ICELANDIC ECONOMIC UPDATE

Arion Bank

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Proposed changes to the Housing Finance Fund (HFF)

In early May the government proposed changes to the HFF, based on a report issued by a committee that was appointed to come up with suggestions on the future of the housing market in Iceland. From the viewpoint of the HFF's bondholders, the proposed changes appear to be positive.

Increased fiscal surplus on rising revenue

Treasury finances have been published for the first quarter of 2014 and the numbers are encouraging, especially as far as revenues go. Although changes have been made to the budget on the expense side, we can expect a decent surplus this year as revenue estimates may safely be revised upwards.

How does the EUR/USD cross affect pricing of the ISK?

We examine how changes in the EUR/USD cross affect the EUR/ISK and USD/ISK exchange rates. These fluctuations can have substantial and asymmetrical impact on foreign investors depending on their accounting currency.

Private sector deleveraging in the home stretch?

At the beginning of 2010 McKinsey Global Institute issued a report on the consequences of the financial crisis that hit in 2008 and what we could learn from history. It turns out that in the last century we have had about 45 periods where a high degree of leverage has adversely affected GDP growth of various countries. Iceland seems to be a rather typical example – and deleveraging appears to be in the home stretch.

The Landsbanki bond extension

Landsbankinn and its predecessor have finally reached an agreement on extending the former's debt with the latter. We try to estimate what impact the extension may have on Iceland's balance of payments.

Currency auctions and the ISK

Liquid ISK holdings of non-residents have declined considerably in the last few years. Has the way been paved for capital account liberalization?

A balanced economy – and then what?

The Monetary Policy Committee of the Central Bank of Iceland decided to keep interest rates unchanged. Furthermore, the Central Bank has revised its macroeconomic forecast considerably upwards. It is now predicting GDP growth to be 3.7% this year, a whole percentage point stronger growth than previously forecast. The CBI has also made some changes to its monetary policy instruments. What implications will these changes have?

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Proposed changes to the Housing Financing Fund (HFF)

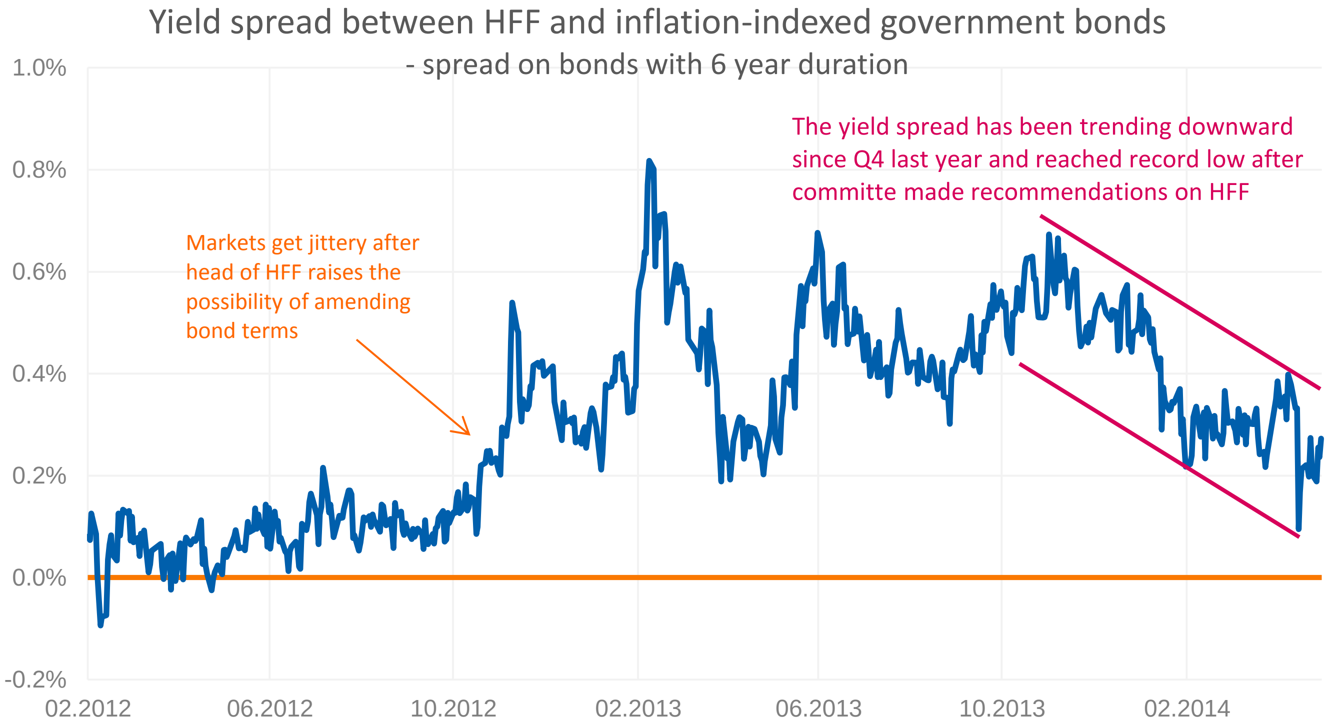
In June of 2013 a parliamentary resolution was submitted which stated that the government should follow through on a plan to deal with the remaining debt overhang of Icelandic households. The excessive debt is, according to the resolution, the result of the unforeseeable increase in principal on indexed mortgages following the currency crash and subsequent inflation of 2008-2009. The resolution also states that actions must be taken in order to ensure stability and transparency in the housing market going forward. To this end, the government appointed a committee to make suggestions on housing market reform. In early May, the committee made its recommendations public. Broadly speaking, the committee's proposals address two general themes; the future of the HFF on the one hand, and the general structure of the housing market on the other.

Recommendations on the HFF

The main emphasis of the proposals as far as the HFF and its bondholders are concerned are these;

1. The HFF loan portfolio will be allowed to expire.
2. Housing bonds will continue to be traded in the market as long as necessary with market makers providing continued liquidity.

This seemed to calm investors' nerves. We had witnessed a spread open up between the HFFs and indexed government bonds (RIKS) with similar duration on worries that bondholders would be forced to "share the pain" of resolving the HFF's woes. After news of the committee's proposals broke, the HFF-spread decreased from about 40 bps to about 20 bps. The proposals seem to give investors some comfort that the terms of its bonds will not be altered, making the future of the HFF less uncertain and investors less skeptical about the extent of the bonds' government guarantee.



Recommendations on housing market structure

Proposals regarding the structure of the housing market tackled both the market to own and the market to rent.

The committee's main proposals regarding housing ownership:

- A new system of housing financing is established where specialized companies operate as mortgage lenders without government guarantees in the same vein as the Danish lending market. These companies will be required to be non-discriminatory as far as location goes and ensure the availability of housing credit across the entire country.
- HFF will be split in two; a mortgage lending company and a Department of Housing left with social obligations.

- Private pension savings will be permanently made available for real estate purchases, as will reimbursement of the VAT for private real estate maintenance.

The committee‘s main proposals regarding the rental market:

- The government will provide financial support to non-profit real estate companies in the form of initial funding.
- Interest and rental subsidies will be combined into a single housing system which will consider financial standing instead of type of housing.
- The tax on capital gains from rental income for individuals will be lowered from 20% to 10%.

In our view the largest change to the housing system entails the founding of specialized mortgage lenders based on the Danish model. One feature of the system designed to minimize maturity mismatch is the requirement that the cash flows on liabilities (i.e. issued bonds) roughly equal those on assets (i.e. outstanding loans). The debtor can de facto repay his loan at any time (also the case in the current system) by purchasing a bond corresponding to his mortgage (also the case with HFF‘s current issued bonds).

