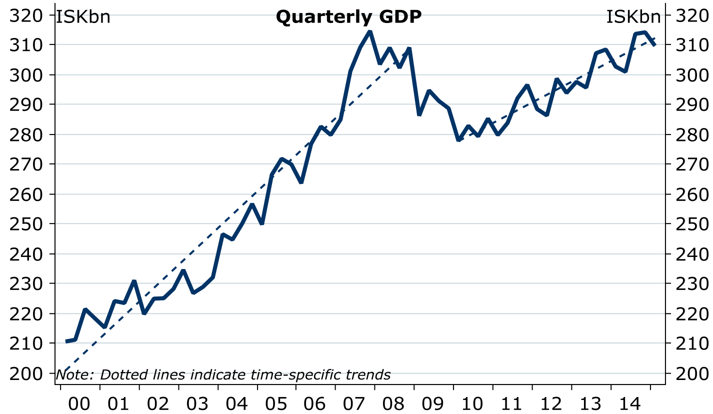
Nordea

Iceland

Updated 18 June 2015

The big picture

- Since 2010 growth in the Icelandic economy has varied, but growth rates have overall been positive. As can be seen from the trend-lines in the upper chart, growth is more modest than the pre-crisis level, but this is only natural given the explosive GDP growth characterising the period.
- We see growth on a par with recent years' expansion. And as the loss of output is recaptured, growth will reach 2.5% slightly longer term.
- To a large extent the pick-up in growth is to be driven by consumers, who have been relatively cautious since the financial crisis. Higher real wage growth and a restructuring of the high level of mortgage debt will ensure that households' disposable income rises in the period ahead.
- For Iceland, the key challenge is the capital controls that prevent free currency movements (for investment) across borders. The government has proposed a plan that aims to get rid of a large excess stock of ISK, which is a necessary condition for the controls to be lifted.



Source: Nordea Markets and Macrobond

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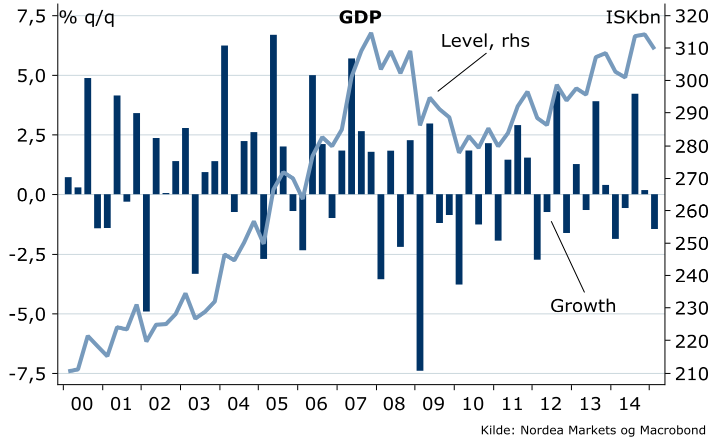
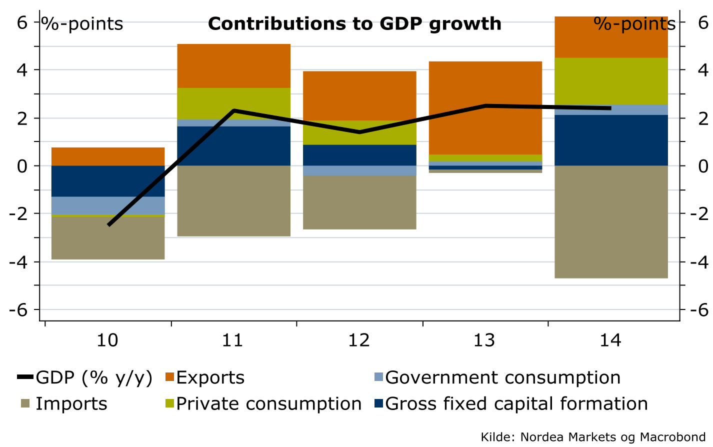
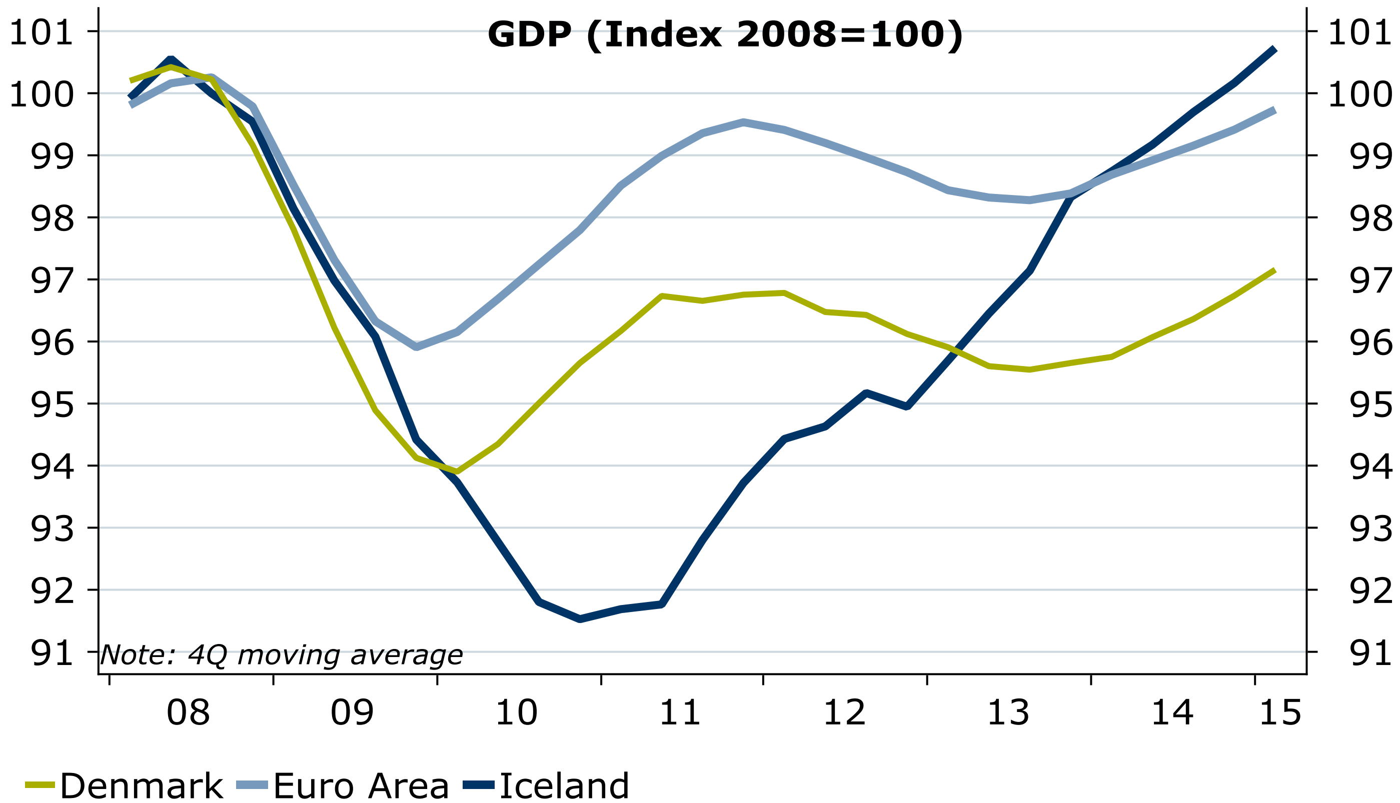
Exports have contributed to decent growth

