

### **Economic growth in Q1 takes Icelandic economy in the right direction**

- Statistics Iceland published national accounts for the first quarter of 2011 in June. The Icelandic economy grew 2.4% from the preceding quarter according to official seasonally adjusted estimates. The growth amounts to 4.5% year-on-year (i.e. compared with Q1 2010), driven by a 4% increase in consumption, a 9% increase in investment and an overall growth in domestic demand of 3.9%. In addition, exports grew 4% year-on-year, although import growth of 3% weighed down its contribution to overall GDP.

### **Enough for now – the CBI raises policy rate 25 bps**

- The Monetary Policy Committee (MPC) of the Central Bank of Iceland raised its policy rate by 25 basis points earlier this month, leaving the active interest rate at 5.125%. While the decision was consistent with market expectations, we consider the wording of the MPC's statement a bit curious.

### **The treasury saves billions in debt servicing costs**

- It was revealed last week that the Treasury of Iceland and the CBI will make repayments in the amount of ISK 171 billion on loans from the IMF and the Nordic countries in connection with the IMF-led Stand-By Arrangement. According to the CBI, these transactions will bring the total repayments to 53% and 59%, respectively, of the loans originally extended to Iceland by the IMF and the Nordic countries under the Arrangement. In our view, this sends a powerful signal to the markets regarding the quality of sovereign debt issued by the Icelandic government, and stands to improve the current account balance.

### **Summary of forecasts published in Q2 2012**

- Analysts from various research departments, international organizations, unions etc. have published their economic projections for Iceland during the period 2012-2014 in Q2. These include Arion Research, the International Monetary Fund, the Icelandic Confederation of Labour, the Central Bank of Iceland and Landsbankinn Bank. Arion Research has compiled and compared the highlights of the forecasts.

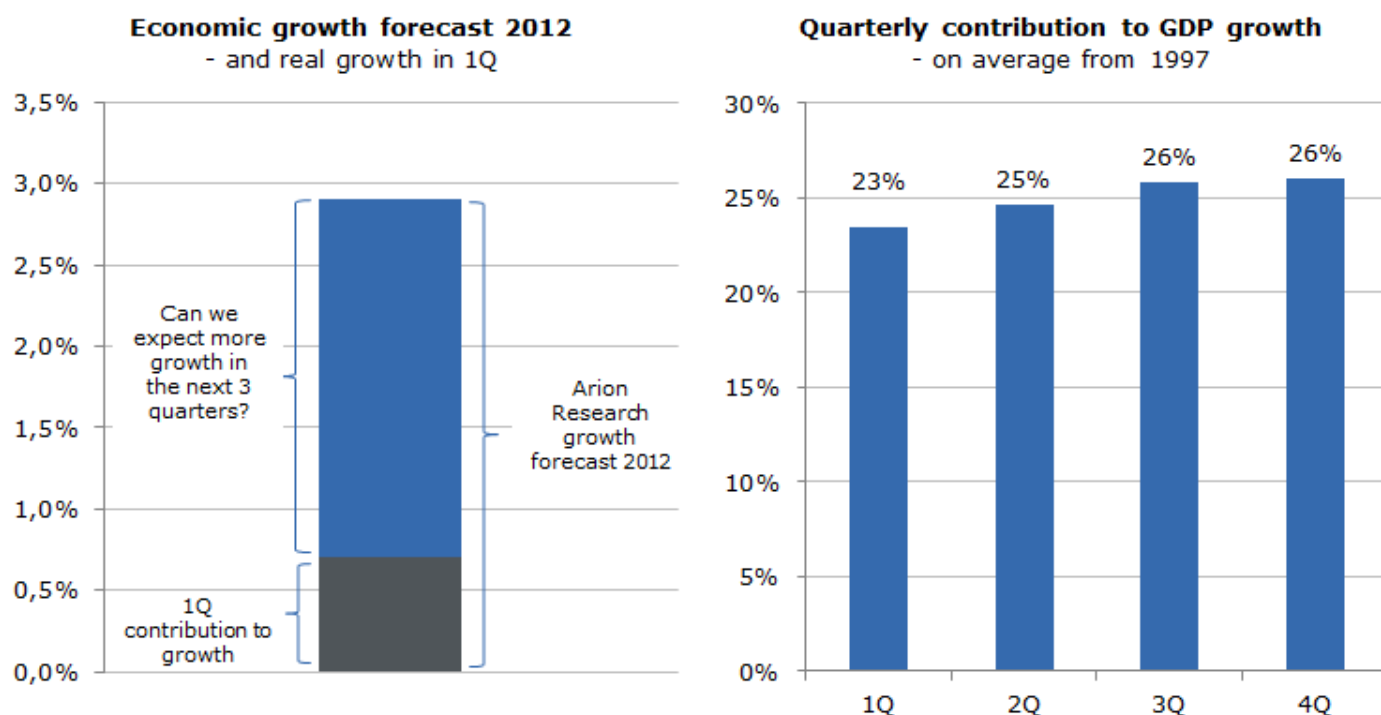
## Economic growth in Q1 takes the Icelandic economy in the right direction

