



# Icelandic Economic Update

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## Increased uncertainty holds back economic recovery

- The decision of the president of Iceland to call for a referendum on parliament's bill on a state guarantee for the Icesave obligations has fuelled uncertainty over the state of the Icelandic economy, at least in the short term.

## GDP 2010: Weak economic recovery ahead

- Gross domestic production in 2010 contracted by 3.5% between years, slightly more than forecast by the Central Bank of Iceland (CBI) and Statistics Iceland. The good news is that GDP stopped contracting in the last quarter of the year from the same time last year – following continuous contraction for the past nine quarters.

## The year 2010: Small current account surplus

- The underlying current account surplus, reflecting Icelanders' foreign trade excluding the impact of banks in a winding-up process, amounted to ISK 26bn in the year 2010, or 1.7% of GDP. The outcome falls short of expectations as the CBI recently (in its Monetary Bulletin) issued a forecast for an underlying current account surplus of 6.6% of GDP in 2010.

## No policy rate reduction on 16 March

- We deem very unlikely that the Central Bank will reward or punish the nation, i.e. with a rate hike or reduction, while the nation is making up its mind before the national referendum. Therefore we expect the policy rate to be left unchanged, the next step will become clear once the nation has voted.

## Calendar

Date	Title	Period
16 March 2011	Policy rate decision	
18 March 2011	Auction Treasury Notes	
29 March 2011	Consumer Price Index	March 2011

## Increased uncertainty holds back economic recovery

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The decision of the president of Iceland to call for a referendum on parliament's bill on a state guarantee for the Icesave obligations has fuelled uncertainty over the state of the Icelandic economy, at least in the short term. Each option, i.e. whether the dispute is settled through the courts or negotiations, will have a completely different impact on the Icelandic economy and its access to capital.

While the economy has certainly started to recover, it appears that it will be a fragile process. The capital controls have served a certain purpose and brought stability to the economy. In the long term, however, they have hampered investments in Iceland. A prolonged period of uncertainty is likely to slow down economic recovery even further as the situation will clearly delay various investment projects underway.

There are two key factors to consider:

**Will the lifting of capital controls be postponed?** There is now even greater uncertainty over the plans of the authorities and the IMF to lift the capital controls. A report on the matter is expected in the end of the month. It is however clear that no steps will be taken until the outcome of the Icesave referendum in April is known, but the wait is not long. However, there is a risk of small or even no steps being taken to lift capital controls if the nation rejects the Icesave contract in favour of court proceedings, which might take 2-4 years.