- Following the severe collapse in 2008, the Icelandic economy is still in a restructuring process. Growth has largely returned and is now broadly back at pre-crisis levels.
- In recent years growth has been driven by a marked currency depreciation halving the value of the ISK over a short period. This dramatically changed Iceland's terms of trade and accounted for the large growth contribution from exports; especially in 2013 exports underpinned the Icelandic economy (see lower chart).
- After slowing sharply in 2008-10, consumer spending has regained momentum and expanded. In the years ahead we see continued stable consumer spending growth thanks to higher disposable incomes.
- It is worth noting that imports (which are also driven by higher consumer spending) were a significant drag on GDP growth in 2014; this will probably remain the case given an acceleration in consumer spending.
- Despite this, growth is set to remain at a decent level of just under 3% in coming years, and this will close the output gap before long.





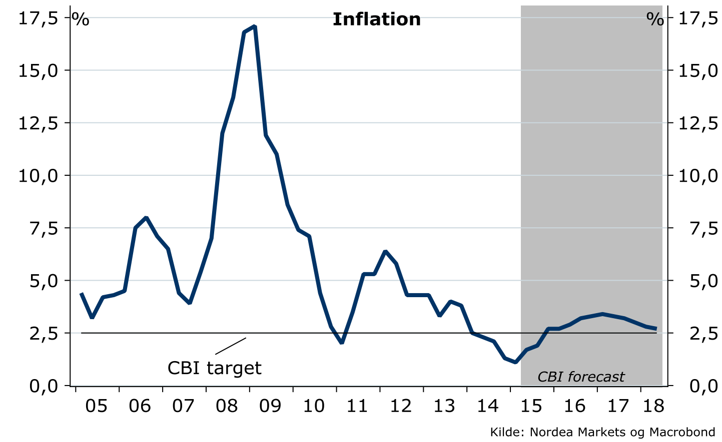
Output has regained lost ground

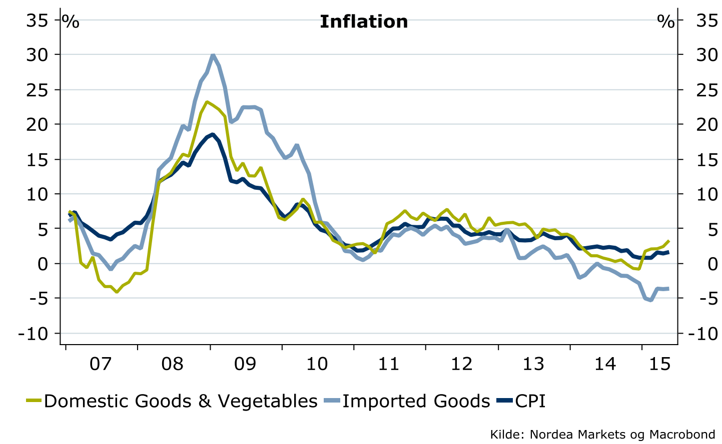


Source: Nordea Markets and Macrobond

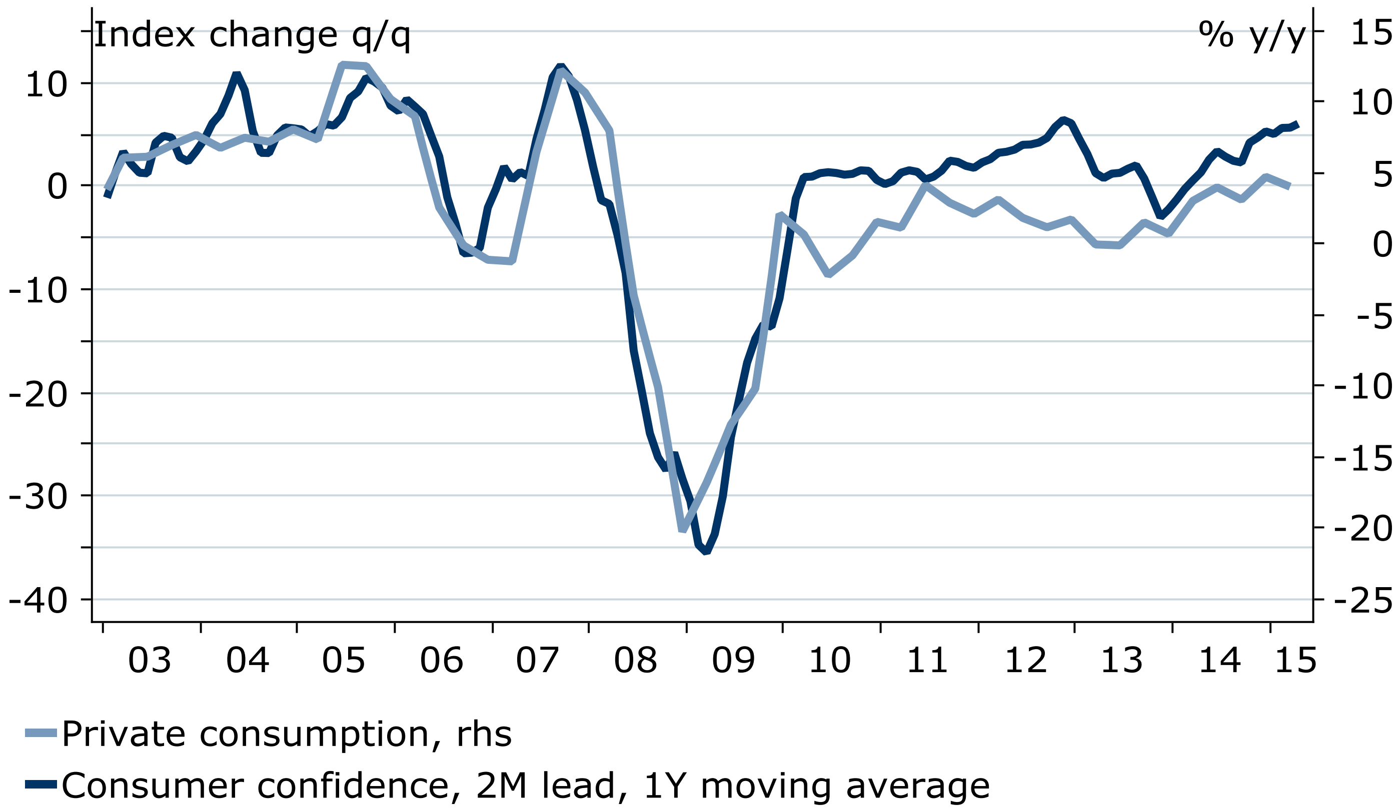
Stable inflation key to confidence

