The CBI has had its fill: MPC keeps policy rate unchanged

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Treasury accounts for 2011: Deficit disappointing, not catastrophic

- A hallmark goal of the long term fiscal plan presented by the Icelandic minister of finance in 2009 was posting a positive primary balance in 2011, i.e. a positive balance net of capital charges and income. The bottom line of the recently published 2011 treasury accounts must be considered a disappointment, partly in light of this goal, since the government posted a primary deficit in excess of 43 billion ISK (-2.7% of GDP), and a net deficit of more than 89 billion ISK (-5.5% of GDP); a negative deviation of more than 43 billion from the year's total budget. It is, however, an improvement on 2010 when the deficit amounted to 123 billion ISK.

Treasury finances in 2012: A mixed outlook

- The current balance in the first sixth months of 2012 indicates that even though revenue is still grossly below its maximum, the treasury cash flow is improving slowly but surely. Even though the shrinking deficit gives rise to cautious optimism, the expenditure remains at pre-crisis levels due to high costs from unemployment etc., while interest payments have soared, which emphasizes the importance of starting net debt redemption.

ISK overvalued according to Big Mac Index

- Since the ISK has been excluded from The Economist's Big Mac Index since McDonald's left Iceland in 2008, Arion Research took the liberty of calculating an adjusted index by using the price of a *Heimsborgari* as an input (*Heimsborgari* is a hamburger roughly identical to the Big Mac sold by the former McDonalds franchisee in Iceland, now rebranded as Metro). The ISK would have to depreciate substantially relative to most other currencies to equate the price of hamburgers across countries.

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- Arion Research has repeatedly criticized the Quarterly Macroeconomic Model (QMM) forecasting model of the Central Bank of Iceland (CBI) for flaws that lead its inflation scenarios to continually converge to the bank's inflation target in 8-9 quarters, making it unrealistic. The model's *growth* forecast, which is based on the model's estimated parameters and raw data, as well as the judgment of Central Bank analysts, appears to be more on the money.

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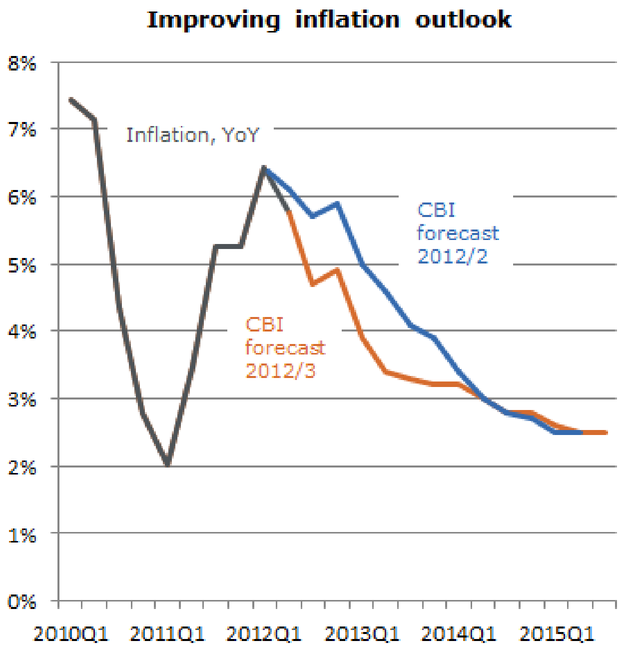
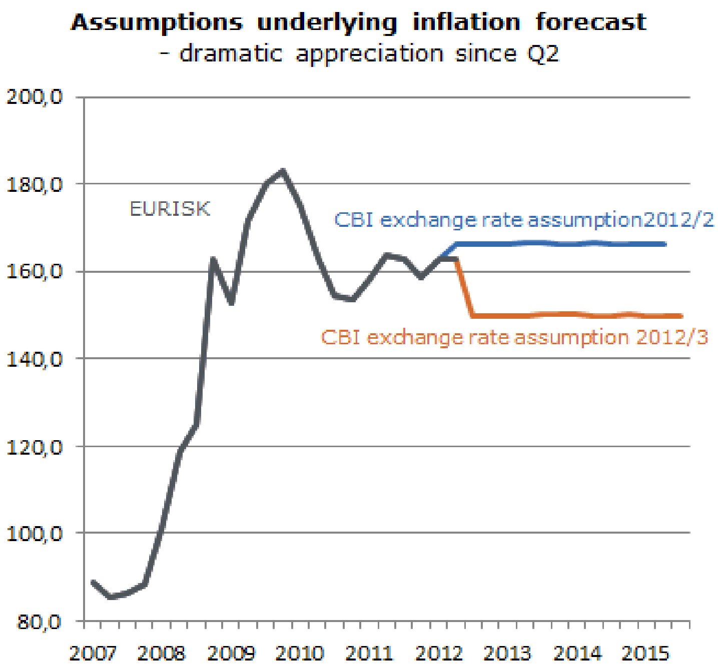
The inflation forecast published by the bank alongside the policy rate setting on August 22 is based on the assumption that the ISK will stand its ground at the current level. In our view, that assumption is unrealistic absent some intervention in the forex market. On the contrary, we believe that the ISK will slip come winter, once the inflow of foreign currency via tourism subsides. Based on that, we consider it likely that the Bank will raise its policy rate again before the year ends.

The statement of the MPC declares that the outlook is for somewhat stronger output growth in 2012 than forecasted in May. Furthermore, the MPC tones down the language regarding the crisis in Euroland from its last meeting, when they raised concerns that the "[…]developments could significantly affect output growth and inflation in Iceland." Thus, the sovereign debt crisis within the EU doesn't seem to have become the catalyst the MPC feared it might.

