



# Icelandic Economic Update

Arion bank • Research • [research@arionbanki.is](mailto:research@arionbanki.is) • [arionbanki.is](http://arionbanki.is)



## Long-awaited plan on the table

- The long wait for the plan about the lifting of the currency controls ended on Friday 25 March when the Central Bank of Iceland published a report on the subject. The report traces in detail the next steps planned by the government and the Central Bank towards lifting the controls. It seems clear that initial measures concerning auctions of offshore ISK will commence soon. However, the report contains no fixed timeframe as the progression of the plan will depend on the success of preceding steps.

## “Definite” short-term uncertainty

- The decision by Icelandic voters to reject the Icesave agreement has resulted in increased uncertainty over the Icelandic economy in the short term. However, it is difficult to predict what the long-term effects on the economy will be while many questions remain unanswered. The Icelandic economy is riddled with numerous uncertainties, the Icesave dispute being one of them. There are three relevant factors at the present. Will the treasury’s credit rating be downgraded? The lifting of the capital controls and the economic programme of IMF and Iceland.

## Long-awaited plan on the table

---

The long wait for the plan about the lifting of the currency controls ended on Friday 25 March when the Central Bank of Iceland published a report on the subject. The report traces in detail the next steps planned by the government and the Central Bank towards lifting the controls. It seems clear that initial measures concerning auctions of offshore ISK will commence soon. However, the report contains no fixed timeframe as the progression of the plan will depend on the success of preceding steps.

The big news in our opinion is not the strategy itself but the government's announcement that **the currency controls could remain in place until 2015** and the impact this statement will have on the interest-rate decisions of the Monetary Policy Committee at its coming meetings, as well as general asset prices in the country.

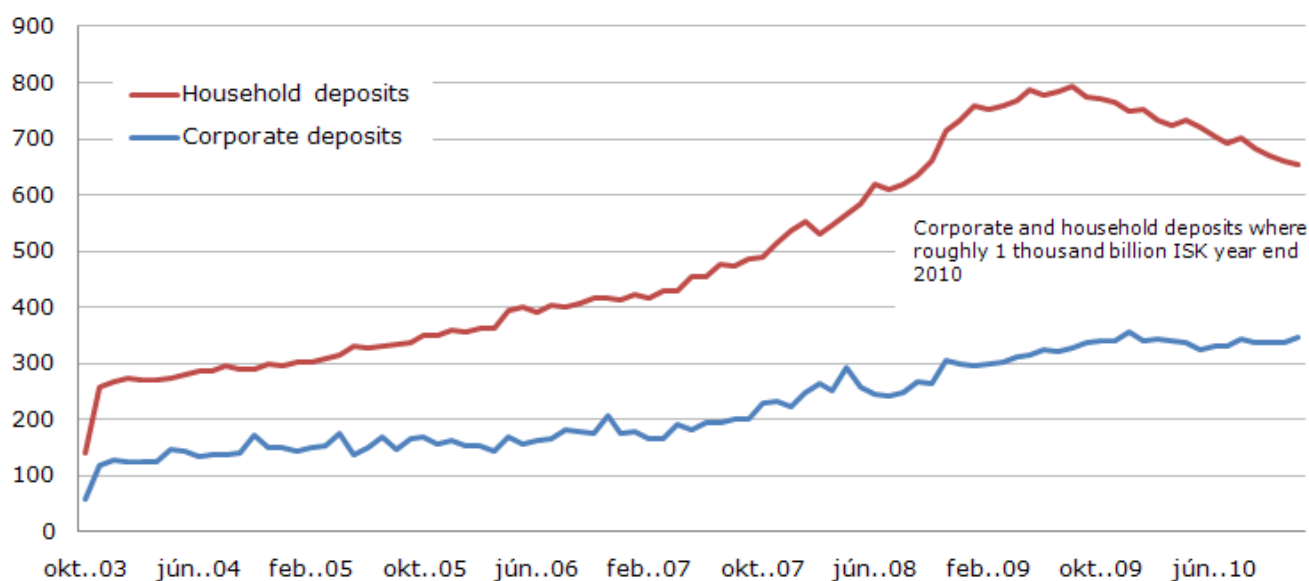
### I. A longer wait for lifting of the controls – will interest rates go lower?

If the Monetary Policy Committee had realized from the start that the wait for the lifting of the controls would be as long as it is turning out to be, the interest rate would have been lowered faster and would even have reached an even lower level today. Such speculation is just as relevant now as before and the question that arises is: Will the Central Bank keep lowering the interest rate or will it aim to support the liberalization procedure with high/higher interest rates?

