

# Economic and monetary chronicle 2005

## January

On January 1, the average municipal income tax rate in the PAYE system went up from 12.83% to 12.98%. The main factor at work was the decision by local authorities in Reykjavík and neighbouring Kópavogur to levy the maximum municipal income tax rate of 13.03%. However, the total PAYE income tax rate went down by 0.85%, from 38.58% to 37.73%, due to the recently approved cut in state personal income tax.

On January 13, Íslandsbanki hf. increased its share capital by a nominal value of 1.8 b.kr. Originally, a pre-emptive rights issue of 1,500 million shares of 1 kr. each was made, but a further 300 million were offered to meet excess demand. The price of the new capital was 10.65 kr. per share and the market value of the offering just over 19 b.kr. Total nominal share capital in Íslandsbanki hf. after the increase is 13 b.kr.

On January 20, Landsbanki Íslands hf. announced its decision to establish a branch in the UK.

## February

On February 3, Moody's Investors Service affirmed Landsbanki Islands' A3 long-term and P-1 short-term debt and deposit ratings and its C financial strength rating. The outlook on all ratings remained positive.

On February 10, Standard & Poor's Ratings Services raised its longterm foreign currency sovereign credit rating on the Republic of Iceland to AA- from A+, and affirmed the AA+ long-term local currency and A-1+ short-term foreign and local currency ratings. The outlook was stable. The state Housing Financing Fund's (HFF) rating was upgraded correspondingly, but S&P placed the HFF's AA+ longterm local currency credit rating on CreditWatch with negative implications, following recent changes in the Icelandic mortgage market, which had reduced the HFF's market share. S&P removed the AA+ long-term currency issuer credit rating on the HFF from CreditWatch on February 16 and changed the outlook on the local currency rating to negative.

On February 17, Íslandsbanki hf. received a banking licence from the Ministry of Finance in Luxembourg. The new bank is planned to commence operations in spring 2005 and aims to expand the activities of Íslandsbanki's current branch in Luxembourg.

On February 18, the Board of Governors of the Central Bank submitted a report to the Government of Iceland after inflation moved beyond the tolerance limits in February. At the same time, the Board of Governors announced its decision to raise the Central Bank's policy rate (repo rate) by half a percentage point to 8.75% as of February 22. The Central Bank's other interest rates were also hiked by half a percentage point as of February 21.

## March

On March 7, Moody's Investors Service upgraded the long-term deposit and senior debt ratings of Landsbanki Íslands hf. to A2 from A3. The outlook on these ratings is stable. At the same time, Moody's affirmed with a stable outlook its financial strength rating of C (outlook changed to stable from positive) and the P-1 short-term deposit and debt ratings.

On March 15, Íslandsbanki hf. increased its share capital by a nominal value of just over 134 m.kr. Shareholders were given the option of receiving part of their dividends in the form of these new shares at the price of 10.65 kr. per share. After the increase, Íslandsbanki's listed nominal share capital amounts to 13,134 m.kr.

On March 16, Landsbanki Íslands hf. announced its completion of a €350m (28 b.kr.) subordinated bond issue under its EMTN programme. It consisted of two tranches: €150m of Tier I capital and €200m of Tier II capital.

On March 18, Straumur Fjárfestingarbanki hf. investment bank announced an issue of subordinated bonds in the amount of 5 b.kr. This was Straumur's first subordinated debt issue and was classified as Tier II capital.

On March 22, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.25 percentage points to 9% as of March 29. Other interest rates were also raised as of April 1: on credit institutions' current accounts in the Bank by 0.5 percentage points and on their reserve accounts by 0.25 percentage points.

On March 31, Straumur Fjárfestingarbanki hf. investment bank increased its share capital by a nominal value of 700 m.kr. After the increase, Straumur's listed nominal share capital on Iceland Stock Exchange (ICEX) was 6.1 b.kr. Sale price of the new shares was 7 b.kr.

