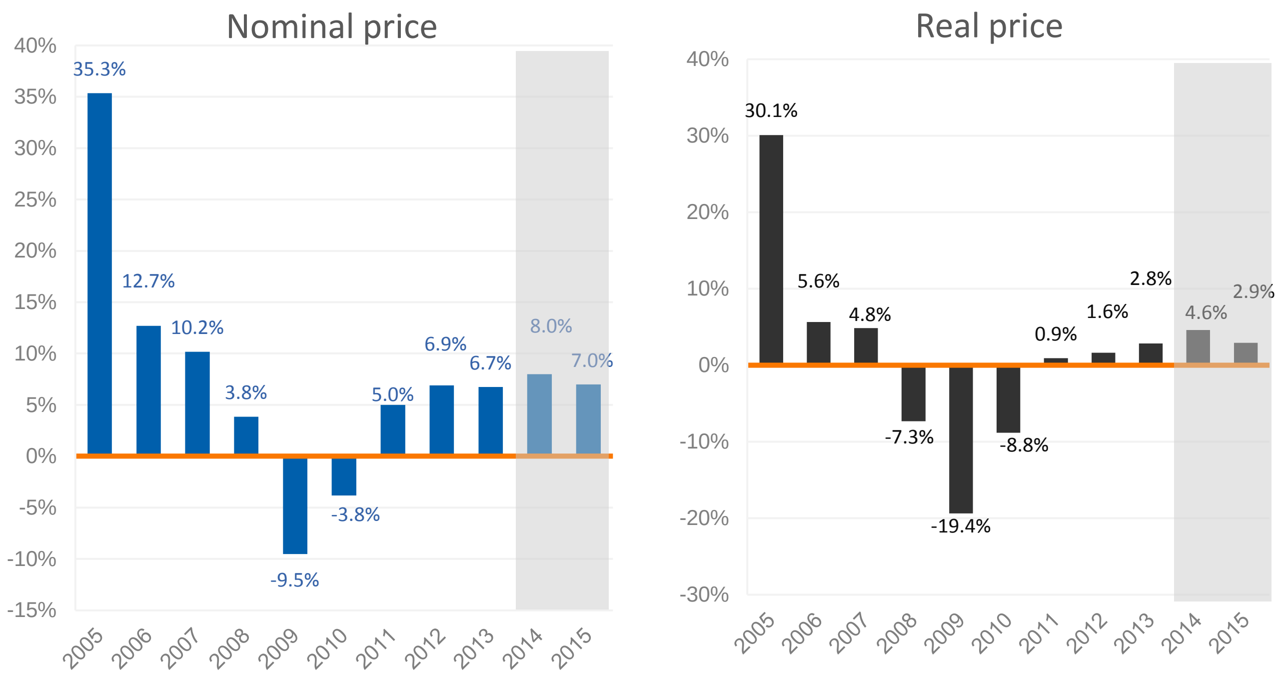
Source: Registers Iceland

In December, Arion Research published an extensive report on the housing market. We found that housing is fairly priced, or even slightly underpriced, depending on which ratio you look at.



