MPC: Interest rates unchanged, FX market interventions to come

- The Central Bank of Iceland's monetary policy committee decided at its interest rate setting meeting this month to keep its policy interest rate unchanged. The decision came as no surprise as analysts had unanimously predicted that interest rates would not be moved. The bigger story, however, was that the monetary policy committee did send out an interesting message concerning the Central Bank's strategy of foreign exchange market intervention. The CBI also published an update to its economic forecast.

New government – new focus

- The new center-right coalition government of the Progressive Party and the Independence Party released its policy statement last week. Sigmundur Davíð Gunnlaugsson, the 38-year-old chairman of the Progressive Party, has taken over as prime minister, becoming the youngest person to hold the position in the history of the Republic of Iceland. Put simply, while the outgoing government placed its main emphasis on reducing the treasury deficit, the new government is focusing on reducing household debt and boosting economic growth. As is normally the case, the government policy statement is somewhat general in its wording but we believe that the measures set out could stimulate quite rapid economic growth. We fear, however, that it could be at the expense of fiscal restraint.

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Although the currency intervention was described in somewhat unclear terms in the statement released by the monetary policy committee, the Central Bank governor nevertheless shed a great deal of light on the bank's plans at a meeting with analysts and media. In our opinion the central points are as follows:

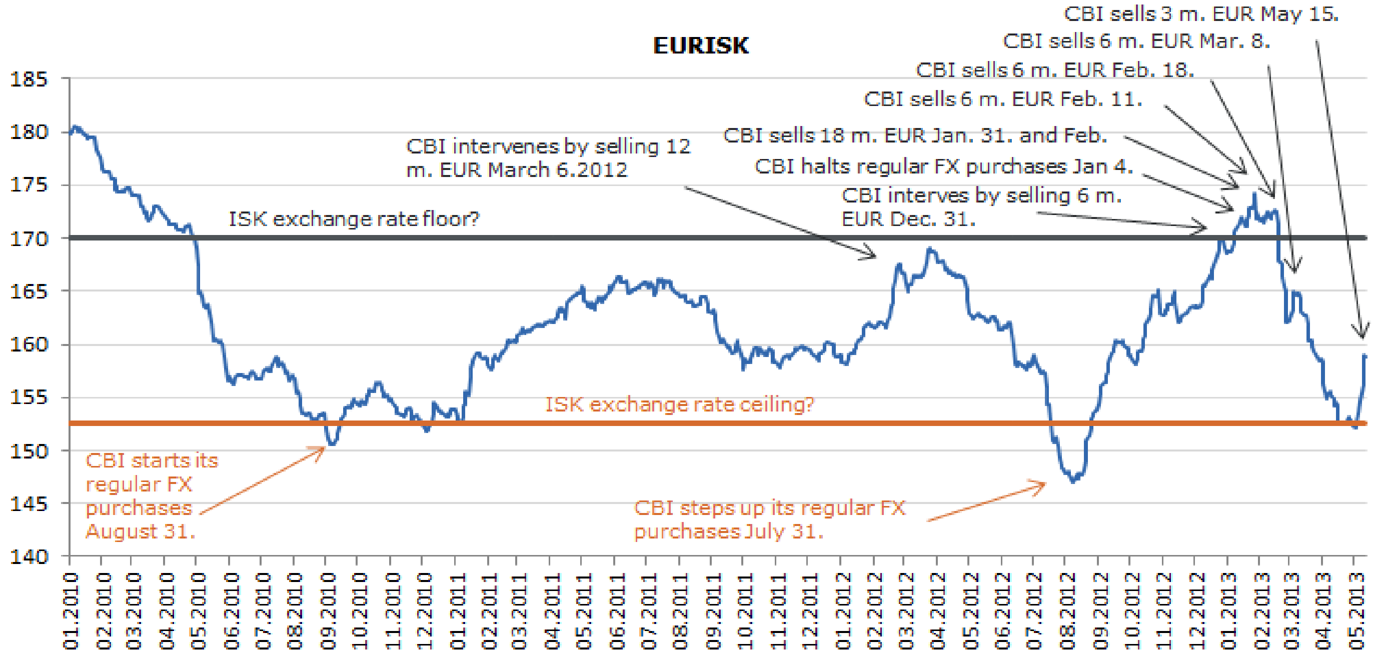
- **The Central Bank of Iceland is going to intervene in the foreign exchange market with renewed force, both as a seller of foreign currency, as it is now, and also as a buyer following a hiatus since the beginning of the year.** It appears to us that the Central Bank intends to put greater focus on reducing fluctuations in the exchange rate, which, as we have noted, has been promised from the outset but not yet attained. The statement implies increased buying of foreign exchange when conditions allow to strengthen reserves. The Central Bank is clearly keen to ensure that interventions on the buy side won't shock the market into a selloff of domestic currency and therefore stresses that it will also support the ISK if it starts to depreciate.

