The CBI sets new rates – A faster beat for policy rate increases?

- The Monetary Policy Committee of the Central Bank of Iceland (CBI) has raised its policy rate by 25 basis points, making its overnight rate 6.0%, the maximum bid rate for CBI notes 4.75% and the current account deposit rate 4.0%. Arion Research is anticipating further policy rate increases.

Capital controls tightened – Parliament passes legislation at the request of the CBI

- The Icelandic parliament passed a law tightening the capital controls on 12 March. Investors will no longer be allowed to leave the country with principal installments on annuities and the CBI will have complete control over how payments from the estates of the collapsed banks to their creditors will be handled to maintain stability in the foreign exchange market. The law and its backdrop show beyond a doubt that the Icelandic economy is faced with a set of undesirable choices when it comes to the execution of capital controls.

GDP increases by 3.2% – Strong growth in 2011 but investment still lacking

- The latest figures from Statistics Iceland indicate that GDP growth in 2011 measured 3.2%, while during the fourth quarter the economy grew by 2.7% year on year. Private consumption recovered strongly during the year, increasing by 4% in the course of 2011, spurring a 6.4% rise in imports since 2010. At the same time exports grew by 3.2%. Gross fixed investment has also picked up, with investment rising 13% between years. Investment nevertheless remains historically low as a percentage of GDP and it is therefore clear that there is still a long way to go before it reaches a level which enables the economy to grow sustainably.

A faster beat for policy rate increases?

The Monetary Policy Committee (MPC) of the Central Bank of Iceland has raised its policy rate by 25 basis points, making its overnight rate 6.0%, the maximum bid rate for CBI notes 4.75% and the current account deposit rate 4.0%.

The main reasons for the rate increase cited by the committee are:

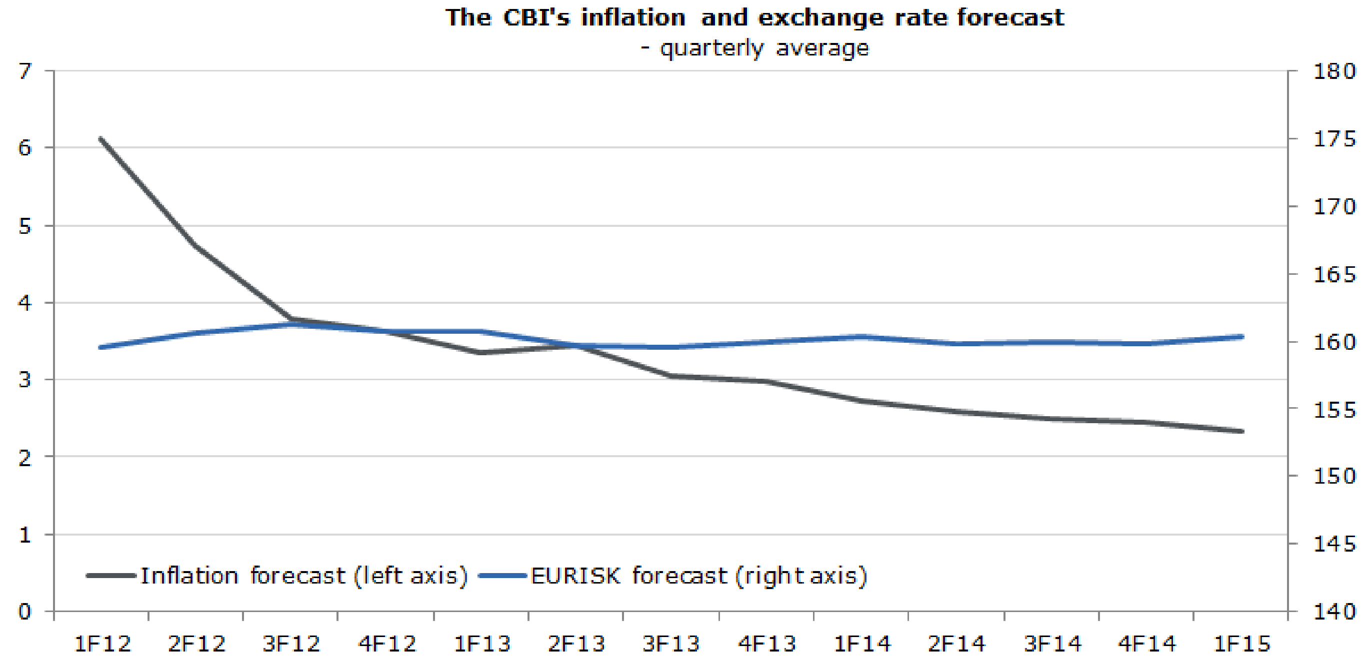
- A depreciation of the ISK since its last meeting
- A worsening short-term outlook for inflation since the bank's last forecast
- A worsening long-term outlook for inflation in absence of any appreciation of the ISK
- An unchanged outlook for general economic conditions