Source: CBI

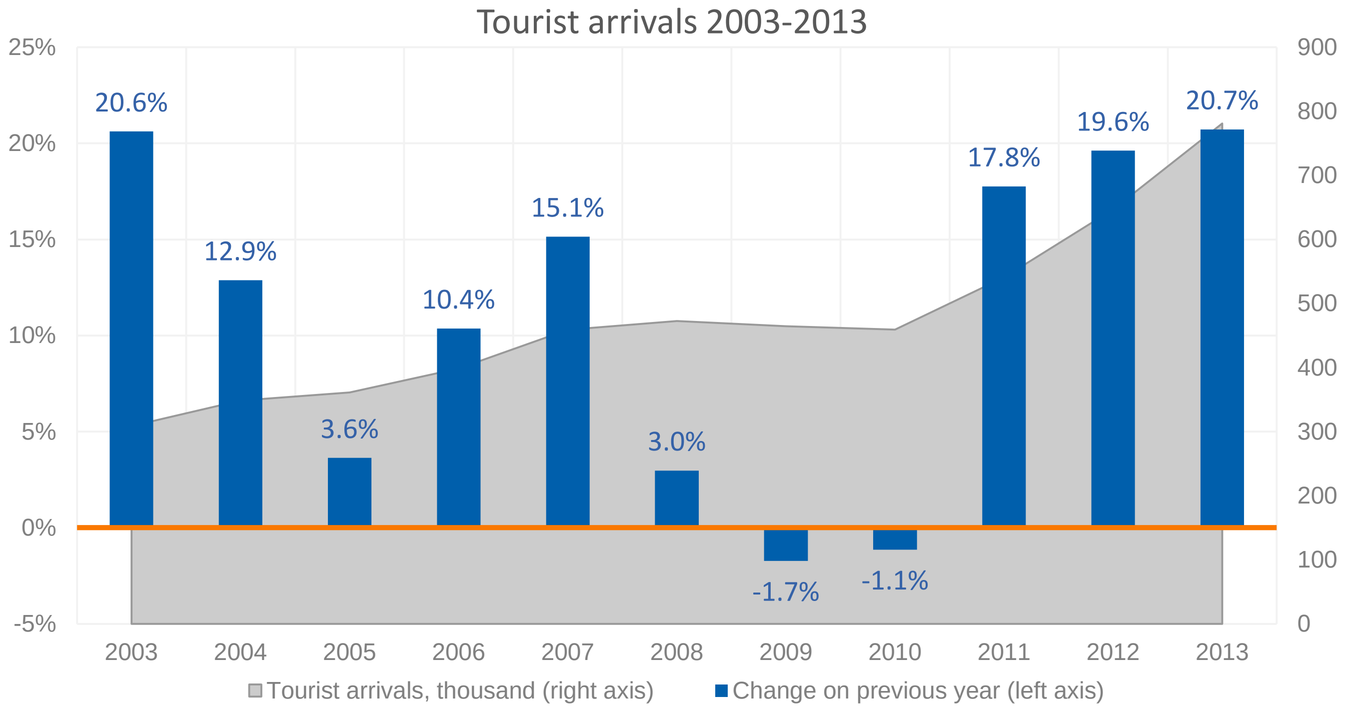
It seems like prices are aligned with fundamentals in the market. Our forecast for the next two years indicates that further price increases are to be expected.



Source: Registers Iceland, Arion Research forecast

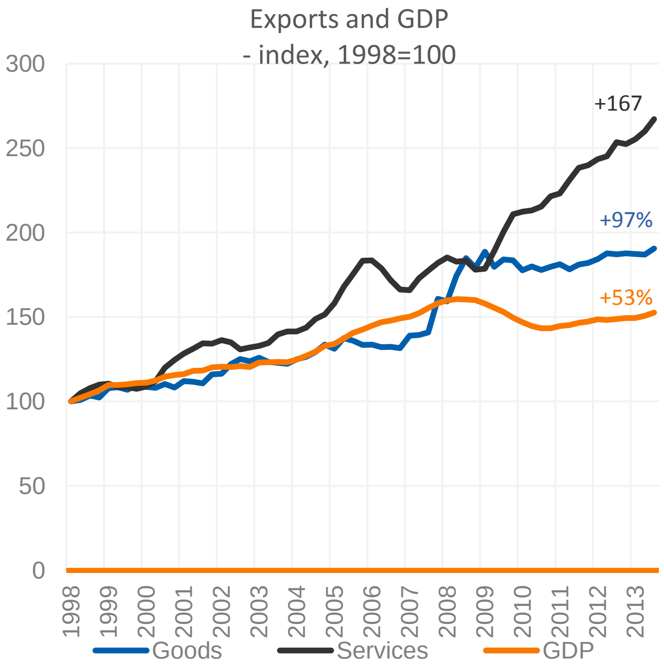
A million tourists in 2015?

