

## EURUSD trending down... but where does the króna go?

The EURUSD cross has been taking FX traders for a ride in recent months. How have these movements been affecting the EURISK or the USDISK? Arion research examined the relationship some months ago and now we look at how the results have held up.

## CBI amends auction terms

In an attempt to further reduce the „old overhang“ and perhaps gain some insight into what kind of haircut foreign ISK holders are willing to take on their ISK assets, the CBI amended its auction terms in advance of its last announced auction on February 10.

## Government bond issuance in 2015

The government's net domestic borrowing is likely to be negative in 2015 for the first time in seven years. However, government finances have been improving recently due to large irregular items so further fundamental improvements are needed in order to reduce debt levels by a meaningful amount.

## Progress in the removal of capital controls

According to the Ministry of Finance progress is being made in the capital control removal process. Changes were recently made to the executive board assembled to review the proposals of the government's foreign advisors, in order to decide on and finally implement the appropriate policy.

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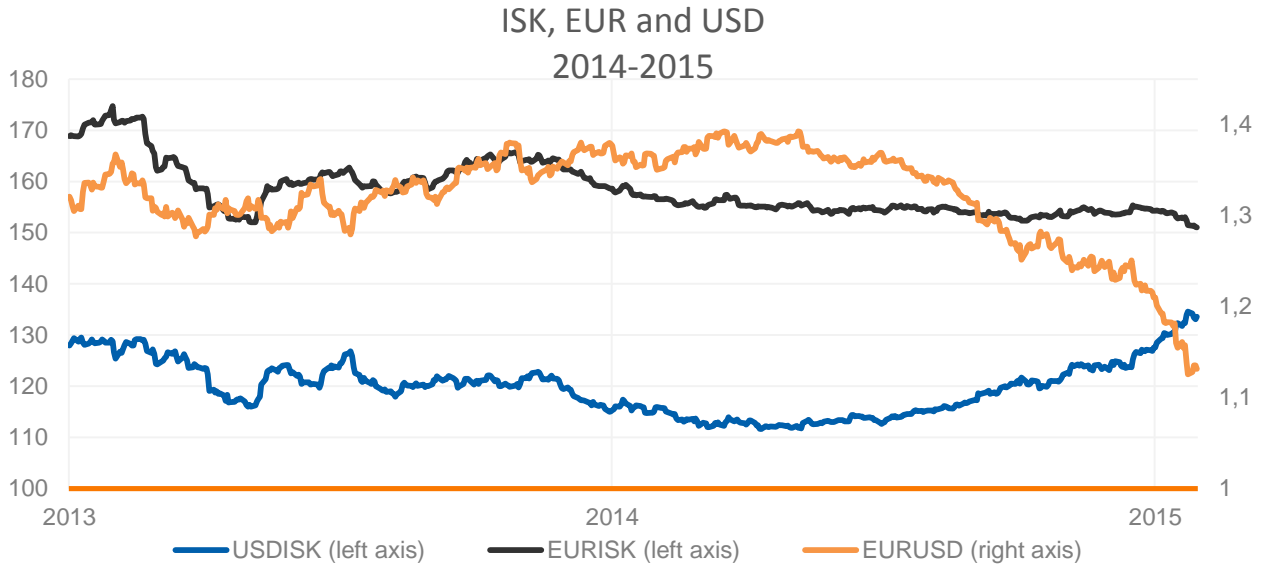
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### Provisional release:

