

### **The Central Bank of Iceland out on its own**

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### **Ticking along nicely: 2.5% economic growth during first half of 2011**

- Gross Domestic Product (GDP) increased in real terms by 2.5% during the first half of 2011, compared with the same period last year according to figures published by Statistics Iceland last week. National expenditure (domestic demand) increased by 5% and it is clear that the main obstacle to economic growth in the first six months of the year is foreign trade. Despite the fact that the economy is recovering, GDP still falls far short of pre-crisis levels. In fact the economy is in a similar position to what it was in 2005-2006, which perhaps is not too bad.

## The Central Bank of Iceland out on its own

The Central Bank of Iceland's monetary policy committee raised the policy interest rate by 25 basis points at its last meeting in August. By doing this the Central Bank of Iceland set itself apart from other central banks which have stopped raising interest rates while uncertainty remains on the international markets.

The monetary policy committee supported its decision with the following logic:

*"The inflation outlook has deteriorated"*

*"Domestic demand and employment have increased more this year than previously expected"*

*"High inflation expectations, negative real interest rates and a narrow risk-adjusted interest rate-differential with abroad could have a negative impact on the ISK."*

In light of the above it is interesting to see how the main factors have developed since the last meeting:

**The inflation outlook has improved:** Inflation has certainly been increasing and the annual rate will continue to rise over the next few months. However, Arion Research believes that the Central Bank took a step too far when updating its inflation forecast in the most recent Monetary Bulletin, which was published at the same time as the last interest rate setting meeting took place. Statistics Iceland has published inflation figures since the last meeting and these figures fell short of the market's expectations. One set of figures is perhaps not particularly significant – it becomes clear, however, how pessimistic the Bank's forecast is when inflation for the current quarter is scrutinized. In order for the forecast to prove accurate, inflation in September will have to measure 1.6% from the previous month – such a high rate has not been measured since November 2008 however!

**More slack in the economy than previously thought:** The Central Bank of Iceland has revised its economic forecast and believes that more growth in domestic demand and higher employment justify the rise in interest rates. Statistics Iceland recently published new GDP figures for the second quarter of 2011 and revised its figures for 2010. The figures imply that the slack in the economy is greater than assumed in the Central Bank's revised economic forecast.

**Risk-adjusted interest-rate differential has widened:** The risk-adjusted short-term interest-rate differential with abroad has widened from approximately 0.2% to 0.75% since the last meeting; at the same time the ISK has appreciated by more than 1% which should be welcomed by the committee members. However, Arion Research believes that the appreciation of the ISK has virtually nothing to do with the risk-adjusted interest-rate differential as there are other flow figures affecting the ISK today, i.e. the huge stream of tourists during the summer.

**Persistent turbulence on the international markets:** The global economic growth outlook has been downgraded and economic growth among Iceland's main trading partners could easily become negative. Should this happen the effects will be felt in Iceland soon enough. While uncertainty remains over the severity and longevity of the global financial crisis, it can be strongly argued that the most normal course of action would be for the Central Bank of Iceland to adopt a wait and see approach, particularly as the economic recovery is still built on weak foundations and it wouldn't take much to turn economic growth into contraction again. We must not forget, though, this state of uncertainty also existed when the last decision on interest rates was taken.

*On the other hand...*

**Inflation expectations have increased:** The most recent interest rate hike seems to have gone down the wrong way with market participants as inflation expectations have increased since the last meeting. There are probably two factors involved here; firstly, the market is looking at the new inflation forecast from the Central Bank which now projects that annual inflation will peak at 7%

instead of 3% in the original forecast; and secondly, no credible monetary policy exists, i.e. investors have no confidence that the current monetary policy can rein in inflation.

**Real interest rates are still negative:** Despite the 25 basis point rise in interest, real interest rates are still negative by more than 1% on the scale used by the Central Bank. The monetary policy committee is concerned that negative real interest rates could undermine the exchange rate of the ISK.