In the view of Arion Research, most signs are pointing towards further policy rate increases in the near term in tandem with increasing economic activity and anticipated inflation. This view is reinforced by the likely developments in foreign exchange markets, where there is limited cause for optimism on behalf of the ISK. The MPC's press release states that if the outlook for inflation does not improve, the most likely scenario will consist of additional policy rate increases. This implies that we are correct to focus on inflation and exchange rate developments to predict near term policy rate setting.

The CBI's inflation forecast and the ISK

What should be apparent from the figure below is that inflation in Q1 2012 will be higher than the Central Bank's latest forecast anticipated (6.1% on average YoY). Arion Research places the expected average inflation rate for Q1 closer to the region of 6.4% or higher, since fuel prices have risen and the ISK has depreciated further since our last inflation forecast.

The Central Bank's exchange rate forecast has obviously failed as well. It predicted an average EUR/ISK rate of 159.5, but so far it has been somewhat weaker this quarter; around 163. If the ISK does not appreciate sharply in the coming months, the inflation rate is certain to rise even higher than the CBI is predicting.



More policy rate increases approaching?

There are numerous uncertainties that could accelerate the policy rate increases already anticipated in the coming quarters. For one, the CBI has not factored in the effect of sizeable write-offs of household debt on demand following a recent Supreme Court ruling. It will conduct a more thorough analysis of these effects in May, which might indicate a greater need for increases than realized at this point. In addition, it is clear that the policy rate will most probably rise progressively as the capital controls are abolished. The CBI is also monitoring asset-price bubbles, which might be inflating because of limited investment opportunities due to the capital controls. Any symptoms of bubbles will most likely be met with further policy rate increases, although the CBI maintains there is no sign of them yet.

Further tightening of capital controls

The Icelandic parliament passed a law tightening the capital controls on 12 March. The changes lead to the following:

- Investors will no longer be allowed to leave the country with principal installments on annuities
- Foreign claimants of the collapsed banks will not be able to exchange payments in ISK for foreign currency
- The Central Bank will have complete control over how payments from the bankruptcy estates of the collapsed banks to their claimants will be handled to maintain stability in the foreign exchange market

The law and its backdrop show beyond a doubt that the Icelandic economy is faced with a set of undesirable choices when it comes to the execution of capital controls.

The Icelandic krona has dropped noticeably against most other currencies throughout this quarter. On 6 March, the CBI attempted to mitigate the outflow of foreign capital by intervening in the foreign exchange market. In a subsequent release, the bank tried to maintain that the outflow causing the drop in the ISK was strictly temporary. The parliament's decision, however, confirms what Arion Research has repeatedly pointed out; the current account balance cannot possibly cover the amount of foreign exchange outflows apparent in the financial account. Calling the outflow temporary is simply not credible.

Despite it being high season in the fishing sector, the real exchange rate being way below its historical average and the tourism season quickly approaching, the government still seems to think it has no choice but to tighten the controls.

Why now?

The law was probably passed due to heavy repayments on HFF14, housing bonds mostly owned by foreign investors, scheduled on 15 March. The repayments would have caused a further drop in the krona in the absence of further foreign exchange intervention by the CBI. An intervention might have proved a costly experiment, since it would be extremely risky to expend borrowed reserves on maintaining the repayment schedule.