**Reasons to keep lowering rates still remain.** Most people realize that the currency controls have a hampering impact on investment in the country, and thus economic growth. Therefore, it is good news that the first steps towards liberalization of the controls aim to stimulate investment in the economy by channeling offshore ISK into domestic investment. This is not enough, however, especially with view of the long time frame of the liberalization strategy. The Central Bank's most effective remedy for a weak investment level is to keep lowering the policy rate to bring real interest rates lower. Reasons to keep lowering interest rates still remain as there is substantial slack in the economy (the slack last year having been greater than projected by the Central Bank's economic forecast), inflation is low (especially when excluding rises in commodity prices and taxes) and the ISK exchange rate is relatively stable.

**Will the Monetary Policy Committee alter its world view?** The Monetary Policy Committee has until now placed great emphasis on maintaining a high interest-rate level, even though conditions in the economy may not have occasioned it. This has been done both to support the short-term ISK exchange rate and to support the pending lifting of the currency controls. We deem unlikely that a major strategic change is underway at the Committee's coming interest-rate meetings.

## Corporate and household deposits (ISK billion)



Source: Central Bank of Iceland

## II. Asset prices may rise

Arion Research believes that an important uncertainty factor has been eliminated. This new strategy will most likely make a significant impact on asset prices in the country as domestic investors have now “finally” received an announcement from the authorities stating that their money cannot leave the country in the next few years. Therefore, only domestic investment options will be available for domestic parties in coming years. Accordingly, funds are likely to flow increasingly from deposits into other asset markets in coming months and even years – especially as deposit rates are historically low at present. Increased demand for other asset classes, i.e. shares, bonds and real property, should therefore encourage a rise in asset prices.

## “Definite” short-term uncertainty

The decision by Icelandic voters to reject the Icesave agreement has resulted in increased uncertainty over the Icelandic economy in the short term. However, it is difficult to predict what the long-term effects on the economy will be while many questions remain unanswered.

**Will the weak recovery become even weaker?** The estimates of Arion Research, the Central Bank of Iceland, the IMF and Statistics Iceland all assume that there is a weak economic recovery ahead, where there is a risk that limited economic growth could easily transform into contraction again. Since the economic collapse it has been shown that any uncertainty (whether over the Icesave dispute or other issues) holds back major investment projects; for example the Central Bank of Iceland has repeatedly had to lower its economic growth forecast on account of delays in the construction of the Helguvík aluminium plant. The main requirement for economic growth is a recovery in investments. A continued state of uncertainty will clearly not strengthen any imminent economic recovery. However, whether it will actually undermine the upturn also remains to be seen.

## Main uncertainties

The Icelandic economy is riddled with numerous uncertainties, the Icesave dispute being one of them. There are three relevant factors at the present.

1. Will the treasury's credit rating be downgraded? Before the Icesave referendum took place the rating agency Moody's announced that it would probably lower the Icelandic government's credit rating from BBB- to Ba1 or lower; this would put Iceland's sovereign rating in the speculative grade (i.e. junk category). A rating such as this would obviously make it more difficult for the Icelandic government to raise funding on the international credit markets (at least at reasonable terms). Faced with such prospects, the Central Bank would presumably move closer towards Plan B, which would involve buying up more foreign currency on the market to boost the currency reserves (see discussion below). A lower credit rating would have more far-reaching repercussions, however; it would lead to poorer terms of funding for companies in Iceland (particularly publicly owned energy companies) and this would lead to further delays in investments. It is also not certain whether a downgrading would affect the construction of the Búðarháls power station, where part of the funding is conditional on the treasury's credit rating not being downgraded. If funding was raised elsewhere on poorer terms, it would reduce the plant's profitability.
2. Lifting the capital controls. The governor of the Central Bank has repeatedly pointed out that a "No" vote in the Icesave referendum would hold back the lifting of the capital controls. It was therefore not surprising when a representative of the IMF hinted the same thing at the weekend. In this case we are not talking about delays to the first phase of lifting the controls (expected to commence shortly), i.e. plans to reduce the position of offshore ISK and direct some of it into the Icelandic economy and the government's long-term funding. The first steps therefore call for either an influx of foreign currency or investment with offshore ISK in the economy which should have a positive impact on the Icelandic economy. Delays to the lifting of capital controls refer mainly to the second phase – i.e. the relaxing of controls on onshore ISK. A number of conditions need to be met before this can begin. Firstly, it is crucial that the government has access to the international credit markets. Whether an unresolved Icesave dispute will be an obstacle to this process is difficult to say for certain.
3. Economic programme of IMF and Iceland. A representative of the IMF said at the weekend that it would be necessary to review Iceland's economic programme following the rejection of Icesave. However, it is unclear what these comments signify and whether such a review would have much impact on economic developments in Iceland in the near future.