#### **April**

On April 1, Bolig- og Næringsbanken ASA (BNbank) of Norway became part of the Íslandsbanki hf. consolidated accounts after all conditions for Íslandsbanki's acquisition of it had been fulfilled. Íslandsbanki originally bid for all the shares in BNbank on November 15, 2004. The offering price was NOK 3.3 b. (35 b.kr.) and the final condition for the acquisition was fulfilled on March 15.

On April 13, Íslandsbanki hf. announced that its subsidiary SB Luxembourg S.A. had formally started operations and lending activities of Íslandsbanki's branch in Luxembourg would be transferred to it.

On April 18, Landsbanki Íslands hf. increased its share capital by a nominal value of 800 m.kr. After the increase, Landsbanki's listed nominal share capital on ICEX was 8.9 b.kr. Sale price of the new shares was 11.4 b.kr.

On April 19, Íslandsbanki hf. sold 66.6% of shares in its insurance subsidiary Sjóvá to Páttur eignarhaldsfélag ehf. holding company for 17.5 b.kr. Sjóvá thereby ceased to be part of the Íslandsbanki consolidated accounts. After the sale, Íslandsbanki holds 33.4% of shares in Sjóvá.

#### **May**

On May 2, it was announced that the Central Bank would purchase foreign currency in the domestic interbank market on behalf of the Treasury, in connection with a discretionary prepayment of Treasury foreign debt. The purchase was made in tranches of 20 m. US dollars each, on May 12, 17, 19, 23 and 25.

On May 10, Moody's Investors Service affirmed Kaupthing Bank's A1 long-term and P-1 short-term debt and deposit ratings, and its C+ financial strength rating.

On May 10, Moody's Investors Service downgraded the financial strength rating of Íslandsbanki hf. to C+. Moody's affirmed Íslandsbanki's A1 long-term and P-1 short-term debt and deposit ratings, with a stable outlook.

#### **June**

On June 3, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.5 percentage points to 9.5% as of June 7. For one-week certificates of deposit, the rate of interest was set at 0.15 percentage points below the repo rate and ceilings were abolished in weekly auctions. Other Central Bank interest rates were also raised as of June 11: on credit institutions' current accounts in the Central Bank by 0.75 percentage points and on overnight loans by 0.25 percentage points.

On June 15, Íslandsbanki hf. announced an issue of subordinated capital bonds in the amount €150 million (12 b.kr.). The bonds will be accounted for as Own Funds Part A (Tier I) under rules on additional own funds items for financial undertakings.

#### **July**

On July 12, the Central Bank announced a new currency basket following the annual revision on the basis of Iceland's foreign trade in goods and services the preceding year. The new basket took effect the same day.

On July 19, Moody's Investors Service affirmed its ratings on the Republic of Iceland at Aaa for long-term obligations and P-1 for short-term obligations, both in foreign and domestic currency, with a stable outlook.

## New currency basket 2005 (%)

Based on foreign trade in 2004

<i>Region</i>	<i>Currency</i>	<i>Export basket</i>	<i>Import basket</i>	<i>Currency basket</i>	<i>Change on previous basket</i>
USA	USD	22.03	24.02	23.03	1.19
UK	GBP	14.66	9.55	12.10	0.21
Canada	CAD	1.27	0.94	1.10	0.04
Denmark	DKK	7.67	8.59	8.13	-0.28
Norway	NOK	5.02	7.05	6.04	0.13
Sweden	SEK	2.11	5.64	3.87	0.19
Switzerland	CHF	1.50	0.92	1.21	-0.18
Euro area	EUR	42.67	39.60	41.14	-1.23
Japan	JPY	3.07	3.69	3.38	-0.07
North America		23.30	24.96	24.13	1.23
Europe		73.63	71.35	72.49	-1.16
EU		67.11	63.38	65.24	-1.11
Japan		3.07	3.69	3.38	-0.07
Total		100.00	100.00	100.00	0.00

On July 11, Kaupthing Bank announced that all the conditions set for Kaupthing Holdings UK's offer for the acquisition and control of Singer & Friedlander Group Plc had been fulfilled. It is subsequently intended to delist Singer & Friedlander shares from London Stock Exchange. The offer price was 316 pence per share, which is equivalent to 547 million pounds (64.6 b.kr.) for all issued share capital in Singer & Friedlander. The board of Singer & Friedlander recommended shareholders to accept the offer. Before this acquisition, Kaupthing Bank held a 19.5% share in Singer & Friedlander.