- Inflation is a key factor in the Icelandic economy, not merely because of the price level. Inflation also has a considerable impact on the housing market via the inflation indexation of a large percentage of mortgage loans.
- This indexation is now being partially abandoned, for instance via the government's restructuring package. In addition, there are now more conventional mortgage loans.
- To a large extent the current low inflation is the result of a lower-than-expected increase in unit labour costs and low oil prices.
- The central bank projects inflation at 2.5-3% in the years ahead chiefly based on two factors:
    - The government's debt package will boost households' disposable income, in turn lifting inflation.
    - The closing of the output gap will reduce idle capacity in the economy, driving down unemployment and pushing up wage growth and prices.
- Recently, the CBI raised interest rates in response to a higher than expected wage growth. The CBI additionally expects a rise in inflation over the remainder of the year and is therefore ready to hike rates again in August.





Pick-up in confidence signals higher consumer spending



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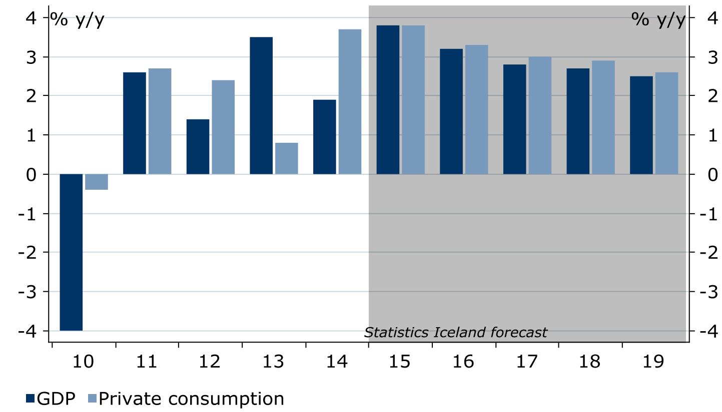
Consumer spending rising on higher net wealth

