

The CBI keeps rate hikes on hold in February

On February 10 the Central Bank's Monetary Policy Committee decided to keep rates, as well as the banks' reserve requirements, unchanged. A favorable development in the terms of trade and a strengthening króna have relieved some of the inflationary pressures due to domestic conditions in the labor market, but the MPC still sees risks ahead and expects the monetary stance to be tightened sometime in the coming quarters. The CBI also released its *Monetary Bulletin*, where it points out that economic imbalances are on the rise.

A strong start to tourism in 2016

In September, Arion Research predicted a 20% increase in the number of tourist arrivals in 2016. In January, the Y-o-Y increase was 23.6%. Will we be able to receive all these tourists? Hotel investment has been growing rapidly in recent years while occupancy rates have been climbing. Concerns have been raised that a strengthening real exchange rate could hurt the tourism industry going forward. Plans for new hotel construction keep growing, with the largest increase of hotel rooms now coming onstream in 2019. Will that be too late?

The balance of goods slightly negative in January

Imports have been growing quite rapidly, mainly due to investments, but also increased consumption. Keeping the exchange rate fixed, exports grew by 0.4% Y-o-Y while imports grew by 17.9% in January. The balance of traded goods is expected to be negative this year, but we could still see a sizeable surplus on the balance of trade with the ongoing boom in the tourism industry.