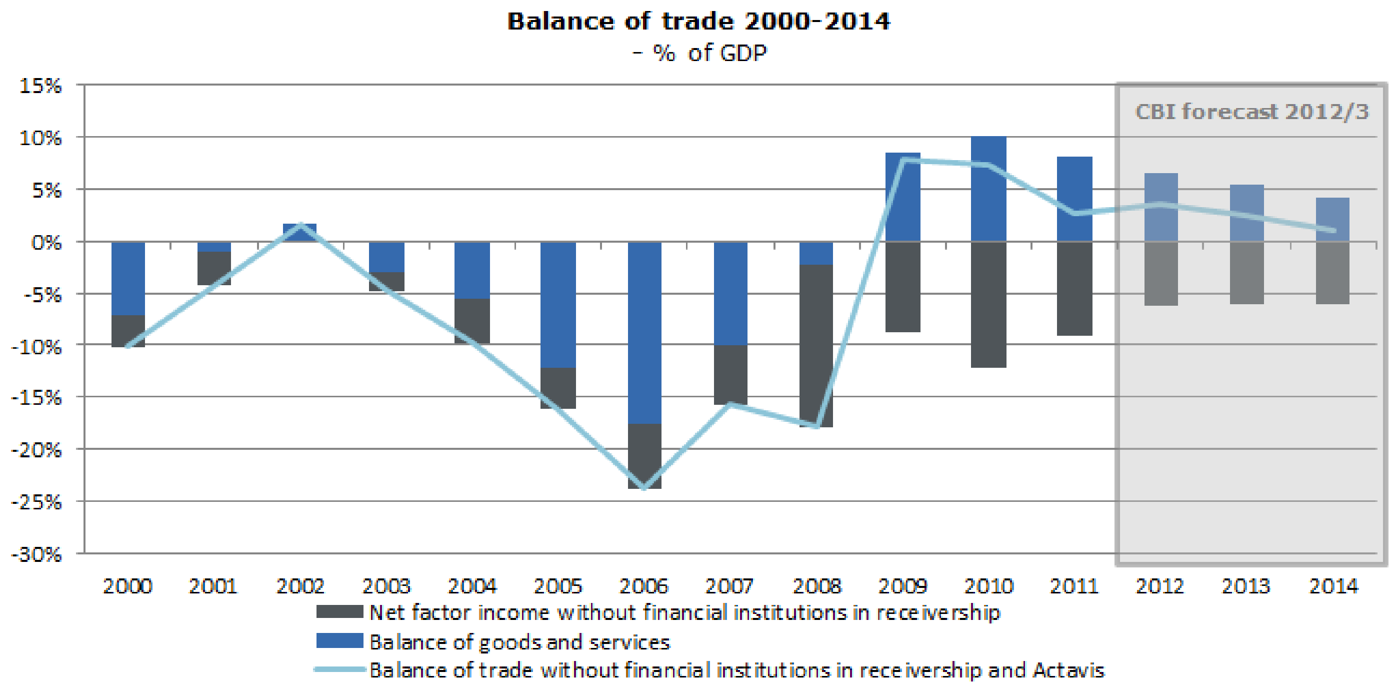
Quite on the contrary; the main catalyst in the latest forecast of the CBI seems to be the ISK. The substantial appreciation of the domestic currency in recent months is named as the main reason for the significant improvement in the inflation outlook.





Source: Central Bank of Iceland

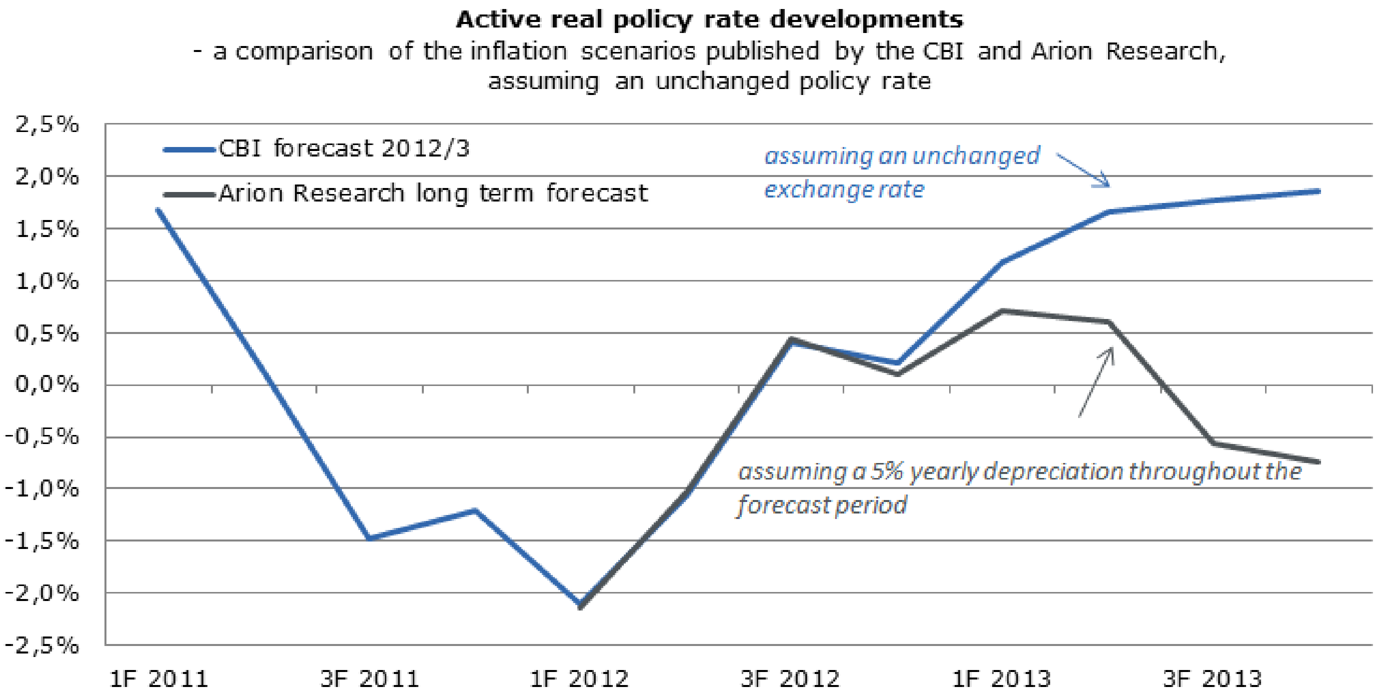
We are concerned, however, that the appreciation is unsustainable. The CBI's forecast expects the trade surplus to be around 2% of GDP *less* in the next two years, than it did in May, due to the stronger ISK. We believe the twin hypothesis of a strong ISK and a shrinking surplus to be internally inconsistent. Huge outflows are to be expected due to debt redemption and interest payments in the coming months which, when coupled with the shrinking trade surplus, spell out certain depreciation. The inflows simply won't be able to cover the outflows, forcing a fall in the exchange rate.



Source: Central Bank of Iceland

The MPC's statement affirms that as soon as the economy starts operating on full capacity, it will be necessary to tighten the policy stance. The degree to which such normalization takes place through higher nominal rates will depend on future inflation developments.