- Consumer spending is a key factor of the Icelandic economy, accounting for 50-60% of GDP historically. So a pick-up in consumer spending is vital.
- After a setback in the pace of growth in 2013, consumer spending accelerated again in 2014. In line with Iceland's statistical bureau, we project consumer spending to rise by some 3-4% in the years ahead, chiefly thanks to the government's debt reduction package. This package boosts the disposable income of households, by reducing the large interest payments on mortgage loans.
- Retail sales also show fairly solid gains, rising around 20% since 2010. Yet this is far from the 2007-08 level when retail sales rose 50% in four years. We see the current pace of growth as more consistent with a stable path that is sustainable in the period ahead.



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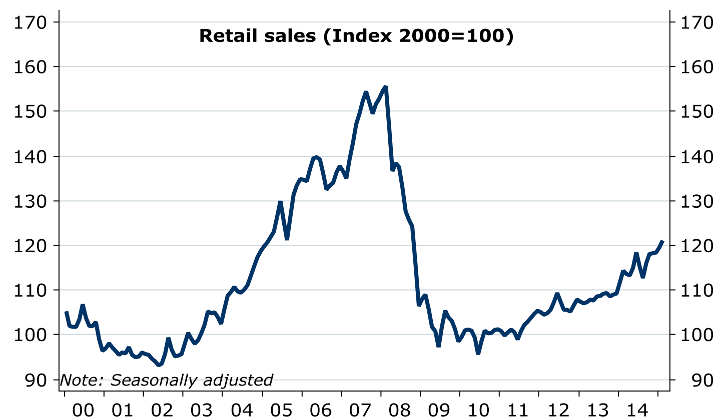

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Higher spending to be driven by incomes, not lending

- Real wages are critically important for consumer spending. Due to high inflation in the crisis years, real wages were eroded with a severe adverse impact on spending.
- In recent years we have seen growth in real wages to some extent underpinning spending. This 3-4% rise in real wages is set to continue in the new few years.
- Households' borrowings from the banks have only increased slightly over the past four years. This is largely because households have become more cautious about taking on more debt.
- The increase in net wealth (from the restructuring package) and rising real wages should pave the way for moderate gains in consumer spending. We do not see any signs of spending growth financed by borrowings.

Source: Nordea Markets and Macrobond

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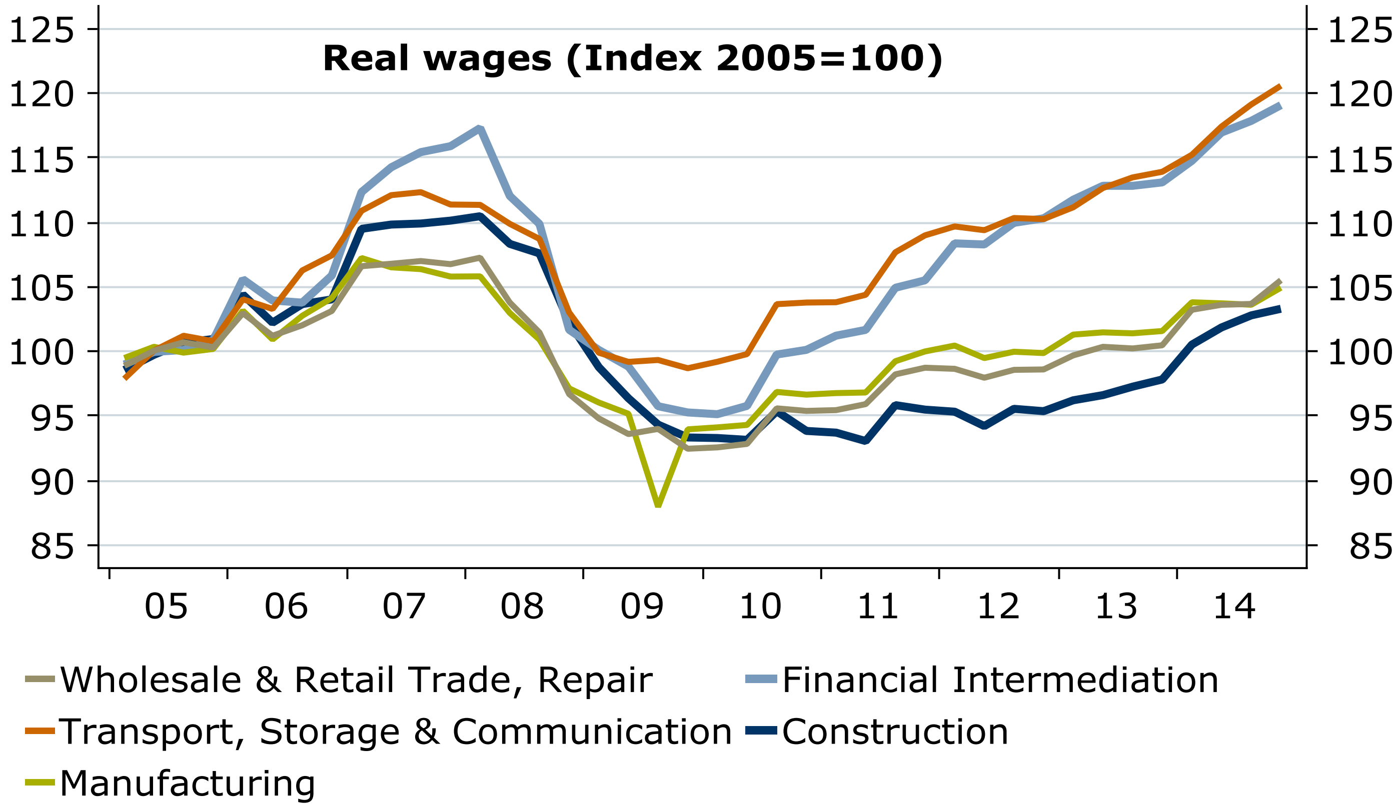
Wide differences in wage patterns since the crisis