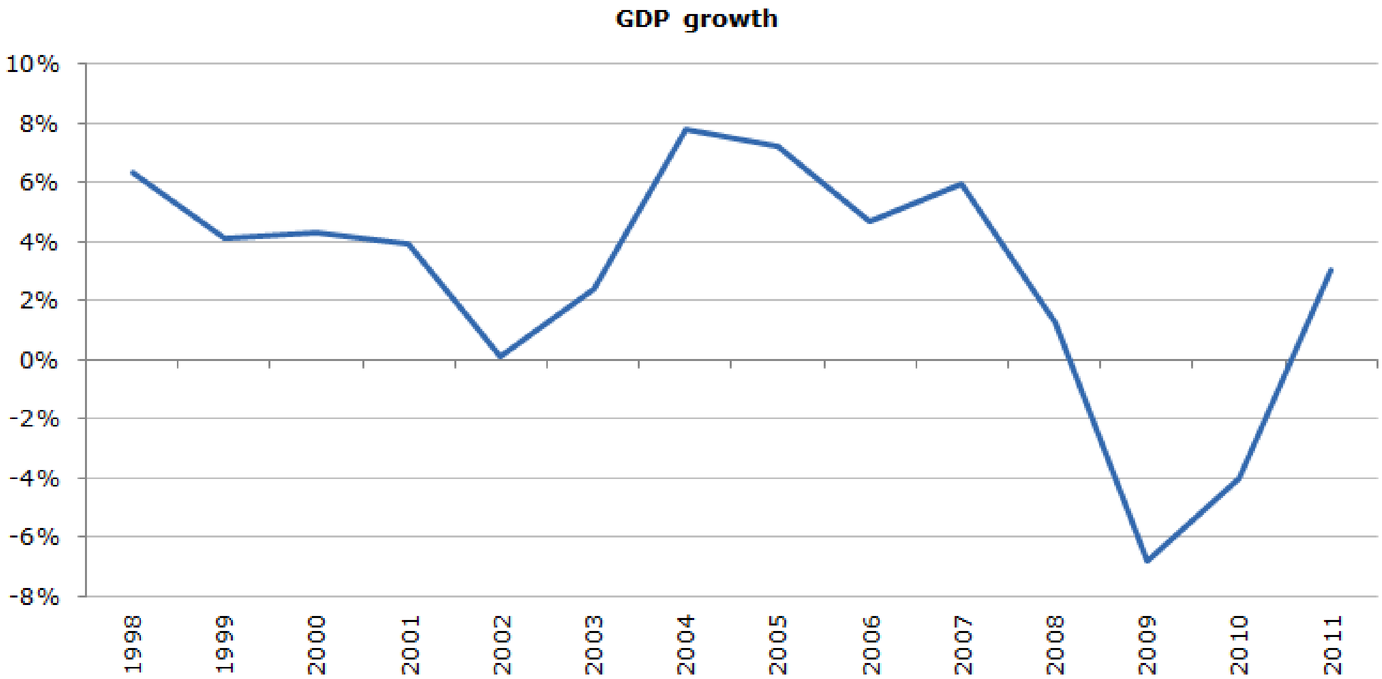
The abruptness of the decision makes the authorities appear unaware of the extent of inflows and outflows of currency, and the passing of the law conjures up an image of them not being in control of the situation. This might further undermine the faith of foreign investors in the Icelandic authorities.

What's next?

In the short run, tighter controls might cause the ISK to rise, but clouds are gathering in the long run. Projections for the current account balance have been worsening to say the least, and imports appear to be growing while exports cannot move in tandem because of natural restrictions on the supply side (Iceland's two biggest exports are subject to supply side constraints; seafood production is contained by licenses and natural developments and aluminium production in many ways by aluminium prices). The parliament's actions unfortunately do not counter these long-term challenges facing the nation's currency and the outlook remains negative since the current account balance will not cover foreign loan repayments.