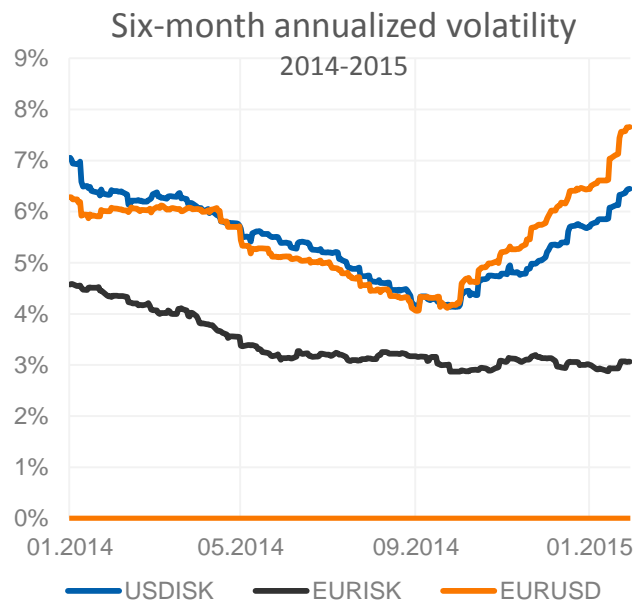
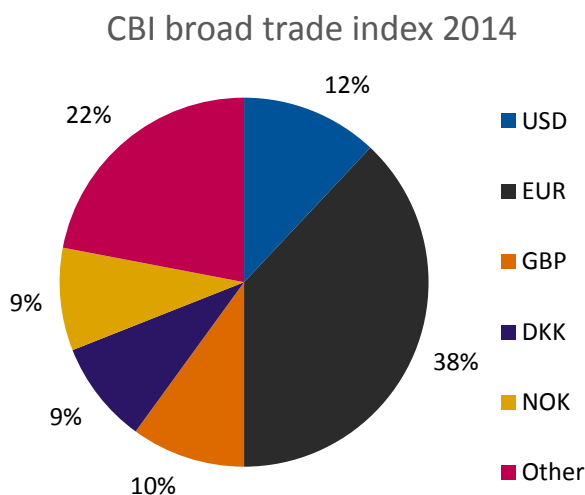
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# EURUSD trending down... but where does the króna go?

With the movement in the EURUSD cross over the past months many have wondered about the effect on the króna. In early 2014, [Arion Research examined](#) how changes in the EURUSD are generally reflected in the USDISK and the EURISK crosses. To summarize, regression results indicated that a 1% strengthening of the dollar against the euro resulted in market makers altering their bids and offers so that the króna strengthened by 0,18% towards the euro and weakened by 0,82% against the dollar – solely due to the change in the EURUSD cross. Of course we are operating under capital controls which prevent the króna from flowing freely. In the first half of 2014 these currencies were relatively stable, but by mid-year the dollar started strengthening against the euro and the króna. Meanwhile the EURISK cross stayed rather stable.



In 2014, the euro lost 12% of its value against the dollar. The aforementioned regression results would predict a resulting 2% strengthening of the króna towards the euro and a 10% weakening against the dollar during that period, which is, incidentally, what happened despite the CBI's frequent interventions in the currency market. The CBI's trade index is intended to reflect the composition of Iceland's foreign trade in the previous year. The 2014 broad trade index indicates that the euro and the dollar make up a combined 50% of Iceland's foreign trade (38% EUR and 12% USD). The ratio of each currency to their sum is therefore 76% euro and 24% dollar.