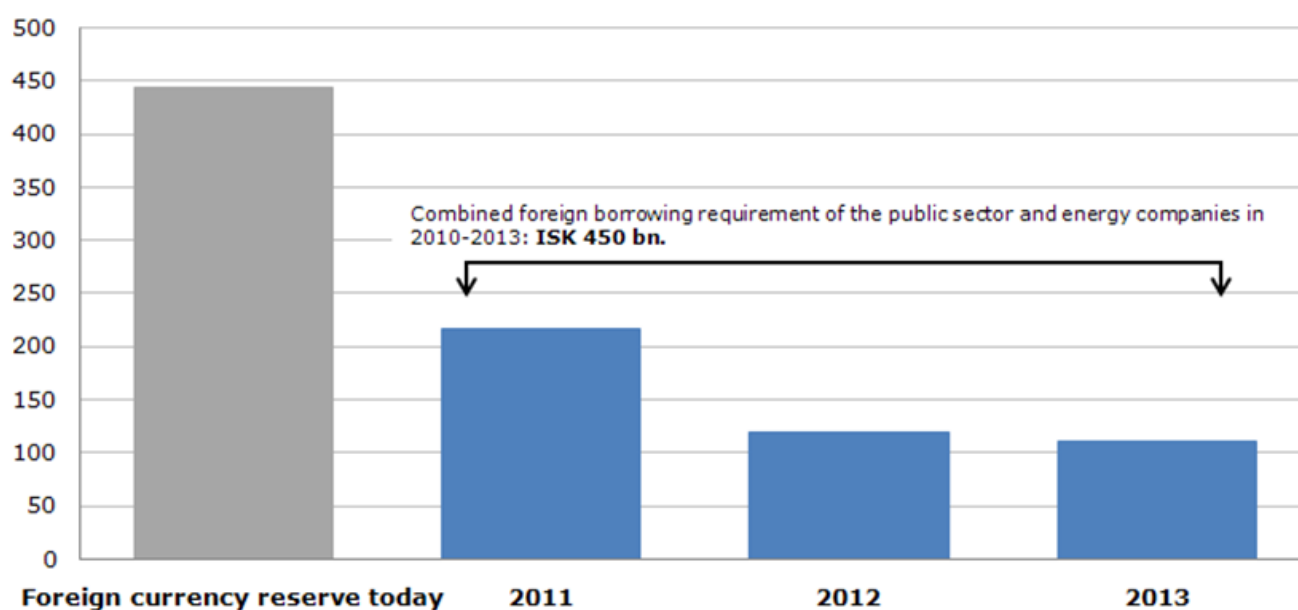
**Access to foreign capital** is of great importance in the country's economic regeneration. A situation could easily arise where the national treasury's access to foreign capital would be substantially limited or blocked while waiting for a court decision, but just how serious the long-term effect would be is impossible to predict. The treasury's plans for refinancing foreign loans this year (for up to EUR 713m) have most likely already been delayed because of this. The outcome is also bound to impact the possibility of other public enterprises and municipalities to refinance in foreign markets.

### Reserves last until 2013 if all markets close

Arion Research estimates that the combined foreign borrowing requirement of the public sector (state and municipalities) and energy companies will be ISK 450bn in the years 2011-2013, or the equivalent of today's entire foreign currency reserves. (The current reserves are ISK 444bn excluding foreign currency deposits in the Central Bank of Iceland (CBI)). Assuming that access to foreign credit becomes entirely blocked, the reserves will last to meet payments on foreign loans until the year 2013. In addition, other loans will mature after 2013 (such as loans from IMF and the Nordic countries (in addition to interest)) - a total of ISK 206bn that matures in 2014-2016.

It is therefore quite certain that pressure will increase on the CBI's FX purchases in the meantime, if access to foreign credit is limited even further.

## Foreign borrowing of the public sector and energy companies - compared with the foreign currency reserves (in billion ISK)



Source: Central Bank of Iceland

**No more policy rate reductions for the time being.** Hopes for a reduction in the policy rate at the next policy rate decision meeting on 16 March have most likely faded.

It is interesting to read the latest statement of the Monetary Policy Committee when the president had referred the Icesave contract (the older one) to a referendum about a year ago.

*From the statement of the Monetary Policy Committee, 27 January 2010*

*"Given the effectiveness of the capital controls, the short-run effect on the króna should be modest; However, further steps towards removing the capital controls would be risky given the above uncertainties."*