Statistics Iceland published national accounts for the first quarter of 2011 in June. The Icelandic economy grew 2.4% from the preceding quarter according to official seasonally adjusted estimates. The growth amounts to 4.5% year-on-year (i.e. compared with Q1 2010), driven by a 4% increase in consumption, a 9% increase in investment and an overall growth in domestic demand of 3.9%. In addition, exports grew 4% year-on-year, although import growth of 3% weighed down its contribution to overall GDP.

The year-on-year growth in both consumption and imports over the last two quarters is especially noteworthy in light of the substantial depreciation of the ISK during the period. The Economic Outlook published by Arion Research in May forecasted annual GDP growth of around 3% in 2012. The first estimate of Q1 production published by Statistics Iceland is consistent with our projections, with the first quarter contributing a little under a quarter of our forecasted GDP for the year.

### In midnights, in cups of coffee – how do you measure growth?

Accordingly, the first quarter's contribution to growth amounts to around 0.7% for the whole of 2012, which is around a quarter of the growth projected by Arion Research in May. As shown in the figure below, the GDP contribution of each quarter has been relatively even, with marginally more robust growth kicking in during the latter half of the year. Economic performance during the first quarter should therefore on average provide a pretty sound indicator of the quarters to come. Real annual growth (inflation adjusted) net of changes in inventories<sup>1</sup> amounts to 3% year-on-year, so if similar quarters are to follow, the 2012 GDP growth will be roughly the same.



