

## The lifting of capital controls attracts foreign investors

Over the past few months inflow into the domestic bond market has increased significantly. In August, foreign investors purchased ISK 18 bn worth of T-bonds, which is equal to over 30% of the Treasury's issuance this year. The increase in demand for T-bonds has pushed yields downwards despite the Central Bank's hawkish stance and raising of interest rates. The question is whether this trend will continue and how it will affect the transmission mechanism of monetary policy.

## The Central Bank keeps rates unchanged in September

The Central Bank's Monetary Policy Committee kept rates unchanged on September 30. The committee cited lower-than-expected inflation as the main reason for its decision, as well as declining prices of imported goods and a stronger currency. This has improved the inflation outlook over the near term while the medium-term outlook has stayed roughly the same, meaning that interest rate hikes are likely to continue. Results from the latest collective bargaining round are still seen as the single most threatening factor when inflation is concerned.

## Arion Research expects continued growth in tourism

Arion Research published a report on the status and outlook of the tourism industry in Iceland. The tourism sector has played an instrumental role in the Icelandic economy's post-crisis recovery and growth is expected to continue over the coming years. However, the sector is facing some potential capacity constraints, mainly relating to the country's only international airport, the labor market and the hotel industry.

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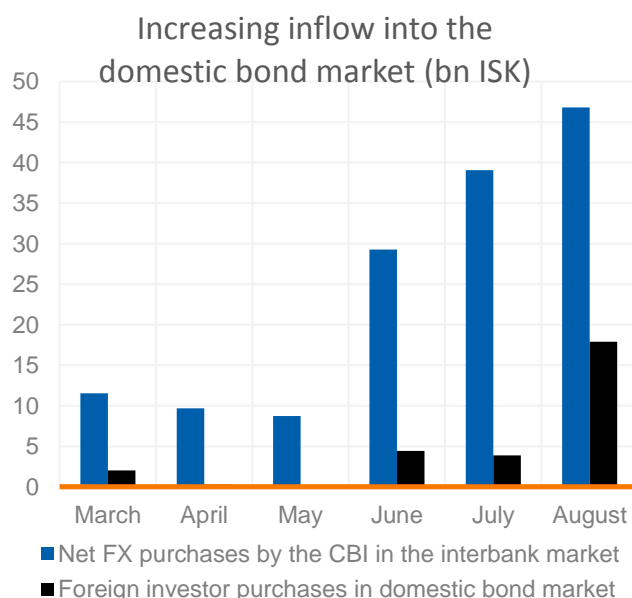
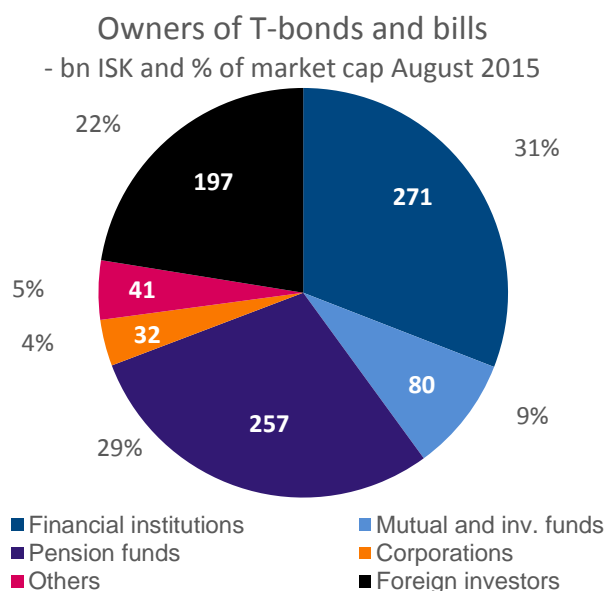
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# The lifting of capital controls attracts foreign investors

During the past seven years or so capital markets in Iceland have been mostly closed due to capital controls. Little foreign inflow has entered the markets during that time despite the fact that “new investment” has been exempt from controls and free to exit at any time. Foreign investors are currently holding approximately 22% of the total market cap of T-bonds and bills, or ISK 197 bn, but the majority consists of „offshore ISK holders“ who purchased ISK denominated bonds before the financial crisis and have invested in the bond market based on the Central Bank’s exemption list. Net inflow into the domestic bond market has been close to zero in recent years. Since domestic pension funds, mutual funds, investment funds and other investors have not been allowed to invest in foreign markets the demand in the bond market has been somewhat predictable and almost solely supported by domestic parties. Likewise, little uncertainty has surrounded the Treasury’s and others’ issuance this year.