According to the Bank's latest inflation forecast, the real policy rate will become around 1.5% in H1 next year, which is closer to the CBI's appropriate long term stance of 2-2.5% than it has been for a while. A realization of the Bank's forecast (however unlikely) would mean that the real policy stance will tighten via subsiding inflation to a greater degree than we previously assumed. Developments in the coming quarters will be largely contingent on exchange rate movements, and that's where we suspect the CBI to be too optimistic in its assumptions.



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Treasury accounts for 2011: Deficit disappointing, not catastrophic

A hallmark goal of the long term fiscal plan presented by the Icelandic minister of finance in 2009 was posting a positive primary balance in 2011, i.e. a positive balance net of capital charges and income. The bottom line of the recently published 2011 treasury accounts must be considered a disappointment, partly in light of this goal, since the government posted a primary deficit in excess of 43 billion ISK (-2.7% of GDP), and a total deficit of more than 89 billion ISK (-5.5% of GDP); a negative deviation of more than 43 billion from the year's total budget. It is, however, an improvement on 2010 when the deficit amounted to 123 billion ISK.

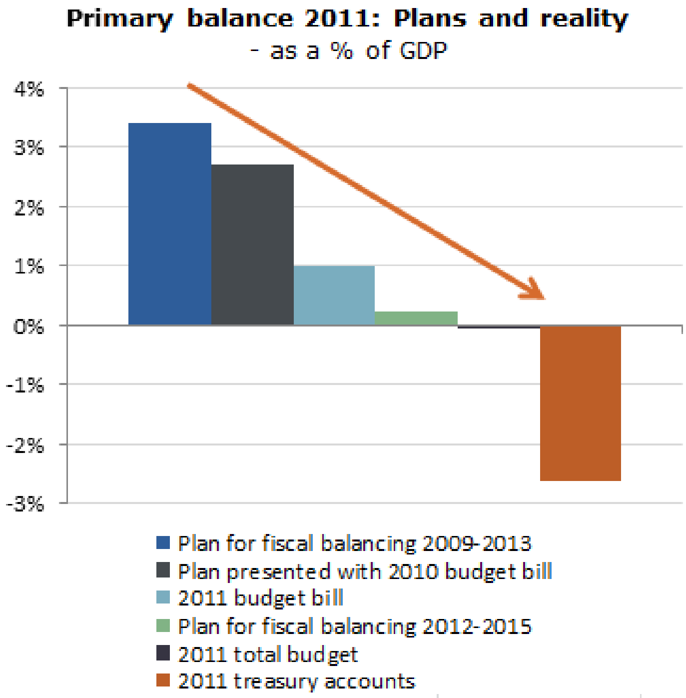
Treasury accounts 2011 at a glance
- million ISK

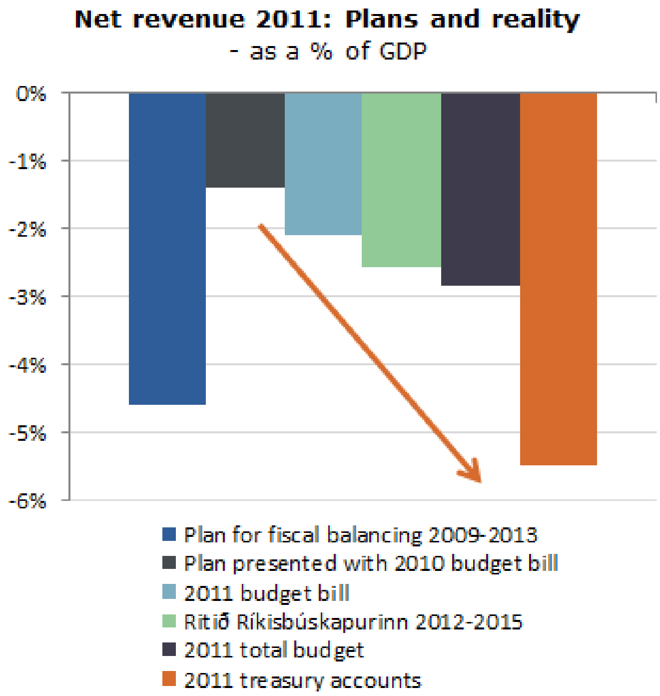
	Accounts 2011	Total budget 2011	Deviation	Accounts 2010
Revenue	486,526	480,856	5,670	478,697
Expenditure	575,950	527,248	48,702	601,982
Net revenue	*-89,424*	*-46,392*	*-43,032*	*-123,285*
Primary balance	*-43,204*	*-1,066*	*-42,138*	*-84,437*

Source: Treasury accounts 2011

A rocky path from plan to reality

When compared with the initial long term fiscal plan presented in 2009 (and subsequent revisions), the deficit might appear catastrophic since it exceeds even the most pessimistic of projections. There might however be less cause for concern as the deviation can mostly be attributed to irregular and non-recurrent items, partly due to settlements following the financial collapse in 2008.





Source: Various official documents named in figures

The most relevant explanations for the size of the deficit offered by the Ministry of Finance include a 20 billion expensing due to a takeover of SpKef savings bank, and write-downs of shares in both the Regional Development Institute (Byggðastofnun) and government run venture fund NSA to the tune of 13 billion ISK. The expensing was financed by the issuance of new debt to Landsbankinn bank, which took over SpKef, while the write-downs impact neither the debt nor the cash flow of the central government (the write-offs were spurred by an anomaly in the government accounting method that needed correction, although the Regional Development Institute might nevertheless need a cash injection due to operating losses). Furthermore, the expense of pension commitments exceeded budget estimates by 5 billion, and tax claims written off by 5 billion.

Fiscal consolidation has not failed, but IMF still concerned

Since a significant part of the deficit is not due to regular items, and some of it does not even affect the cash flow, we think its size is not necessarily a sign of fundamental failure of fiscal consolidation, although it certainly underscores the importance of staying the course over the next few years to attain a positive balance.