The Danish model

The Danish housing financing system has been widely criticized. The Economist points out that Denmark has the highest ratio of debt-to-disposable income among the 34 members of the OECD and says that the housing market is to blame. The following appeared in the Economist in the piece: „Danish mortgages: Something rotten“ on April 19th 2014:

> “In 2004 only 10% of Danish mortgages had long interest-only periods, during which borrowers repaid none of their principal. By 2013 that number had climbed to 57%... Thanks to the prevalence of interest-only loans, Danes are paying down their mortgages at a rate of only 2% a year on average. When the interest-only periods end (typically ten years into the loan), their monthly payments wil rise sharply [...] The European Banking Authority (EBA) has recommended that Danish mortgage bonds, which it currently categorises as very liquid, be given a less favorable classification [...] Ane Arnth Jensen of the Association of Danish Mortgage Banks says that Denmark enjoys some of the cheapest mortgages in the world, thanks to a transparent and competitive market. But if the EBA does lower the status of Danish mortgage bonds, banks would presumably have to offer higher interest to attract enough buyers. The increase would then be passed on to borrowers, further stretching their finances.“

Even though the committee seemed to be aware of various shortcomings of the Danish system, it did not specify how Iceland would avoid these when implementing a similar system.

We also question the assumption made in the proposal that a specialized mortgage company operating without a government guarantee, but with a mandate to service all markets indiscriminately, carries less risk than a bank with a diversified loan portfolio. In addition, the operations of such a company would require considerable overhead which is bound to be reflected in a higher cost to the customer.

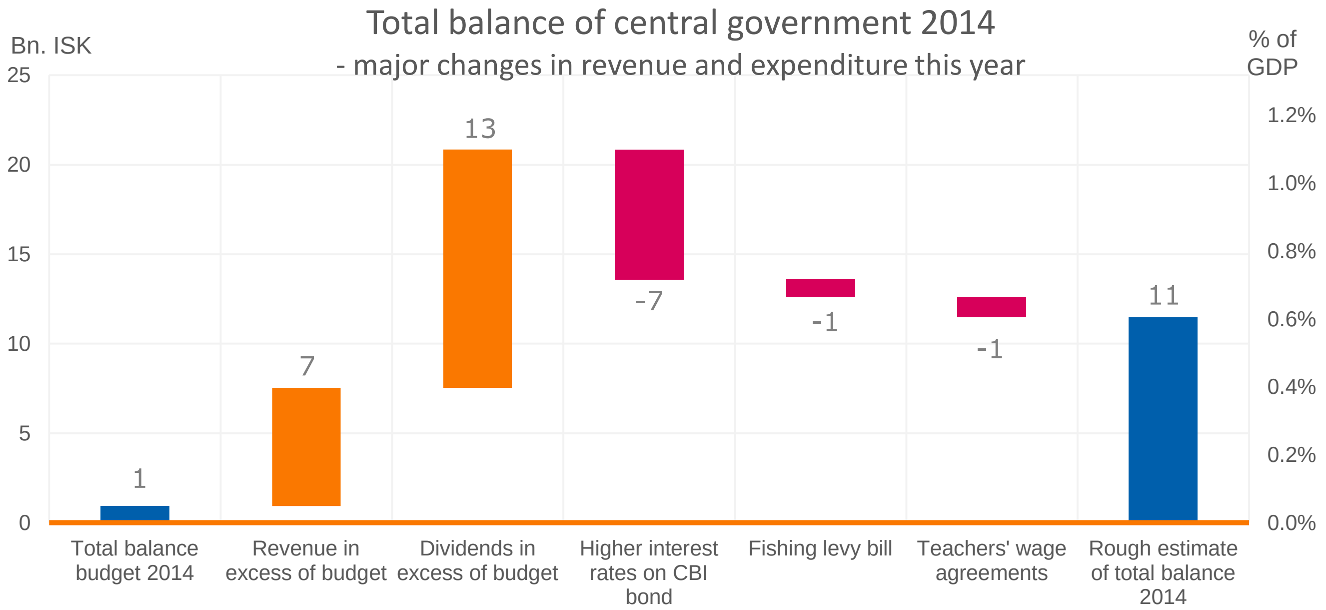
Increased fiscal surplus on rising revenue

Treasury finances have been published for the first quarter of 2014 and the numbers are encouraging, especially as far as revenues go. Dividends received exceeded budget estimates by a substantial margin or 13.3. bn. ISK The surplus is mostly due to an almost 20 bn. ISK dividend from Landsbanki Íslands hf. that was paid out at the end of the quarter. Tax receipts and income from social security charges have been on the rise and are 10% higher than last year, which is 6.5% higher than the budget assumed. Although changes have been made to the budget on the expense side the increased revenues mean that we can expect a decent surplus this year as revenues may be revised upwards.

Putting the puzzle together

We have staged a simple scenario which assumes that revenue will continue to grow at a pace consistent with the first quarter results. However, we are cautious when it comes to tax revenue since positive deviations like the ones at the beginning of the year tend to smooth out as the year progresses. Therefore, we are assuming that tax revenue will be close to target for the year as a whole. Nevertheless, we expect that total revenues could exceed the budget by about 20 bn. ISK, of which dividend payments account for approximately 13.3 bn. ISK, and other sources of revenue account for the remaining 7 bn. ISK. A drop in levies on fisheries might slightly offset the revenue increase.

Changes have been made to the terms of a bond issued in 2009 to strengthen the CBI's equity, which will entail higher coupon payments, while recent wage agreements with teachers will lead to increased outlays to education. Additionally, expenses tend to overrun the budget and discipline has been lacking in the past when it comes to state finances, but there are indications that the growth in the supplementary budget is becoming better controlled in recent years. Adding this all up we could see a surplus this year in the amount of over 10 bn. ISK as can be seen in the chart below.



Source: Arion research estimates

A chance to be more ambitious with the budget

Even though we are only hypothesizing about developments in the state budget this year, our view is supported by the positive turn in the Treasury's settlement of accounts in Q1. This good news follows better than expected results for last year's settlement when there was a surplus of close to 4 bn. ISK. In addition to this the Minister of Finance has indicated that the plan is to put more stringent rules in place when it comes to public finances. Among those is a rule stating that the Treasury must return a surplus over any 5 year period and that the deficit in any given year must not exceed 2.5% of GDP. Furthermore, a debt ceiling would be put in place which ensures that the government debt, not including pension obligations and accounts payable, shall not exceed 45% of GDP in any given year. And as long as government debt is above the debt ceiling, action must be taken to wind down debt by 5% of GDP per year.

It appears that an emphasis will be put on the repayment of debt as well as more stringent budgeting. The long-term budget outlook only assumed a surplus of 1-3 bn. ISK in 2015-2017, but it looks like we might be seeing a much more positive result. In all likelihood, we will soon see a parliamentary resolution about the budget for the next four years. We'd certainly welcome fiscal restraint and increased national savings as the economy's output gap is likely on the verge of closing.

How does the EUR/USD cross affect pricing of the ISK?

Even though the CBI can intervene in the FX market and affect the exchange rate of the ISK relative to other currencies it has no tools to affect the relative prices of foreign currencies. EUR/USD has been quite volatile in recent years so we thought we should examine how changes in the EUR/USD cross affect the EUR/ISK and USD/ISK exchange rates respectively, as these fluctuations can have an asymmetric impact on foreign investors carrying risk in ISK depending on their accounting currency.

But how does a change in EUR/USD manifest itself in the EUR/ISK and USD/ISK exchange rates? More specifically; if the EUR/USD cross would appreciate by 1% how would the exchange rate of the ISK move relative to these two currencies? If the króna was equally tied to the euro and the dollar a 1% increase in EUR/USD would lead market makers to price in a 0,5% depreciation of USD/ISK and a 0,5% appreciation of EUR/ISK, given that the ISK was not being traded simultaneously. If the ISK was completely tied to the euro, a 1% increase in EUR/USD would lead to a full 1% repricing of the ISK relative to the dollar, while the EUR/ISK would be left unchanged (and vice versa if the ISK was completely tied to the dollar).

