



Icelandic Economic Update

Arion bank • Research • research@arionbanki.is • arionbanki.is



The Central Bank of Iceland will cut interest rates by 75 bps on 5 May

- We expect the Central Bank of Iceland to cut its policy interest rate by 75 bps at its next interest rate setting meeting. At the last such meeting the Central Bank's monetary policy committee hinted that further interest rate cuts could be expected if the ISK remained stable and if inflation continued on its downward decline.

Moody's changes outlook on Iceland's ratings to stable

- Moody's has changed the outlook on Iceland's ratings from negative to stable. Moody's upgraded its outlook following the IMF's review of Iceland's economic programme. The key factor was the elimination of any doubt over the ability to refinance the state's foreign obligations in 2011-2012 after Iceland secured a loan facility from Scandinavia. Iceland is therefore still clinging on to its status as a nation with an investment grade rating.

Calendar

Date	Title	Period
5 May 2010	MPC's interest rate decision	
7 May 2010	Auction Treasury Notes	
12 May 2010	Consumer price index	April 2009-2010

The Central Bank of Iceland will cut interest rates by 75 bps on 5 May

We expect the Central Bank of Iceland to cut its policy interest rate by 75 bps at its next interest rate setting meeting. At the last such meeting the Central Bank's monetary policy committee hinted that further interest rate cuts could be expected if the ISK remained stable and if inflation dwindled. As this has indeed happened, we believe that the Central Bank will slash rates by at least 50 points.

Given that the IMF has approved the review of the economic programme, the monetary policy committee should feel it has room to cut interest rates even more. The IMF's statement that capital controls will remain in place for the time being should also provide more scope for a drop in interest rates. Since relaxing the capital controls is not on the near-term agenda, the argument for high interest rates to support the ISK is rather weak.

It is difficult to say, however, how the monetary policy committee will view the abolition of the capital controls. Let's take an example:

- Central Bank Governor Már Gudmundsson favours Plan A. He has said that Plan B, i.e. the postponement of the relaxation of capital controls and the subsequent major cut in interest rates, is a weaker option than Plan A, which allows for the ending of the controls but assumes higher interest rates.
- Some people think that things are moving too fast. Moreover, some members of the monetary policy committee probably think that there is little room for more interest rate cuts, judging by the comments of one committee member at the last interest rate setting meeting.

We believe that the committee will take the middle road on the merits of Plans A and B and will cut deposit rates and the policy rate by 75 points.

Commitment to cut interest rates

The key point in the last statement from the monetary policy committee (17 March) was possibly this:

"If the ISK remains stable or appreciates, and if inflation continues to subside as forecast, there should be scope for continued gradual monetary easing."

The Central Bank has repeated the above statement in its last four announcements (5 November 2009, 10 December 2009, 27 January 2010 and 17 March 2010). In every case the committee has stood by its words and cut deposit rates by 50 points at the following meeting and there is every likelihood that this will be the case at the meeting on 5 May and further 25 points because of the IMF's review.

The exchange rate has remained stable

The monetary policy committee closely monitors factors such as the exchange rate of the ISK and the state's CDS spread. These factors have developed quite positively since the last interest rate setting meeting:

The exchange rate is virtually the same as it was before the last meeting.

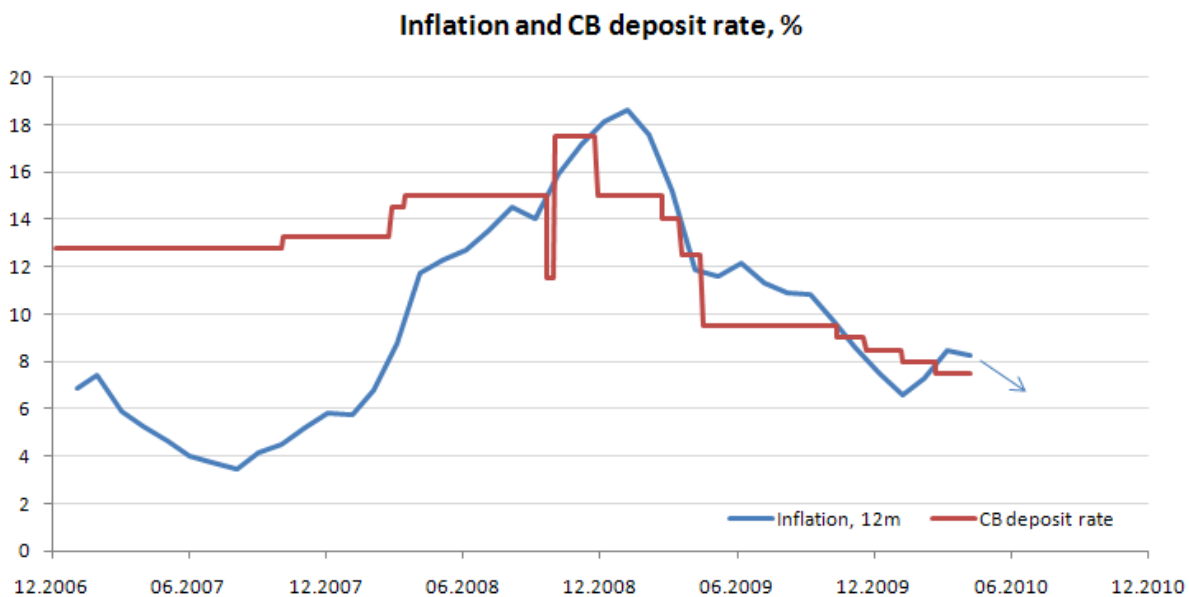
Iceland's CDS spread has fallen slightly since the last meeting while the spreads of many countries have widened. The recent announcement by the Central Bank governor that the bank has recently bought some of the government's Eurobonds on the secondary market probably had an effect in this respect.