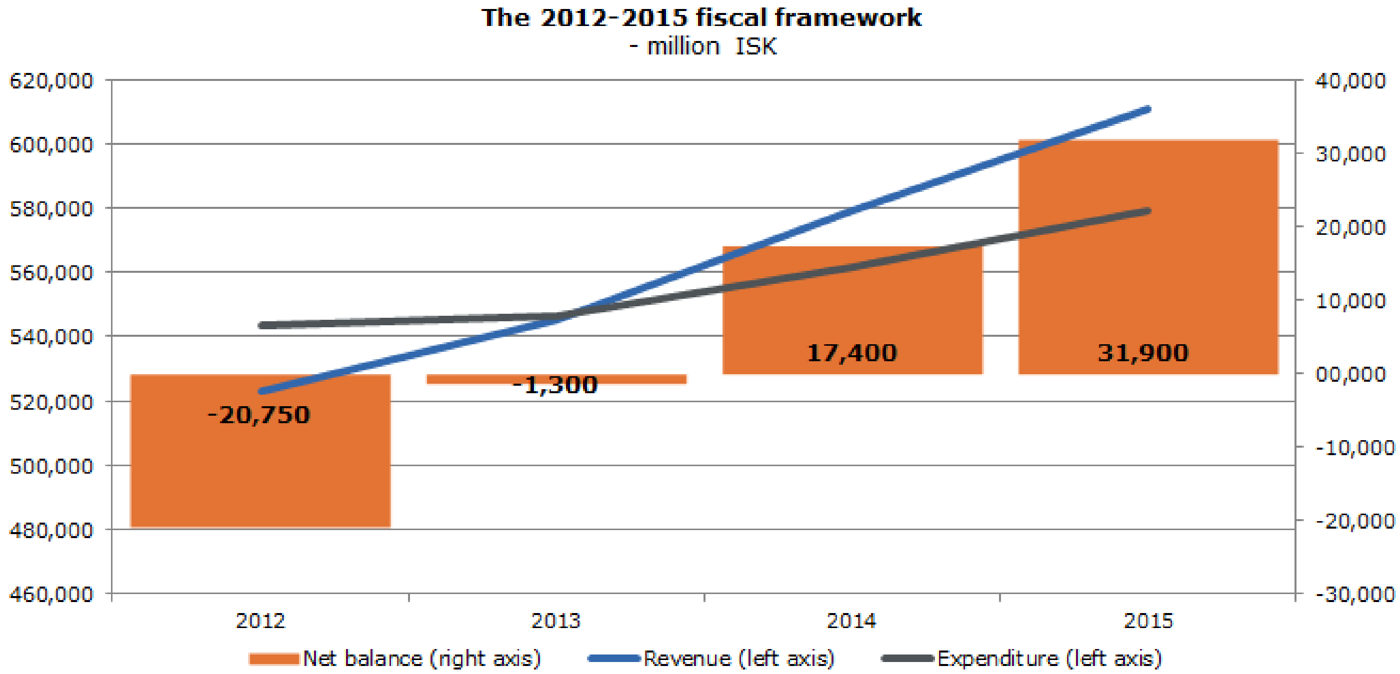
The IMF has stressed this point and expressed concern about deviations from the original long term fiscal framework, even before the deficit of 2011 was announced:

> The mission is concerned about these deviations, especially in light of the considerable risks to the revenue projections in 2012 and the medium term. Moreover, there is a risk that expenditure overruns may appear again, which would also affect the medium-term fiscal path.
>
> **It is essential that fiscal adjustment be completed.** After the slowing of consolidation in the authorities' 2012 budget and medium-term framework (as agreed at the time of the last IMF mission), the scope for deviations from that framework is limited.
>
> - *2012 Article IV Consultation Concluding Statement of the IMF Mission*

The road ahead

According to this year's budget, the primary deficit is expected to transform into a surplus of 36 billion, while the net deficit is expected to shrink to 21 billion. The first long term fiscal plan, published in 2009, targeted a net surplus as soon as 2013, while that goal has been delayed until 2014 according to the most recent long term framework. The reasons for the delay given by officials in October last year are that the restructuring of the banking system cost less and the deficit was less severe in the first years of the cooperation with IMF than initially assumed, giving increased headroom later in the program to foster the recovering economy.

It is worth wondering whether the government is better situated to tackle the deficit than it was in October last due to a stronger recovery than was expected by this time, or worse due to the large deficit posted in 2011.



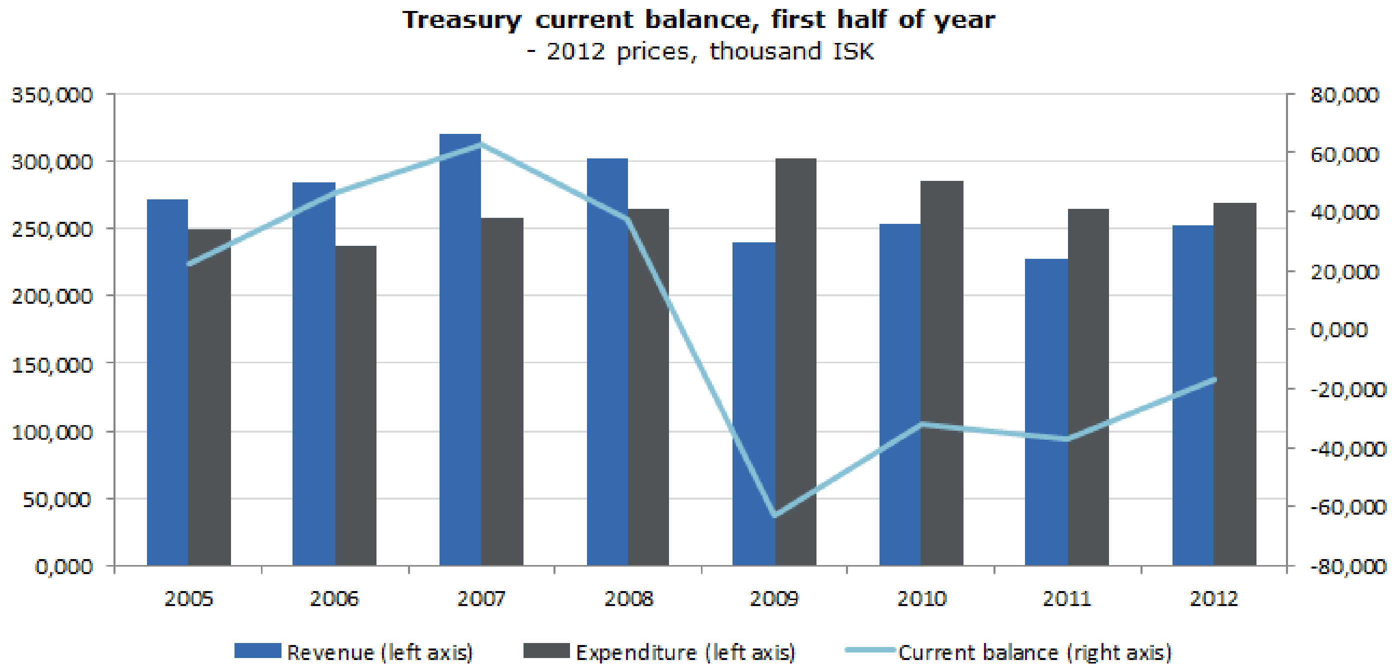
Source: The 2012-2015 fiscal framework

Treasury finances in 2012: A mixed outlook

Shortly following the 2011 Treasury accounts, the Ministry of Finance released the statistics for Treasury finances for the first six months of 2012. Treasury finances are reported on a cash basis, not an accrual basis like the treasury accounts.