We attempt to quantify this relationship using the following equation:

$\Delta\ln(ISK/JPY_t) = \alpha + \beta\Delta\ln(EUR/JPY_t) + \gamma\Delta\ln(USD/JPY_t) + \varepsilon_t$

Here, a third currency, the JPY, is used as an anchor. $\Delta\ln(X)$ represents daily movement in the FX cross "X" and ε_t is the residual error. The coefficient β represents the relative relationship between the króna and the euro while γ represents the relative relationship between the króna and the US dollar. The relationship becomes stronger as the coefficient approaches 1.

It should be noted that if the euro coefficient were to equal 1 it would not necessarily mean that the ISK was perfectly correlated with the euro, but only that the relative change between the euro and another currency would not affect the exchange rate between the euro and the króna - only the exchange rate between the króna and the other currency in question.

The regression (results pictured below) yields a β coefficient of $\approx$0.82 and a γ coefficient of $\approx$0.18. This means that when EUR/USD appreciates by 1% we can assume market makers will adjust the ISK exchange rate so that EUR/ISK appreciates by 0.18% and USD/ISK depreciates by 0.82%, *holding all else constant*. In other words: the USD/ISK is more sensitive to changes in EUR/USD than EUR/ISK.

Dependent Variable: DLOG(ISKJPY)
Method: Least Squares
Date: 02/25/14 Time: 15:28
Sample (adjusted): 1/02/2009 2/13/2014
Included observations: 1335 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	6.01E-05	0.000116	0.519425	0.6036
DLOG(EURJPY)	0.815598	0.019041	42.83370	0.0000
DLOG(USDJPY)	0.181037	0.023966	7.554010	0.0000

R-squared	0.764613	Mean dependent var	0.000136
Adjusted R-squared	0.764260	S.D. dependent var	0.008704
S.E. of regression	0.004226	Akaike info criterion	-8.092775
Sum squared resid	0.023791	Schwarz criterion	-8.081097
Log likelihood	5404.927	Hannan-Quinn criter.	-8.088399
F-statistic	2163.389	Durbin-Watson stat	1.450928
Prob(F-statistic)	0.000000		

Source: Arion research calculations

Similar results can be obtained by performing two simpler regressions:

$$\Delta\ln(ISK/USD_t) = \alpha + \beta\Delta\ln(EUR/USD_t) + \varepsilon_t$$

$$\Delta\ln(ISK/EUR_t) = \alpha + \beta\Delta\ln(USD/EUR_t) + \varepsilon_t$$

Dependent Variable: DLOG(ISKEUR)
Method: Least Squares
Date: 02/25/14 Time: 16:09
Sample (adjusted): 1/02/2009 2/13/2014
Included observations: 1335 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	6.00E-05	0.000115	0.520289	0.6029
DLOG(USDEUR)	0.188887	0.018664	10.12022	0.0000

R-squared	0.071351	Mean dependent var	6.31E-05
Adjusted R-squared	0.070655	S.D. dependent var	0.004373
S.E. of regression	0.004215	Akaike info criterion	-8.098645
Sum squared resid	0.023687	Schwarz criterion	-8.090860
Log likelihood	5407.846	Hannan-Quinn criter.	-8.095728
F-statistic	102.4189	Durbin-Watson stat	1.438536
Prob(F-statistic)	0.000000		

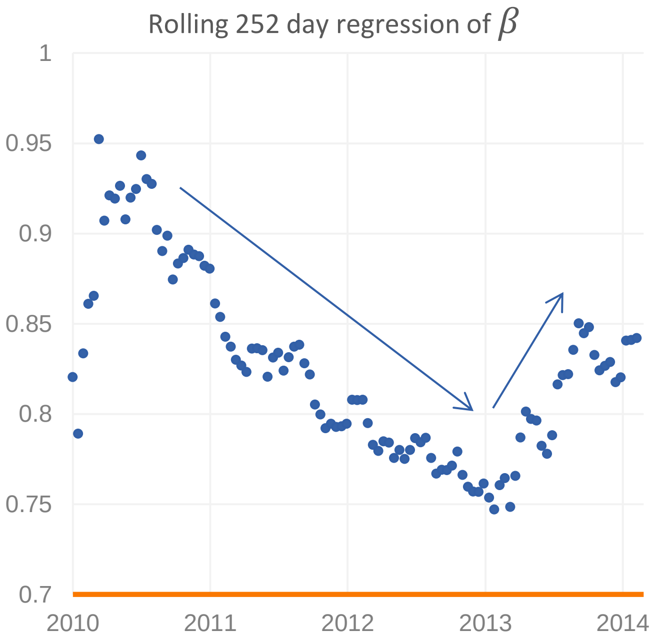
Dependent Variable: DLOG(ISKUSD)
Method: Least Squares
Date: 02/25/14 Time: 16:15
Sample (adjusted): 1/02/2009 2/13/2014
Included observations: 1335 after adjustments

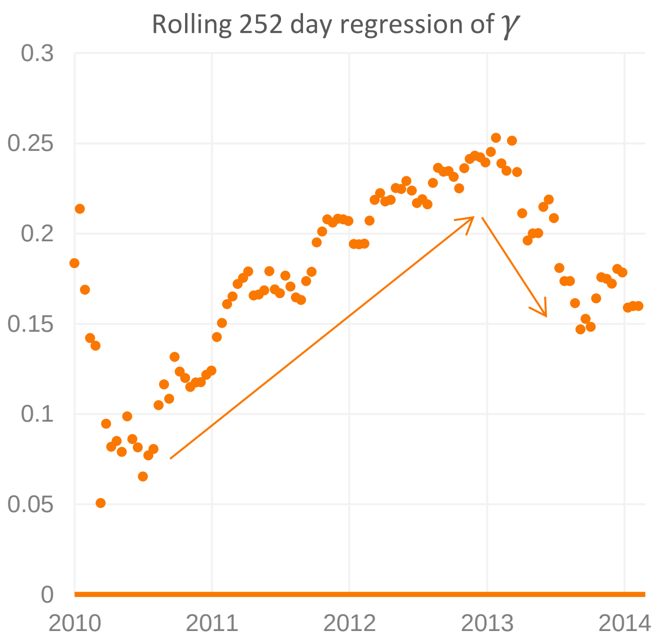
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	5.97E-05	0.000115	0.516909	0.6053
DLOG(EURUSD)	0.813744	0.018783	43.32391	0.0000

R-squared	0.584730	Mean dependent var	4.70E-05
Adjusted R-squared	0.584419	S.D. dependent var	0.006546
S.E. of regression	0.004220	Akaike info criterion	-8.096633
Sum squared resid	0.023735	Schwarz criterion	-8.088848
Log likelihood	5406.503	Hannan-Quinn criter.	-8.093716
F-statistic	1876.961	Durbin-Watson stat	1.443974
Prob(F-statistic)	0.000000		

Source: Arion research calculations

By performing a rolling regressions like the one above using a 252 day period (there are about 252 business days in the year) we can see whether the relationship between the króna and euro is growing stronger or weaker over time. As the charts below demonstrate, it seems like the relationship between the euro and the króna grew weaker from 2010 until the beginning of 2013, but has been strengthening continuously since.