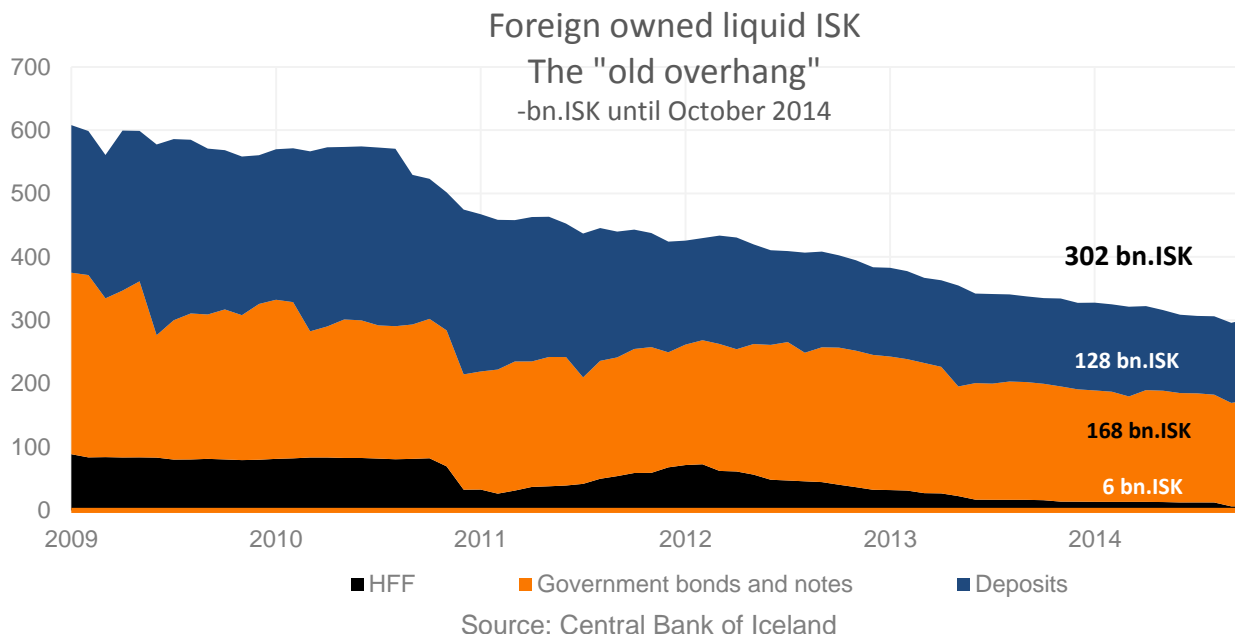


The volatility of these three currency crosses has generally been on a downward trend since the financial crisis, but EURUSD and USDISK volatility started spiking from post-crisis lows last summer. When comparing the volatility of these currencies it looks like fluctuations in USDISK are much more correlated with fluctuations in EURUSD than EURISK. Additionally, fluctuations in USDISK and EURUSD have been consistently higher than EURISK fluctuations throughout the period.

## CBI amends auction terms

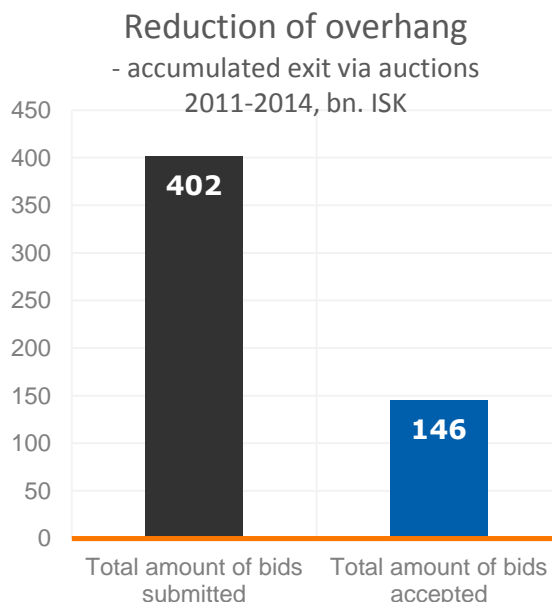
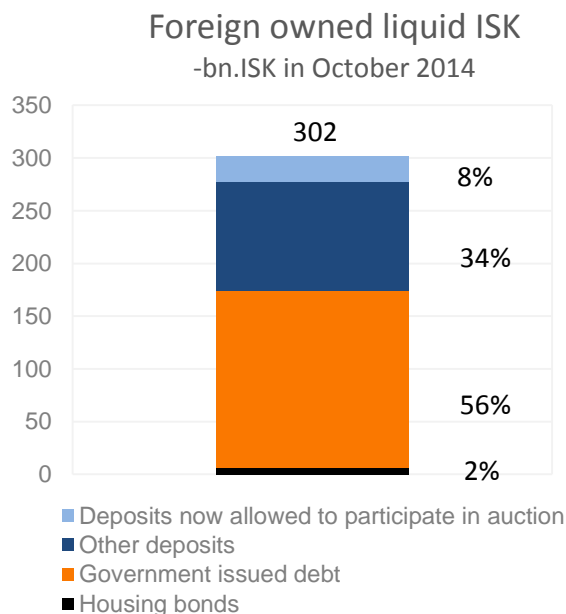
Last December the CBI announced amended terms to its auction, allowing foreign holders of ISK, who have krónur as a result of priority claims having been paid out, to participate. In January the CBI amended its terms further so that the minimum amount required to participate was lowered. The question is whether the amendments will increase the amounts bid in the upcoming auction so that the „old overhang“ may be reduced in advance of major steps being taken in the capital control lifting process.

Last October, foreign held liquid ISK assets stood at approximately 302 bn.ISK, thereof 128 bn.ISK were deposits, 168 bn.ISK were placed in government bonds and 6 bn.ISK in housing market bonds.