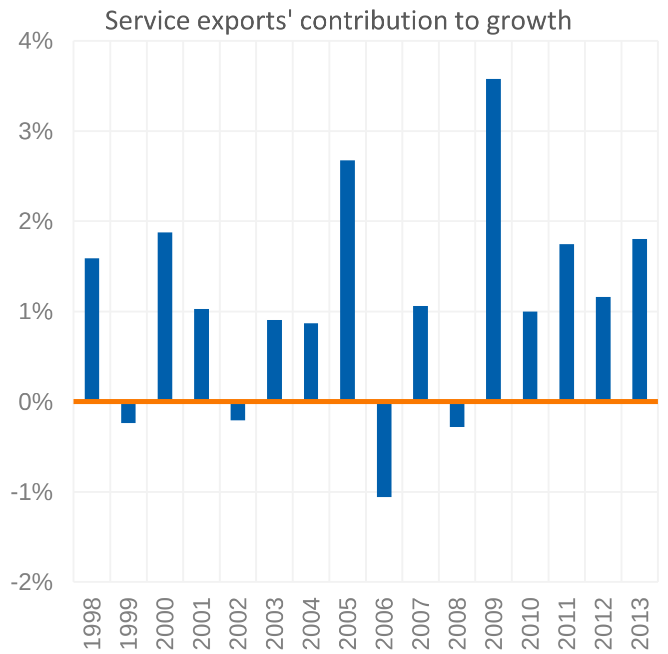
Tourism in Iceland set yet another record in 2013 when more than 780 thousand tourists visited the country. Tourists arrivals in Iceland have increased by more than 70% since 2010; an unprecedented jump in the history of Icelandic tourism.



Source: Icelandic Tourist Board

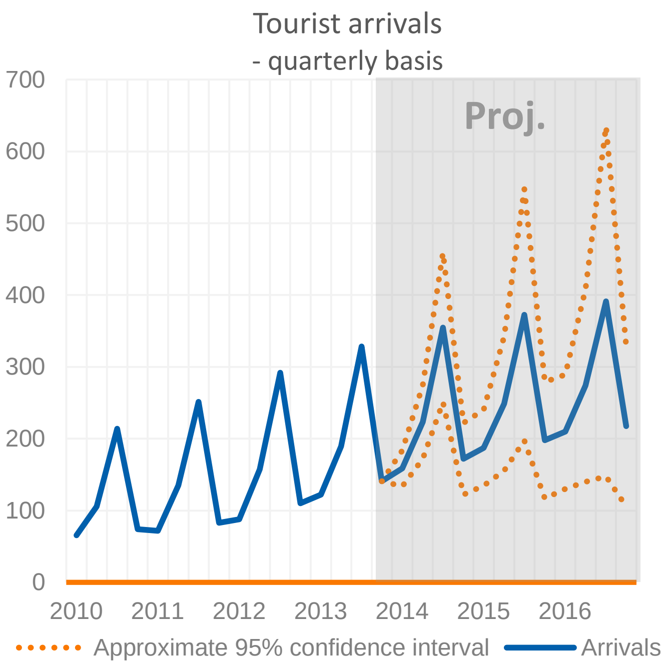
Tourism has been a major source of foreign revenue during the Icelandic economic recovery, and an important driver of growth. Last year, foreign credit and debit card turnover amounted to more than 90 bn. ISK (more than 5% of GDP), and that's not counting air travel. Exports of services have grown at a much faster rate than both exports of goods and the economy at large, so it shouldn't be surprising that service exports have contributed generously to growth in recent years; about +9,6% cumulatively in 2009-2013.