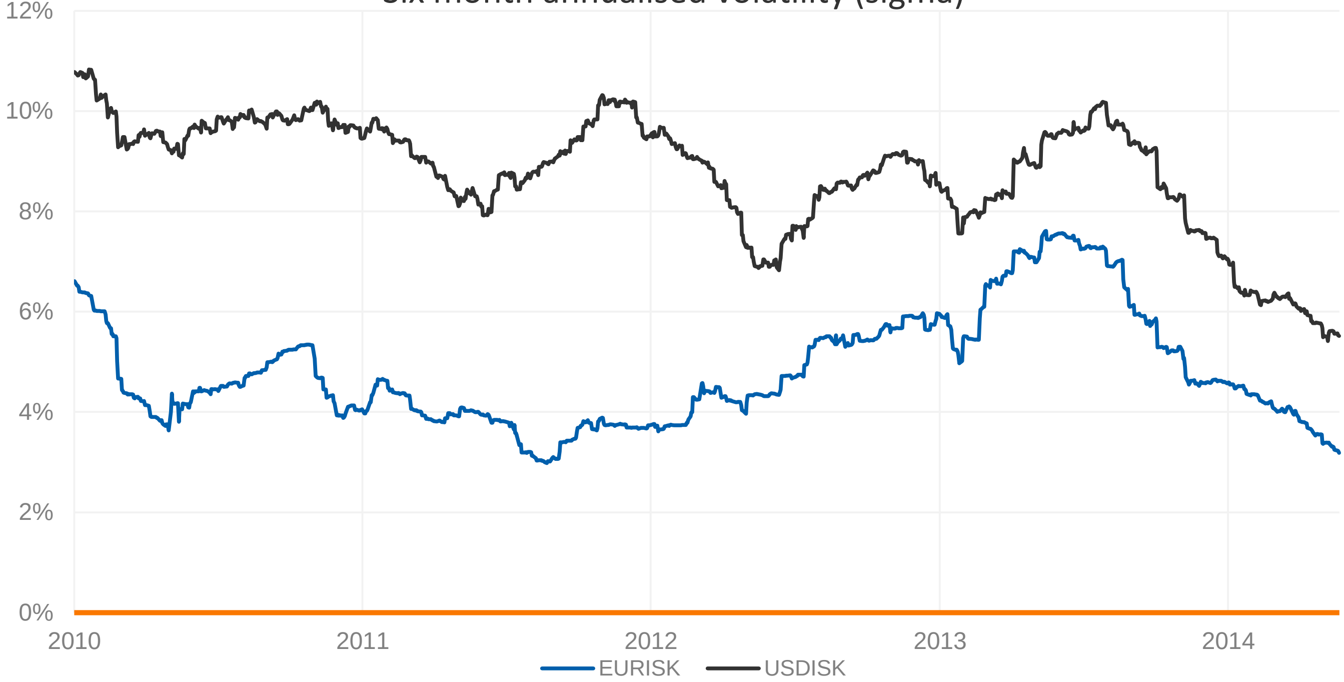




Source: Arion research calculations

This carries important implications for international investors in Iceland. It means that investors using the dollar as an accounting currency take on greater exchange rate risk when investing in Iceland than investors using the euro. Effectively, dollar investors carry both the risk of general movements in the ISK exchange rate, and a disproportionate share of any EUR/USD adjustment as well. This is plainly apparent in the consistently higher volatility of USD/ISK than EUR/ISK.

Six month annualised volatility (sigma)



Source: Bloomberg, Arion research calculations

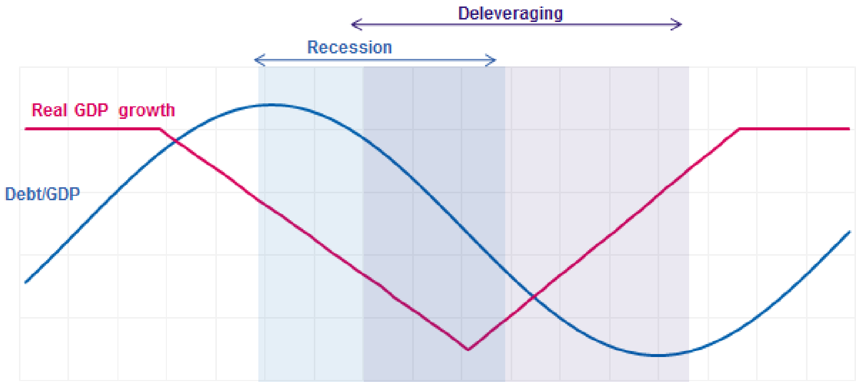
Private sector deleveraging in the home stretch

At the beginning of 2010 McKinsey Global Institute issued a report on the consequences of the financial crisis that hit in 2008 and what we could learn from history. It turns out that in the last century, the global economy has witnessed about 45 periods where a high degree of leverage has adversely affected GDP growth of various countries while firms, households and/or the government undergo sharp deleveraging. Restructuring of private debt is an important factor in the revival of the economy following financial crises and McKinsey predicted that GDP growth in the next 5-7 years would be largely determined by how deleveraging went.

Deleveraging and financial crises

Throughout history there have been four main ways of recovering from overleveraging:

1) Tightening where debt grows at a slower pace than GDP and the debt ratio is wound down as time goes by.
2) The lowering of debt via high inflation and high nominal growth in GDP. This eventually leads to the lowering of debt as a percentage of GDP.
3) Deleveraging through bankruptcy and consequent write-downs of debt.
4) Strong GDP growth (rare).



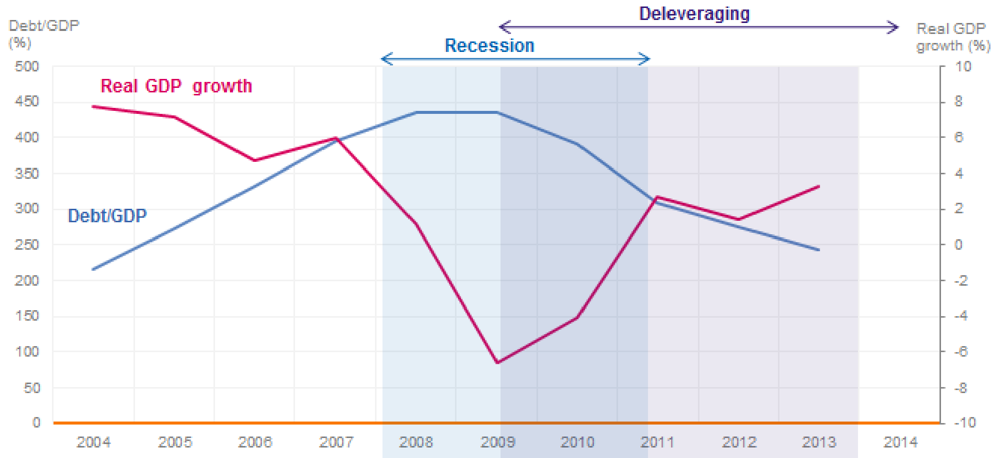
Average annual real GDP growth, %	10 years	1-2 years	2-3 years	4-5 years	10 years
Belt-tightening	4,7	0,6	-0,6	4,8	3,2
High inflation	4,3	-1,7	-1,4	4,1	4,2
Defaults and write-downs	4,3	-1,8	-3,0	5,7	4,8
Growing out of debt	7,9	0,8	← 12,8 →		2,3
Average	**4,6**	**-0,5**	**-1,3**	**5,1**	**3,8**

Source: McKinsey Global Institute, Debt and deleveraging: The global credit bubble and its economic consequences

Considerable headway in deleveraging in recent years

Data from Iceland seems to make the country a rather typical example of post-crisis deleveraging. As leverage reached a high in 2008, economic growth slowed down and the economy entered a period of deleveraging and contraction.

After a considerable decrease in debt levels, growth typically starts picking up again, which is what the Icelandic economy has been witnessing in the last three years. In Iceland, deleveraging of private debt has been largely accomplished via write-downs and bankruptcy, while the government has gone the route of tightening.