Given recent movements in the bond market it looks like some foreign owners of Icelandic bonds might be liquidating their positions ahead of the auction in February. Ideas about a 35% exit tax on all assets leaving the country surfaced in the media since the last auction so perhaps an exit through the auction might be a more favorable option to some who view the tax as a likely result.

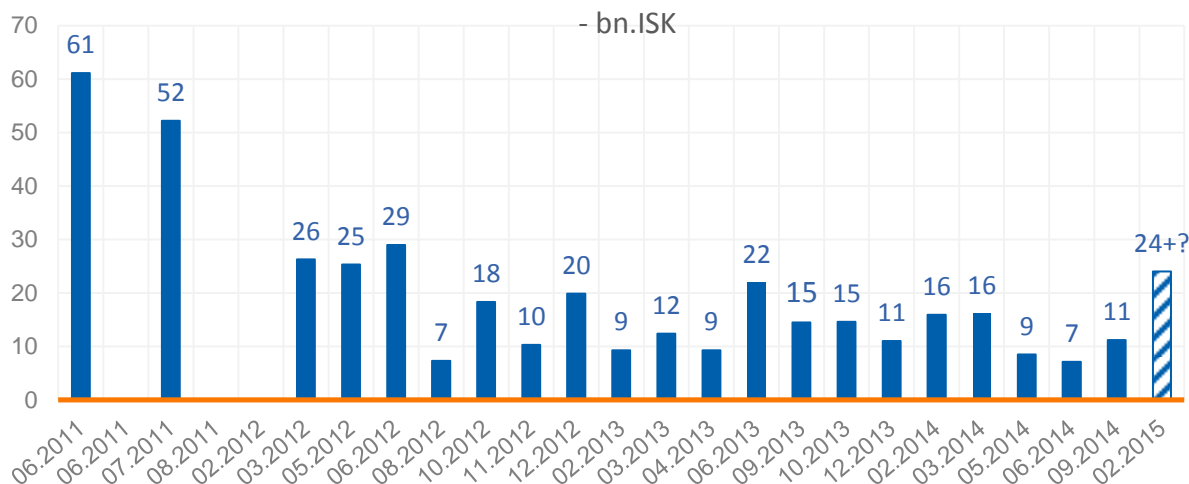
It's not unusual for a sizeable chunk of a domestic bond market to be held by foreigners so we are not expecting all foreigners to dump their Icelandic bonds when controls are lifted, especially given the global investment environment and current government bond yields. However, more uncertainty remains about the intentions of deposit holders, among them those who have received payments in ISK as a result of priority claims and may now, for the first time, join the auctions. According to Arion research the amount added to the pool of those allowed to exit with their ISK through the CBI's auction is close to 24 bn.ISK, or about 19% of foreign held ISK deposits and 8% of the „old overhang“. Since the auctions started in 2011 the total amount bid by foreign ISK holders has been 402 bn.ISK of which 146 bn.ISK have been accepted.



Sources: Central Bank of Iceland, Arion Research

In the first auction the amounts bid were to the tune of tens of billions of ISK. Since then participation has dwindled while the discount from the onshore rate has decreased so it is not unlikely that the most impatient ISK holders have been awarded exit already. In the first year the total bids amounted to about 194 bn.ISK while accepted bids were only for 50 bn.ISK.

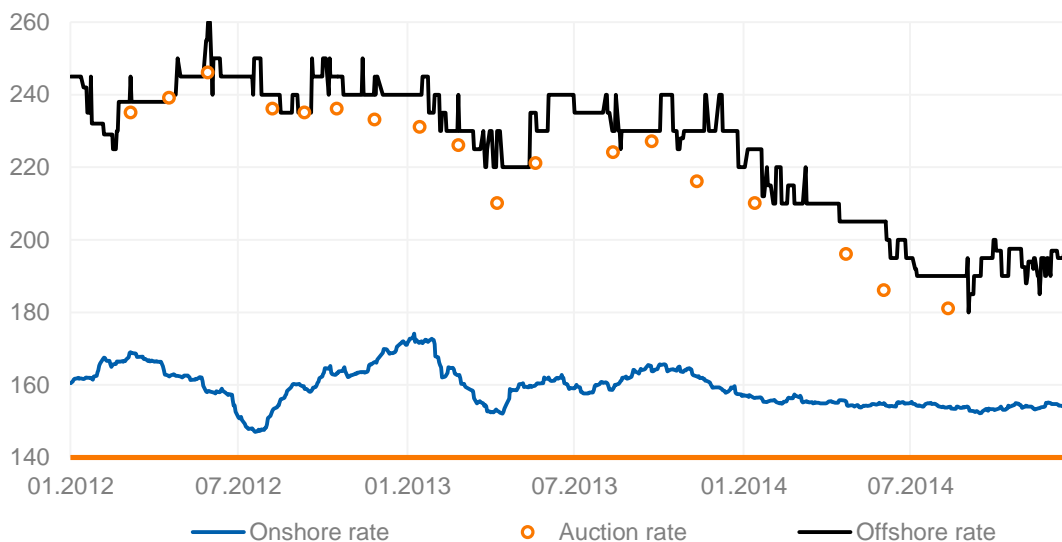
### Amounts bid by foreign holders of ISK in CBI auctions