- The Central Bank states that the exchange rate of the ISK, all other things being equal, has been close to the level needed to reach medium-term inflation targets. It has also emphasised that the monetary policy committee expects the Central Bank's policy on the foreign exchange market to facilitate the adjustment of domestic pricing to the stronger ISK sooner, bringing down inflation expectations in the process. **We can only interpret the above as meaning that the Central Bank believes the ISK to be more or less fairly valued given economic fundamentals, at or under EURISK 160.**

We believe therefore that the Central Bank is happy enough with the exchange rate of the ISK at the current level, and will therefore intervene to make sure that it remains stable, or at least that any changes will be gradual. The Central Bank governor has stated that it was not the bank's intention to completely eliminate the signal inherent in the FX market price mechanism, but rather to even out the volatility of the ISK more forcefully than before. Their strategy should therefore not be understood as a pegging of the exchange rate, but rather as a managed float regime akin to that of Singapore. If the Central Bank sticks to its plans, sharp fluctuations in the exchange rate should be rather infrequent in the next few months.

The Central Bank's research (see **Price setting in turbulent times**) has indicated that Icelandic retailers are generally reluctant to lower prices in response to exchange rate appreciations as they expect the trend to be reversed – which unfortunately, given the history of the ISK in recent decades, isn't a bad bet. This lack of confidence in the currency is therefore probably a major hurdle in the way of bringing down inflation expectations, greatly slowing down the rate of disinflation. One of the Central Bank's main objectives in committing itself more unequivocally to reducing volatility is probably to have an effect on these expectations. Given the above, we believe it is almost certain that the Central Bank will intervene comparatively heavily to support the ISK at the current exchange rate in order to bolster expectations that the ISK will not depreciate any further, thereby attempting to generate sufficient confidence among households and firms that the recent appreciation of the ISK will lead to disinflation.

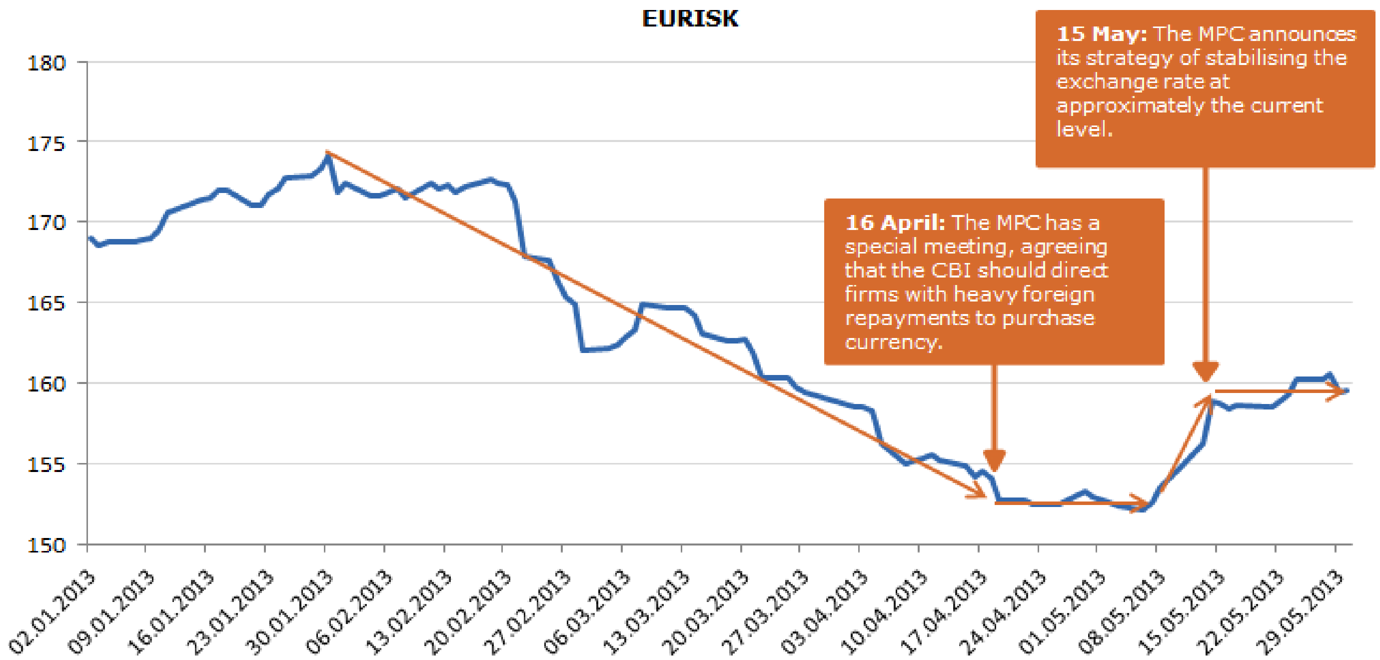
If the Central Bank interventions are successful at providing a floor for exchange rate expectations it will also be easier accumulate currency reserves when FX inflows increase - for example when foreign tourists arrive in the summer – without spooking the market and triggering a depreciation of the currency. It is interesting to note that the Central Bank intends to buy currency irregularly, depending on conditions. This signals a change in direction from how the bank acted between the autumn of 2010 and the end of 2012 when it made regular weekly purchases from every market maker.