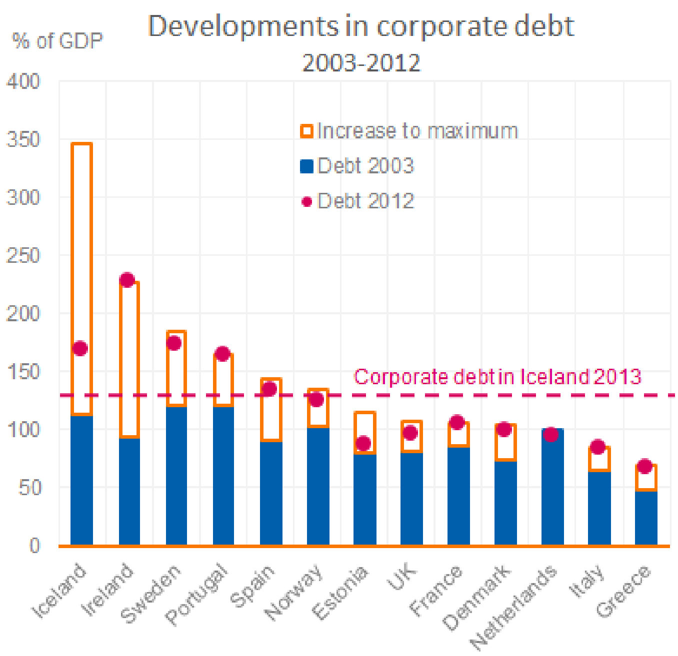


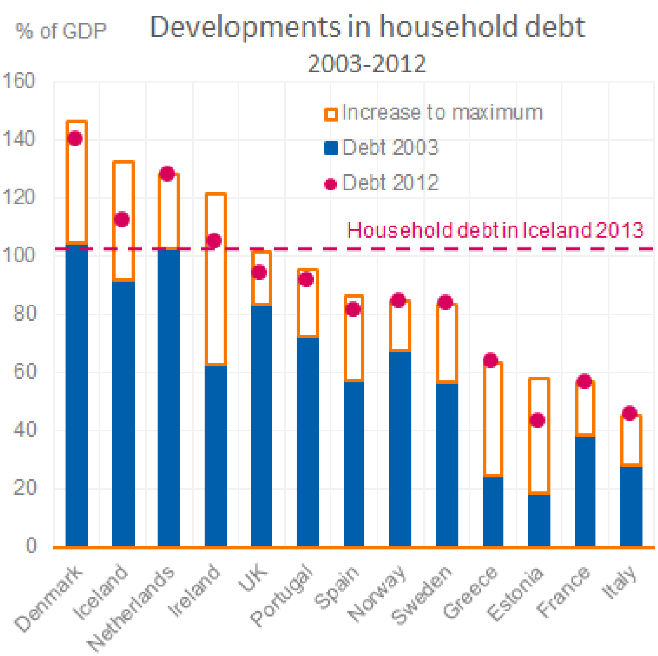
Average annual real GDP growth, %	10 years	1-2 years	2-3 years	4-5 years	10 years
Iceland	4,7	1,2	-5,4	2,5	
UK	3,3	-0,8	-5,2	1,2	
USA	3,2	-0,3	-2,8	2,3	
Euro area	2,6	0,4	-4,5	0,8	
Years	1997-2007	2008	2009-2010	2011-2013	

Source: Statistics Iceland, CBI, Eurostat

But have we seen the level of debt come down enough to fuel higher growth in investments and private consumption in the coming years?

Firms have been quite successful at deleveraging although about half of the decrease in total corporate debt is due to write downs of loans to holding companies, which do not affect the real economy as much as other firms. According to the CBI, debt-to-EBIDTA of the 500 firms with the highest turnover has gone down from 12.8 in 2008 to 7.7 in 2012, and their equity ratio has increased from 20% to 36% over the same period. In light of this, we believe there is room for increased investment in the private sector. We also believe that investment will play a larger role in GDP growth in the coming years, especially when it comes to industries and real estate.





Source: CBI, Eurostat

However, growth in domestic demand has a downside. It tends to negatively affect the current account balance due to import leakages. It will therefore become increasingly important to encourage national savings to offset the negative effect on the current account surplus, for instance by tightening the government's belt - which seems to be the plan according to a recent bill regarding public finances.

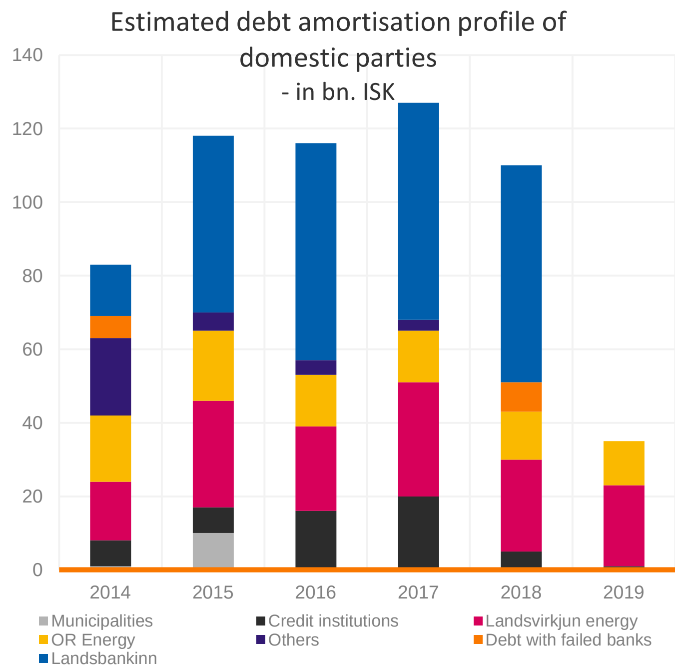
The Landsbanki bond extension

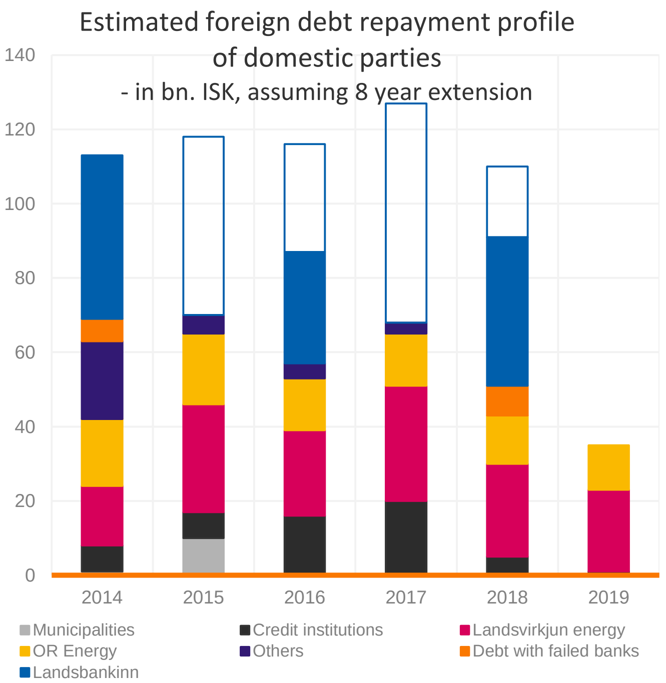
Like we covered in [our last Economic Update](), the heavy and frontloaded repayment schedule of Landsbankinn's foreign debt to its predecessor is one of the major risk factors facing the economy's balance of payments – the resulting outflow of FX can cause a depreciation of the ISK or strain CBI reserves. We therefore welcome the news that Landsbankinn and LBI finally reached an agreement on the extension of the bond.

The amended terms of the bond are as follows:

I. The remaining balance is 226 bn. ISK
II. The bond's final maturity will be in 2026 instead of 2018 (an 8 year extension).
III. Payments will be made every other year.
IV. The bond is callable at any time at no penalty to Landsbankinn.
V. Interest terms are unchanged from the previous contract until 2018 (LIBOR+290bps).
VI. Interest terms will rise after that (ranging from LIBOR+350bps for the 2020 maturity to +406bps for the 2026 maturity).
VII. The agreement is conditional upon the Winding up Board of LBI obtaining certain exemptions from the capital controls for payouts.