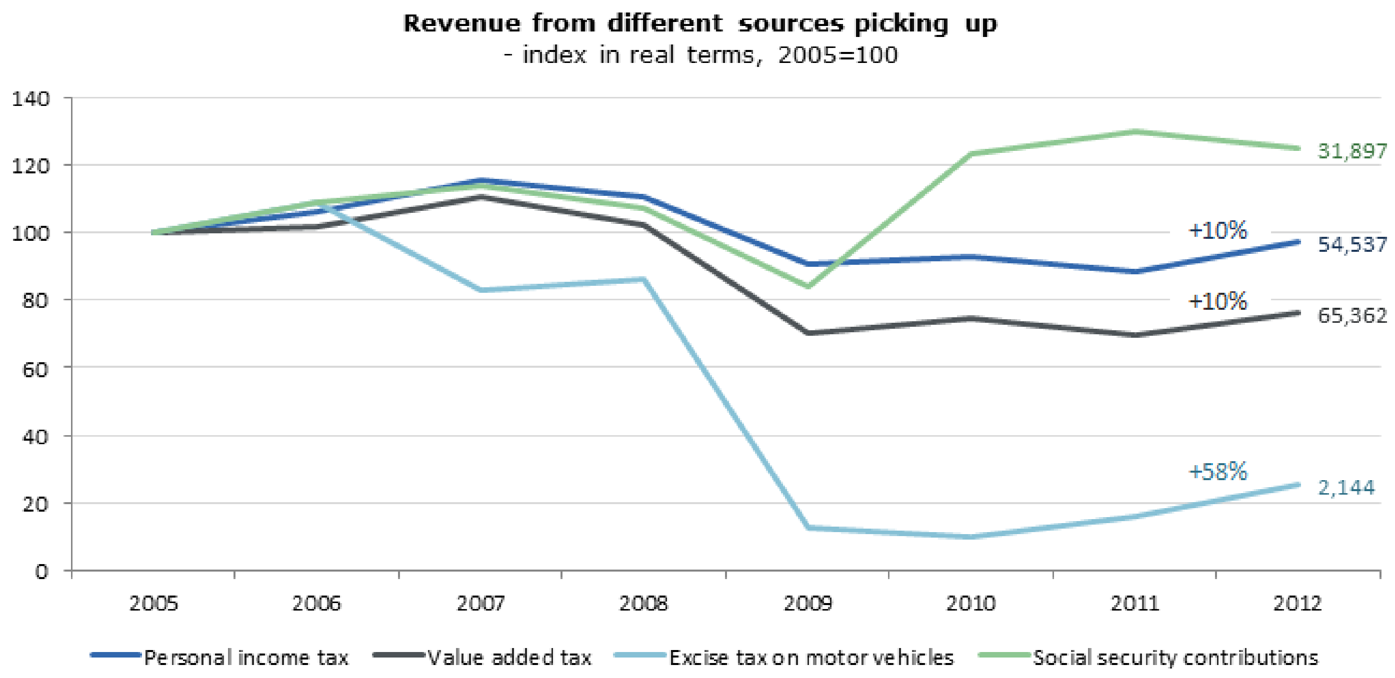
The current balance in the first sixth months indicates that even though revenue is still grossly below its maximum, the treasury cash flow is improving slowly but surely. Even though the shrinking deficit gives rise to cautious optimism, the expenditure remains at pre-crisis levels due to high costs from unemployment etc., while interest payments have soared, which emphasizes the importance of starting net debt redemption. When examined closely, however, the government debt redemption plan does not assume substantial nominal net reduction in debt until 2015. It is clear that the interest rate on Icelandic debt is de facto subsidized by the implementation of capital controls, but in light of how heavily the interest payments weigh on government finances regardless, it is doubtful that the controls can be abolished by year end 2013 as planned.

The treasury posted a current deficit of 16.6 billion ISK in the first half of 2012, while cash flows from operations were negative by 19.2 billion; the best result since the collapse of the Icelandic Banks in 2008. It was also better than anticipated, since the budget allowed for a negative cash flow from operations of 46.1 billion. Although the positive deviation can mostly be explained with irregular income (such as dividends) and one-offs, the development of the largest revenue posts gives cause for optimism going forward.