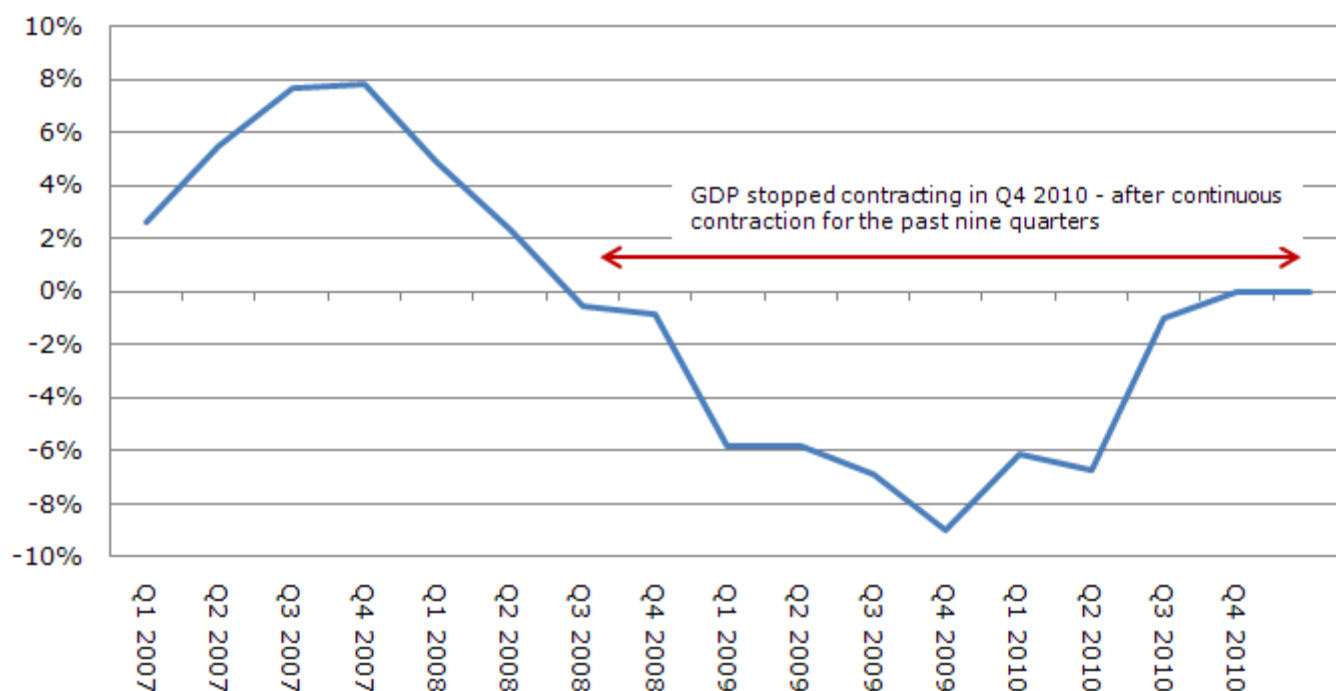
*"However, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, the MPC will have limited room for manoeuvre."*

## GDP 2010: Weak economic recovery ahead

Gross domestic production in 2010 contracted by 3.5% between years, slightly more than forecast by the Central Bank of Iceland (CBI) and Statistics Iceland. The good news is that GDP stopped contracting in the last quarter of the year from the same time last year – following continuous contraction for the past nine quarters.

There are numerous indications that the economy begun to recover, but ahead lies substantial uncertainty, mostly related to the unresolved Icesave dispute and even rising commodity prices which could easily bleaken the economic outlook.