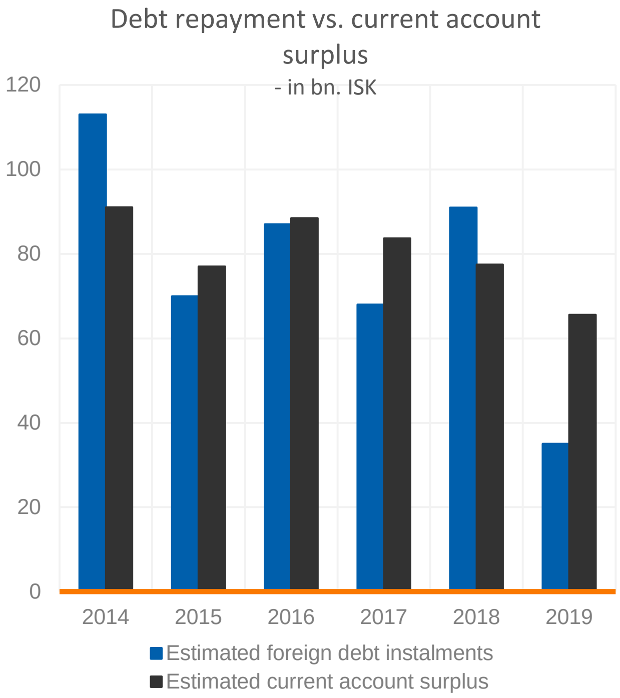
Based on this information we have tried to hypothesize what the repayment schedule of the nation's foreign debt will look like when taking the bond extension into account. As can be seen below it will be much more manageable with the extension.

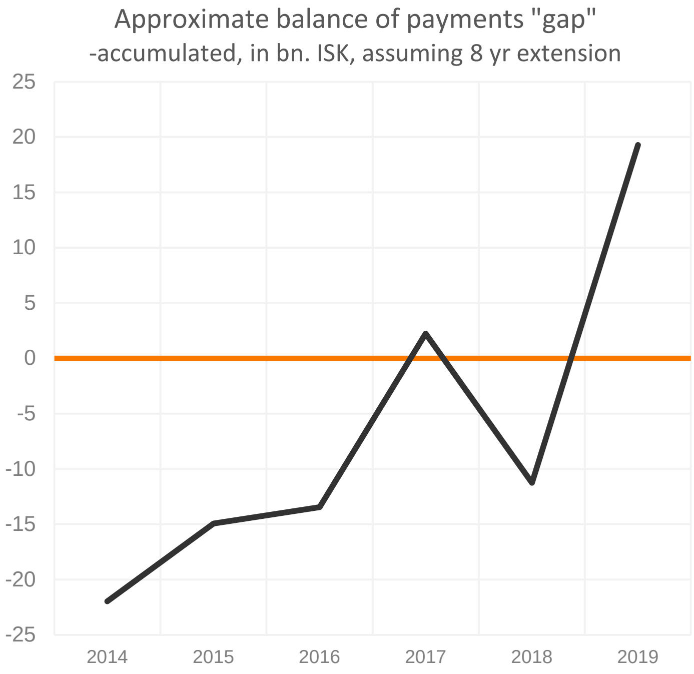




Source: CBI, Arion research calculations

When the estimated repayment schedule (factoring in the bond extension) is compared with our current account forecast, they are close to matching. We believe that this extension will suffice to drastically reduce pressure on the balance of payments caused by foreign debt repayment. Without the extension we estimated the accumulated balance of payments gap to be close to 140 bn. ISK in the period 2014-2018, whereas with the extension it all but disappears.





Source: CBI, Arion research calculations

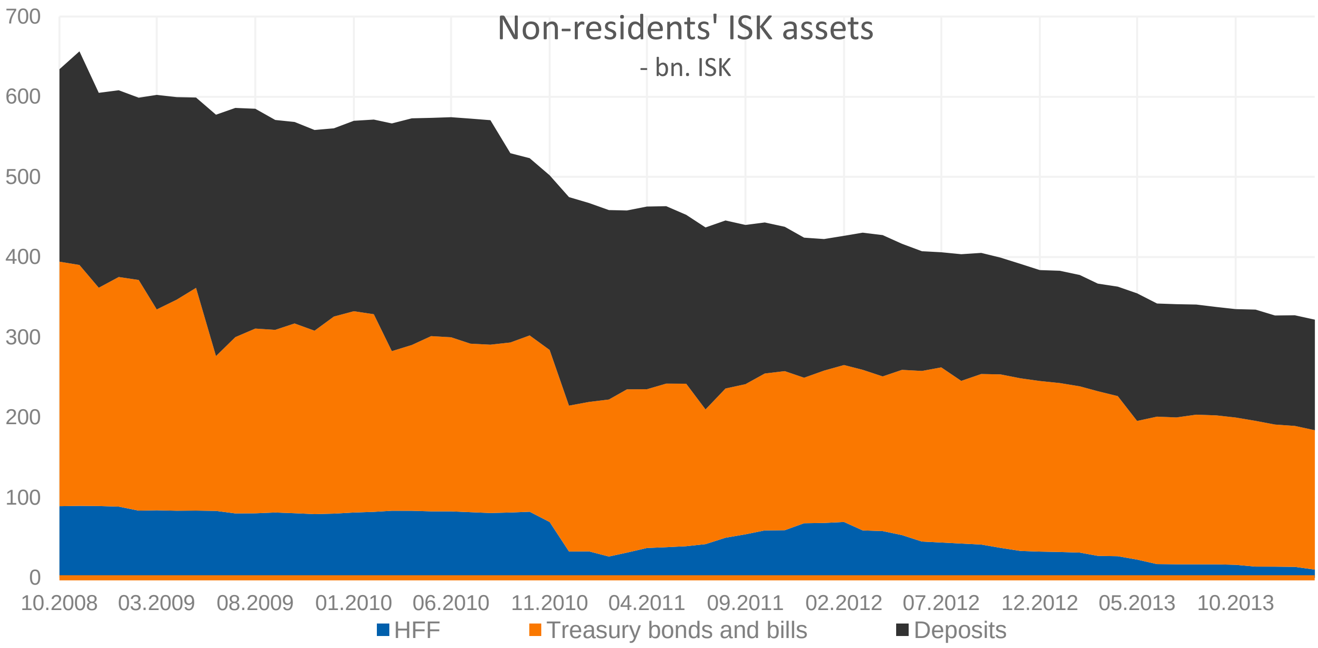
It should also be noted that the BoP analysis above does not assume any inflow of capital related to FDI, no refinancing of other parties besides Landsbankinn (not even on the Íslandsbanki and Arion banki debt due in the years 2016 and 2017), and no foreign asset liquidation. All of these factors provide substantial upside potential. For instance, Landsbankinn has sizable FX assets on its balance sheet already, which will probably suffice to cover the new 2014 and 2016 maturities even in the absence of cash flows from its foreign loan portfolio and FX brokerage activities.

Taking all of this into account we believe that the Landsbanki bond extension should provide a BoP buffer which would make the liberalisation of capital accounts easier. Note that the extension of the bond is contingent on whether the government grants an exemption on payments from the estate. The authorities have repeatedly stated that imbalances of the estates must be resolved comprehensively. Therefore we must assume that there is a possibility that the exemption will not be granted and the bond not extended.

When pondering the effects of the change in the terms of the bond on the Icelandic economy a few things come to mind. The balance of payments scenario should greatly improve, which means that the króna should be under less pressure. The odds of a depreciation of the króna and increased inflation are decreased in the short term. The strength of the króna should then positively affect inflation expectations and decrease the need for monetary tightening by the Central Bank. At the same time it could increase the confidence of both the public and investors (domestic and foreign) and thus increase economic activity via expectation channels, increasing the need for monetary tightening.