Analysts

Anna Hrefna Ingimundardóttir
+354-444-6997
anna.ingimundardottir@arionbanki.is

Erna Björg Sverrisdóttir
+354-444-6993
erna.sverrisdottir@arionbanki.is

Hrafn Steinarsson
+354-444-6910
hrafn.steinarsson@arionbanki.is

Konráð S. Guðjónsson
+354-444-6991
konrad.gudjonsson@arionbanki.is

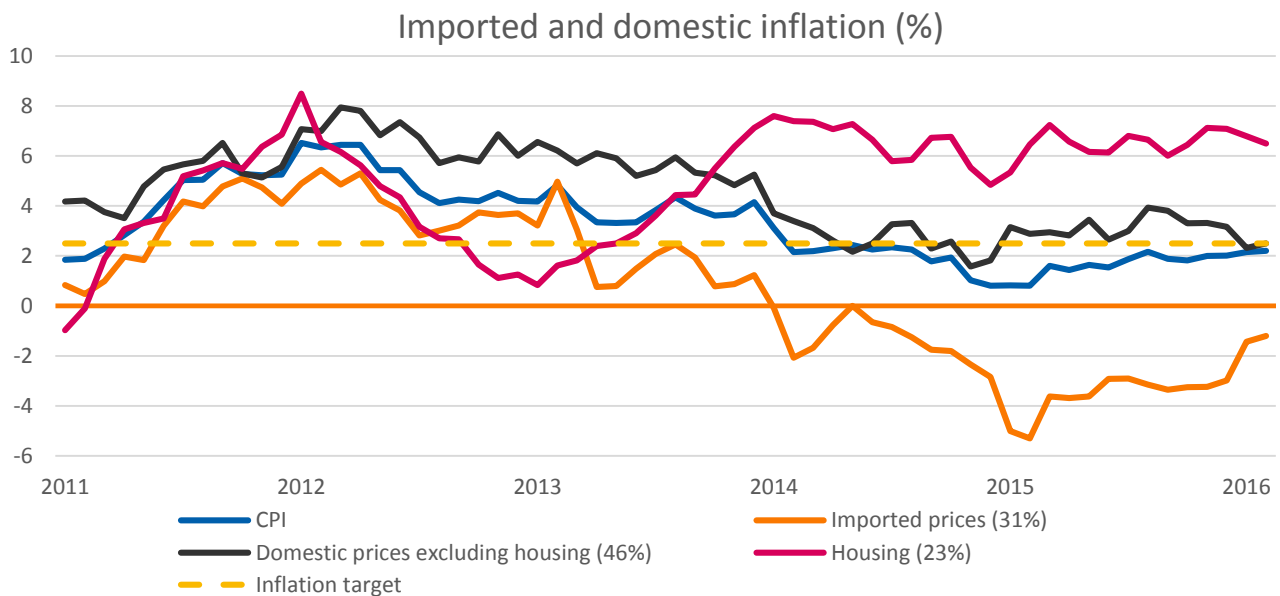
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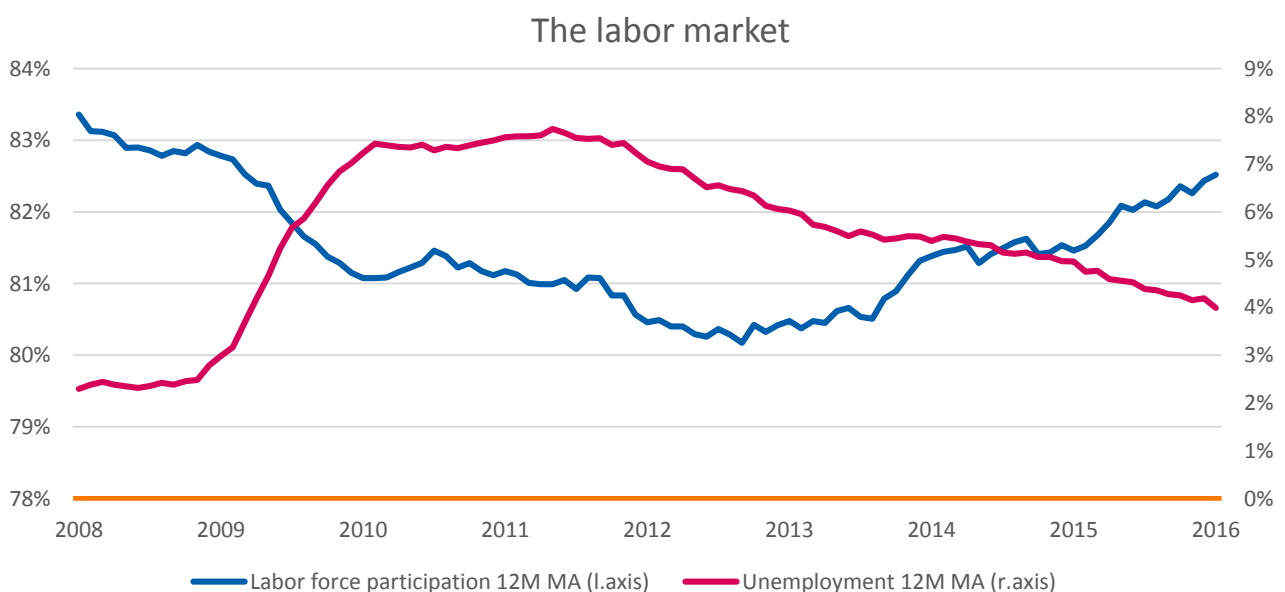
The CBI keeps rate hikes on hold in February

On February 10 the Central Bank's Monetary Policy Committee decided to keep [interest rates unchanged](#), despite having repeatedly issued stern warnings last year following wage negotiations where pay increases were much higher than the Bank's target inflation + expected productivity increases. Inflation has not yet materialized and remains below the Central Bank's 2.5% target at 2.2%. Inflation excluding housing stands at a mere 0.7% but has been on the rise over the past year as deflation in imported prices has decelerated.

In the Bank's latest [Monetary Bulletin](#), also published on February 10, the Bank focused on rising imbalances in the global economy although the effects on the Icelandic economy have been limited so far. One of the main factors keeping inflation low over the past two years, however, has been a strengthening króna (an 8% appreciation in 2015 in trade-weighted terms) and deflation in imported prices, which currently account for 31% of headline inflation.