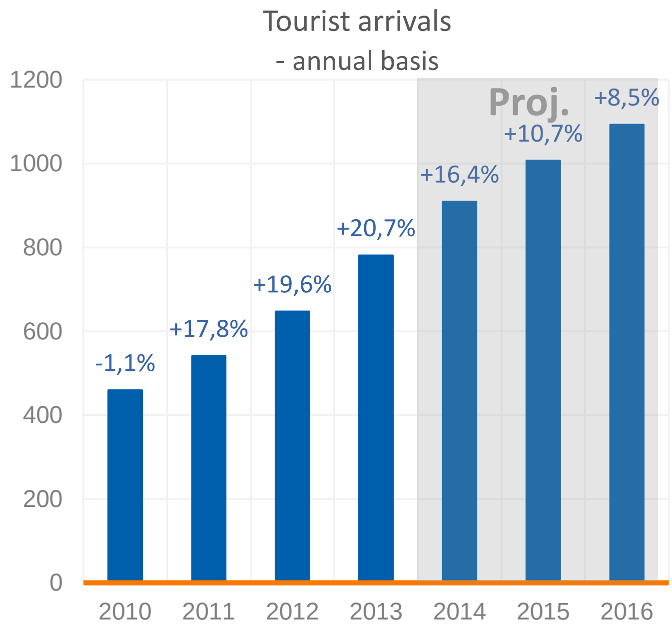




Source: Statice, Arion Research estimate

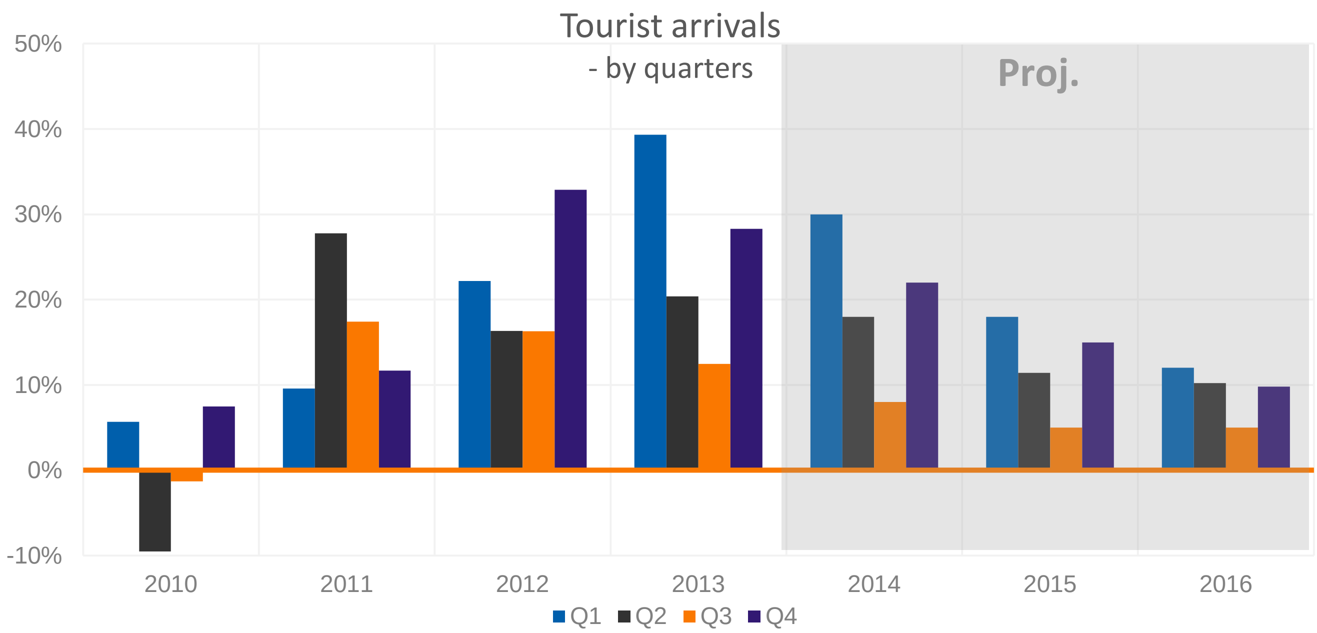
Now, the million dollar question at this point has to be whether there's scope for continuing growth. In our view, the pieces are in place for further expansion. If our projections of tourist arrivals are realised, the millionth tourist in a single year will touch down sometime in December 2015; cumulative growth over 2014-2016 will be close to 40%.