**August**

On August 3, Fitch Ratings, the international rating agency, affirmed the ratings of Landsbanki Íslands hf. at long-term A, short-term F1, individual C and support 2. The outlook remains stable.

On August 4, Fitch Ratings affirmed the Republic of Iceland's longterm foreign and local currency ratings at AA- and AAA respectively with a stable outlook. The short-term foreign currency rating was affirmed at F1+.

On August 5, the Treasury's 98.8% shareholding in Landssími Íslands (Iceland Telecom) was sold to Skipti ehf., an investor group comprising Exista ehf. (45%), Kaupthing Bank (30%), Lífeyrissjóður verslunarmanna (the Pension Fund of Commerce, 8.25%), Gildilífeyrissjóður pension fund (8.25%), Sameinaði lífeyrissjóðurinn pension fund (2.25%), Samvinnulífeyrissjóðurinn pension fund (2.25%), MP fjárfestingarbanki investment bank (2%) and Imis ehf. (2%). The acquisition price of 66.7 b.kr. was based on the Central Bank of Iceland's official exchange rate on July 27, 2005. It was spread between three currencies: 34,505,550,000 kr., €310,000,000 and 125,000,000 US dollars. The new owners are obliged to fulfil conditions set by the Treasury in its terms of sale. These include that no single entity or associated or related entities shall acquire a shareholding of more than 45% in Iceland Telecom until its listing on the Iceland Stock Exchange (ICEX) Main List, and that a minimum of 30% of total share capital shall be offered for sale to the public and investors no later than the end of 2007. Before that time, the company shall be listed on the ICEX Main List. After this privatisation, the state has completely withdrawn from competitive operation in the telecommunications market.

On August 12, Moody's Investor Service affirmed the ratings of Landsbanki Íslands hf. at A2 for long-term deposits, P-1 for shortterm liabilities and C for financial strength. The outlook was stable.

On August 17, Lánasjóður sveitarfélaga (Municipality Credit Iceland) was licensed to operate as a credit undertaking by the Financial Supervisory Authority (FME).

## September

On September 6, the Treasury received a payment of 66.7 b.kr. from Skipti ehf. for its shareholding in Iceland Telecom. The 32.2 b.kr. portion paid in foreign currency will be used to prepay external debt of the Treasury. Most of the remainder of the privatisation proceeds will be deposited in the Central Bank of Iceland and will be available over the period 2007-2010. The part of the payment rendered in Icelandic currency has been earmarked (at adjusted prices) as follows: 2007-2010: 15 b.kr. to roadbuilding; 2008-2012: 18 b.kr. towards the development of a high-technology hospital, 3 b.kr. to the purchase of a patrol vessel and aircraft for the Icelandic Coast Guard; 2.5 b.kr. towards promoting business innovation; 2.5 b.kr. to a telecommunications fund; 1 b.kr. to infrastructure investment for the mentally handicapped; and 1 b.kr. for new premises for an Institute of Icelandic Studies.

On September 8, the Central Bank announced that it will increase its regular currency purchases in the domestic interbank market on behalf of the Treasury. In light of the improved liquidity position of the Treasury, the Minister of Finance has decided to retire more of the government's foreign debt than had previously been planned. From September 12, the Bank will purchase 10 million US dollars a week in addition to the 2.5 million dollars that it has purchased weekly so far this year.

On September 15, Straumur Fjárfestingarbanki investment bank was renamed Straumur – Burðarás Fjárfestingabanki.