## Economic Growth - real changes in GDP from previous year



Source: Statistics Iceland

### Lost economic growth or scare tactics?

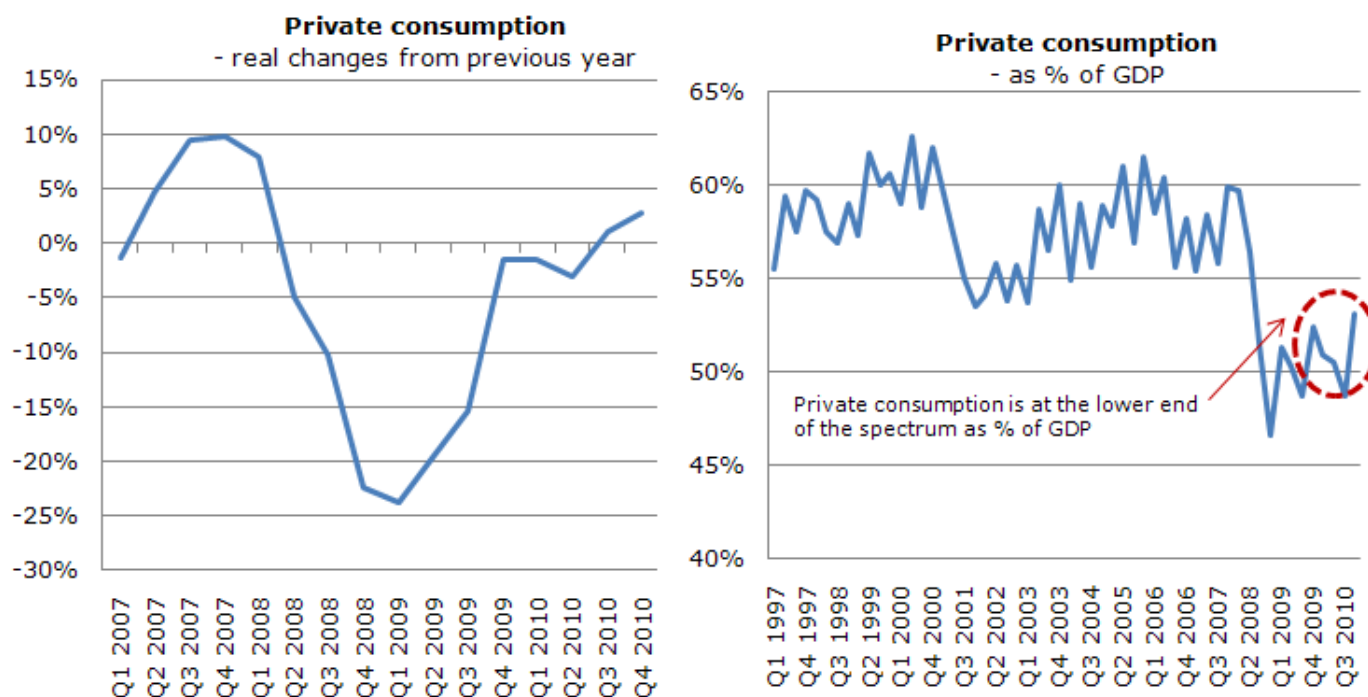
As pointed before by Arion Research, the unresolved Icesave dispute has increased uncertainty in the Icelandic economy. It is clear that longstanding uncertainty serves to slow down the country's economic recovery and could easily turn recovery into a new period of contraction. Since the financial crisis, any uncertainty has proved to hamper investment projects, revived investment being the main precondition for economic growth in coming quarters and years.

It is clear that uncertainty relating to the unresolved Icesave dispute may have reverberating effects. As mentioned above Arion Research has estimated that the combined foreign borrowing requirement of the public sector and energy companies will be ISK 450bn in the years 2011-2013, or the equivalent of today's entire foreign currency reserves. (The current reserves are ISK 444bn excluding foreign currency deposits in the CBI). It is necessary to view the said amount in context with comments made by the CBI governor at Parliament's open committee meeting last week. He said that the unresolved Icesave dispute would make access to foreign credit markets more difficult for the Treasury. The CBI would then have to work according to plan B which means buying more currency in the market to bolster the debt-free foreign reserve in order to meet payment in coming years. Consequently, simultaneous pressure is put on the ISK (probably in weaker krona).

This takes us to another part of economic growth affected by the said uncertainty, i.e. private consumption, which is generally very sensitive to the ISK exchange rate, as depreciation of the currency diminishes the household's imported purchasing power. This might be offset by some increase in exports, but low investment in the export sector in recent years prevents significant volume changes in that area, (although ISK revenues may perhaps be somewhat higher). Therefore, if significant buying pressure is created in the FX market there is a risk of delays in further economic regeneration in the country and a greater slack in the economy than presently forecast.

## Highlights of the 2010 GDP:

**A robust turnaround in private consumption.** Private consumption grew by 2.8% in the last quarter of the year compared with the same quarter last year, growing for two consecutive quarters. This robust turnaround can partly be traced to the repayment of foreign loans. Therefore, a backlash in consumption growth can be expected next year when repayments end. Despite the pickup in private consumption, it is at the lower end of the spectrum measuring 53% of GDP, compared with around 60% of GDP before the economic crisis. In the year as a whole in 2010, private consumption remains almost stagnant from 2009.