However, there are now signs of growing net inflow into the capital markets - mainly into the government bond market, but also the stock market. In August, foreign investors purchased ISK 18 bn worth of T-bonds, which is equal to over 30% of the Treasury’s issuance this year. The inflow of FX can also be noticed when looking at the net FX purchases by the Central Bank (CBI) in the interbank market, although inflows are mostly due to a surplus in foreign trade. The CBI’s FX purchases have been increasing dramatically in recent months. In August, the CBI purchased ISK 47 bn in the interbank market, which is four times the amount it purchased on average in the spring. The CBI has declared that it will keep purchasing FX for the purpose of reducing ISK exchange rate fluctuations as well as to bolster reserves.

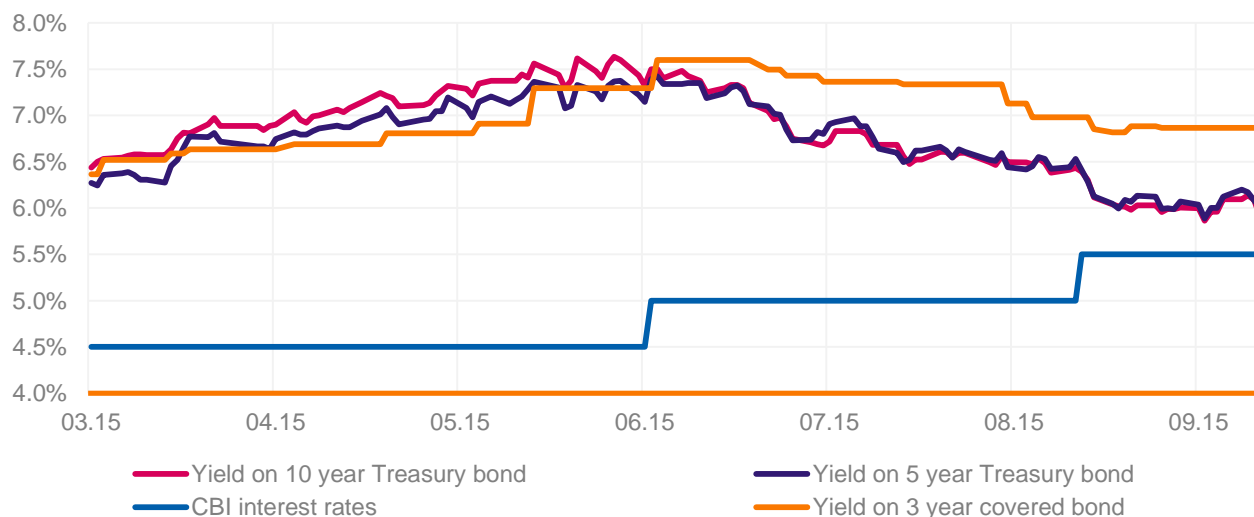


Sources: Government Debt Management, The Central Bank of Iceland

## Declining yields on T-bonds despite the Central Bank’s hawkish stance

The inflow into the domestic bond market marks a sudden increase in demand for bonds, especially T-bonds. Since June of this year, when the net inflow into the bond market started increasing notably, the yields on T-bonds have declined despite concurrent interest rate hikes by the CBI.