Source: Central Bank of Iceland, Arion Research

The auction rate has followed the offshore rate quite closely, even though the offshore market is very thin, but over the past year there has been some convergence between the onshore and offshore rates. It is possible that with the addition to the pool of potential bidders the auction rate will be pushed up again, but whether the CBI will be able to match those bidders with patient investors who are willing to commit to the króna for 5 years remains to be seen. Those investors might require a larger discount off the ISK onshore rate to be willing to make such a commitment given the fact that major steps might be taken towards the abolition of capital controls in the coming months.

### EURISK



Source: Central Bank of Iceland, Bloomberg

Even though the latest FX auction in September was the last announced auction at the time the amounts bid were not very large. Foreign ISK owners bid 11 bn.ISK of which only 5 bn.ISK were matched. If participation in the coming auction is also weak we can only assume that foreign ISK holders are not as impatient as feared. However, if we see a large increase in the amounts bid it would be ideal if those impatient investors would be matched with patient ones entering Iceland so the overhang may be reduced by a meaningful amount in advance of major steps towards lifting controls.

## Government bond issuance in 2015

The Government Debt Management usually issues, at the end of each year, prospects for the coming year as far as government debt issuance is concerned. Unfortunately, due to its timing, this tends to fall in the shadow of year-in-reviews and therefore does not get warranted attention considering its effects on the bond market and hence, interest rates.

According to the prospects for 2015 the net domestic funding need will likely be negative – that is debt repayments will be larger than new debt issuance for the first time in seven years. Gross domestic bond issuance will amount to 85 bn.ISK of which approximately 55 bn.ISK will be bonds (net Treasury bond issuance of 6 bn.ISK) and 30 bn.ISK will be bills (net Treasury bill issuance of 5 bn.ISK). Redemptions and instalments will amount to 89 bn.ISK, which makes net domestic borrowing negative by 4 bn.ISK in 2015.

Domestic funding need 2015 (bn.ISK)	
Redemptions and instalments	89
Treasury bills	25
Treasury bonds	49
Other loans and buybacks	15
<b>Net domestic funding need</b>	<b>-4</b>
<b>Gross domestic funding need</b>	<b>85</b>

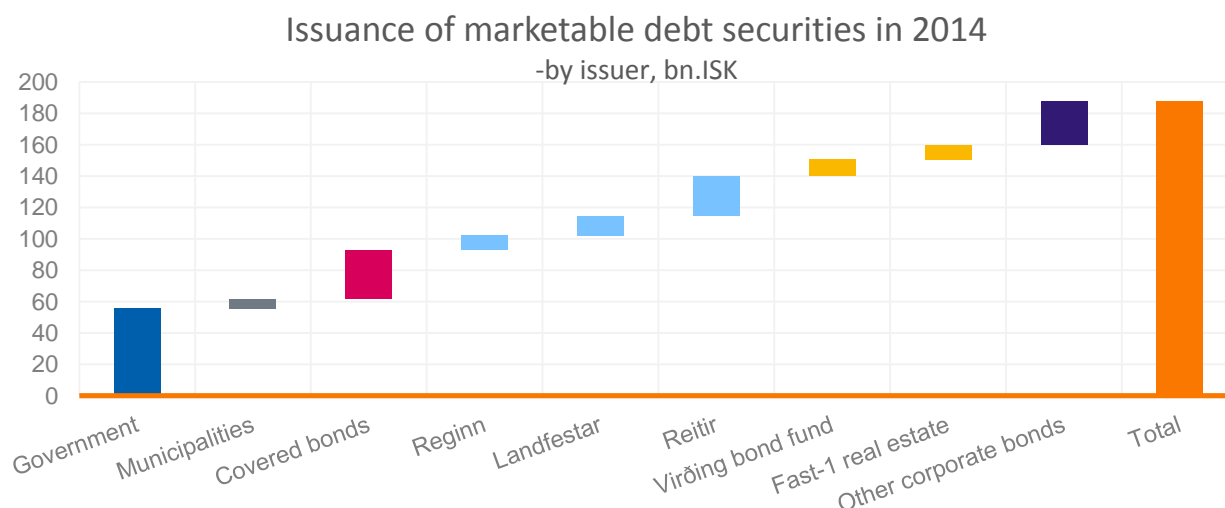
Domestic borrowing 2015 (bn.ISK)	
Treasury bills	30
Treasury bonds	55
<b>Debt issuance</b>	<b>85</b>
Change in Treasury deposits at CBI	0