Source: CBI, Arion Bank Research comments

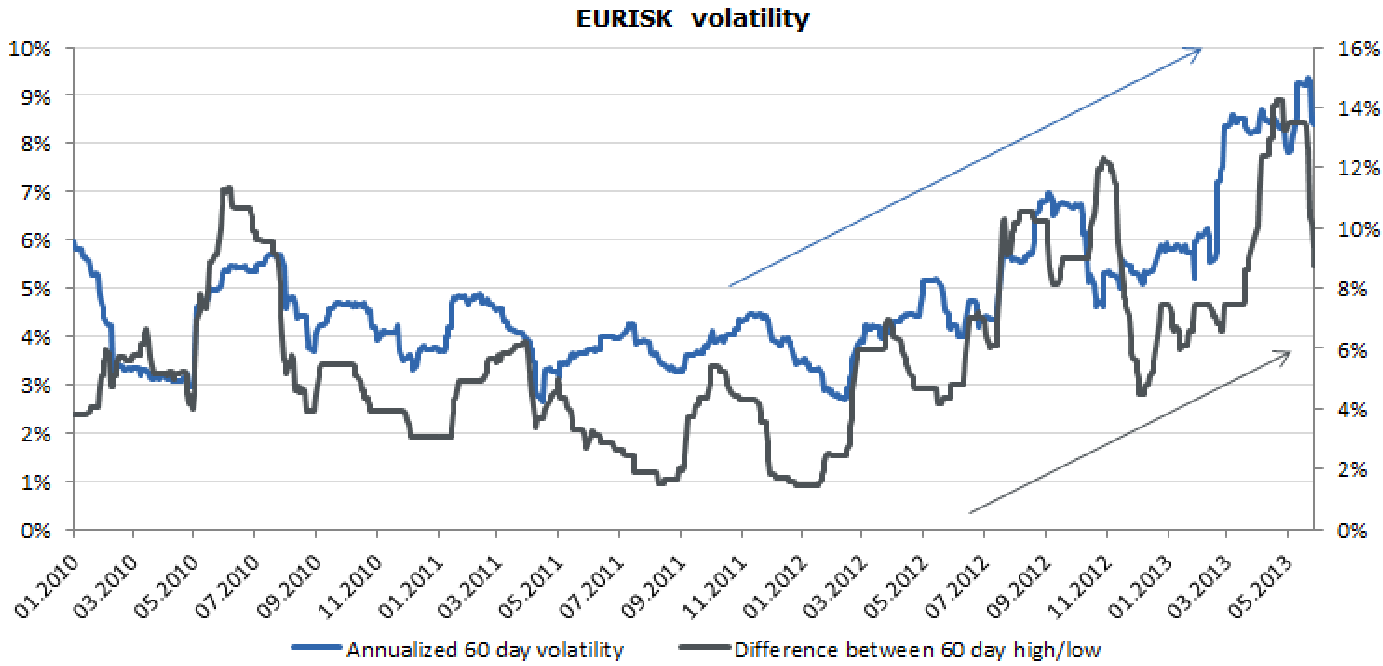
The objective of strengthening reserves remains the same, i.e. to regain some of the foreign currency which has been used, or will be used, to support the ISK; to accumulate unleveraged reserves and to cover interest payments on the treasury's and Central Bank's foreign debt. The Central Bank governor has said, however, amassing unleveraged reserves is a long term goal, and therefore seems to be in no hurry to buy more foreign currency than is sold on the interbank market.

The MPC also stated that the bank's foreign exchange purchases of currency will take into account the deleveraging of the private sector in foreign currencies – indeed, the minutes from the committee meeting showed that it had directed firms with heavy repayments in FX to purchase currency in the days following 16 April. In other words, it appears that the bank will "intervene indirectly" by directing other parties with foreign debt into the market when the inflow of foreign currency is substantial in order to accumulate capital to meet maturity dates (Landsbankinn and OR Energy immediately spring to mind in this context). The bank therefore hasn't exactly been sitting on its hands as we thought, although it has not been buying foreign currency for its own account. The bank will continue to time its currency purchases so that they do not coincide with the currency accumulations of other parties.