### Bond yields declining despite recent interest rate hikes



Sources: Kodiak, The Central Bank of Iceland

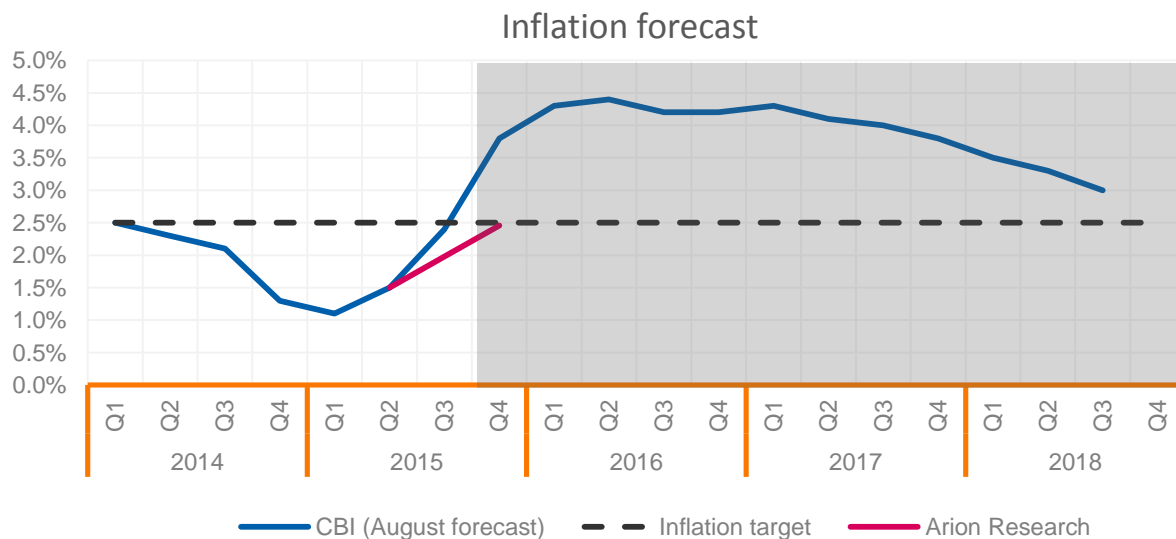
Recent wage agreements are well beyond what the increase in productivity and the inflation target allow, so the inflation outlook is worsening. At the same time fiscal restraint seems to be easing according to the new fiscal budget proposal for 2016, which includes very limited budget cuts. Under usual circumstances the yields on T-bonds would undoubtedly be rising, but the increase in demand for Icelandic government bonds has been pushing the yields downwards.

The Central Bank's interest rate hikes could be counterproductive in the sense that they are increasing the interest differential between Iceland and most other countries, which in turn attracts foreign capital and pushes yields downwards. A stronger real exchange rate reduces our international competitiveness and will likely result in a deterioration of the current account balance. The question is whether this development will continue in the coming months. If so, the transmission of monetary policy is likely to be more difficult than otherwise.

## The Central Bank keeps rates unchanged in September

The Central Bank of Iceland decided to keep rates unchanged on September 30th. Even though the decision was in line with analysts' expectations it seems to have surprised the market, which had priced in a 25bp hike. The yield on non-indexed government bonds declined by 17 bps while the yield on inflation indexed government bonds declined by 7 bps on September 30th.

The MPC has been hawkish in the wake of the latest collective bargaining round, stating that it's not a question of whether to raise rates but rather how much and how quickly. The decision to keep rates unchanged at the September meeting was mainly due to the fact that inflation had been rising more slowly than anticipated and is currently below target at 1.9%. Additionally, the króna has strengthened by 4% since the MPC's last meeting and imported prices have been falling as well. The short-term inflation outlook has thus improved while the committee believes that the medium-term outlook has stayed roughly the same.



There is still no news regarding the auction the Central Bank was planning in the fall for offshore ISK holders. Már Guðmundsson, the CBI governor, said it had become clear that the auction would not be held in October as had been previously suggested (they would like to allow participants 6-8 weeks to prepare and no announcement has been made yet). December-January seems like a likely result for the auction date although Már also mentioned that the Central Bank did not want the auction to coincide with the winding up of the old banks' estates as that could strain on the new banks' cash position – some weeks would have to pass between these two events.

Regarding the recent increase in capital inflow into the bond market, Már mentioned that the CBI's FX purchases had been one way of counteracting the development, although they would like to implement some macroprudential rules to deal with potential imbalances. However, that would be the last step taken when deciding on monetary policy post controls so no news is expected on that front just yet.