Source: Statistics Iceland and Arion Research

### Weak ISK not weighing on consumption and imports

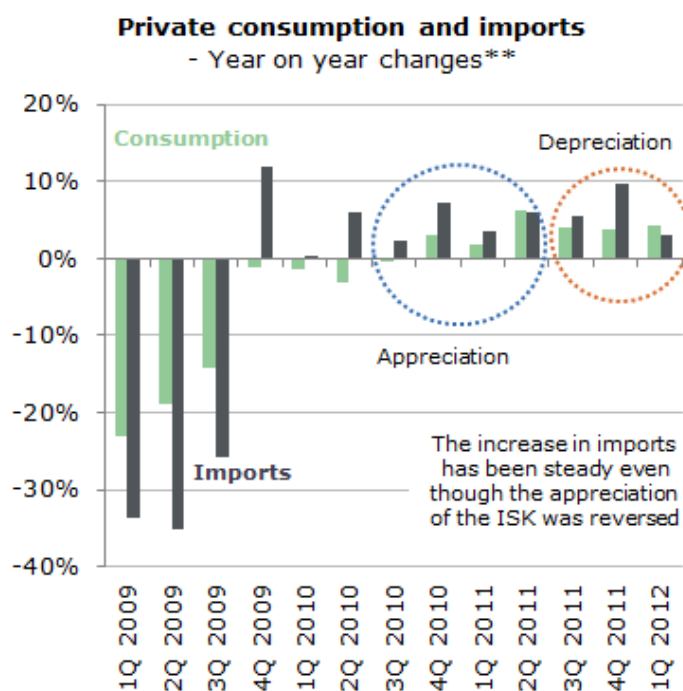
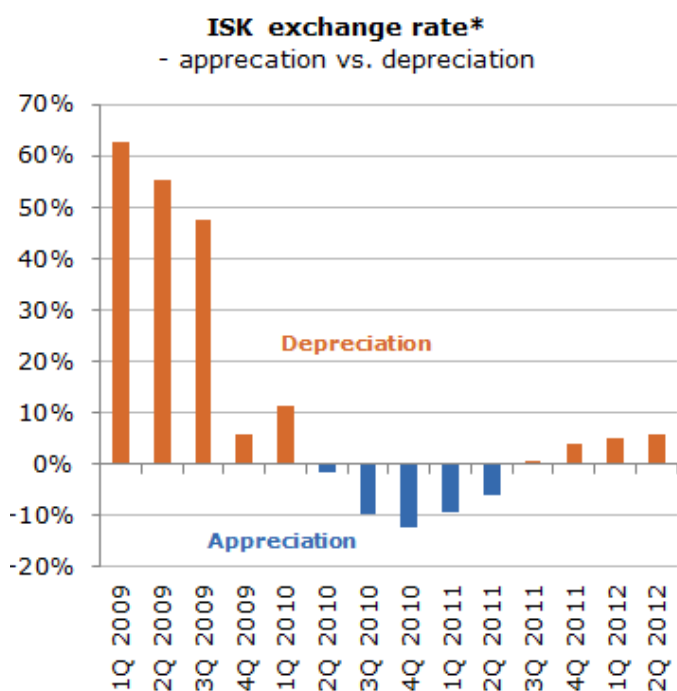
The magnitude of the increase in consumption and imports varies with the estimation method being used. According to the chain linked method of Statistics Iceland (one available estimate of real changes), consumption grew 4% from Q1 in 2010, while a more modest increase of 3% was estimated for imports. The increase is even more robust when measured using constant prices instead, with consumption racking up a 4.7% increase and imports a 5.4% jump from Q1 in 2010.

As shown in the graph below, consumption and imports have been continuously increasing since year-end 2010 – around the same time as the ISK began rebounding from the preceding depreciation. The

<sup>1</sup> Changes in inventories are netted out throughout the year, since they will be recorded as exports later on.

ISK has, however, been depreciating slowly but surely for each of the quarters following Q2 2011 up until now, without any decrease in the upward trend of consumption and imports.

The depreciation therefore does not seem to weigh on imports this time, as opposed to the great decline in imports which followed the depreciation of the ISK in the wake of the banking collapse in late 2008.



\*12 month change. \*\*According to StatIce's Chain linked method  
Source: Statistics Iceland and the Central Bank of Iceland

### Private consumption boosts growth, imports consume foreign currency

It should be noted, however, that the contraction in private consumption during the first quarters of the Icelandic crisis might have been an exaggerated reaction to the extreme economic uncertainty of the time. The economy therefore might have some increase in the level of consumption in store.

It should also be noted that private consumption is generally the first component of GDP to pick up after a contraction. This is consistent with what is happening in Iceland right now, since consumption has been the main driver of the Icelandic economy's growth in the past two years.

It is, however, a matter of concern that imports (whether they be imports of goods, or the purchases of services abroad) are not more sharply affected by the depreciation of the ISK. It should be clear that the dip in imports that followed the initial tumble of the exchange rate in late 2008 and early 2009 did not create elbowroom for increased imports just yet. The economy needs the inflow of foreign currency, and a boom in imports causes an adverse outflow.

To put this more firmly in perspective; Icelandic tourists spent more foreign currency abroad, than foreign tourists spent in Iceland, despite the ratio of foreign tourists arriving in Iceland to Icelandic tourists departing through our air terminals being around 1.5 to 1.

## Enough for now – the CBI raises policy rate 25 bps

The Monetary Policy Committee (MPC) of the Central Bank of Iceland (CBI) raised its policy rate by 25 basis points earlier this month, leaving the active interest rate at 5.125%.

While the decision was consistent with market expectations, we consider the wording of the MPC's statement a bit curious:

*Uncertainty about the global economy has increased in recent weeks, not least because of the financial crisis in Europe. This causes additional uncertainty about the domestic economic and inflation outlook. In the near future, monetary policy may need to respond to developments that could significantly affect output **growth and inflation** in Iceland. In such circumstances, the MPC will aim, as before, **to achieve the inflation target over the medium term while attempting to stabilise fluctuations in domestic output.***

Although the bolded passage is difficult to interpret, we gather that the MPC will be paying more consideration to economic growth and employment than it has done in the past – even up to the point of looking past a high rate of inflation temporarily should international developments affect the recovery of the Icelandic economy adversely.