Source: CBI, Arion Bank Research comments

The bank says that if there are major changes in external conditions or if other aspects of economic policy undermine economic stability, the foreign exchange market intervention policy will be reviewed. We believe that various factors could come into play here. If terms of trade or other external factors relating to Iceland weaken, the Central Bank may allow the ISK to depreciate to slow down imports and maintain a surplus on foreign trade. If increases in government spending put pressure on the current account surplus, the bank may also allow the ISK to depreciate to maintain a positive trade balance. The same could happen if sharp wage increases undermine the competitiveness of the economy.



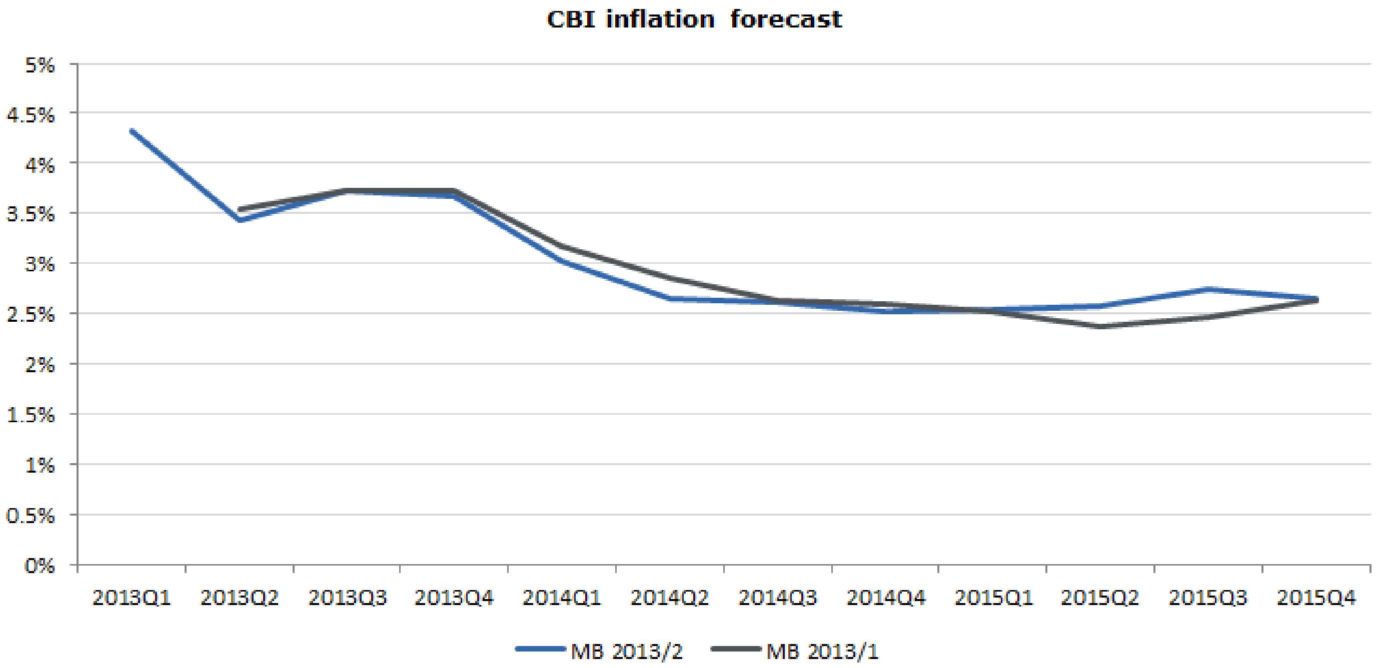
Source: CBI, Arion Bank Research calculations

The message is clear; the Central Bank intends to intervene to reduce fluctuations in the exchange rate of the ISK. From the start of its interventions it has been the Central Bank's objective to keep the ISK stable so the message is hardly new. In our opinion, however, the Central Bank has been unsuccessful in this respect, as clearly shown in the diagram above which depicts the volatility of the ISK. Now that the ISK has reached a level which the Central Bank believes is sufficient to bring inflation down to target, it reiterates its message with renewed vigor to establish credibility in the exchange rate target. We now actually believe that the bank is taking it very seriously and that the ISK will remain stable, at least for the next few months. An increased inflow of foreign currency is imminent as tourists arrive in Iceland in big numbers. Therefore the Central Bank will probably tend to be on the buy side rather than the sell side in the coming months, thereby strengthening reserves, while its strategy will probably be reversed in the fall when the inflows from tourists subside.

Lower inflation and target reached a quarter earlier than scheduled

At the same time as announcing its interest rate decision the Central Bank issued a new inflation and economic growth forecast in its Monetary Bulletin. The Central Bank has updated its inflation forecast to cover the second quarter of 2016 and it now believes that its 2.5% inflation target will be reached a quarter earlier. The bank continues to forecast an increased rate of inflation in the second half of this year.