The main source of recent FX inflows is due to foreign trade in goods and services so it is only natural that the króna should strengthen with a hefty foreign trade surplus (ISK 65bn surplus in 1H 2015 compared to a ISK 30bn surplus at the same time last year). Exported services have exceeded expectations with the continuing boom in tourism. In order to limit the monetary expansionary effects the CBI's FX purchases might have, as well as a precautionary measure in connection with the winding-up of the failed banks' estates, the CBI decided to raise reserve requirements from 2% to 4%. We still believe we will see some further rate hikes this year, in November and/or December. How much depends on how domestic inflation and external conditions develop over the next couple of months.

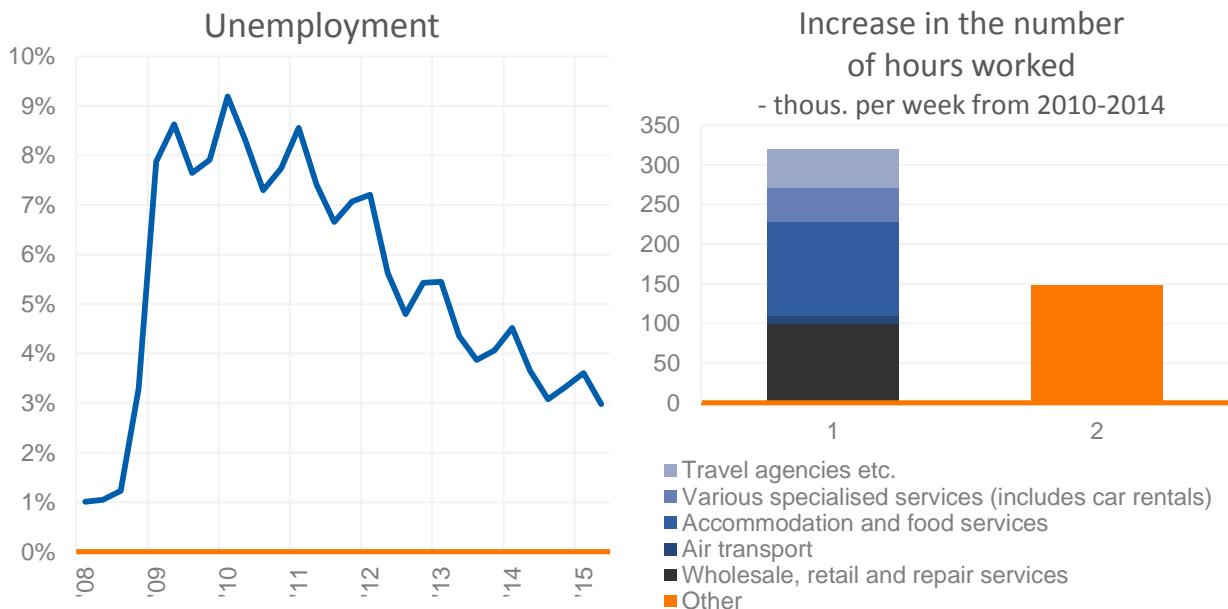
## Arion Research expects continued growth in tourism

Arion Research recently published a report on the status of the tourism industry in Iceland. When viewed in a macroeconomic context it is clear that the recent growth in the tourism industry has played a major role in the country's economic recovery in recent years. The growth in tourist arrivals has increased substantially every year since 2011 and is expected to be between 27 and 28% this year.