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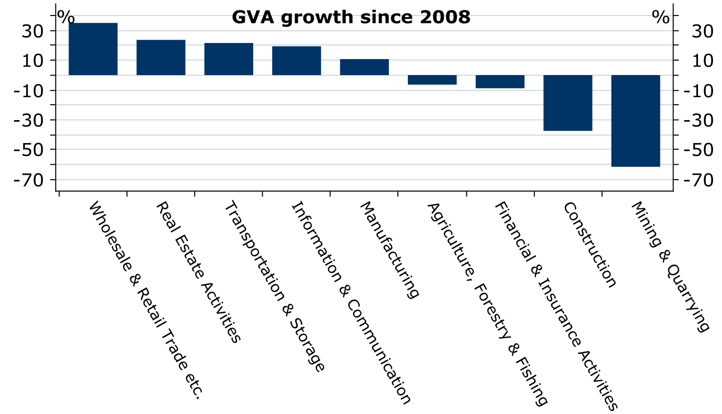
Large differences across industries

- The upper chart shows the value added for selected industries since 2008. Raw material extraction and construction are the industries hit hardest by the crisis.
- Financial services, insurance and construction were also hit hard, partly because they had expanded to an unsustainable level in the run-up to the crisis.
- Looking at the rest of the economy, several industries have largely recovered and are at the 2008 level in terms of output. This especially goes for trade and transport, which have also seen a strong gain in employment partly attributable to increased tourism.
- After five and a half years at rock bottom, business confidence surged in 2014 and is currently at 175, an unnaturally high level.
- In recent years there have also been major differences in the corporate sector's perception of the situation now and in six months' time. Now this gap has been closed, indicating that reality is now more in line with long-term expectations.



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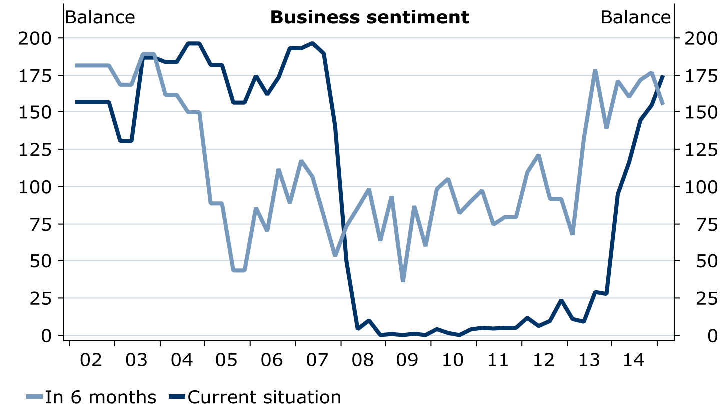

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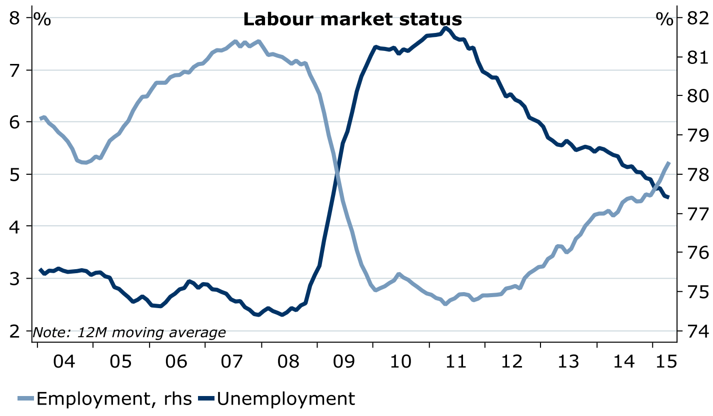
Strong labour market recovering

- Unemployment tripled during the crisis. As is often the case in a financial crisis, typical male jobs were hit hardest. Unemployment among men peaked around 11%, a somewhat unusual level compared with the lowest level (1.1% in 2005).
- The unemployment gap between men and women was sharply reduced around the turn of the year 2011-12 and has subsequently been closed; this may stem from a partial recovery in the construction industry.
- Iceland has a quite strong structural labour market characterised by high labour force participation and employment rates, low structural unemployment and many hours worked. Combined with the severe currency depreciation, this has likely helped Iceland back on the growth track quickly – in contrast to the situation in Southern Europe.
- Low wage costs and a flexible labour market have attracted available resources to the service sector in the wake of the crisis, helping to ensure a stable trend in the sector.