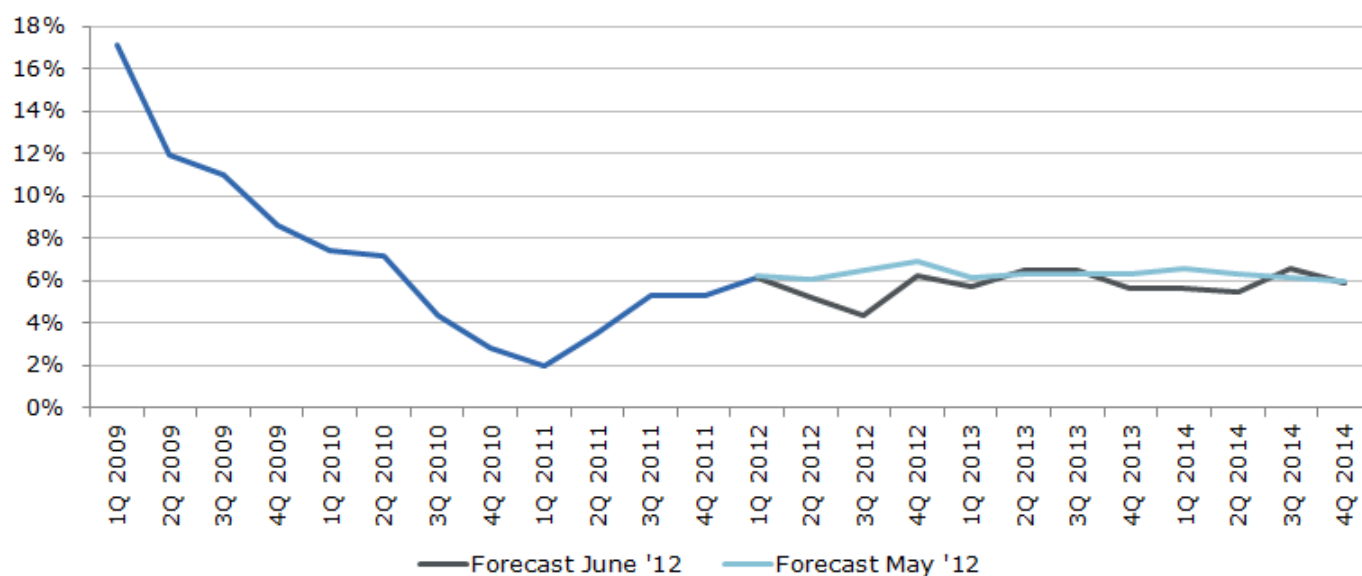
However, the Committee does not seem to be too worried about that scenario unfolding in the near term since it cites a reduction in spare economic capacity, as well as other signs of recovery evident in the latest national accounts publication, as some of the reasons for a less accommodative monetary stance.

### Surprising estimate of inflation calls for updated outlook

The estimate of inflation in May released by Statistics Iceland earlier this month surprised the market, since it was quite lower than expected. We have updated our long term inflation outlook published last month to accommodate the surprise, as well as our policy rate projections. We now forecast inflation to reach 6.2% year-end 2012, down from 6.9% in our earlier outlook.

We nevertheless expect inflation to remain high in the following years, especially if our projections regarding wage hikes and a strong real estate rebound materialize. Our projected annual depreciation of the ISK to a tune of 5% throughout 2014 will also affect inflation adversely.

**Arion Research Updated Inflation Forecast**  
- 12 month inflation



Source: Arion Research, Statistics Iceland

It is interesting to note that the MPC's statement is not as optimistic with regard to exchange rate developments as it often is, since it states that despite the signs of subsiding inflation in May "[...] the outlook is for it to remain above the Bank's target for longer than is acceptable, particularly if the króna remains weak."