Strong growth in 2011 but investment still lacking

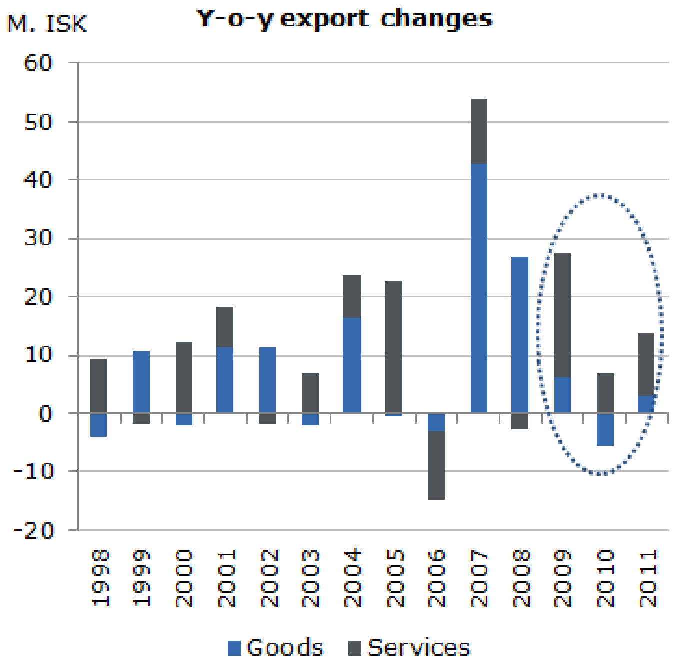
Statistics Iceland published the 2011 national accounts in the second week of March. It was clear as early as the first quarter of 2011 that it was going to be the first year of growth since the collapse of the Icelandic economy. The latest figures from Statistics Iceland indicate that GDP growth in 2011 measured 3.2%, while during the fourth quarter the economy grew by 2.7% year on year. Private consumption recovered strongly during the year, increasing by 4% in the course of 2011, spurring a 6.4% rise in imports since 2010. At the same time exports grew by 3.2%. Gross fixed investment has also picked up, with investment rising 13% between years. Investment nevertheless remains historically low and it is therefore clear that there is still a long way to go before it reaches a level enabling the economy to grow sustainably.

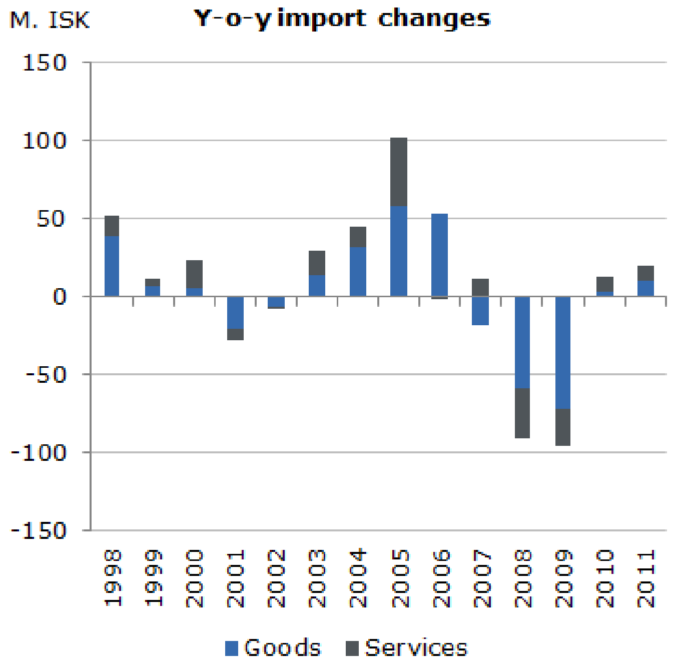


Service sectors the main drivers of exports

For the second year in a row imports grew at a faster rate than exports. Soaring private consumption was undoubtedly a major factor in this development. The growth in exports since the economic collapse has primarily been fuelled by the service sector. This is illustrated in the diagram below. While it is difficult for Iceland's main goods exporters to increase supply, there is considerable growth potential in the service sector, particularly in tourism which has undergone a real boom in recent years. Growth in the service sector is one of the main reasons exports have kept pace with imports.