Source: Nordea Markets and Macrobond

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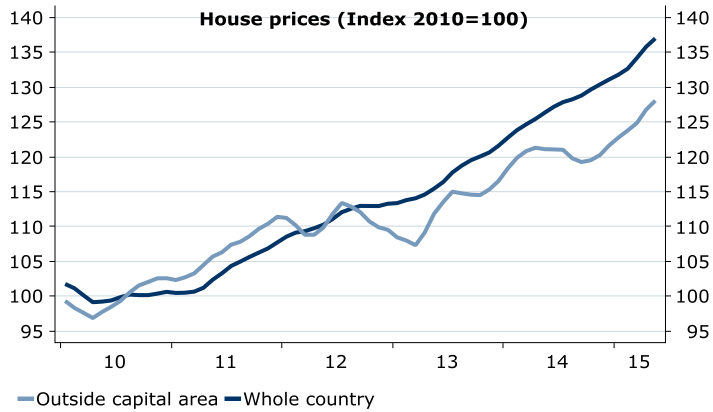
New construction more attractive as house prices rise

- For the country as a whole, house prices have seen an upward trend since 2011, albeit from low levels. Excluding Reykjavik from the statistics, the picture is more mixed with prices not showing the same linear pace of increase. Recently the peripheral areas have seen rising prices, and this provides the basis for more uniform price increases across regions.
- Having said that, prices in Reykjavik have risen very sharply, to a large extent driven by speculation. Rents have seen a similar rise, in turn pushing inflation higher.
- Construction remains at a historical low after a period of exceptionally high activity. 2012 and 2013 did, however, show a rise in new construction starts, a pattern that is likely to continue with recent years' house price increases.



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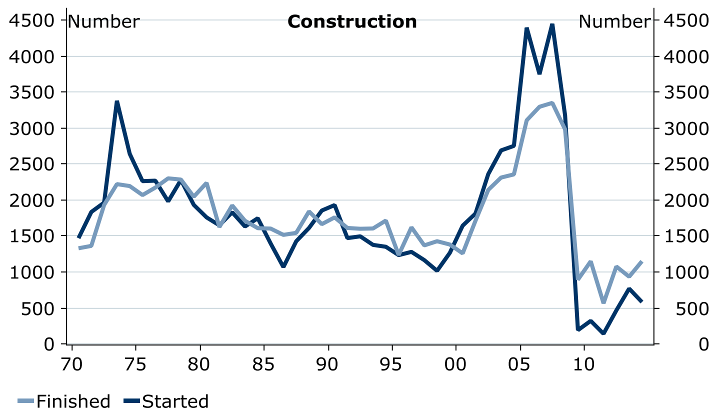

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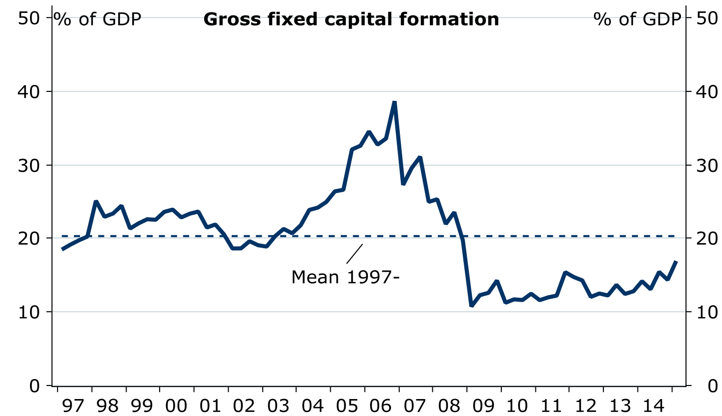
Investment to contribute to higher growth

- Besides consumer spending, investment is an important part of the economic puzzle. Investment as a percentage of GDP has seen a historical decline but has recently recovered to around 17% versus 20% historically.
- Although investment activity has been sluggish, the central bank projects a fairly solid pick-up in investment in coming years. To a large degree this will be driven by residential investment, which could rise based on the debt reduction package.
- The Icelandic stock index has posted decent gains since the start of 2009, with the index having lost 95% of its value during the crisis. Adjusted for prices, the positive pattern since 2009 is maintained, but with a modest decline driven by the European debt crisis at end-2011.
- Taken together, confidence is the challenge for investment as well as consumer spending. Confidence has been eroded, but a well-designed easing of capital restrictions and healthy public finances are key to restoring international confidence.