## Iceland without international funding

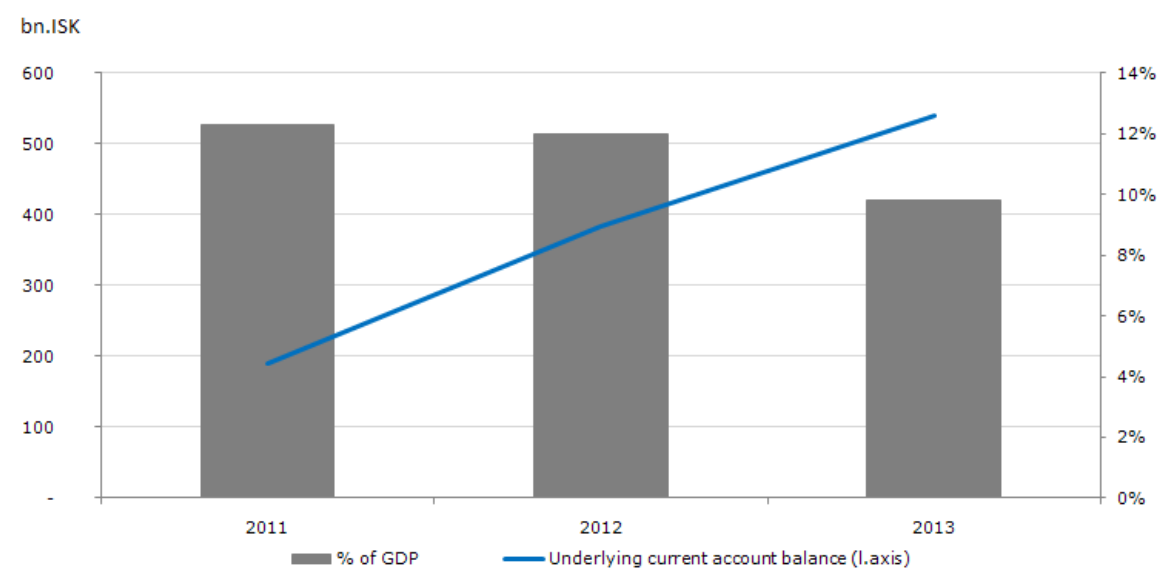
There is considerable uncertainty over further loans from the Nordic countries/IMF and the government's participation in the international capital markets following the rejection of the Icesave bill. The question is whether Iceland can fund its maturing liabilities over the next few years without access to foreign markets. If not, how much FX would the Central Bank need to buy on the market, and is it realistic to think that it could do so?

## Strong on paper

On paper the Central Bank should have plenty of flexibility to buy foreign currency over the next few years. In the paper "What does the nation owe?" it transpires that the underlying current account surplus (trade and services surplus minus net interest and dividend payments from Iceland, less the company Actavis and the effect of the failed banks) will be 12.3% in 2011, 12% next year and 9.8% in 2013. The accumulated current account surplus up until 2013 should therefore be ISK 540 billion (3.3 bn.EUR). If it is assumed that this currency comes to Iceland, then the Central Bank appears to have plenty of headroom to amass currency reserves, provided that only a part of the current account surplus passes out through the capital account. However, it should be remembered that these are estimates and the currency is by no means "in the bag."

### Underlying current account surplus

excluding the old banks and Actavis (from the report "How much does the nation owe?")



Source: Central Bank of Iceland

### Will these tactics work?

The exchange rate of the ISK last year (12% appreciation) indicated that the trend assumed by the Central Bank had been realistic (i.e. underlying current account surplus was 12.8% in 2010). However, the 3.5% depreciation of the ISK this year does undermine this explanation to some extent.

There is little to suggest that the current account surplus is reaching Iceland in the volume estimated by the Central Bank, but it might still be too early to tell. It should be mentioned here that a large-scale influx of currency should lead to a stronger exchange rate or increased foreign currency positions at the banks (which end up at the Central Bank due to the capital controls). It cannot be ruled out that Icelandic companies are paying off debts in foreign currencies to foreign banks; but it is unlikely that such payments make a big difference. It should be noted that the Central Bank has only acquired ISK 10 billion (60 m.EUR) in regular purchases on the interbank market since August 2010.

### Borrowed currency reserves

It is important to remember that the Central Bank's currency reserves have never been so large and amounts to ISK 766 billion (4.7 bn. EUR). However, it should also be borne in mind that the entire sum has been borrowed. In fact assets minus liabilities in foreign currency are negative by ISK 30 billion.