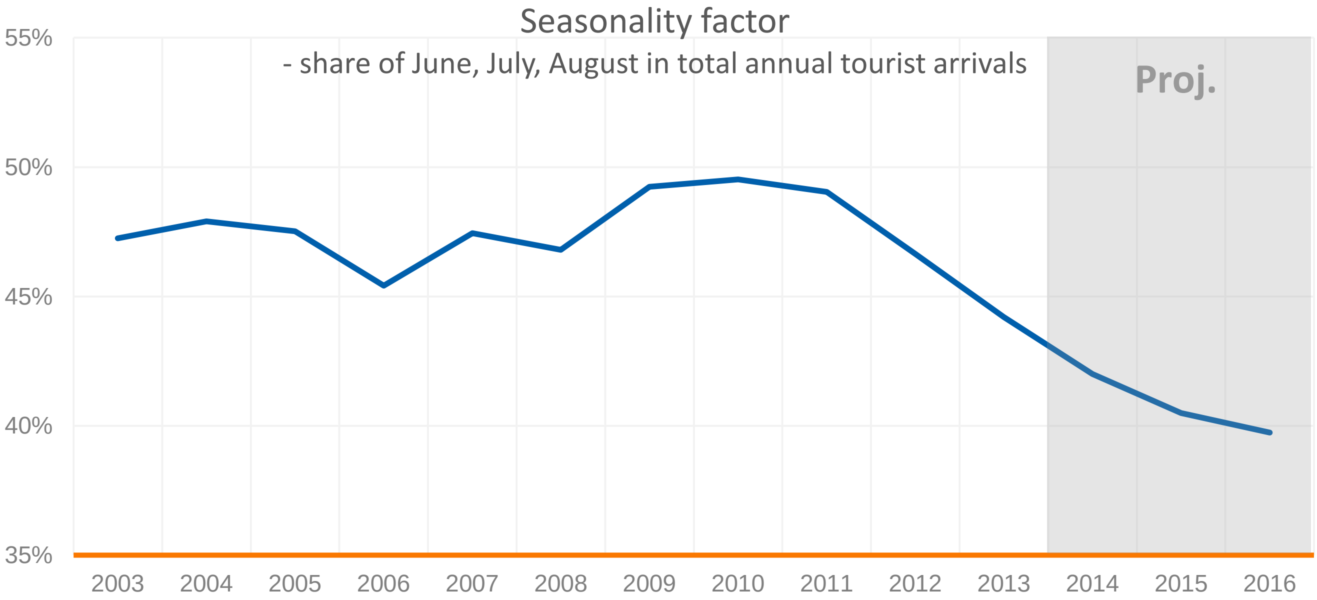
Source: Icelandic Tourist Board, Arion Research forecast

The key to continuing growth is better utilisation of capital and infrastructure. Capacity constraints are on the verge of becoming a limiting factor during the high season (i.e. in June, July & August – it should be noted that various large accommodation projects already underway will come to expand capacity as time progresses), but there is excess capacity during any other month of the year. We are therefore projecting strong growth during the off-season in Q1 and Q4, but weaker growth during the high-season in Q3.



Source: Icelandic Tourist Board, Arion Research forecast

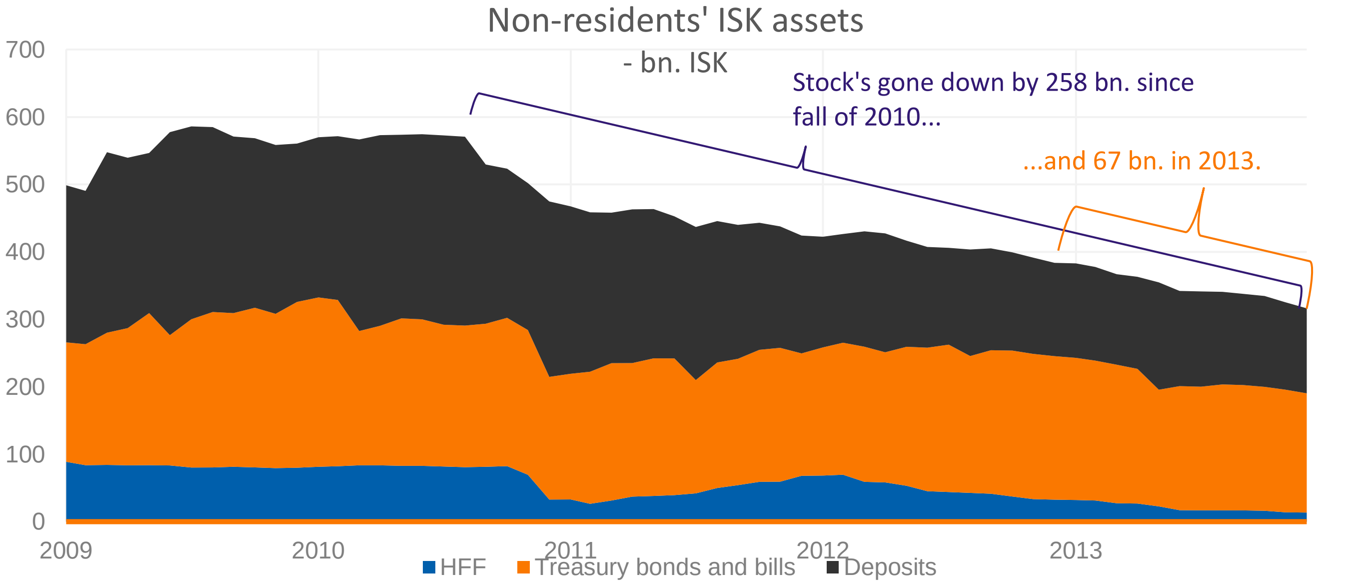
A reduction in seasonality will enable sustainable growth and facilitate an increase in productivity. The tourism industry has already made substantial headway over the last three years by marketing winter tours and northern lights safaris to even out the seasonality in tourist arrivals. If our projections prove accurate, the seasonality factor will come down further in the coming years.