### **Further policy rate increases to be expected**

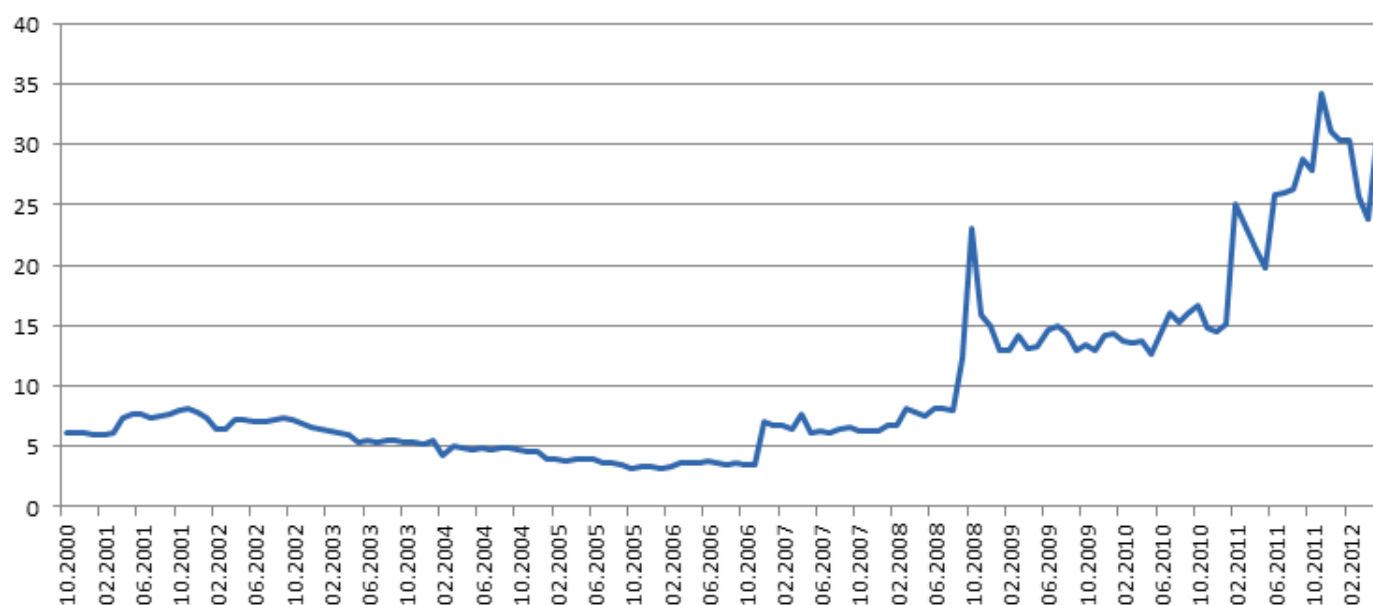
Arion Research has until now projected a 125 bps rise in the policy rate over the course of 2012, the MPC having raised it 100 bps as of June. Although it might appear that our previous projections undershot their target, we do not, however, expect further rises during Q3, and believe the CBI to have reached an acceptable policy stance with its sharp hike in Q1 and Q2. Come fall, a tightening of the monetary policy is to be expected in the region of 25 to 50 bps.

## The treasury saves billions in debt servicing costs

It was revealed last week that the Treasury of Iceland and the CBI will make repayments in the amount of ISK 171 billion on loans from the IMF and the Nordic countries in connection with the IMF-led Stand-By Arrangement. According to the CBI, these transactions will bring the total repayments to 53% and 59%, respectively, of the loans originally extended to Iceland by the IMF and the Nordic countries under the Arrangement. In our view, this sends a powerful signal to the markets regarding the quality of sovereign debt issued by the Icelandic government.

As long as no new debt will be issued, this move is certain to bring down the debt servicing costs from interest payments in foreign currency by a substantial margin. Prior to the repayments, the annual debt servicing costs of the leveraged foreign reserves were close to ISK 30 billion.