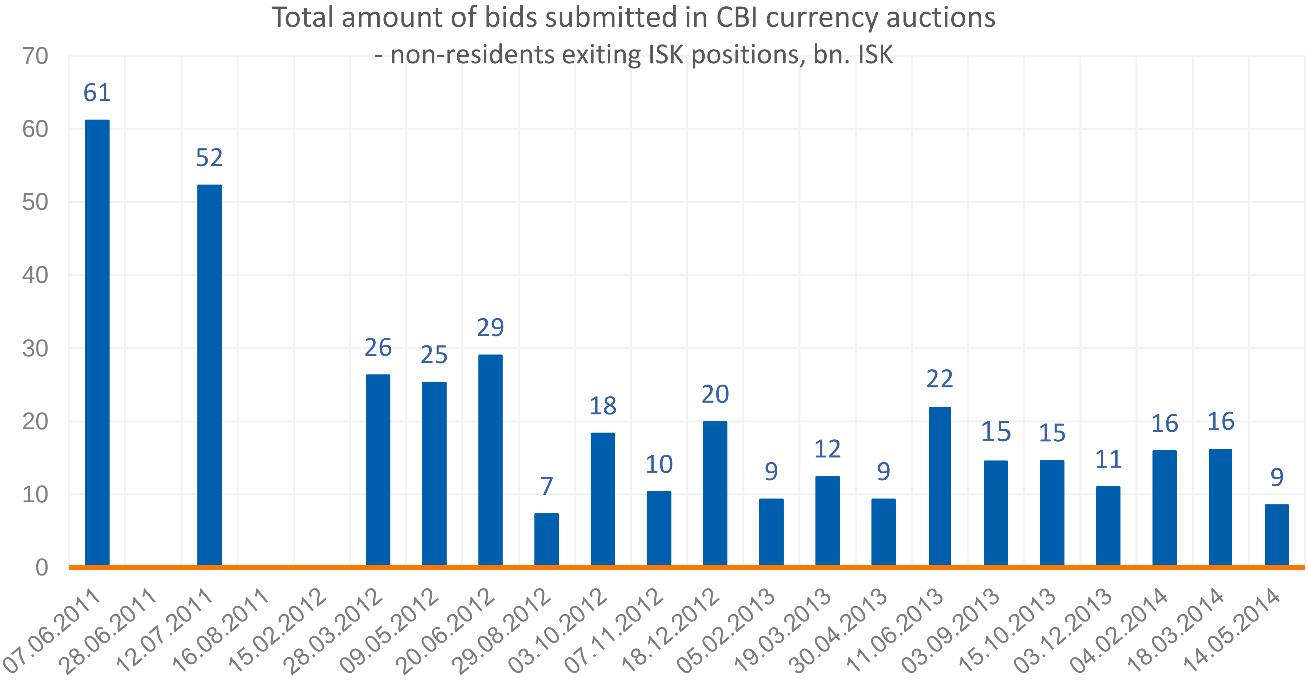
Currency auctions and the ISK

In November 2008, when capital controls were implemented, liquid offshore ISK holdings amounted to approximately 657 bn. ISK or 44.3% of that year‘s GDP. When the authorities published a strategy to liberalise capital accounts in 2011, they had no way of knowing how eager these investors were to get out or at what price, but they had to assume that the offshore ISK holdings were still a major risk factor. Since then, liquid ISK holdings of foreign parties have declined considerably, in part due to the CBI‘s auctions (interested readers are directed to our micro primer on the FX auctions administered by the CBI). Investors who are willing to accept a relatively poor exchange rate in order to get out of their positions are matched with those who are willing to invest in Iceland for at least 5 years at a relatively favorable exchange rate. These auctions (and other large one-off deals such as the Avens-agreement) have resulted in a considerable decrease in these liquid offshore ISK holdings, which now stand at 322 bn. ISK or about 17.2% of this year‘s GDP.



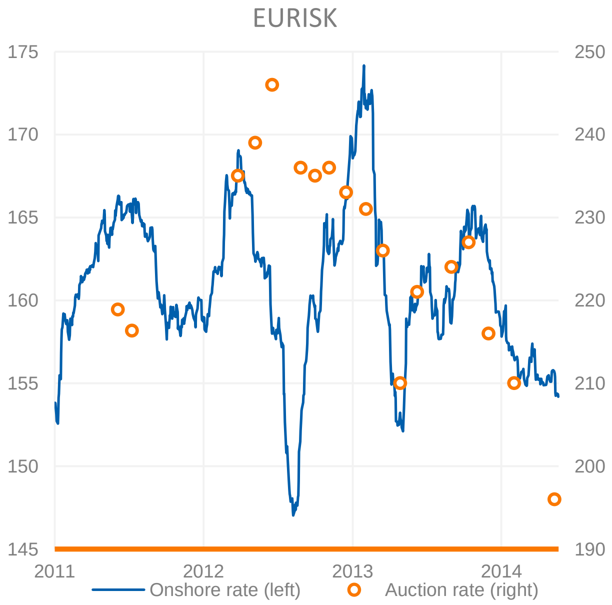
Source: CBI

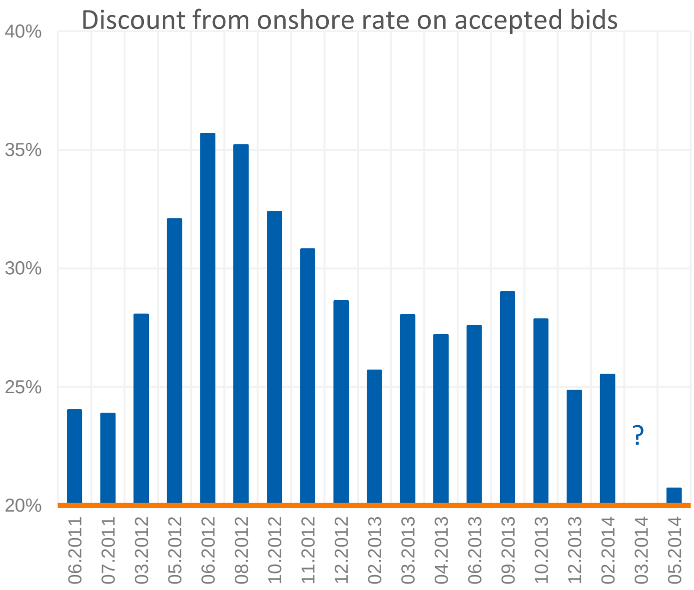
Aside from the obvious benefit of lowering the pressure on the króna the auctions also give us an important indication of how eager these investors are to get out. Participation has been steadily declining since mid-year 2011, when the first auctions were held. The auction results indicate that pressure has subsided and that perhaps the most eager ISK holders are already out of their positions.



Source: CBI

In any case, those investors who have submitted offers to the CBI's auctions have been accepting lower discounts on the onshore rate since 2012, which indicates that those who remain are not willing to get out at just any price.





Source: CBI, Arion research calculations

We have also seen the appreciation of the ISK in offshore trading in the past 24 months as well as the overall increase in the time to maturity of the asset portfolio of foreign parties. This indicates that impatient investors may have been replaced with more patient ones in the marketplace, since non-residents can freely trade the ISK on offshore markets.

So it seems like the pressure on the króna has subsided considerably and that perhaps investors are no longer so eager to get out of Iceland. It is even quite possible that we would not see a major run on the ISK in the event of capital account liberalization. What remains to be seen now is what will be done in the event of the continuing appreciation of the króna and decreasing participation in the CBI auctions. Will the way have been paved for the next steps towards liberalization?

A balanced economy – and then what?

On May 21st the Monetary Policy Committee (MPC) of the Central Bank of Iceland decided to keep interest rates unchanged. The Bank revised its macroeconomic forecast considerably upwards and is now predicting GDP growth to be 3.7% this year, a whole percentage point higher growth than previously projected. The CBI is also predicting that the slack in the economy will disappear earlier than previously thought, resulting in a positive output gap peaking in 2016. However, the CBI is concerned that national saving is estimated to decrease noticeably in the forecast period and that the current account surplus will turn into deficit.