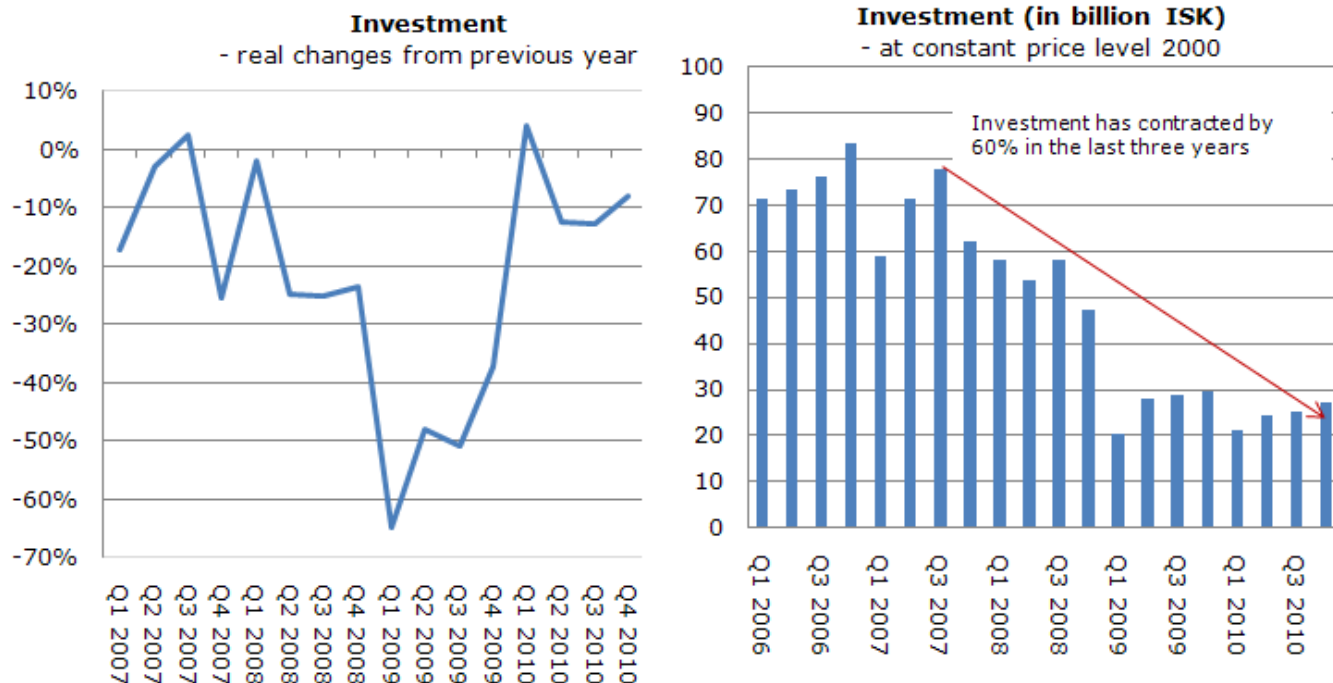


Source: Statistics Iceland

**Investments continue to decrease.** Investment has grinded to a halt since the financial crisis, still showing more than 8% contraction between years. Apart from the first quarter of 2010, when investment between years rose unexpectedly by more than 4%, investment has contracted continuously for three years, or by a total of 60% in the period.

Investment is currently at a minimum, weighing around 14% of GDP, whereas it measured around 20% of GDP on average before the crisis. As mentioned above we are rather pessimistic concerning revival in investments in coming quarters as many projects are on hold due to the prevailing uncertainty. Added to the uncertainty is obstruction to investment in the country caused by the capital controls.

**Foreign trade reduces economic growth.** For the year as a whole, foreign trade (exports minus imports) reduces economic growth, despite the low real exchange rate. This can be traced to contraction in merchandise exports between years as well as an increase in imported consumption.