Next year the Central Bank expects a higher output gap than forecasted in the Monetary Bulletin 2013/1, with less inflation pressure and lower inflation than previously expected. With its statement, the monetary policy committee is furthermore as good as promising that the ISK will remain stable at its current level, at least in the short term. If things work out well, we do not see much inflation ahead in the next few months.



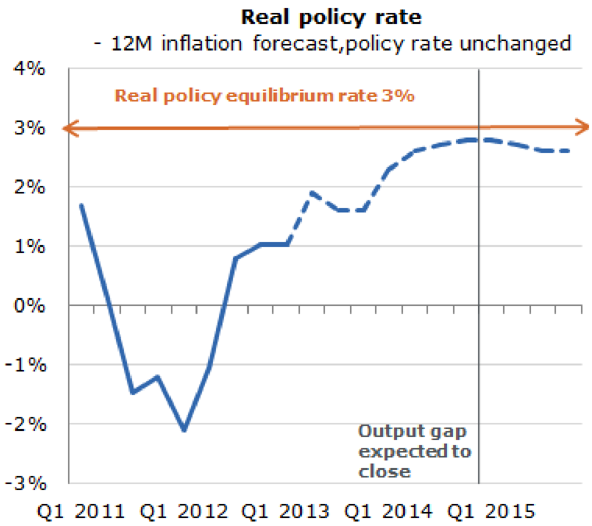
Source: CBI Monetary Bulletin

It is reiterated in the Monetary Bulletin that the monetary stance will become increasingly tight as the spare capacity disappears from the economy. Based on the Central Bank's inflation forecast it appears that the monetary stance (effective real policy rates) will gradually become tighter as disinflation kicks in, without any need for nominal interest rate hikes. In other words, as long as inflation keeps receding in line with the Central Bank's forecast we believe that the MPC will see fit to keep policy interest rates unchanged.

Table III-1 The monetary stance (%)

Real interest rates based on:[1]	Current stance (10 May 2013)	Change from MB 2013/1 (1 Feb. 2013)	Change from MB 2012/2 (11 May 2012)
Twelve-month inflation	2.0	0.9	3.9
Business inflation expectations (one-year)	0.8	0.0	1.0
Household inflation expectations (one-year)	0.4	0.5	2.4
Market inflation expectations (one-year)[2]	1.3	0.5	2.4
One-year breakeven inflation rate[3]	2.3	1.1	4.2
Central Bank inflation forecast[4]	2.3	0.7	2.9
Average	1.5	0.6	2.8

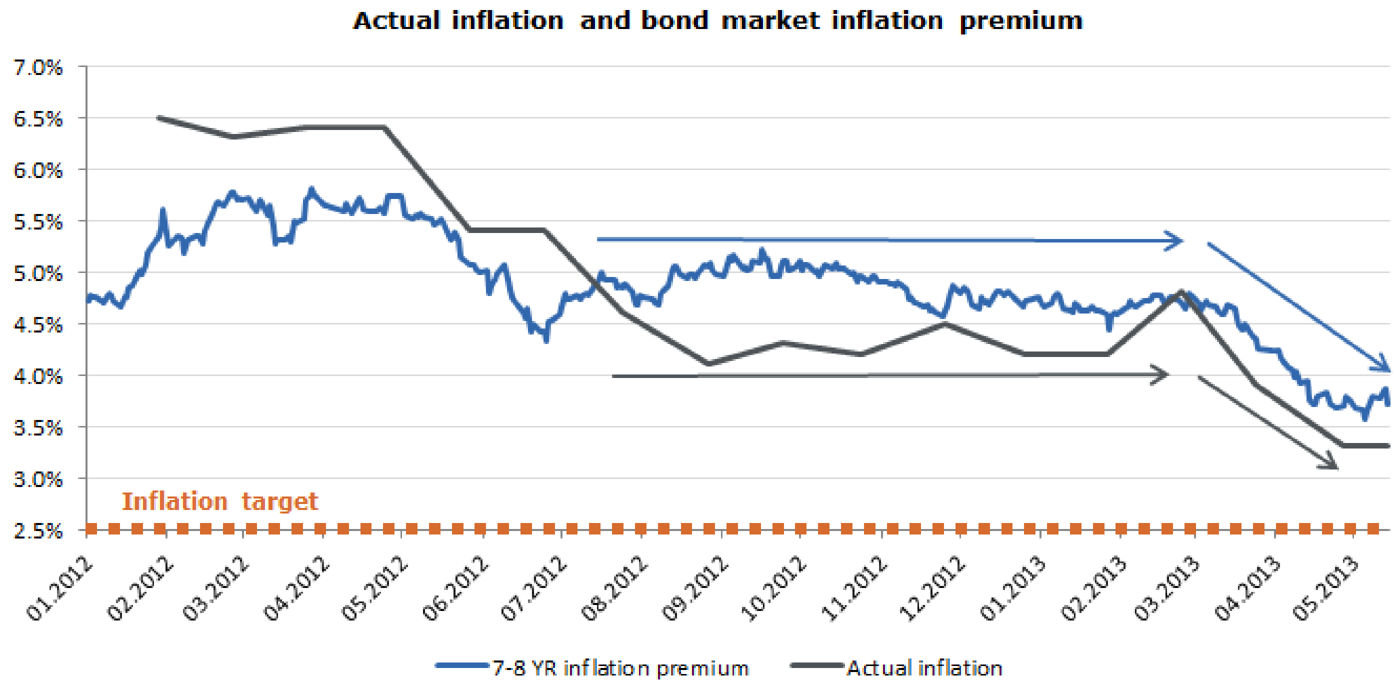
1. The effective Central Bank nominal policy rate is the average of the current account rate and the maximum rate on 28-day CDs. 2. Based on survey of market participants' expectations. This survey was first carried out in mid-February 2012. 3. The one-year breakeven inflation rate based on the difference between the nominal and indexed yield curves (five-day rolling average). 4. The Central Bank forecast of twelve-month inflation four quarters ahead.