On September 29, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.75 percentage points to 10.25%. Other Central Bank interest rates were also raised by 0.75 percentage points. Interest rates on one-week certificates of deposit and the repo rate were raised as of October 4 and other rates as of October 1.

On September 30, Burðarás investment company was divided up and its separate parts were merged into Straumur – Burðarás Fjárfestingabanki and Landsbanki respectively, on completion of all the conditions for merger which had been laid down in an agreement from August 1. Burðarás was thereby removed from the register of companies.

## October

On October 1, the draft budget for 2006 was presented to Parliament. It assumed a budget surplus of 14 b.kr. The bill also presented the Government's medium-term fiscal programme for 2006-2010.

On October 3, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iceland. The IMF Staff Report on the current economic outlook and prospects was compiled after Iceland received a regular staff visit in June. Four Selected Issues Papers were also completed on Simple Efficient Policy Rules and Inflation Control in Iceland; Some Illustrative Simulations of the Potential Impact of Income Tax Cuts in Iceland; Mortgage Market Developments in Iceland and the Role of the Housing Financing Fund; and Corporate Leverage: How Different is Iceland?

On October 14, the Staff Report was published on the IMF and Central Bank of Iceland websites. On October 3, the share capital of Landsbanki was increased by the nominal amount of 2,120 m.kr. The additional shares were delivered to Burðarás's shareholders as partial payment for their shares in that company. After the announcement, Landsbanki's nominal registered share capital amounted to 11,020,677,803 kr.

On October 3, the share capital of Straumur – Burðarás Fjárfestingabanki was increased by the nominal amount of 4,575 m.kr. The additional shares were delivered to Burðarás's shareholders as partial payment for their shares in that company. After the announcement, Straumur – Burðarás Fjárfestingabanki's nominal registered share capital amounted to 10,675,747,810 kr.

On October 3, the share capital of Straumur – Burðarás Fjárfestingabanki was reduced by the nominal amount of 316 m.kr. The reduction of shares was carried out in accordance with the agreement on the acquisition of shares in Burðarás Fjárfestingarbanki whereby shares owned by Burðarás in Straumur at the time of merger would be cancelled and the share capital of Straumur reduced accordingly. After the announcement, Straumur – Burðarás Fjárfestingabanki's nominal registered share capital amounted to 10,359,144,971 kr.

On October 31, the share capital of Kaupthing Bank was increased by 3,867,413 shares. The objective of the increase was to fulfil the terms of employee stock option agreements. The total nominal share capital of Kaupthing Bank after the increase was, 645,530,530 kr.

On October 31, Standard & Poor's Ratings Services affirmed its AA long-term foreign currency and AA+ long-term local currency sovereign credit rating on the Republic of Iceland. At the same time, the A-1+ short-term foreign and local currency ratings on Iceland were affirmed. The outlook is stable.

### November

On November 14, Landsbanki announced that all conditions had been satisfied for its acquisition of Kepler Equities SA and the transaction had been completed. Kepler Equities thereby became part of the Landsbanki group. Landsbanki acquired 82% of the total shares of Kepler Equities for 76.1 million pounds sterling (5.8 b.kr.) and will acquire the remaining shares over a five-year period.

On November 15, the joint committee of the Icelandic Federation of Labour (ASÍ) and Confederation of Employers (SA) reviewing the wage agreement between their members concluded that the price assumptions underlying the current wage agreements had not held. The wage section of the agreements was renegotiated. A one-off payment of 26,000 kr. was agreed for December 2005. This is equivalent to an additional wage rise of roughly 0.65% over the 13 months from that time. If wage settlements are not revoked in the second review in November 2006, wages will go up at the beginning of 2007 by 0.65% on top of the 2.25% originally negotiated in 2004. The social partners also agreed on principles for revising unemployment insurance. The Government of Iceland issued a declaration (see below) that it will sponsor legislation on changes agreed by the social partners and finance the measures with payments from the Unemployment Insurance Fund. Under the ASÍ/SA agreement, unemployment benefit will be earnings-related with a ceiling of 180,000 kr. Earnings-related benefit will be paid from the tenth weekday of unemployment, for no longer than three months over a three-year period. Entitlement to benefit will be renewed over a period of twenty-four months. Basic unemployment insurance benefit will be 96,000 kr. when the new law enters into force in 2006, instead of 93,821 kr., and be revised in step with wage changes at the beginning of 2007.