Source: Statistics Iceland

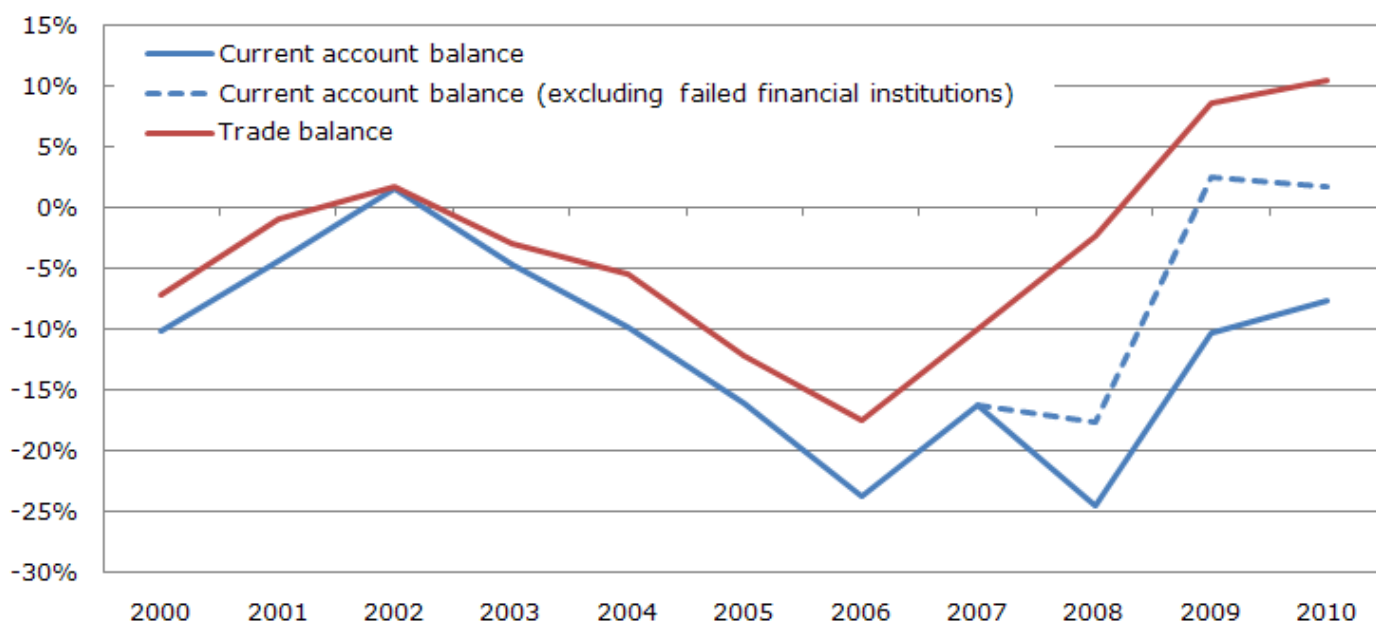
## The year 2010: Small current account surplus

The underlying current account surplus, reflecting Icelanders' foreign trade excluding the impact of banks in a winding-up process, amounted to ISK 26bn in the year 2010, or **1.7% of GDP**. The outcome falls short of expectations as the CBI recently (in its Monetary Bulletin) issued a forecast for an underlying current account surplus of 6.6% of GDP in 2010.

If today's figures are indicative of coming years, the national economy cannot withstand substantial setbacks if it is to maintain the ability to meet interest and dividend payments on foreign loans and the exchange rate to remain unchanged. Also, Iceland's ability to pay off debt and accumulate unleveraged foreign currency reserves could be doubted.

However, the situation is more complicated and the figures most likely reflect a position that has now changed, i.e. the national economy is most likely generating more foreign currency than the underlying current account balance indicates. (See discussion below).

## The balance of payment for Iceland - as % of GDP



Source: Central Bank of Iceland

### Does Actavis distort the picture?

The current account balance is comprised of the trade balance on the one hand and the balance of factor income on the other. The trade balance in 2010 was more or less in line with expectations, yielding net income of ISK 163bn or 10.4% of GDP. At the same time, however, the underlying balance of factor income was negative by ISK 136bn, or 8.7% of GDP (which means that net interest and dividend payments to and from the country were negative by as much).