Inflation outlook conducive to cutting interest rates

We expect inflation to decline over the next few months, falling to 6% in June and 3.5% by the end of the year. The Central Bank's inflation forecasts also reveal some optimism that inflation will drop over the next few months.

The Central Bank's recent policy on interest rates has been that its deposit rates should not be lower than the 12-month rate of inflation. The bank has actually said that it ignores inflation caused by tax increases, such as higher VAT rates. Therefore it is best to compare the Central Bank interest rates with tax-adjusted inflation, i.e. inflation minus the effects of the aforementioned tax increases.

Tax-adjusted inflation will fall to 5% in the next few months (non-adjusted inflation will be 6%). Inflation will therefore provide no obstacle to further interest cuts.



Moody's changes outlook on Iceland's ratings to stable

Moody's has changed the outlook on Iceland's ratings from negative to stable. Moody's upgraded its outlook following the IMF's review of Iceland's economic programme. The key factor was the elimination of any doubt over the ability to refinance the state's foreign obligations in 2011-2012 after Iceland secured a loan facility from Scandinavia. Iceland is therefore still clinging on to its status as a nation with an investment grade rating.

The Eyjafjallajökull eruption

Moody's press release states that the economy will perform slightly better than expected. New investments in the aluminium and power sectors are forecast to help drive a return to positive GDP growth in 2011. Moody's does not expect the Eyjafjallajökull eruption to have a material impact on the economy as the volcano is in a relatively remote location and air transport was closed for only a few days.

The last rating action on Iceland was implemented on 6 April 2010, when Moody's changed the outlook on government's Baa3 local and foreign currency ratings to negative from stable. Arion Research was interested to note that Moody's believes that a new Icesave deal will be more positive than the one rejected by the president in January.

More ratings companies are now likely to also review their credit ratings of Iceland over the next few days after the IMF review was passed. The table below shows Iceland's credit rating with the different ratings agencies.

Term	Foreign currency		Local currency	
	Long	Short	Long	Short
Moody's	Baa3	P-3	Baa3	NR
S&P	BBB-	A-3	BBB+	A-2
Fitch	BB+	B	BBB+	NR
R&I	BBB-	NR	NR	NR

*Red means on negative outlook

Contacts

Ásgeir Jónsson

Head of Research and Chief Economist
Treasury & Capital Markets
Tel: +354 444 6957
asgeir.jonsson@arionbanki.is

Ásdís Kristjánsdóttir

Analyst
Treasury & Capital Markets
Tel: +354 444 6968
asdis.kristjansdottir@arionbanki.is

Thórhallur Ásbjörnsson

Senior Analyst
Treasury & Capital Markets
Tel: +354 444 6967
thorhallur.asbjornsson@arionbanki.is

Fannar Jónsson

Analyst
Treasury & Capital Markets
Tel: +354 444 6962
fannar.jonsson@arionbanki.is

Thorbjörn Sveinsson

Analyst
Treasury & Capital Markets
Tel: +354 444 6964
thorbjorn.sveinsson@arionbanki.is

Provisional release:

The content of this release has been prepared by the Research Division of Arion Bank hf. The Research Division bases its information on data information services and news services, both foreign and domestic, which it considers reliable, along with its own interpretations and evaluations of public information. Arion Bank hf. accepts no responsibility for the accuracy of this information nor any liability for transactions based on this information. In relation to this it should be noted that any of the Research Division's discussion may be an abridged version of more extensive analysis and research and conditions of financial markets change rapidly. For these reasons the recommendations and forecasts of the Research Division can change without notice, but they do reflect the opinions of the Research Division's employees at the time that they are expressed. Those parties who are interested in initiating transactions are advised to contact an expert at Arion Bank hf. before any decision is made. It should also be noted that Arion Bank hf., its employees and other parties associated with the Bank may have vested interests concerning particular organizations, which the Research Division's published material may pertain to at any given time.