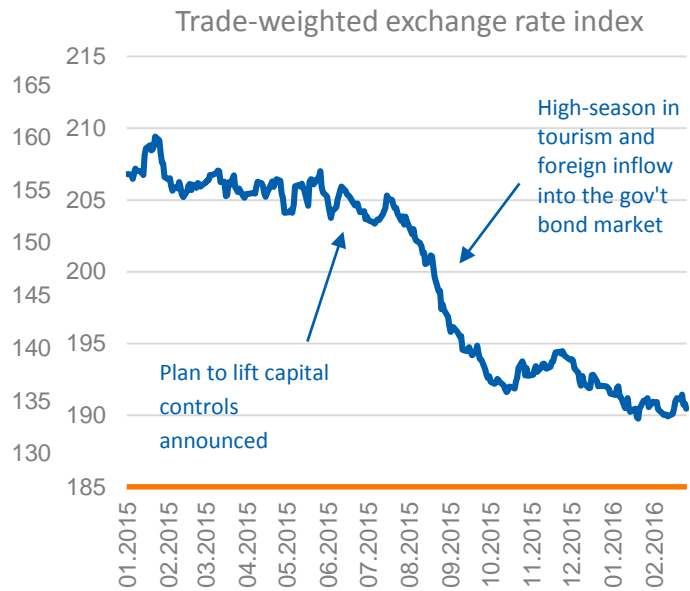
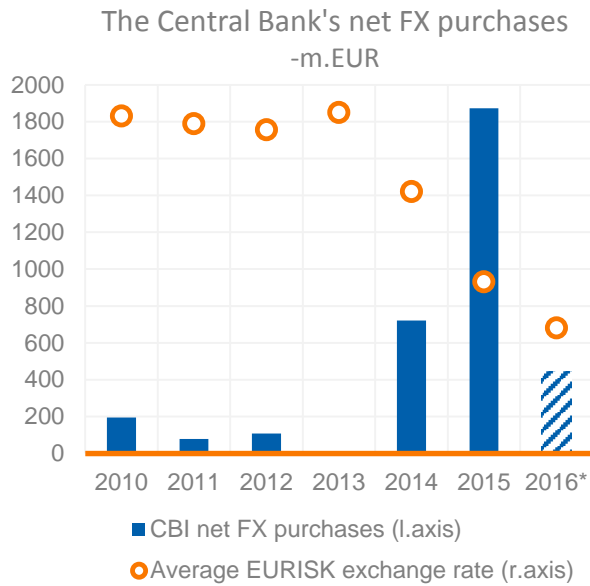


Although wage increases have indeed been quite high, unemployment has kept trending downwards and certain industries are experiencing a shortage of labor. According to a recent survey, close to 60% of firms in the construction industry claimed to be understaffed while the ratio was 40% in tourism. Labor demand is likely to keep growing as more firms indicated they were rather looking to hire than lay off staff than in the last survey. That could be easier said than done as surveyed unemployment stood at 2.8% in January (4.3% in January 2015 and 6.8% in January 2014). Over the same time period, labor force participation has been increasing. With increased demand for labor and vastly improved terms of trade, perhaps high wage increases have been justified to some extent and the effects on inflation more muted than previously feared.



One could argue that inflation would be even lower due to an even stronger króna had the Central Bank not been purchasing about half of the FX in the interbank market in recent months in order to "mitigate exchange

rate volatility". Given the pace at which the CBI has been purchasing FX this year already there are no signs of a slowdown yet.