Source: CBI, Arion Bank Research

The bond market responded

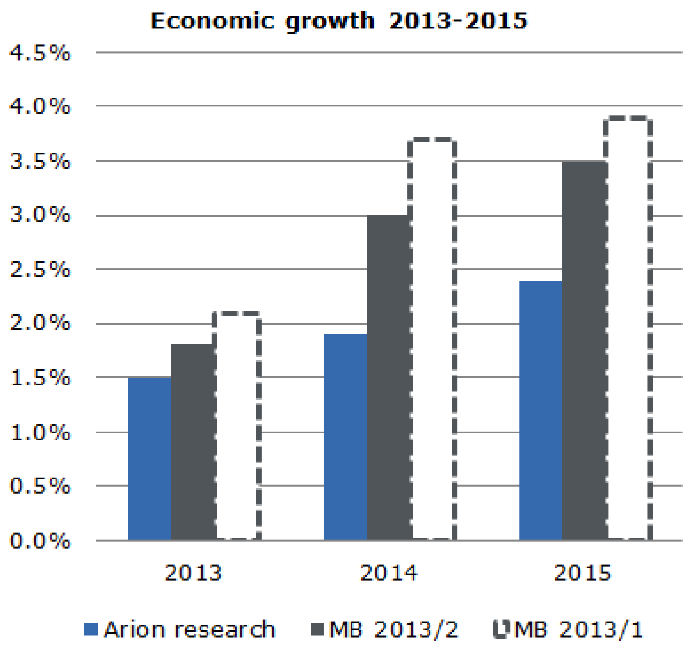
It appears that market participants on the bond market have taken note of the Central Bank governor's words on reducing fluctuations in the exchange rate of the ISK with the aim of keeping inflation as close to the inflation target as possible. There was a high volume of trading with non-indexed government bonds on the same day he announced the bank's strategy in the FX markets, with a strong focus on the longer end of the yield curve, resulting in a 14 point drop in the 7-year inflation premium. This was a continuation of a fairly handsome drop in the inflation premium witnessed in the preceding months. Both inflation and premiums have gone down since the CBI started interfering in the FX market after having been fairly persistent for many months in spite of policy rate hikes – a fact that highlights the dominance of the exchange rate channel over the interest rate channel.

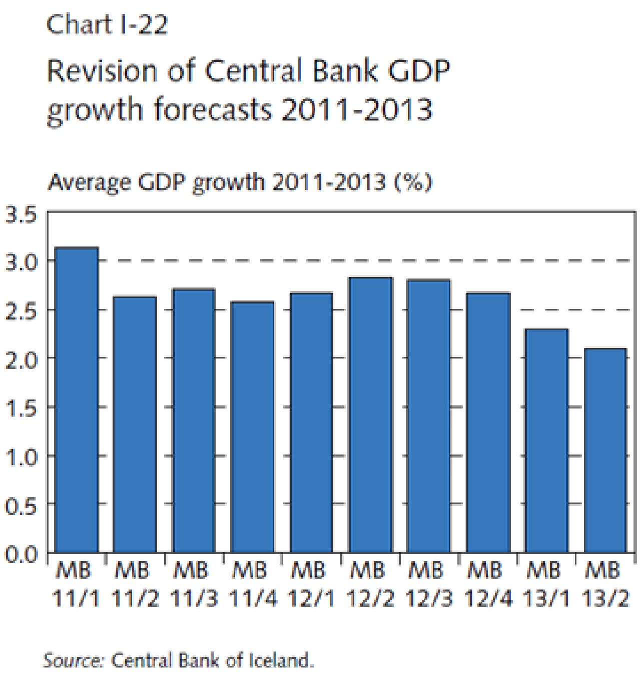


Source: CBI, Kodiak Pro, Arion Bank Research calculations

Weaker economic growth outlook for 2013-2014

Even though Bank projects continuing improvement of economic conditions, its latest growth forecast is weaker than the previous forecast published in Monetary Bulletin 2013/1. A slowdown in economic activity can be attributed to domestic demand, particularly owing to lower investment than previously expected. The forecast projects average economic growth of just over 2% for the next few years. The Central Bank's economic growth forecasts have steadily been revised downwards in recent Monetary Bulletins, as shown in the diagram below.