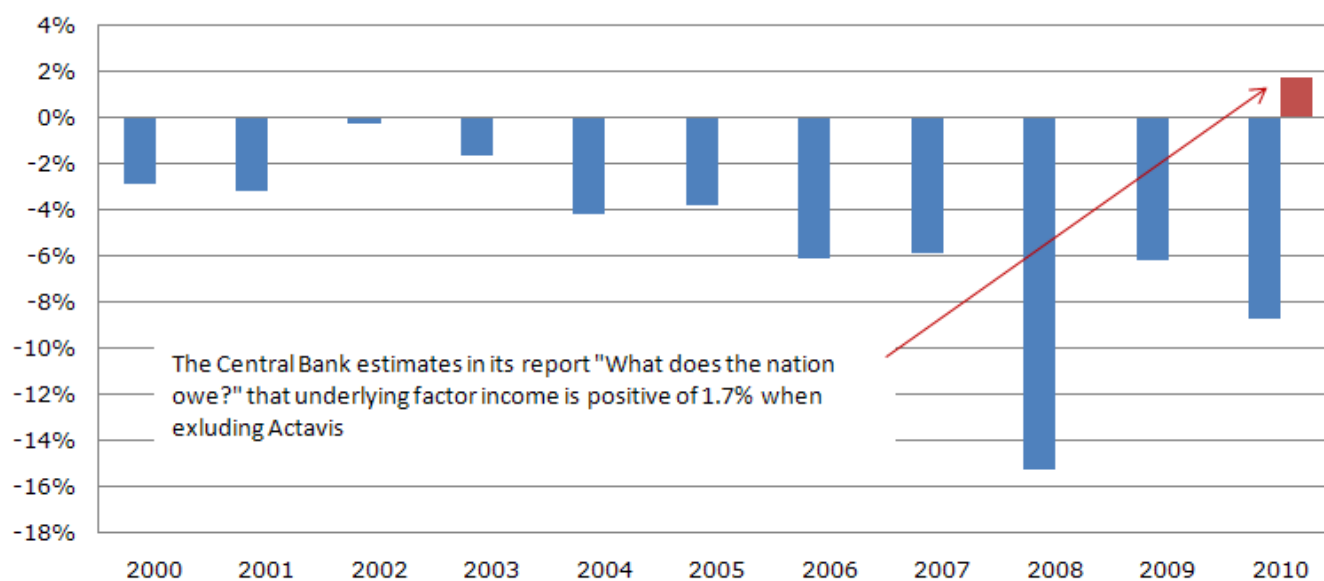
*But what causes the balance of factor income (excluding the effect of banks in a winding-up process) to yield so much loss? A close look at the CBI's news release reveals the following:*

***“Losses recorded by domestic firms owned by non-residents had the greatest impact on the current account balance, although the effect was smaller than expected. Their negative reinvestment is therefore much lower, which means that the deficit in the balance on income was greater than previously projected.***

There can be little doubt that the firm in question is Actavis, as the CBI's latest publication called "What does the nation owe?" indicates that the factor income deficit is mostly explained by the company's estimated net interest payments. The question is therefore whether a true picture is not obtained by looking at the current account balance excluding the influence of Actavis, as is done in the report, since the company's cash flow out of the country does in fact not exist as the company does not buy foreign currency to make the interest payments abroad (but instead the company's revenues and expenses are between related parties). However, the CBI's newly released economic figures do not indicate how large a part the company plays in the said factor income deficit, making it difficult to estimate the real current account surplus excluding the impact of banks in a winding-up process and Actavis.

## Underlying factor income as % of GDP

- excluding banks in winding-up process from the collapse to date



Source: Central Bank of Iceland

## No policy rate reduction on 16 March

The last statement of the Monetary Policy Committee struck a new note as for the first time in a long while it opened the possibility for a rate hike. One of the main rationales for this is that interest rates are now historically low and plans for lifting currency controls have created uncertainty in the near term. This new tone is very interesting in context with the Central Bank's forecast for inflation and economic growth which predicts weak economic recovery and inflation below the set target for the next three years or so, factors that do certainly not call for a higher interest rate in the opinion of Arion Research.