Changes to monetary policy instruments

The Bank has made some changes to its monetary policy instruments. The 28 day CDs will be replaced by two new instruments;

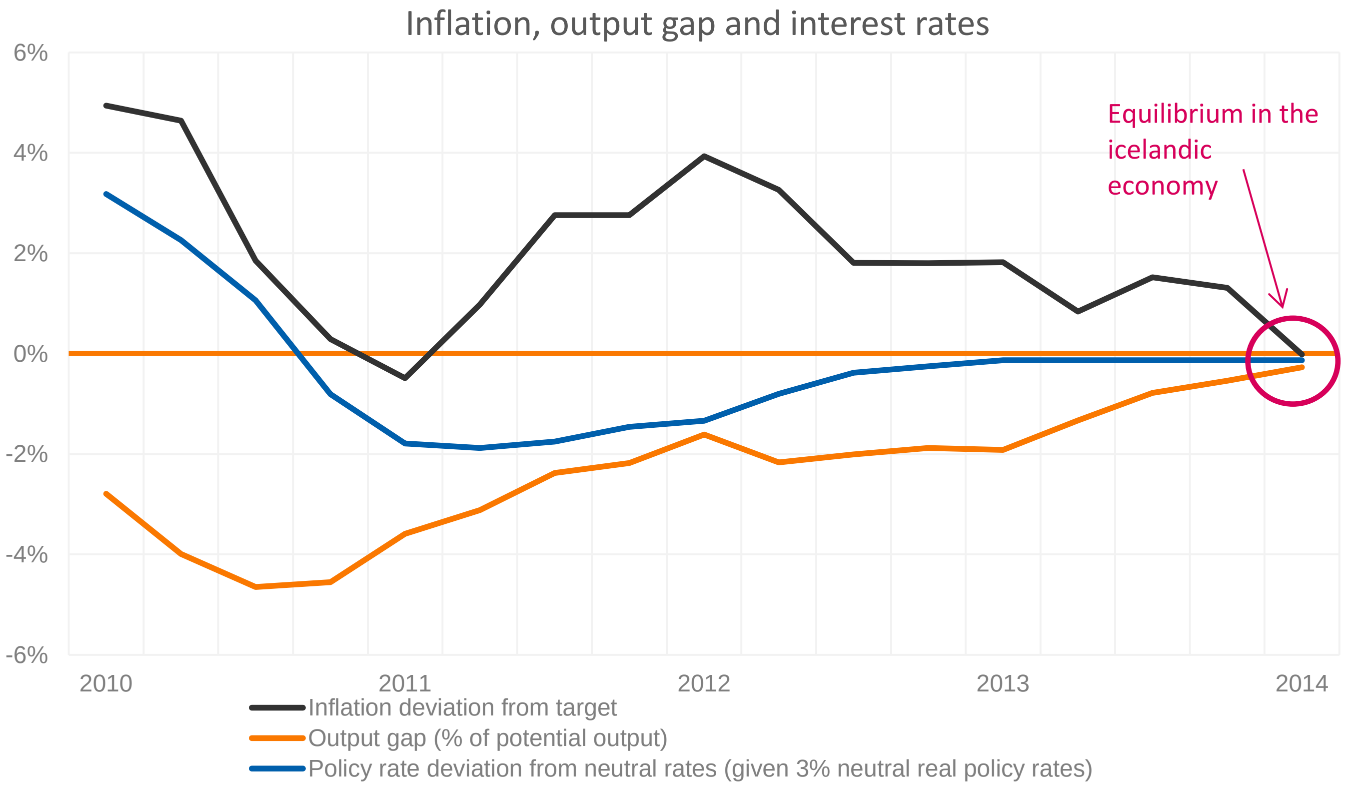
- A week long term deposit at a fixed interest rate of 5.25%.
- A month long term deposit at a rate decided by auction.

The term deposits with the one week maturity will be offered at the fixed rate of 5.25%, so *if* considerable liquidity will be transferred from the month long certificates (which used to be offered at a couple of bps below 5.75) into the shorter term deposits, it could place downward pressure on banks‘ deposit rates, and ultimately market rates. However, the degree to which this will happen depends heavily on the ceiling placed on the amount of the month long deposits offered (the rate of which will be determined by auction). If the ceiling is high enough to accommodate the excess liquidity of all the banks, it should not have a very large impact; the banks will just keep bidding close to 5.75% for the month long lock up and nothing will change materially – just that instead of getting CDs, they‘ll be holding term deposits.

By having the option of placing limits to the amount accepted in term deposits - and also by not offering deposits and loans at the same time - the CBI is hoping to gradually revive the interbank market, which has laid dormant. If the banks are unable to park unlimited cash at the CBI at close to 5.75%, they will be forced to start doing business with each other. However, The Chairman stressed that the changes should be neutral in terms of the monetary stance. We therefore surmise that whatever is going to happen probably will not move the REIBOR around all that much, or at the very least, the CBI will implement offsetting measures to try and keep it in place.

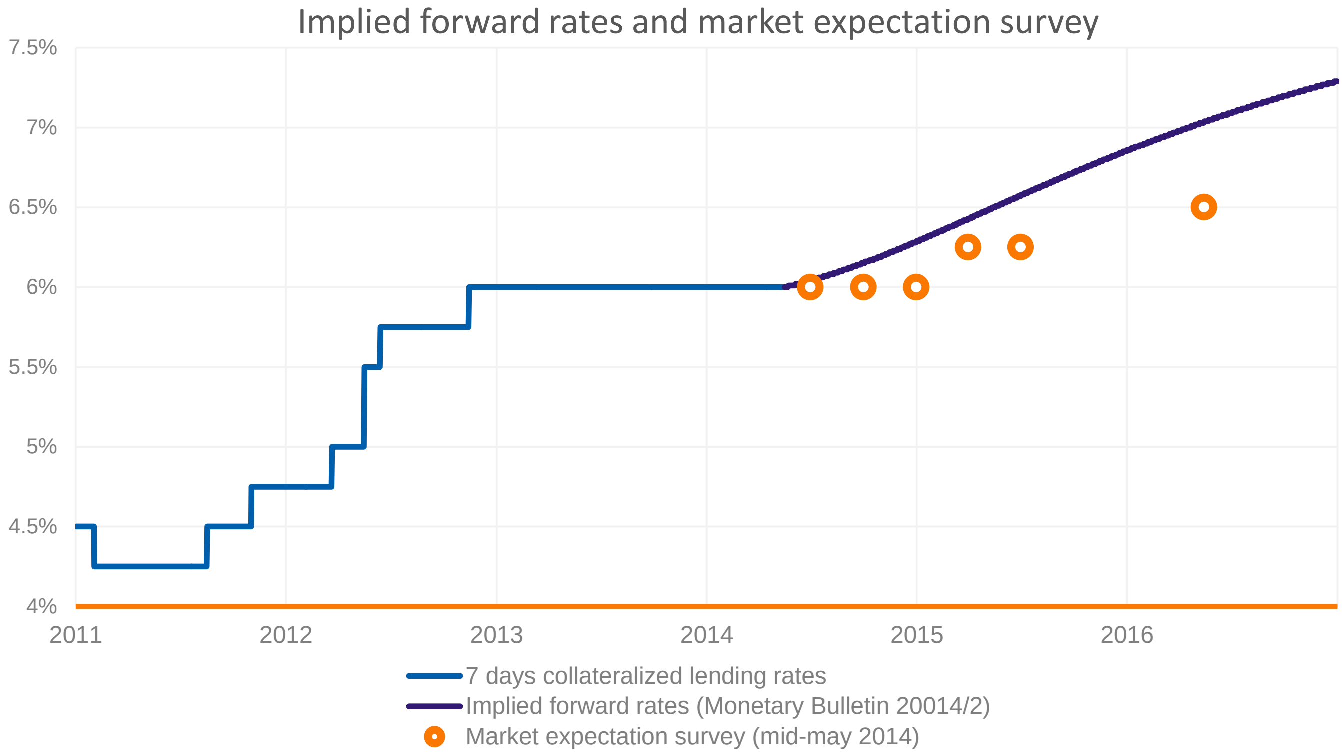
What next?

As previously mentioned, the CBI is estimating that slack in the economy will vanish mid-year, inflation is close to target and the Bank’s real rate is close to its neutral rate so it looks like the economy is quite balanced at this point.



Source: CBI, MB 2014/2

This seems to indicate that rate cuts might be out of the picture for now, and that rate increases are more likely – at least if inflation starts picking up like the bank is projecting to happen towards the end of the year.



Source: CBI, MB 2014/2

As CBI officials have emphasized this will depend on various factors about which there is a great deal of uncertainty. The next steps will be largely determined by the ISK exchange rate, developments in the labour market and how much restraint will be shown in the government's finances.