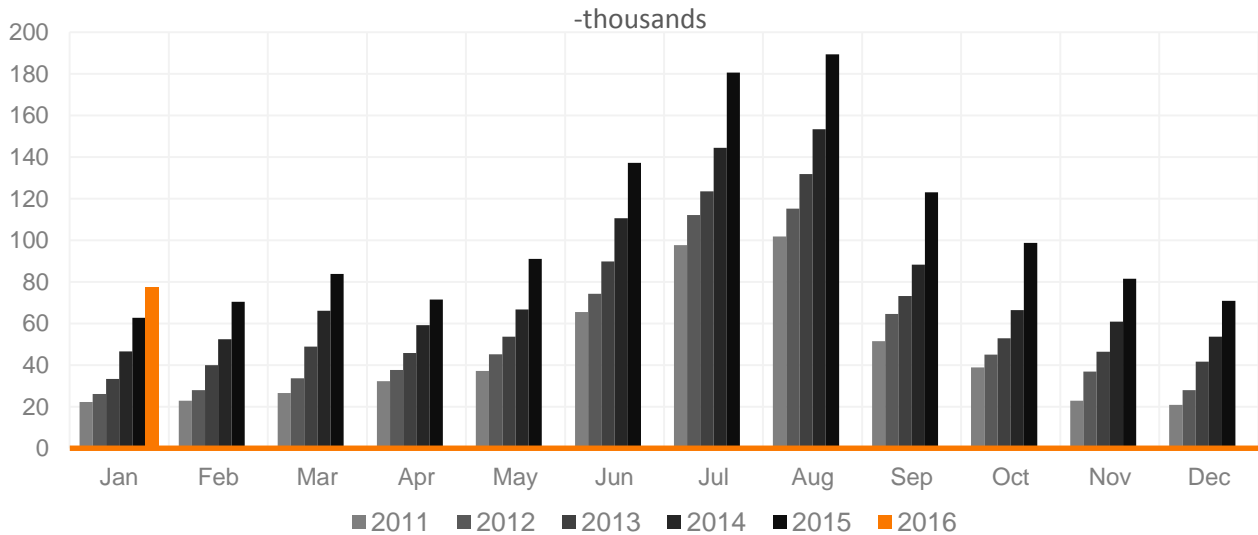
Sources: The Central Bank of Iceland, Arion Research *as of February 23 2016

Although the short-term inflation outlook keeps improving indeed, vast uncertainty surrounds global commodities markets, conditions for international trade and the ISK exchange rate in the coming months. The likelihood is that we will see a rapid pickup in domestic demand in 2016 so we still expect the Central Bank's MPC to raise rates later this year. Given the increased uncertainty regarding external conditions, the timing will depend on how the data develops in the coming months.

A strong start to tourism in 2016

In September, Arion Research published its forecast for tourist arrivals in 2016. We expected a 20% increase for the whole year, which would be impressive growth after a 30% increase last year. The Icelandic Tourist Board has published numbers for January and they indicate that Iceland is still growing in popularity for tourists, even during the darkest and coldest winter months. The number of tourist arrivals in January 2016, which is generally one of the slowest months of the year as far as tourism goes, is now close to high season numbers for 2011 with the YoY increase being 23.6% (most travelers being from the US and the UK).