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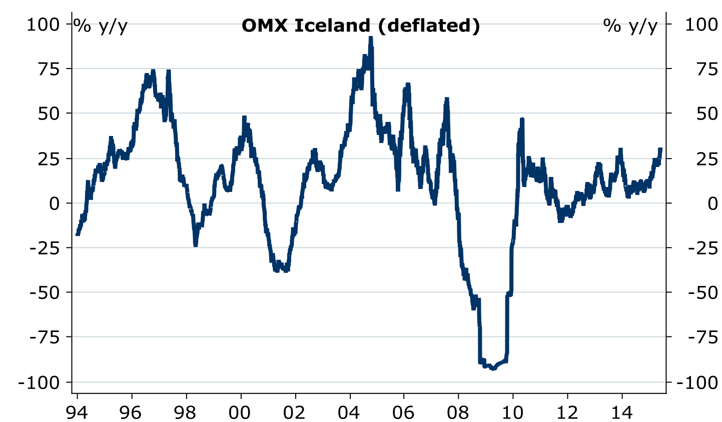
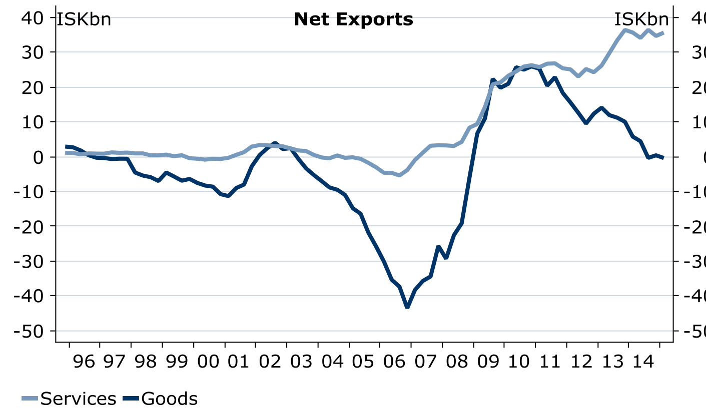


Source: Nordea Markets and Macrobond

Positive goods balance, spectre of banking collapse

- Foreign trade is one specific area where the crisis made its mark. After the crisis, Iceland has experienced historically high net exports, mainly driven by improved terms of trade.
- The terms of trade have a major impact on primary production as the share of imports is low. In recent years, however, net exports of goods have dropped to zero, as is evident across many types of goods. This suggests that the effect of the change in the terms of trade is fading.
- This could also be a source of concern for exports going forward, as declines are mainly evident for some of the biggest groups of export goods.
- Net exports of services remain high, largely due to recent years' strong inflow of tourists.
- Recently the balance of payments has improved significantly, with notably incomes pushing it into negative territory. A strong balance of payments is one of the preconditions for easing capital controls.
- Higher revenues from domestic businesses with income abroad as well as lower interest payments have redressed this in the past three years.



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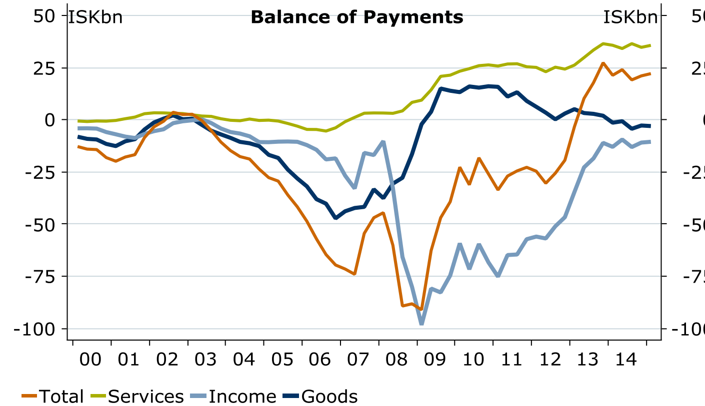


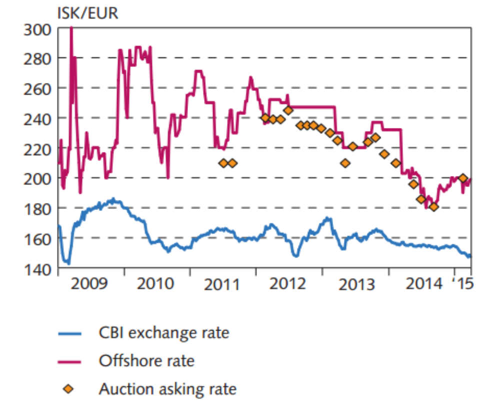
Source: Nordea Markets and Macrobond

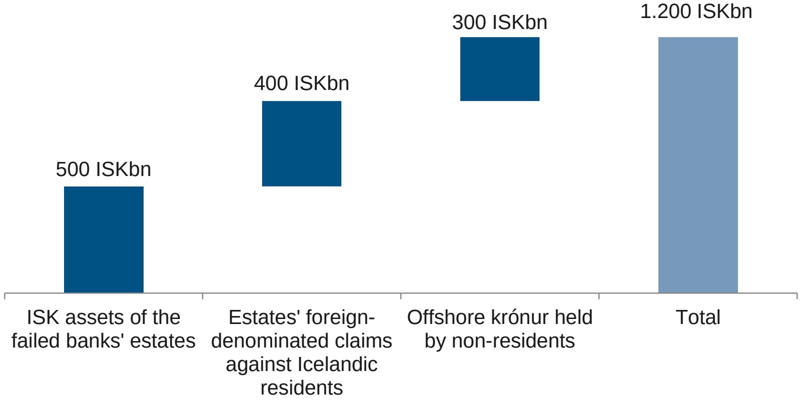
Preparing for Capital account liberalization

- The government recently put forth their plan for a capital account liberalization. Although they did not mention specifically how and when a complete liberalization will take place, the plan addresses 1.200 ISKbn (distribution depicted in the bottom chart) that could destabilize the currency if allowed to flow freely out of the country. The plan is two-fold.
- The first object is to clear the old banks' failed estates of ISK and foreign-currency denominated claims against Icelandic citizens. The estates have until the end of the year to reach a composition agreement that comply to a set of 'stability criteria' put forth by the government. The criteria aim to circumvent the FX market when settling the estates. If the estates fail to comply, a 39% one-off 'stability tax' will be placed on all assets, where after the assets are free to leave the country. All three banks' estates have put together proposals that satisfy the criteria, pending approval from creditors.
- The second is to eliminate the stock of offshore ISK held by foreign residents. Owners of offshore-ISK have three possibilities
    1. Sell ISK at an auction with a large premium
    2. Buy long-term government bonds
    3. Get the money frozen in 0-interest accounts