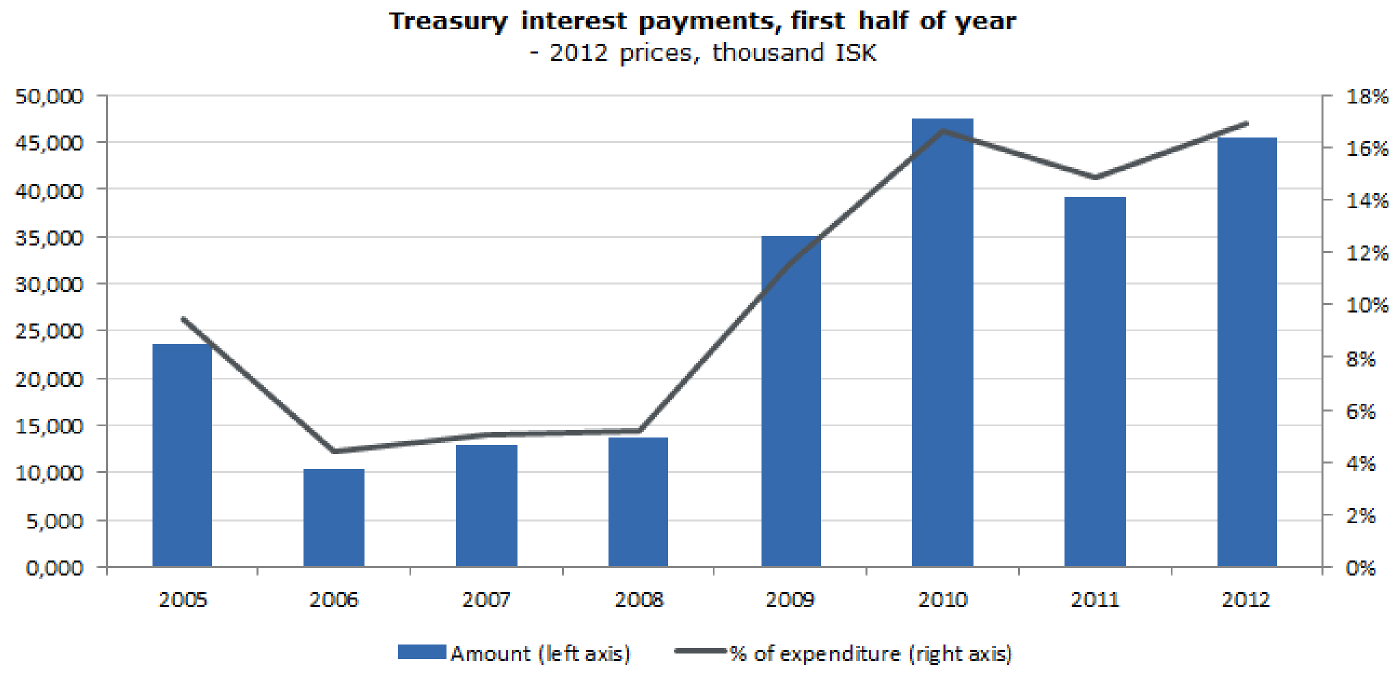
Source: Treasury finance statistics

Increasing economic activity is spurring more revenue from taxes, and even social security contributions almost remain stable in real terms between years, despite having been lowered, due to growth in the tax base.



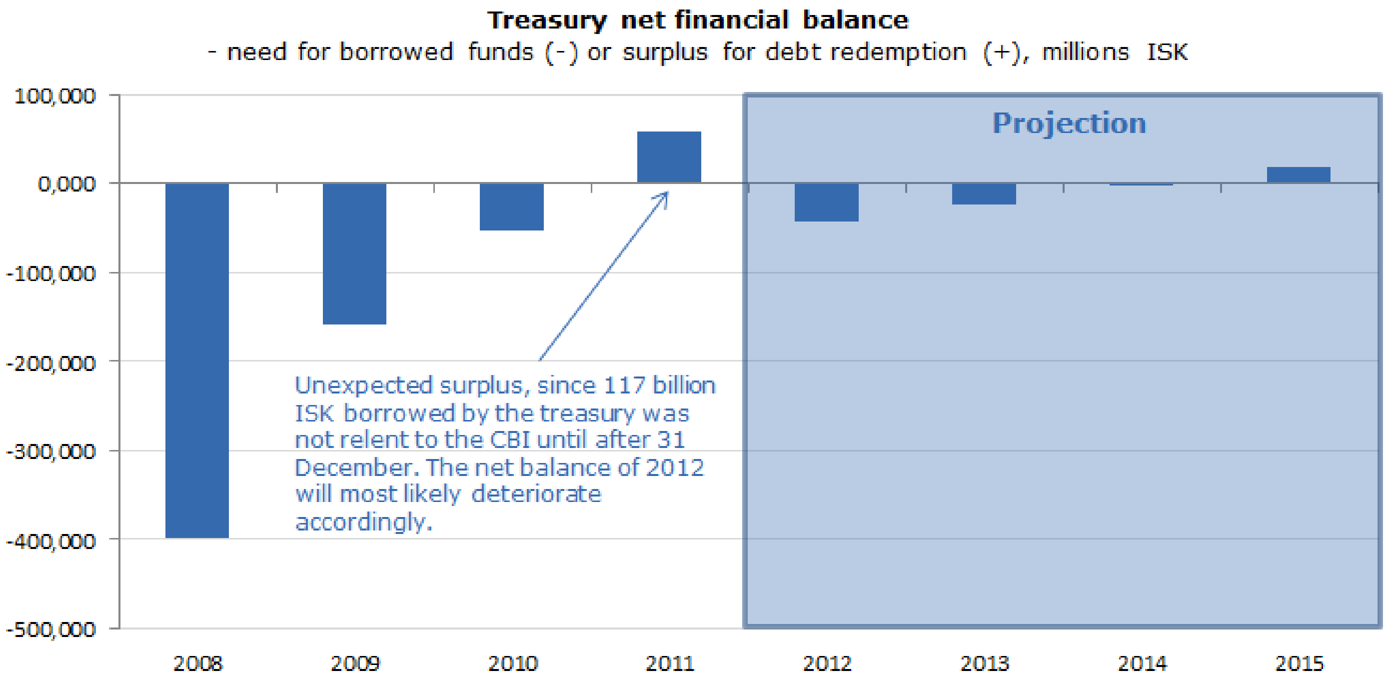
Source: Treasury finance statistics and Arion Research

The most worrying trend revealed in the treasury finance statistics is the heavy load of interest payments. One in six ISK leaving the Treasury's coffers is used for debt servicing, which is why steps must be taken to generate a surplus of revenue to pay down debt as soon as possible. Otherwise, there's a growing risk of interest payments eating up more and more of the government revenue, making it harder to keep up with expenditure, ultimately becoming unsustainable. In addition, debt redemption is imperative to the abolition of the capital controls, which makes it all the more important to stay the course and attain a positive fiscal balance



Source: Treasury finance statistics

Unfortunately, official projections are ambiguous regarding debt repayment, with the government seemingly aiming at lowering the debt-to-GDP ratio through growth and inflation, and not nominal redemption.