What has changed from the last policy rate decision meeting is that inflation was somewhat higher in February than generally expected. Also, the short-term inflation outlook has worsened as hikes in world commodity prices show up in higher goods prices in Iceland. The Central Bank has itself said that it does not react to unrest abroad by raising the policy rate, as it is to no avail.

Although the factors mentioned above are important, they are weak in the face of the uncertainty which the Icesave issue has created for the Central Bank. We deem very unlikely that the Central Bank will reward or punish the nation, i.e. with a rate hike or reduction, while the nation is making up its mind before the national referendum. Therefore we expect the policy rate to be left unchanged, the next step will become clear once the nation has voted.

## The Central Bank dislikes uncertainty

The Central Bank can be said to be on an "uncertainty target" of sorts as, as the clearing up of some matter or another is constantly awaited while underlying conditions in the economy are not given the benefit of the doubt. The uncertainty has usually been linked to the imminent lifting of currency controls, revision by the IMF (so lifting of currency controls can commence), risk-adjusted interest rate differential (so lifting of currency controls can commence), and, in addition, uncertainty about the banks' position due to foreign currency-denominated loans slowed down policy rate reductions around



mid-year, to name a few factors. It is interesting to look back at a paragraph from a statement by the Monetary Policy Committee, which provided rationale for unchanged policy rate.

### **Statement of the Monetary Policy Committee, August 2009**

*"While there is no clear sign that past policy rate reductions have been an important cause of capital control circumvention, accumulation of foreign exchange deposits, or the weakness of the króna in general, such an effect cannot be ruled out. Hence there is a strong case against lowering interest rates further as long as the króna remains as weak as in recent months." (Fourth paragraph)*

Although the paragraph in many ways describes circumstances different from those today, it has a strong resonance. While uncertainty exists about some of the Central Bank's main targets, i.e. the stability of the exchange rate and inflation and numerous related items, that uncertainty will be interpreted to the disadvantage of the policy rate.

The economy certainly faces many uncertainty factors at present and most of them serve to slow down the country's economic recovery. Those factors include uncertainty in relation to the lifting of capital controls, companies' debt position and a complicated public regulatory framework. These are all uncertainty factors that are likely to stay with us.

However, uncertainty in the Icelandic economy has never been greater if the referendum on the Icesave agreement is added to the equation. If the agreement is accepted the Central Bank can continue undaunted into a "known" uncertainty. If the agreement is rejected the Central Bank will be met by uncertainty it dislikes, i.e. a greater uncertainty.

In such circumstances we deem very likely that all *big* plans for lifting the currency controls will be put on hold. The Central Bank might then possibly have the opportunity to lower rates further as the imminent lifting of currency controls would no longer stand in the way. However, one can also envisage a large increase in the Central Bank's foreign currency purchases (to increase the unleveraged currency reserves) that might perhaps call for a higher policy rate to keep the ISK stable. Further speculation about the Central Bank's possible reaction is however untimely until the result of the referendum in April is known.

### **What did the CB say before the last referendum?**

It is interesting to read the latest statement of the Monetary Policy Committee when the president had referred the previous Icesave agreement to a referendum, about a year ago. The reaction at the next meeting cannot be expected to be very different from what it was then.

*From the statement of the Monetary Policy Committee, 27 January 2010*

*"The failure to resolve the dispute over compensation of depositors in foreign branches of Landsbanki has already triggered a sovereign credit rating downgrade to non-investment grade by one of the rating agencies and could delay the second review of the IMF programme. Consequently, access to bilateral and multilateral financing, a prerequisite for successful access to international capital markets, might also be delayed. Given the effectiveness of the capital controls, the short-run effect on the króna should be modest; **However, further steps towards removing the capital controls would be risky given the above uncertainties.**"*

*"However, as long as there is significant uncertainty about Iceland's future access to foreign capital markets, the MPC will have limited room for manoeuvre."*

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