Number of tourist arrivals via KEF airport

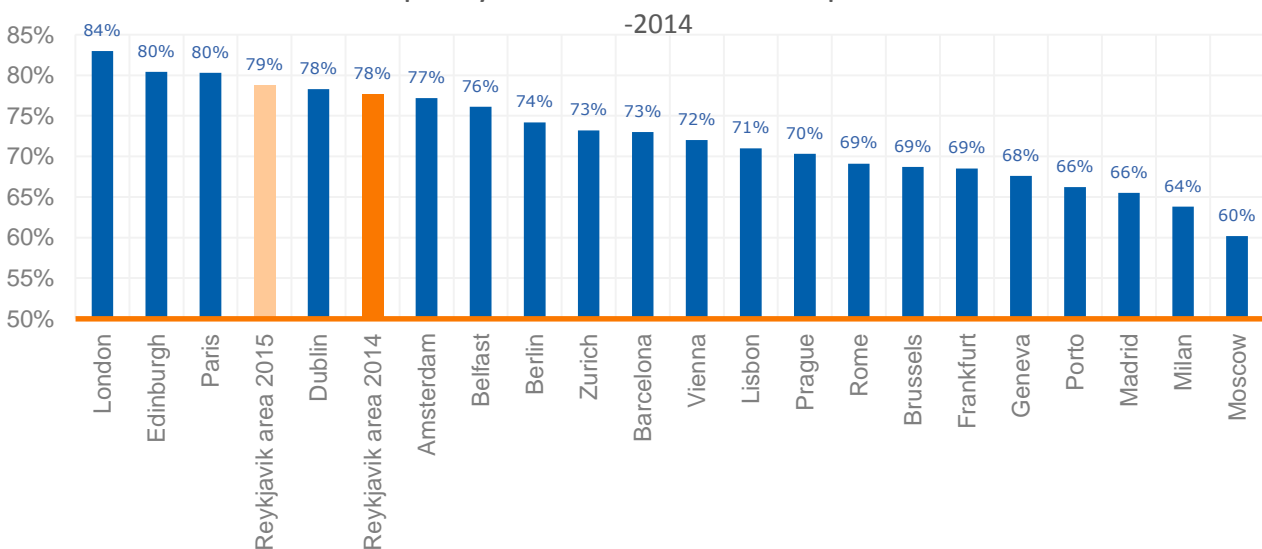


Source: The Icelandic Tourist Board

Revised flight schedules for foreign and domestic airlines for the year so far indicate that we are not likely to have been too optimistic in our forecast.

But will hotel investment be able to keep up with growth? Despite a considerable increase in the number of hotel rooms last year, occupancy rates rose slightly. In July and August of last year occupancy rates stood at 85-90% throughout the country, indicating very little excess capacity during high-season and even during some winter months in the capital area.