Source: Official debt management strategy, 2012-2015

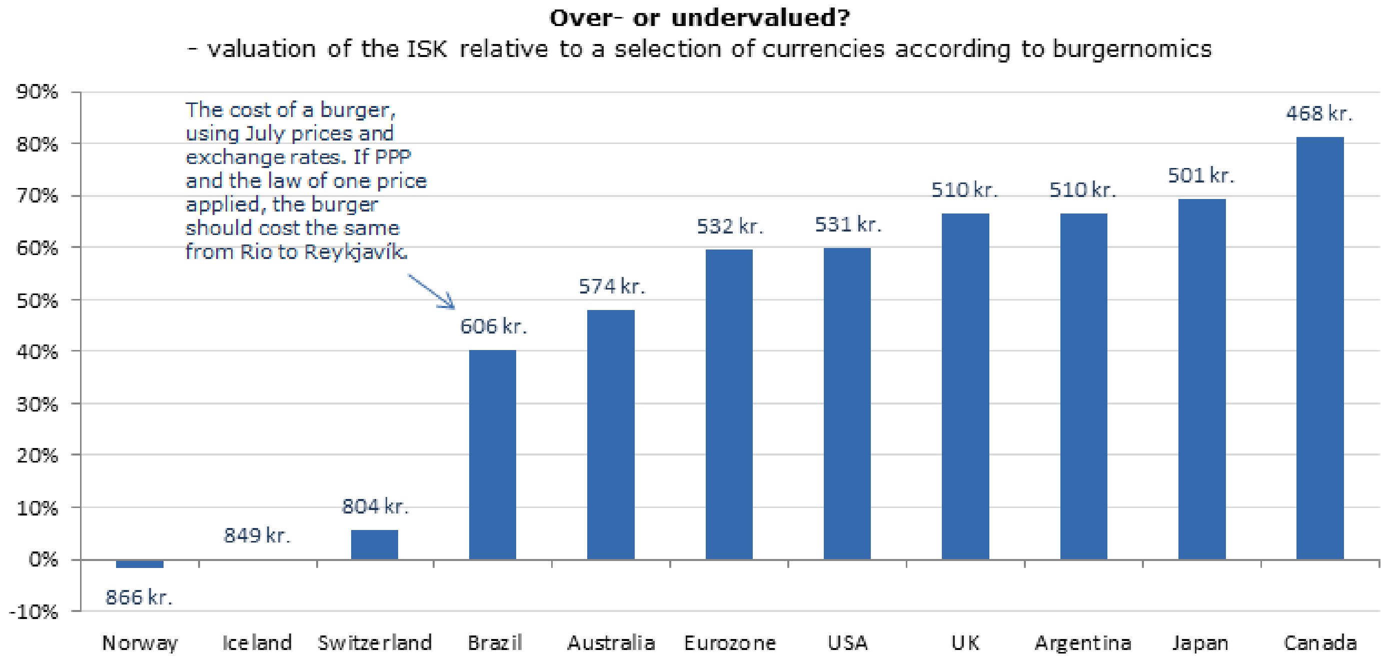
ISK overvalued according to Big Mac Index

Every reader of *The Economist* knows the Big Mac Index, a brilliantly simple tool to see if currencies are over- or undervalued relative to one another based solely on the price of a hamburger.

The index is based on the law of one price, coupled with purchasing power parity, which together state that once the exchange rate of two currencies has been accounted for, the price of a uniform good such as a hamburger should be the same everywhere in the world. Any deviation from that principle must be due to an error in the relative valuation of the two currencies – or so the story goes.

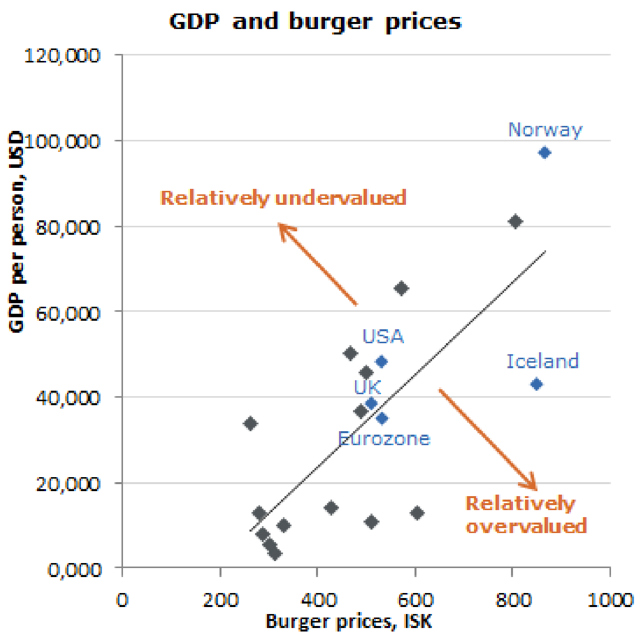
In spite of the method appearing a bit unscientific (or maybe being too literal in its take on economic principle) it has nevertheless shone a light on misalignment in currency valuation in the past that has eventually corrected itself.

Since the ISK has been excluded from the index since McDonald's left Iceland in 2008, Arion Research took the liberty of calculating an adjusted index by using the price of a *Heimsborgari* as an input (*Heimsborgari* is a hamburger roughly identical to the Big Mac sold by the former McDonalds franchisee in Iceland, now rebranded as Metro). As the figure below illustrates, the ISK would have to depreciate substantially relative to most other currencies to equate the price of hamburgers across countries.



Source: The Economist, Arion Research

What might distort the picture painted above is the fact that rich countries tend to have higher relative price levels due to a theoretical construct known as the Balassa-Samuelson effect. The price differences in the burgers might therefore stem from a difference in GDP, rather than misalignment in exchange rates. To correct for the Balassa-Samuelson effect to some degree, a figure like the one shown to the side can be useful. Each data point represents a country in The Economist sample; the ones to the left of the best-fit line are more likely to be undervalued, while the ones to the right are more likely to be overvalued. Even after correcting for differences in GDP, burgernomics indicate an overvaluation of the ISK.