Source: Icelandic Tourist Board, Arion Research forecast

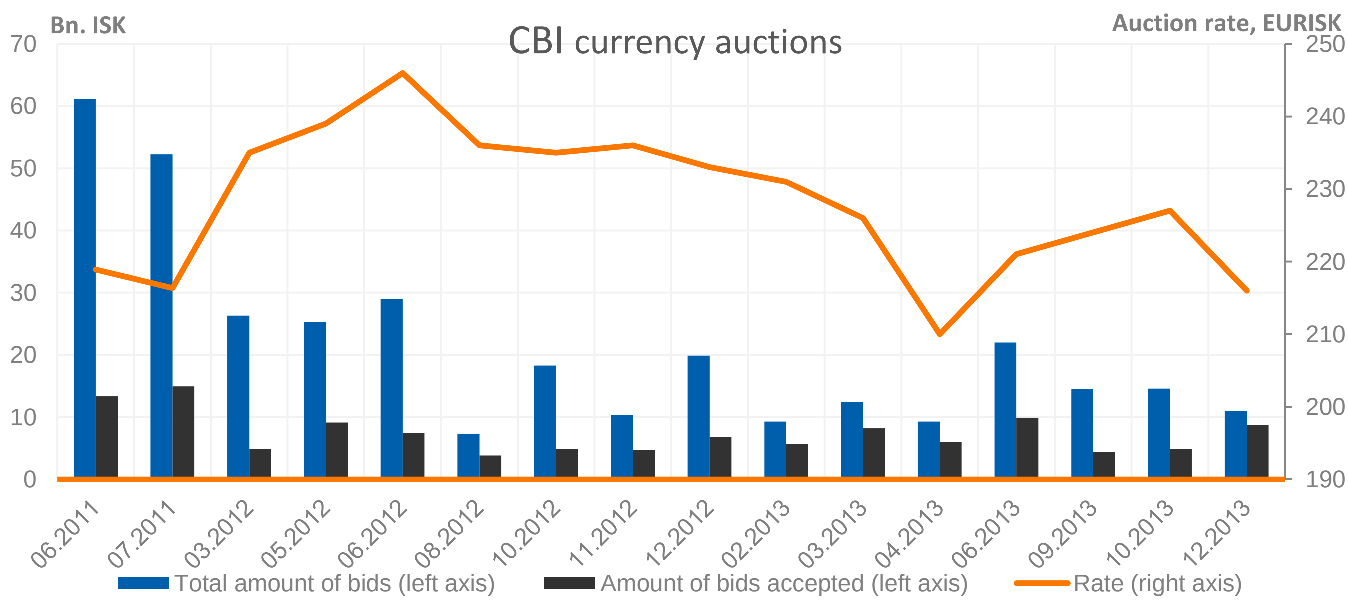
Non-residents' ISK assets down by 67 bn. in 2013

Non-resident's liquid ISK assets trapped within capital controls were wound down by 67 bn. ISK in 2013. The total stock has shrinked by 258 bn. ISK since the fall of 2010, and now stands at roughly 316 bn. This stock is the initial reason that capital controls were imposed, so the slow but steady headway made in reducing it spells good news for the economy. It should be noted, however, that this is only one part of the external debt overhang that threatens balance of payments; the mismatch of domestic and foreign claims and assets on the books of the failed banks poses another large problem.