Occupancy rates in selected European cities

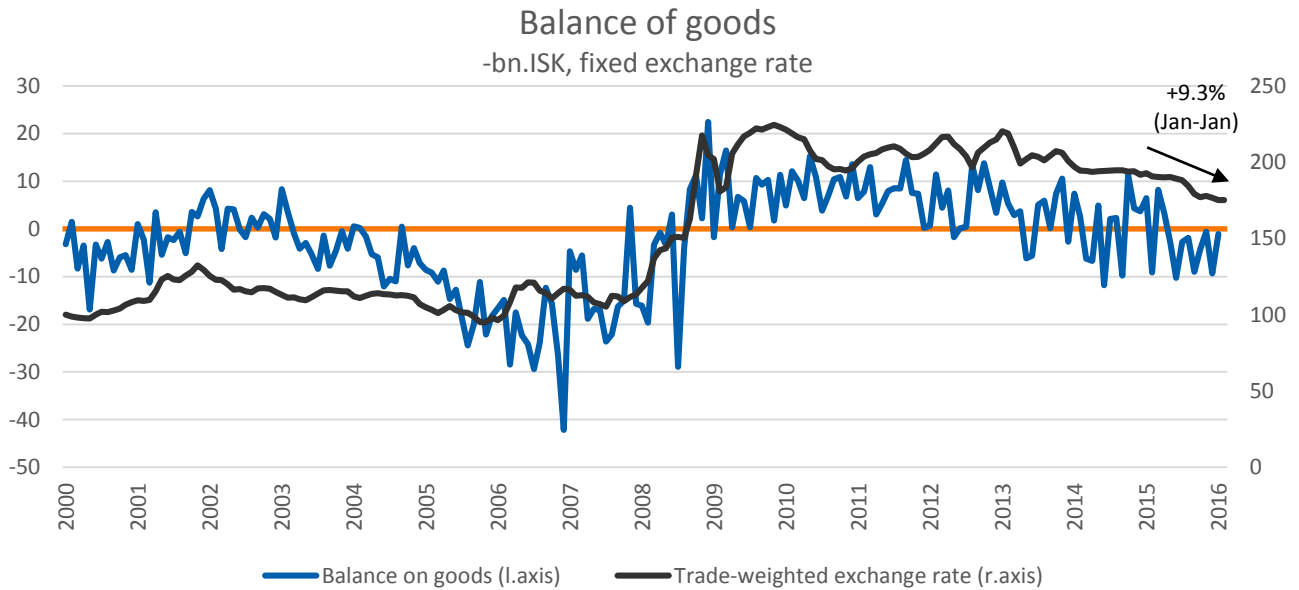


Sources: PwC, Benchmarking Alliance, Statistics Iceland

In September, it looked like plans for hotel construction aligned quite well with tourism forecasts, but since then we have seen the expected increase in the number of hotel rooms rise substantially for the coming years, with the bulk of the increase expected in 2019. Will that be too late? With a rapidly strengthening real exchange rate the concern is that tourism could slow down in the coming years, resulting in the overinvestment of hotels. Although 2016 looks set to be a good year for the tourism industry there is good reason to be cautiously optimistic for the years ahead.

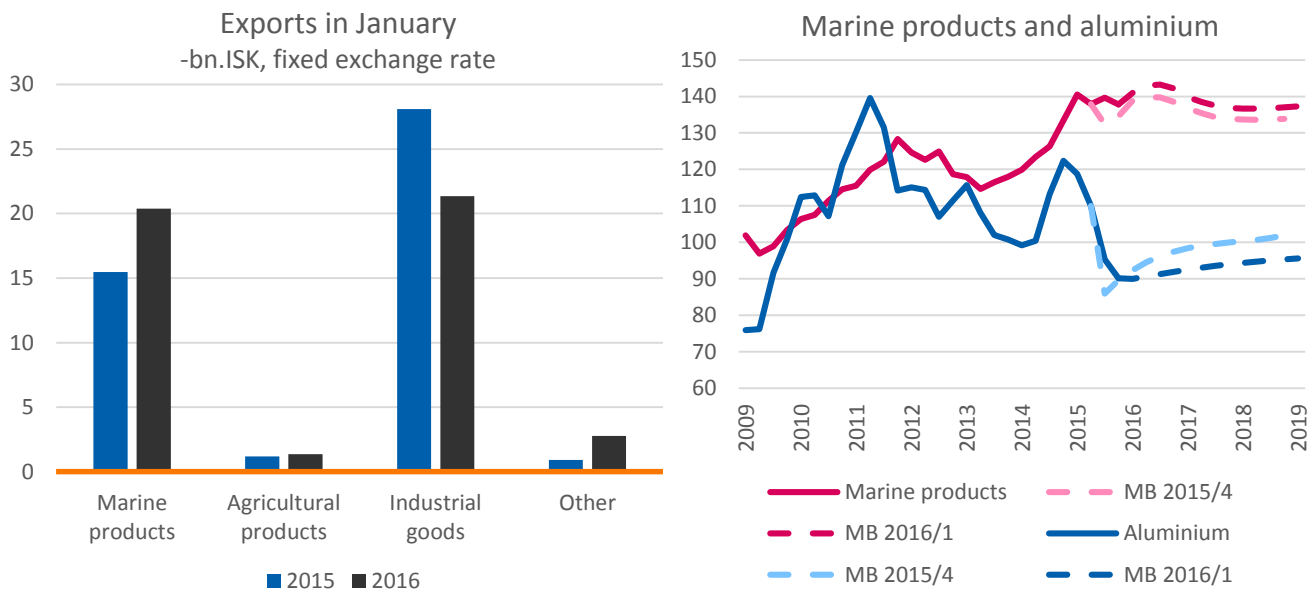
The balance of goods slightly negative in January

According to Statistics Iceland the balance of traded goods was negative by 1 bn.kr. in January 2016. The balance of trade has been positive since 2009, mostly thanks to tourism and exported services in recent quarters, while the balance on goods has been drifting into deficit territory. The króna exchange rate has been strengthening lately, with a trade-weighted index being 9.3% stronger in January of 2016 than in January of 2015.