**Predetermined short-term net drains on foreign currency assets**  
- interest outflows, billion ISK



Source: Central Bank of Iceland

### Interest payments down ISK 4.7 billions

Since the loans have carried LIBOR rates with a 275 bps premium, a rule of thumb approach would put the savings on interest rate payments from the ISK 171 bn. installment at a little over ISK 4.7 billion (roughly equal to the premium over LIBOR rates times the reduction in debt, since the Treasury has presumably been getting a return equal to LIBOR on the reserves so far). This brings the annual interest payments to around ISK 25 bn.

An important benefit from the repayments is a dramatic improvement in the current account, which might either spur more shopping trips abroad or, as would be macroeconomically preferable, a chance to boost net foreign reserves.

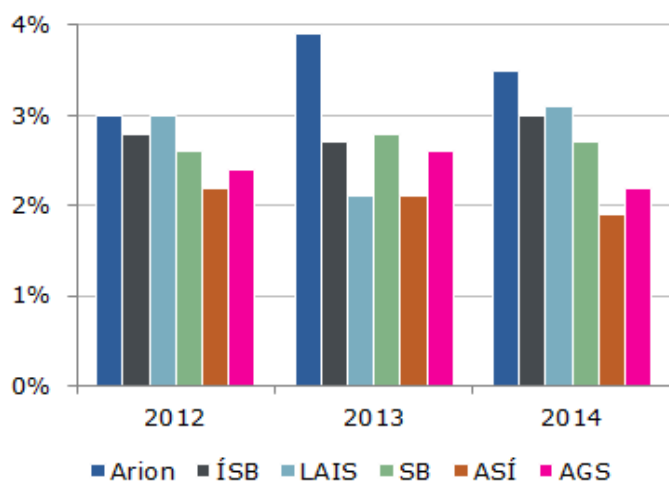
The leveraged part of the CBI's foreign reserves is reduced by the repayments, despite them having no immediate effect on the position of reserves net of foreign debt. Net foreign reserves of the CBI have been negative during the whole of the economic crisis, and deteriorated noticeably during 2010. The position has been improving steadily for the last year and a half, in part thanks to an influx of foreign currency through the investment programme provided in foreign currency auctions for offshore holdings of ISK.

## Summary of forecasts published Q2 2012

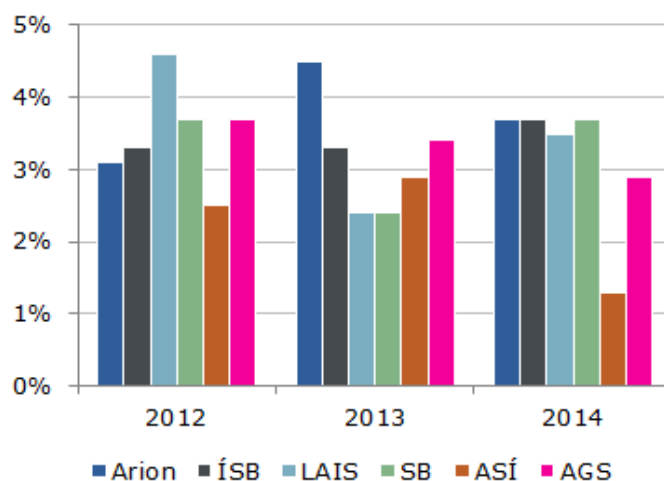
Analysts from various research departments, international organizations, unions etc. have published their economic projections for Iceland during the period 2012-2014 in Q2. These include Arion Research (Arion), the International Monetary Fund (IMF), the Icelandic Confederation of Labour (ASÍ), the Central Bank of Iceland (SB), Landsbankinn Bank (LAIS) and Islandsbanki Bank (ÍSB).

The yearly growth projected for the period is in the region of 1.9-3.9%. Unemployment forecasts are very similar throughout 2014, as are the inflation and private consumption projections for 2012. The projections mostly differ with regard to the outlook for exchange rate developments. Below we present a summary and comparison of the main features of analysts' projections in Q2.