Further breakdown of issuance in 2015 (bn.ISK)	
Net issuance of Treasury bills	5
Net issuance of Treasury bonds	6
<i>Thereof indexed</i>	<i>-26</i>
<i>Thereof non-indexed</i>	<i>32</i>
<b>Total net issuance of bills and bonds</b>	<b>11</b>

Sources: The Government Debt Management, Arion Research

Even though the domestic borrowing need of the government has been on a downward trajectory over the past years various irregular items have improved the government's finances, such as dividend payments by financial institutions and changes to the CBI's balance sheet. However, government finances still need further improvements and the budget for 2015 does not indicate a handsome surplus so we are likely to see new debt issuance by the government in the coming years. In the prospects for 2015 the Government Debt Management adds that any changes to capital controls could change the government's borrowing need and issuance schedule, something which has not been specifically mentioned in the prospects before. Issuance of marketable debt securities in 2014 can be seen in the graph below. Issuance of covered bonds amounted to 31 bn.ISK last year and corporate bond issuance amounted to 95 bn.ISK. Total marketable bond issuance in Iceland in 2014 amounted to 188 bn.ISK.



Sources: Central Bank of Iceland, Icelandic Securities Depository, Arion Research

## Progress in the removal of capital controls

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According to the Ministry of Finance a new chapter has begun in the capital account removal process. The proposals put forward by the foreign advisor group the government previously hired to assist in the process have been submitted. They are currently being closely examined and evaluated and as a result a policy will be implemented.

Changes have been made to the executive board previously assembled for this purpose. The board now consists of:

- Glenn V. Kim, chairman
- Benedikt Gíslason, vice chairman
- Sigurður Hannesson, vice chairman
- Eiríkur S. Svavarsson, supreme court attorney
- Ingibjörg Guðbjartsdóttir, CBI
- Jón Þ. Sigurgeirsson, CBI

According to the Ministry's statement Dr. Sigurður Hannesson, a mathematician, executive at MP banki and the head of the expert group assembled to implement the government's recent debt relief program, has been hired to assist temporarily.

The CBI nominated two employees of the Bank to work as a part of this team: Ingibjörg Guðbjartsdóttir, the executive director of the Bank's capital controls surveillance unit and Jón Þ. Sigurgeirsson, the Bank's executive director of international relations and the CBI governor's office. While working with the executive board Jón Sigurgeirsson will not be operating as the chairman of the board of the Central Bank Company ehf. (ESÍ)

The executive board will continue working with the previously hired foreign advisors on lifting controls. According to the statement, the goal - a priority issue for the government - is to lift controls as soon as possible without jeopardizing economic stability.

In [a recent conference](#) about the economic landscape, and monetary policy options post-controls, Bjarni Benediktsson, the Minister of Finance, said that all economic conditions were currently in place to lift controls. There would always be uncertainties and risks related to the process, but that the goal of the government was to be as prepared as possible for any surprises. Bjarni pointed out that at no point in time had as many people been employed by the government full time in order to find a solution. Other long term goals, such as responsibility in government finances and maintaining the fundamental health of the economy, always had to be in focus as well – a credible commitment to stability is what would attract investors in Iceland in the long run.