Activity in the economy is expected to be weak during the first half of the year - economic growth is projected to be a mere 0.8% during the first six months. However, it is expected to pick up strongly as increased domestic demand begins to be felt. The strength of the recovery is less than certain though, as stated in the Monetary Bulletin. The same is true of the global economic outlook and planned investments in energy-intensive industry. We reckon that the Central Bank is assuming investments in heavy industry of ISK 214 billion during the forecast period. The Central Bank is also concerned about the high level of household and corporate debt which could hold back economic growth.

New government – new focus

The new center-right coalition government of the Progressive Party and the Independence Party released its policy statement last week. Sigmundur Davíð Gunnlaugsson, the 38-year-old chairman of the Progressive Party, has taken over as prime minister, becoming the youngest person to hold the position in the history of the Republic of Iceland.

Put simply, while the outgoing government placed its main emphasis on reducing the treasury deficit, the new government is focusing on reducing household debt and boosting economic growth.

As is normally the case, the government policy statement is somewhat general in its wording but we believe that the measures set out could stimulate quite rapid economic growth. We fear, however, that it could be at the expense of fiscal restraint.

European Union

Both political parties oppose Iceland's entry to the European Union and it is therefore no surprise that their pact states that discussions on Iceland's joining the European Union will be put on hold and that a report will be prepared on the current state of the talks and developments within the EU. Negotiations will not continue until a referendum has taken place on whether to withdraw the nations bid to join the union, although it is not specified when this referendum is supposed to take place. The government says that the Icelandic króna will continue to serve as the national currency for the foreseeable future, which is a marked change of direction from the previous government's policy.

Lifting the capital controls – implications for households and corporate sector

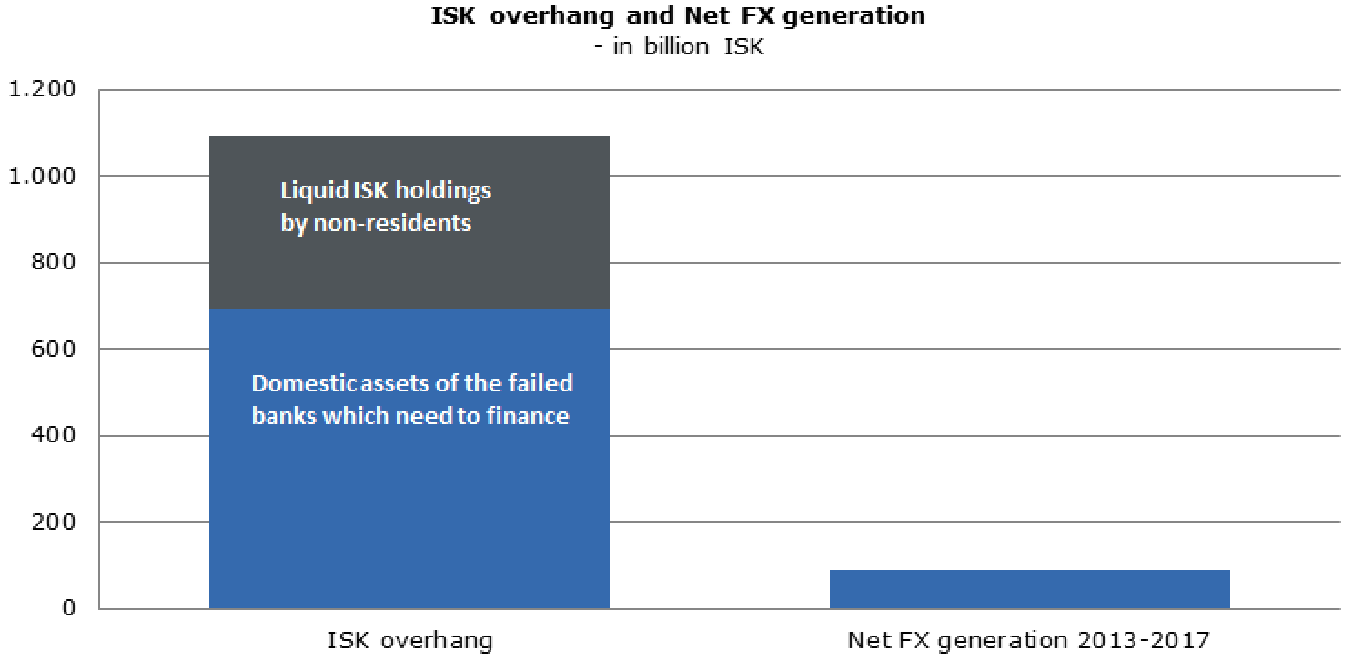
One of the most important tasks facing the government is lifting the capital controls. The sluggishness in lifting the capital controls in recent years may partly be due to the fact that efforts to stimulate FX-earning investments have been ineffective. Economic recovery has receded in the last few quarters and attempts to inspire confidence in the Icelandic economy among international and domestic investors have proven fruitless, with investment remaining way below its historic average. One of the focuses of the present government will therefore be to implement a realistic plan for lifting the capital controls, primarily detailing how it will reduce the ISK 400 billion position in liquid ISK-denominated assets owned by non-residents. However, any such plan will not be set out until the issue of composition with creditors of the bankrupt estates of the old banks has been resolved and it has been worked out how the payment of ISK 690 billion (or 40% of GDP) of domestic assets which need foreign refunding will be executed. Iceland's balance of payments is unable to meet such an outflow without a sharp depreciation of the ISK. Based on earlier statements made by the current prime minister the new government can be expected to push harder than the old government to secure deals with the creditors of the estates of the old banks which do not trigger a significant depreciation of the ISK.