Sources: Statistics Iceland, The Central Bank of Iceland, Arion Research

In January, the total exports of goods remained little changed Y-o-Y at a fixed exchange rate, although the composition was quite different: growth in exports was driven by the marine sector while there was a sizeable contraction in the exports of industrial goods. Prices of marine products have held up well as opposed to the prices of raw materials, including aluminium, which have been declining rather rapidly. The Central Bank's latest forecast assumes that the price of marine products will be slightly higher than assumed in the Bank's November forecast, while the price of aluminium is assumed to be somewhat lower than in the previous forecast, although rising slightly.

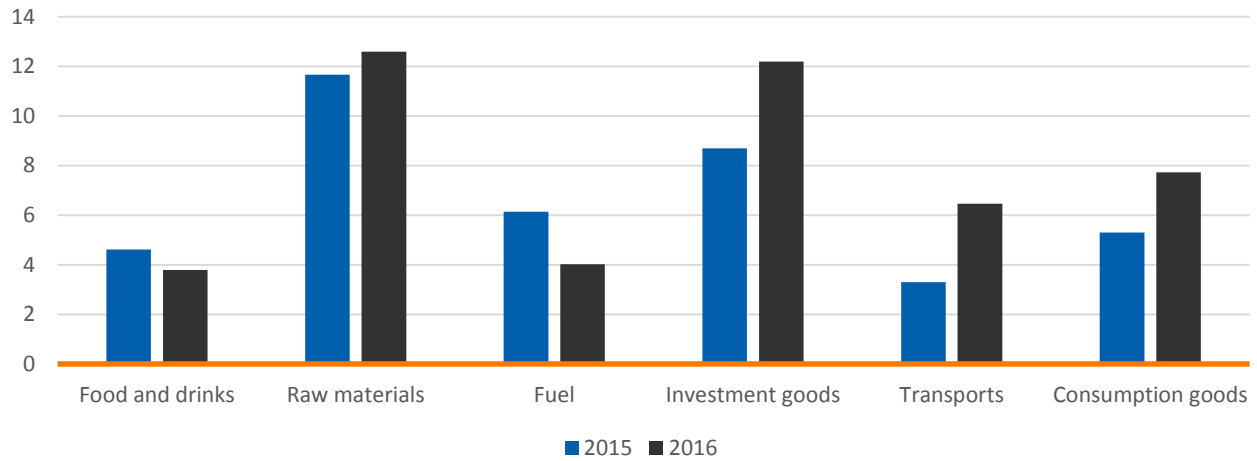


Sources: Statistics Iceland, The Central Bank of Iceland, Arion Research

Imports grew by 18% Y-o-Y at a fixed exchange rate. The growth in imports is mostly related to a pickup in the imports of investment goods and transports. In fact, when looking past the growth in those two components growth is only slightly negative. Although the imports of consumption goods have been growing as well there is a more than offsetting decrease in imported food and drinks as well as fuel. The imports of cars has been picking up recently due to both increased consumption by households as well as the rapid expansion in the car rental industry following the growth in tourism. The growth in the imports of investment goods is largely explained by the import of two fishing vessels in January of this year while none were imported last year.

Imports in January

-bn.ISK, fixed 2016 exchange rate



Sources: Statistics Iceland, The Central Bank of Iceland, Arion Research

Import growth is expected to remain strong this year, due to both investments and consumption. The real exchange rate is widely expected to keep strengthening with a pick-up in inflation, very high wage growth and very possibly a strengthening nominal exchange rate. Should that materialize we can expect the balance on goods to remain in negative territory for the coming quarters. Whether we will see a positive trade balance, however, will depend largely on the tourism industry which is expected to experience double-digit growth this year.