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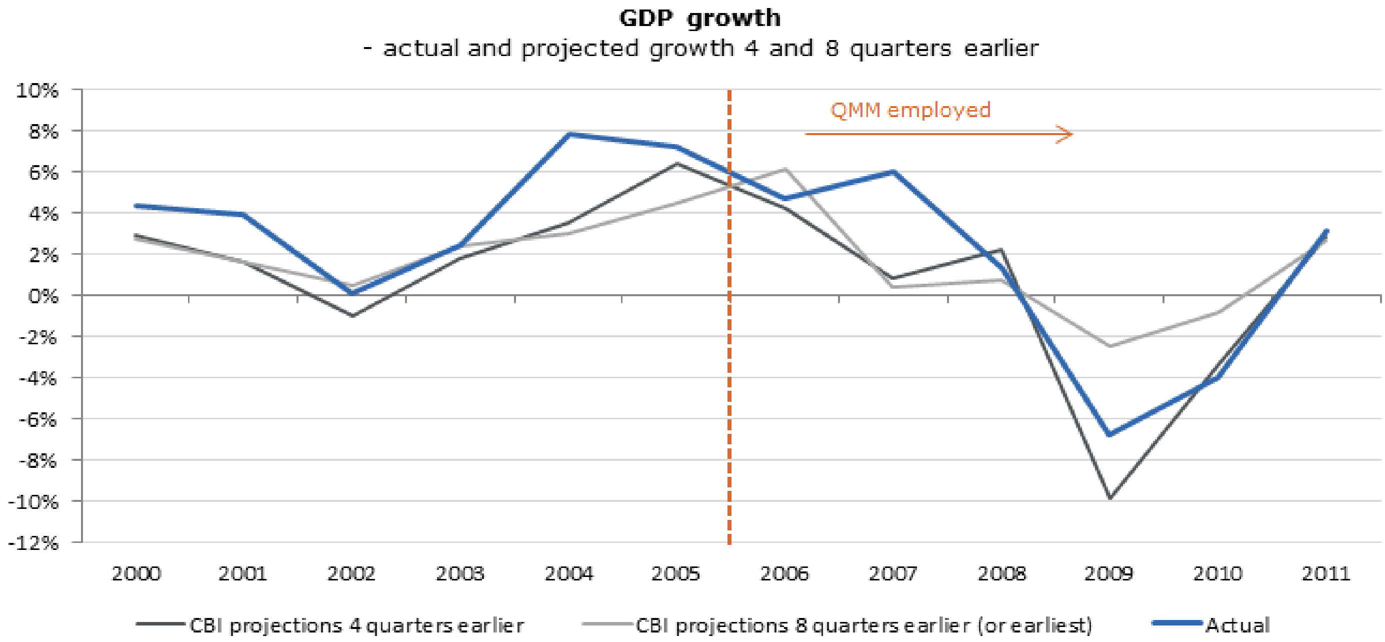
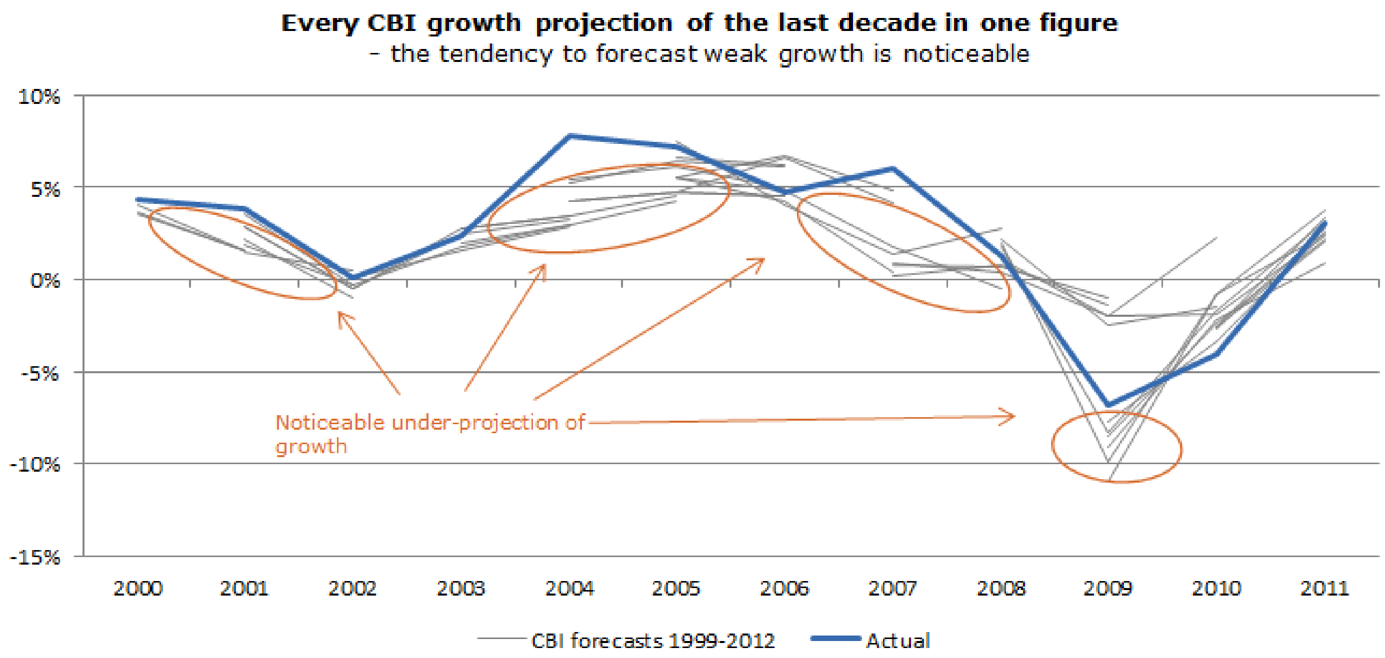
Arion Research has repeatedly criticized the Quarterly Macroeconomic Model (QMM) forecasting model of the Central Bank of Iceland (CBI) for flaws that lead its inflation scenarios to continually converge to the bank's inflation target in 8-9 quarters, making it unrealistic. The model's *growth* forecast, which is based on the model's estimated parameters and raw data, as well as the judgment of Central Bank analysts, appears to be more on the money.

As the figure below shows, the growth projections of both the old forecasting model of the CBI, and the more recently employed QMM, have been largely consistent with the general trends of the economy with the exception of rather large deviations in 2007 and 2009.



Source: Central Bank of Iceland, Statistics Iceland, Arion Research

It should be noted, however, that the figure above only illustrates a sort of general level of performance, since deviations of GDP components (i.e. consumption, investment, foreign trade, etc.) from their forecasted values can be, and often are, larger than the figure indicates. It should also be noted that deviation can be the result of external factors, such as revisions of national accounts that distort the parameters of the model, so deviation is not necessarily always to the model's fault.



Source: Central Bank of Iceland, Statistics Iceland, Arion Research

An interesting tendency of the CBI growth forecast is the same one noted earlier for the inflation forecast, i.e. to project a lower rate than eventually prevails. The difference is that growth is preferable, while inflation is not, which is why we've termed the tendency to under-project *growth* the "Grinch-effect" and *inflation* the "Pollyanna-effect".

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