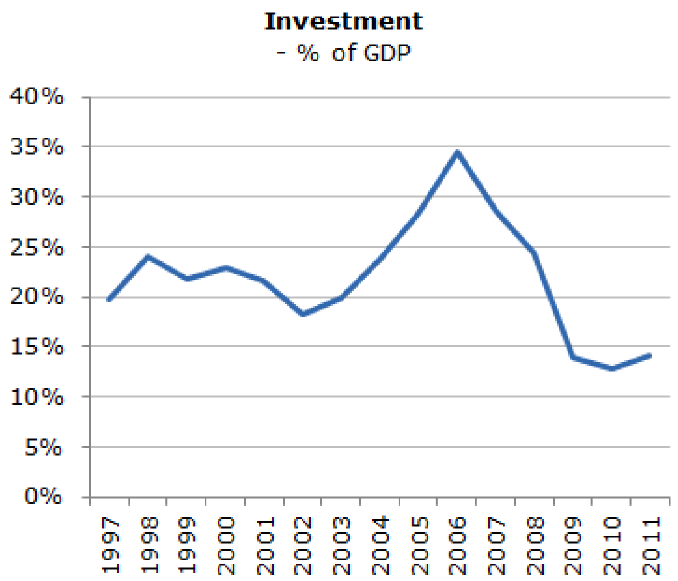
If one examines the growth in imports over the last two years, it would appear that last year's growth rate was not merely a result of increased goods imports but is also attributable to a rise in the import of services, i.e. trips by Icelanders abroad. In 2010 approximately 70% of the increase in imports could be linked to imported services. Arion Research has previously highlighted the trend in private consumption of Icelanders abroad. Income generated by this type of consumption is not passed on to Icelandic companies and does not contribute to more investments by Icelandic companies. The change in the goods and services balance since the economic collapse is thus a cause for concern in light of the country's need for foreign currency as Iceland faces a very heavy repayment schedule on its foreign loans.

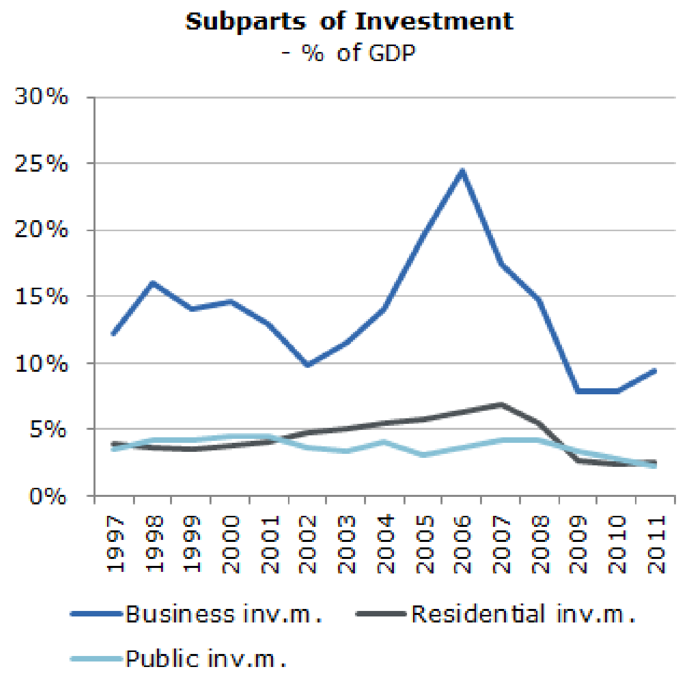




Investment finally gets off the ground – but there is still a long way to go

Although the economy has grown between years and investment has started to recover, it must be acknowledged that investment is picking up from a historically low level. Thus small changes lead to great percentage changes in total investment. Investment in the business sector did grow, however, for the first time since the economic collapse, up 26% between years. However, the decline in public investment for the fourth successive year reduced the relative upturn in investment. The real estate market also appears to have started to get back on its feet. Increased demand for property is undoubtedly one of the main reasons behind the 9% growth in fixed investment in residential property between years, the first year of growth since the collapse. However, there needs to be a substantial increase in investments in the business sector and residential property to make up for the huge drop in investments since 2008. The figure below shows that gross fixed investment, and its sub-categories, is still below the historical average, despite last year's upswing. It is necessary in this context to point out that private consumption cannot pull the economy along by itself in the long run.





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