Sources: Icelandic Tourist Board, Arion Research

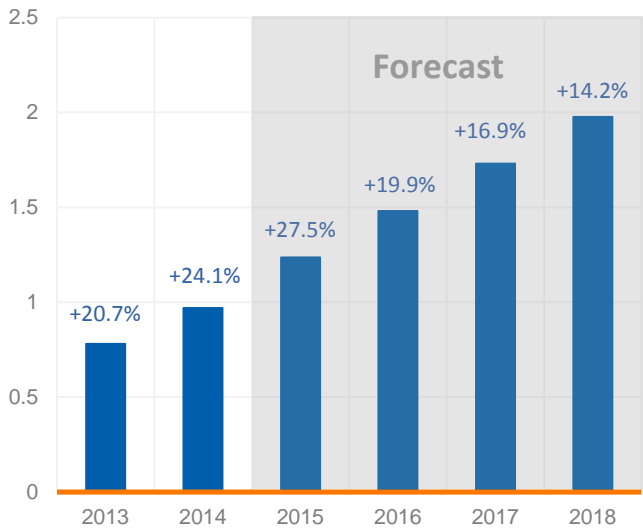
This has led to a rapid decline in the unemployment rate as the increase in the number of hours worked has increased over twice as much in tourism related sectors as in all other sectors combined over the past five years. The number of new enterprises in tourism related industries has also grown far beyond new enterprises in other sectors of the economy on average. Another positive byproduct of the tourism boom are the rapidly expanding foreign currency reserves of the Central Bank. A large surplus in traded services during the tourist season has allowed the CBI to shovel in FX in advance of the lifting of capital controls.



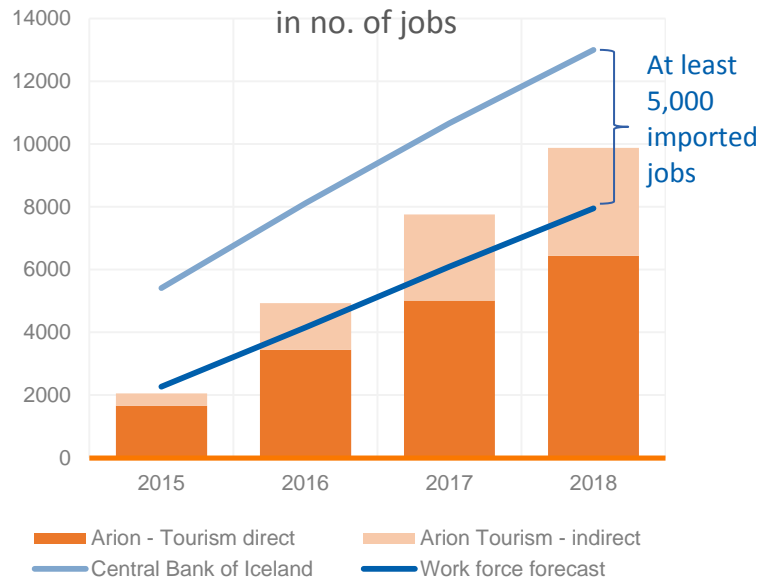
Sources: Central Bank of Iceland, Stattice, Directorate of labour, Arion Research

We also issued a new forecast for growth in tourist arrivals until 2018. We expect close to 1.5 million tourist arrivals (20% growth) via Keflavik International Airport in 2016 and nearly 2 million arrivals in 2018, compared to an expected 1.23 million arrivals this year. Our forecast this year is considerably more steep than our forecast at the same time last year, in part due to the fact that the growth so far this year is already well beyond our last forecast. However, we would like to point out that the prediction interval for the forecast is quite wide.

### Tourist arrivals via KEF airport -millions annually, % increase



### Forecast of cumulative increase in no. of jobs



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

Investment in infrastructure is needed if our forecast is to be realized. Construction is planned at Iceland's sole international airport, but the domestic airlines are calling for a more rapid expansion to keep up with growth. Investment is also needed at the country's most popular tourist attractions due to encroachment. We already have a very low unemployment rate and as service providers in the tourism industry are currently having difficulties finding qualified staff it is foreseeable that we will need to import thousands of jobs for the tourism sector alone over the coming years. Hotel occupancy rates were among the highest in Europe in 2014. Several large scale hotel projects are underway, which should ease capacity constraints on that front over the forecast horizon.

Tourism has become Iceland's main export industry, accounting for 28% of total exports in 2014, making it, larger than both the marine and aluminium industries as well as all other export industries combined. The rapid growth of the past few years was not foreseen so investments have been lagging. Business investment has been growing furiously in recent quarters which hopefully means that we will be able to keep up with growing demand in the coming years. Further growth in the tourism sector will continue to be a welcome addition to the Icelandic economy, which has already benefited greatly from the added diversification.