On November 15, the Government of Iceland issued a declaration on its measures to facilitate the wage review agreement between ASÍ and SA. The Government presented a four-point package: First, a contribution of 100 m.kr. to vocational training and retraining of unskilled workers. Second, measures to facilitate a more even distribution of the disability pension burden between pension funds covered by the agreements between ASÍ and SA with a contribution equivalent to 0.25% of the national insurance base, to be implemented over the period 2007-2009. Based on current forecasts for unemployment insurance revenues, this measure would cost the Treasury 1.5 b.kr. Third, the Government will sponsor legislation on temporary employment agencies for approval by Parliament before the Christmas 2005 recess. Fourth, the Government pledged to sponsor legislation on changes to the payment of unemployment benefits in line with the ASÍ/SA agreement, financing the measures with payments from the Unemployment Insurance Fund.

On November 18, the Government decided to grant old-age pensioners and recipients of disability benefits the same one-off payment that was negotiated when the social partners extended current wage settlements. This measure will cost the Treasury an estimated 700 m.kr.

On November 22, Fitch Ratings upgraded Íslandsbanki's individual rating to B/C from C and affirmed the other ratings at long-term A, short-term F1 and support 2. The rating outlook is stable.

On November 22, Fitch Ratings assigned Kaupthing Bank ratings of long-term of A, short-term F1, individual B/C and support 2. The rating outlook is stable.

On November 29, the supplementary budget for 2005 was passed by Parliament with a surplus of 91 b.kr., of which 64 b.kr. was accounted for by the privatisation of Iceland Telecom. Estimated regular revenues were 10.7% higher than the budget figures, and regular expenditures 3.5% higher.

On November 29, Fitch Ratings upgraded the individual rating of Landsbanki Íslands to B/C from C, and affirmed its other ratings at long-term A, short-term F1 and support 2. The rating outlook is stable.

### **December**

On December 2, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.25 percentage points to 10.5%. Other Central Bank interest rates were also raised by 0.25 percentage points. Interest rates on one-week certificates of deposit and the repo rate were raised as of December 6 and other rates as of December 11.

On December 2, the formal interest rate decision dates for 2006 were announced in Monetary Bulletin, under a new arrangement described in a Central Bank press release from November 11. As of 2006, Monetary Bulletin will be published three times a year instead of quarterly. Besides the publication dates for Monetary Bulletin, interest rate decisions will be announced on three other fixed dates, together with detailed explanations for them. Thus there will be six interest rate decision dates in 2006: the publication dates of Monetary Bulletin on March 30, July 6 and November 2, and announcements with press releases on January 26, May 18 and September 14.

On December 2, the Central Bank announced in Monetary Bulletin its plans to make weekly purchases of 5 million US dollars in 2006 to meet Treasury requirements and strengthen the foreign reserves. The Bank purchased 2.5 m. US dollars five times a week until the end of 2005 and reduced this to 2.5 m. US dollars twice a week in 2006. Under a new arrangement until the end of 2006, the Central Bank will purchase currency before the interbank market opens on Monday and Wednesday mornings.

On December 7, the budget for 2006 was passed by Parliament with a 20 b.kr. surplus. Regular revenues of the Treasury are expected to decrease by 5.1% in real terms and regular real expenditures by 3.8%.

On December 21, Landsbanki Íslands announced that all conditions for its acquisition of Merrion Capital Group Limited had been met and the transaction was complete. Landsbanki will acquire an initial 50% shareholding in Merrion and the remaining 50% over the next three years. Merrion was initially valued at 4 b.kr. but the subsequent acquisition price will be based on future profits generated by it.