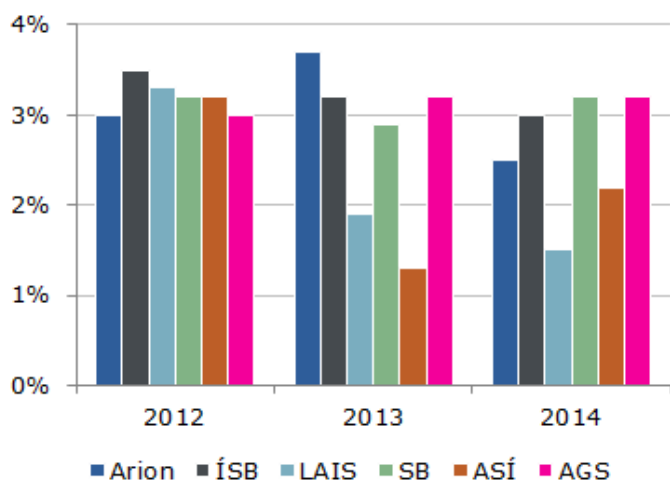
### GDP Growth



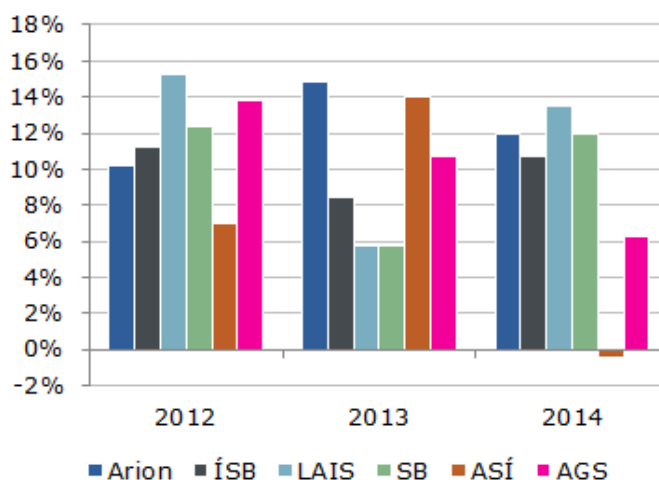
### Domestic Demand



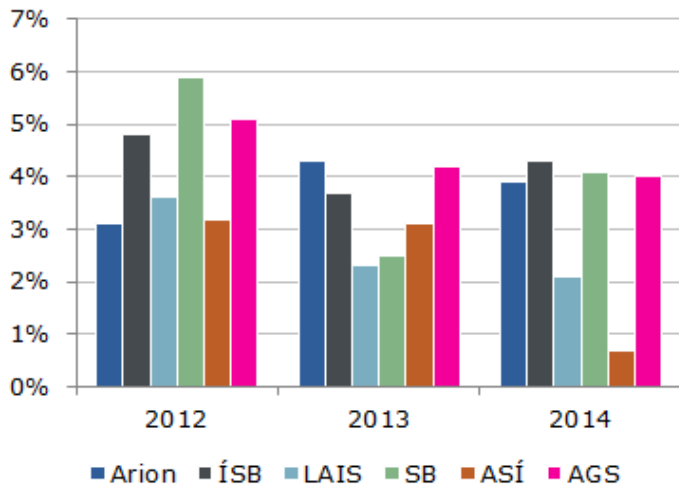
### Private Consumption



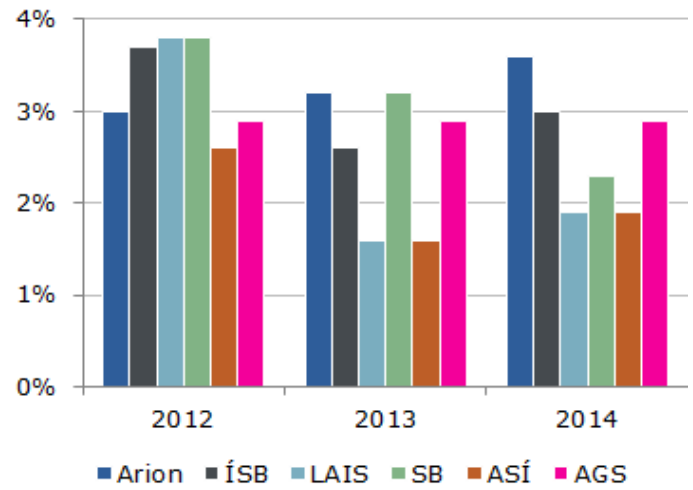
### Investment



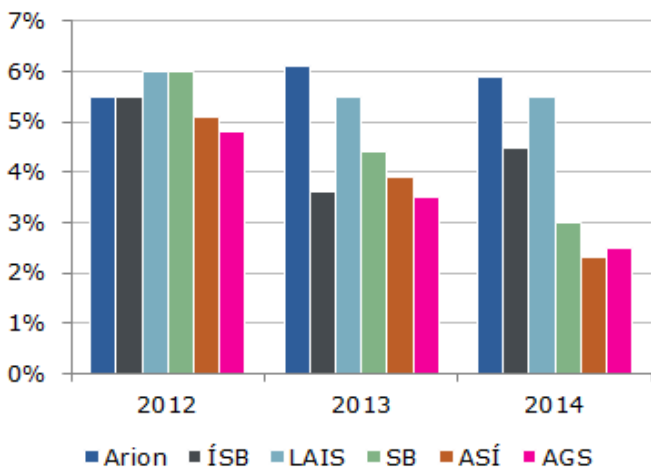
**Imports of Goods and Services**



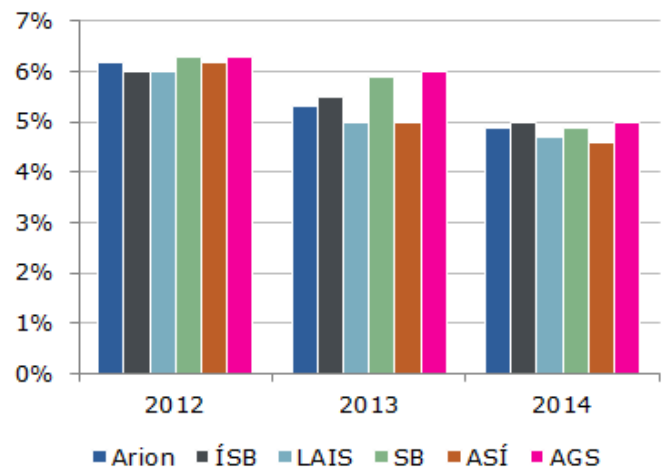