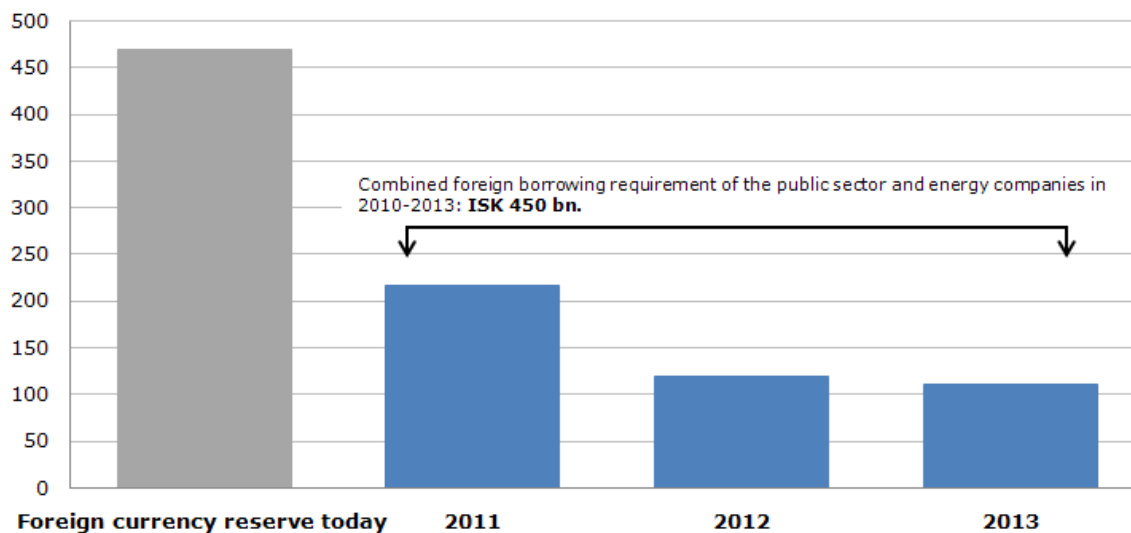
If we examine the composition of the currency reserve more closely, it turns out that only part of it is accessible; ISK 300 billion are deposits from resolution committees and Icelandic banking institutions, money which will largely be paid out to foreign creditors in the near future. The remainder is therefore the "available" reserve, just under ISK 470 billion (see diagram below). Assuming that the reserves will be used to pay off foreign debt of the government and power companies maturing this year, then the available reserves will have dropped to ISK 250 billion by the end of the year. If the public sector had virtually no access to international funding, the currency reserve would be cleared out in the three years. In this sense it is critical that the Central Bank's forecast on the current account surplus is accurate!

If the forecast on the current account balance is accurate, the Central Bank should theoretically be able to amass enough money to meet liabilities of the public sector and energy companies maturing over the next few years, without depleting the currency reserves and jeopardizing the exchange rate. The

big question at the moment is over the Icelandic government's access to the international credit markets. If these markets are closed or the terms are poor then the Central Bank has less time to wait for an influx of foreign currency. As early as the second half of the year or the beginning of next the Central Bank may be required to be more active on the foreign exchange market to build up its future reserves.

### Foreign borrowing of the public sector and energy companies

compared with foreign currency reserves (bn. ISK)



Source: Central Bank of Iceland

## Contacts

### **Ásdís Kristjánsdóttir**

Head of Research  
Capital Markets & Corporate Banking  
Tel: +354 444 6968  
asgeir.jonsson@arionbanki.is

### **David Stefánsson**

Analyst  
Capital Markets & Corporate Banking  
Tel: +354 444 6965  
davidst@arionbanki.is

### **Thorbjörn Sveinsson**

Senior Analyst  
Capital Markets & Corporate Banking  
Tel: +354 444 6973  
thorbjorn.sveinsson@arionbanki.is

### **Fannar Jónsson**

Analyst  
Capital Markets & Corporate Banking  
Tel: +354 444 6962  
fannar.jonsson@arionbanki.is

### **Hallgrímur Björnsson**

Senior Analyst  
Capital Markets & Corporate Banking  
Tel: +354 444 6818  
hallgrimur.bjornsson@arionbanki.is

#### **Provisional release:**

The content of this release has been prepared by the Research Division of Arion Bank hf. The Research Division bases its information on data information services and news services, both foreign and domestic, which it considers reliable, along with its own interpretations and evaluations of public information. Arion Bank hf. accepts no responsibility for the accuracy of this information nor any liability for transactions based on this information. In relation to this it should be noted that any of the Research Division's discussion may be an abridged version of more extensive analysis and research and conditions of financial markets change rapidly. For these reasons the recommendations and forecasts of the Research Division can change without notice, but they do reflect the opinions of the Research Division's employees at the time that they are expressed. Those parties who are interested in initiating transactions are advised to contact an expert at Arion Bank hf. before any decision is made. It should also be noted that Arion Bank hf., its employees and other parties associated with the Bank may have vested interests concerning particular organizations, which the Research Division's published material may pertain to at any given time.