Chart II-12

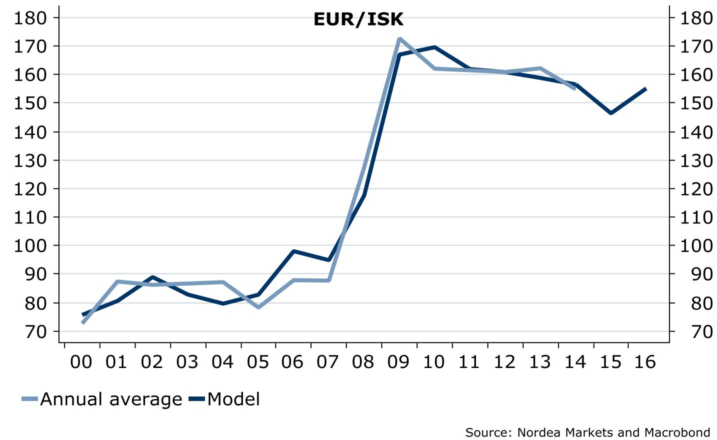
CBI exchange rate, offshore rate, and auction asking rate





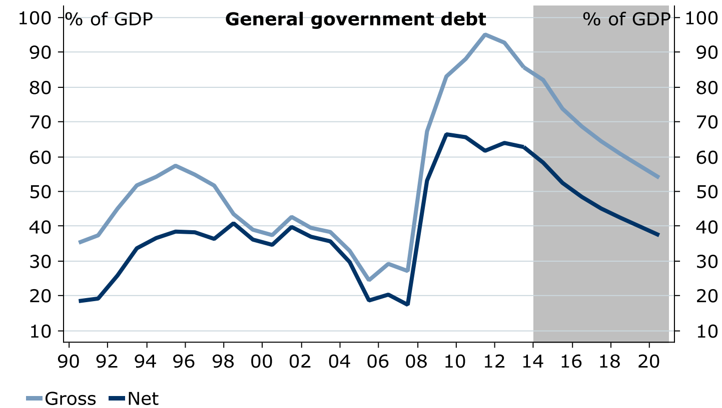
The Icelandic krona

- Our baseline scenario is a broadly unchanged ISK/EUR cross in the time ahead. FX market activity is still very low, with the central bank accounting for the bulk of activity.
- Our view is also based on a continued narrowing of the output gap and sustained economic stability.
- In recent years the central bank has restored its credibility after a turbulent period, creating stability as regards the currency and the inflation target.
- Risks are almost exclusively on the downside. A transition to a situation without capital controls is vital to the value of the ISK. The first steps towards this will be taken within a year, and will largely bypass the FX market, thus leaving the currency unaffected.
- A closing of the gab between the onshore and offshore ISK is paramount to the stability of the currency, if controls are lifted too quickly, it will trigger capital flight and a resultant depreciation. Based on a review of the available material, this seems unlikely as the transition will be very cautious.



Tight public finances in future

- In 2012 the government was able to reduce the government debt for the first time since the crisis. According to the IMF's forecast, this marks the start of a trend that will continue over the next few years. In the upper chart, the effect of the debt reduction package is evident in gross debt, which is above the downward trend in the coming years. In the lower chart, the positive balance in 2014 mainly reflects a one-off payment related to Landsbankinn; therefore, this is not evident from the structural balance.
- Iceland has very successfully reduced its deficit despite a sharp erosion of revenues. However, revenues have picked up slowly driven by accelerating activity and higher taxes, but a balance has yet to be reached.
- In collaboration with the IMF, Iceland had a balanced budget in 2014 and a growing surplus in coming years. The plan for the period to come has three purposes:
  - to underpin growth short term
  - to reduce the government debt
  - to create a buffer in case of new challenges.
- The large deficits of the recent years mainly stem from interest payments on outstanding loans; this is evident from the primary balance which returned to positive territory already in 2012.



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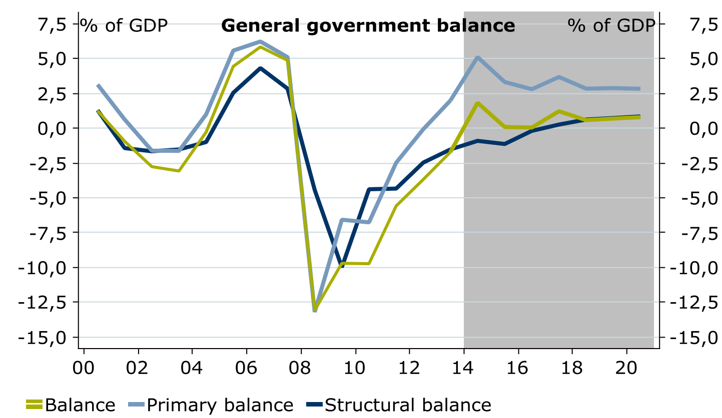

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Thank you!

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