**Exports of Goods and Services**



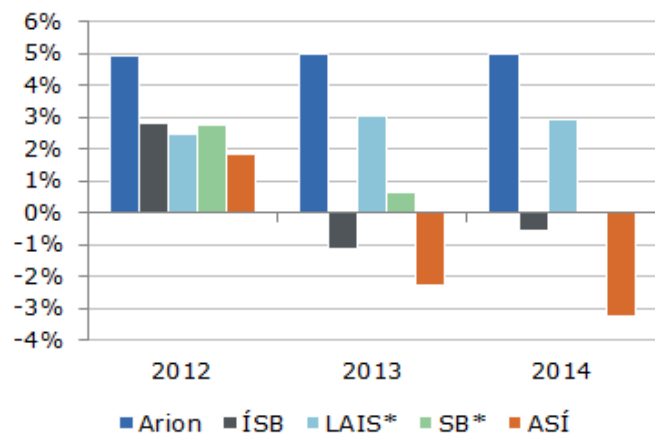
**Inflation - year average**



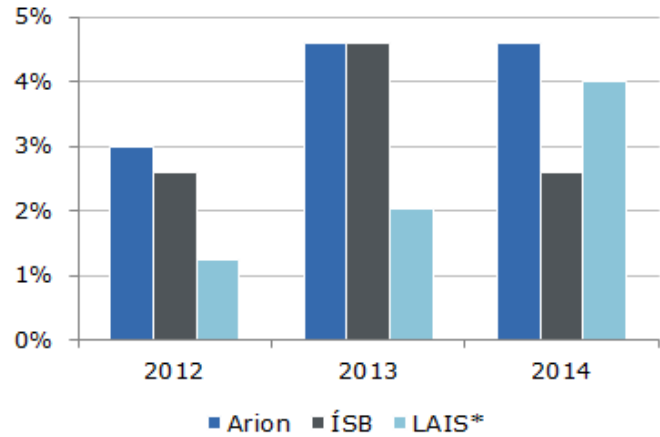
**Unemployment - % of labor force**



**Trade Weighted Index**



**Real Estate Prices (real) - year average**



Source: Various economics forecasts



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