The following points need to be considered:

The holdings of foreign creditors in the new banks have a current book value of ISK 210 billion. Creditors also own other ISK-denominated domestic assets currently totalling ISK 220 billion. In total therefore approximately ISK 430 billion in ISK assets of the bankrupt estates are owned by foreign creditors. At some point, foreign creditors must be enabled to exit these positions without jeopardizing financial and exchange rate stability in Iceland.

The bankrupt estates also have FX claims against domestic parties, mainly Landsbankinn, which do not have corresponding foreign exchange income or -collateral. Contractual repayments of the Landsbanki compensation instrument are too large to be covered by the current account surplus over the next few years. The repayment schedule on the compensation instrument between the new and old Landsbanki needs to be extended or the instrument needs to be refinanced.

The government's priority will therefore be to formalise the payments from the bankrupt estates to foreign creditors and to renegotiate the Landsbanki compensation instrument in such a way that the economy can realistically cope with repayments, given its net currency earning potential. If composition with creditors include provisions that limit the risk to exchange rate stability, it is conceivable that the process of lifting the capital controls might happen quickly. This process has to be credible and inspire confidence in the economy.



Improve household finances and reduce uncertainty

An election promise of one of the parties was to use resources potentially freed up by the settlement of the debts of the old banks to help alleviate household debt. It therefore comes as no surprise that a strong focus is placed on improving the balance sheets of households in the policy statement, and therefore targeted measures are promised to tackle problem debts. The first such action may be to allow the use of private pensions to pay off mortgages or to grant a tax credit in return for paying down debt. The possibility of setting up a special adjustment fund to help lower household debt will also be kept open if the settlement of the debts of the bankrupt estates is not brought to a swift conclusion. How such a fund would be financed has not been announced however. It is clear that the government will strive hard to keep their promise of assisting with household deleveraging, whether composition agreements have been made or not. At the same time the government aims to reduce taxes on income, goods and services, while simplifying the taxation system and lowering various other duties, tariffs and fees.

The government intends to reduce the political uncertainty surrounding the fisheries sector and to significantly modify or cut the resource rent tax which the outgoing government announced it was imposing on the sector. It also plans to increase the harnessing of energy resources by utilizing areas which the outgoing government had decided not to exploit. The government's objective will therefore be to kick-start investment, particularly investments in export sectors.

New focuses - slower to balance government finances

It is taking longer balance government finances than planned by the previous government, and the Central Bank forecasts that the budget deficit this year will be more than 1% of GDP, whereas the 2013 budget projected a budget deficit of merely 0.2% of GDP. Judging by the focuses set out in the government pact, it does not appear that balancing the government finances will be a priority, at least at the beginning of the electoral term – although it should be noted that we do not see this as a substantial risk to fiscal sustainability. The prime minister has said that the potential resources freed up when the debts of the old banks are settled will primarily be used to help households and the minister of finance has prioritised lowering taxes and other fees. In all likelihood it will probably take longer to generate a surplus on the primary balance - current plans assume that the treasury will be run at a surplus next year. If the new government’s plans come to fruition, increased economic grow can be expected to boost the treasury's revenue in the next few years.

Summary

The goal of the new government will be to get the economy going again and to improve household finances by lowering taxes and cancelling debt. If this is successful, the prospects for economic growth could improve markedly over the next few years. The new government’s job is to inspire confidence in the Icelandic economy again. The process of lifting the capital controls needn't be protracted if payments from the old banks to creditors are formalised and a credible plan of action is set out.

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