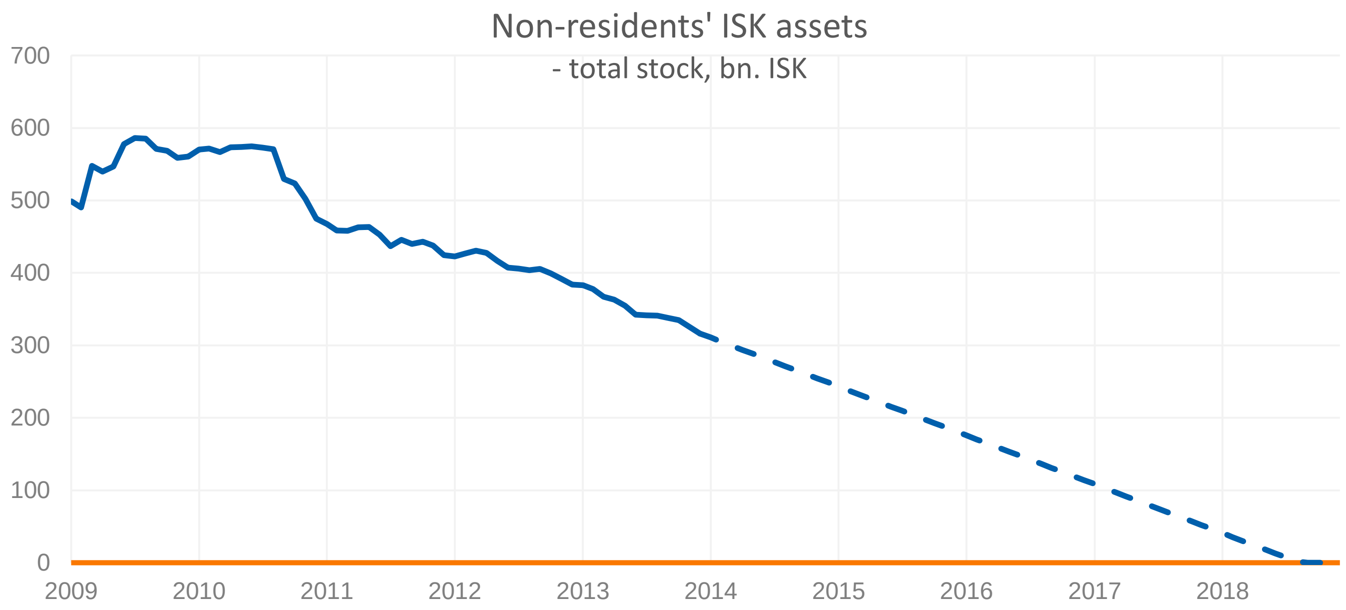
Source: CBI

One-off deals were the main reason for the drop early on, but since 2011, the lion's share of the reduction has been due to CBI currency auctions (if you're not sure what the auctions are about, you can read all about them in [this micro primer]() we published a few months back).



Source: CBI

It is interesting to wonder how long it will take to wind down the entire stock. At the current pace, non-residents' holdings of ISK denominated liquid assets will have completely disappeared from the Icelandic economic landscape mid-year 2018. However, we stress that this should not be a goal in and of itself; several indicators (including the downtrend in the CBI auction rate and participation) suggest that the brand of investors left with these assets is not overly eager to dump its holdings at any price as soon as controls are lifted. Having an investor base with open positions in Iceland is surely no problem as long as they don't want to exit faster than the economy's currency generation can handle.



Source: CBI, Arion Research calculations