**Conclusion:** The overall economic position means that it should be easier for the monetary policy committee to take a less defensive stance. Arion Research still believes however that the Central Bank's struggle to dampen inflation expectations in the hope of boosting credibility will gain the upper hand this time around. **We therefore predict a 25 bp increase in the policy interest rate at the next meeting of the committee on 21 September.**

	Feb-11	Mar-11	Apr-11	Jun-11	Aug-11	Sep-11
Policy rate (change between meetings)	-0,25%	0	0	0	0,25%	0,25% ?
ISK	-4,30%	-1,0%	-0,30%	-1,80%	0,90%	1,10%
Sovereign CDS spreads (5 y)	2,74%	2,43%	2,24%	2,80%	2,42%	2,96%
Market policy rate expectations (next meeting)	Down 0,25-0,75%	Down 0-0,25%	Down 0-0,25%	Unchanged	Up 0-0,25%	-
Real policy rates*	2,10%	1,30%	0,30%	-0,50%	-1,20%	-
Breakeven inflation (average inflation 5 y)	2,50%	3,58%	3,00%	3,8-5%	4,30%	5,17%
12 month inflation (CPI)	1,80%	1,90%	2,30%	3,40%	5,00%	-
Risk-adjusted interest rate differential**	-0,24%	0,08%	0,18%	-0,71%	0,22%	0,74%

Source: Central Bank of Iceland & Arion Research estimates

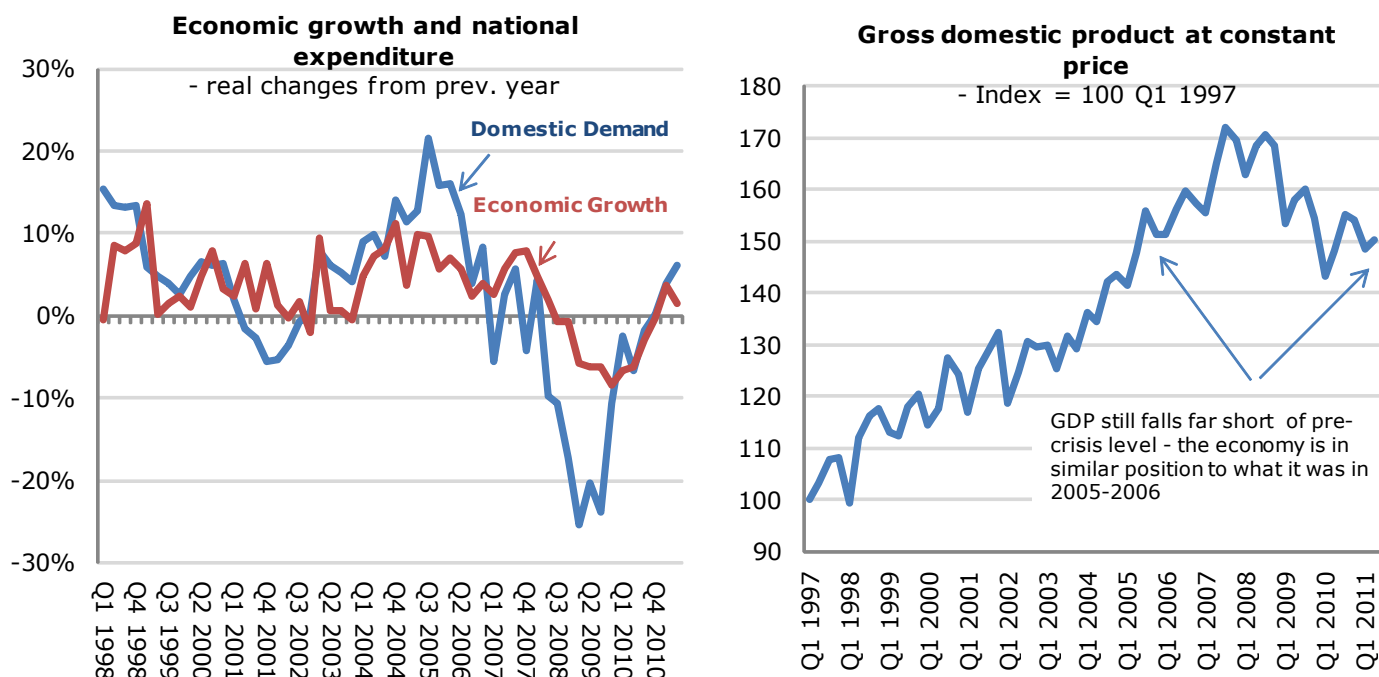
\*The nominal effective policy rate is currently approximated as the simple average of the CB deposit and maximum CD rates. The MPC estimates real policy rates from averaging different measures of inflation and inflation expectations.

\*\*Risk-adjusted interest rate differential is approximated using the difference between German and Icelandic treasury notes, less the countries 5 year CDS spread

## Ticking along nicely: 2.5% economic growth during first half of 2011

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It is worth noting that Statistics Iceland is revising GDP figures for 2010. The economy contracted by 4% and not 3.5% as originally assumed, meaning that the economic slack is slightly higher than previous numbers had implied.



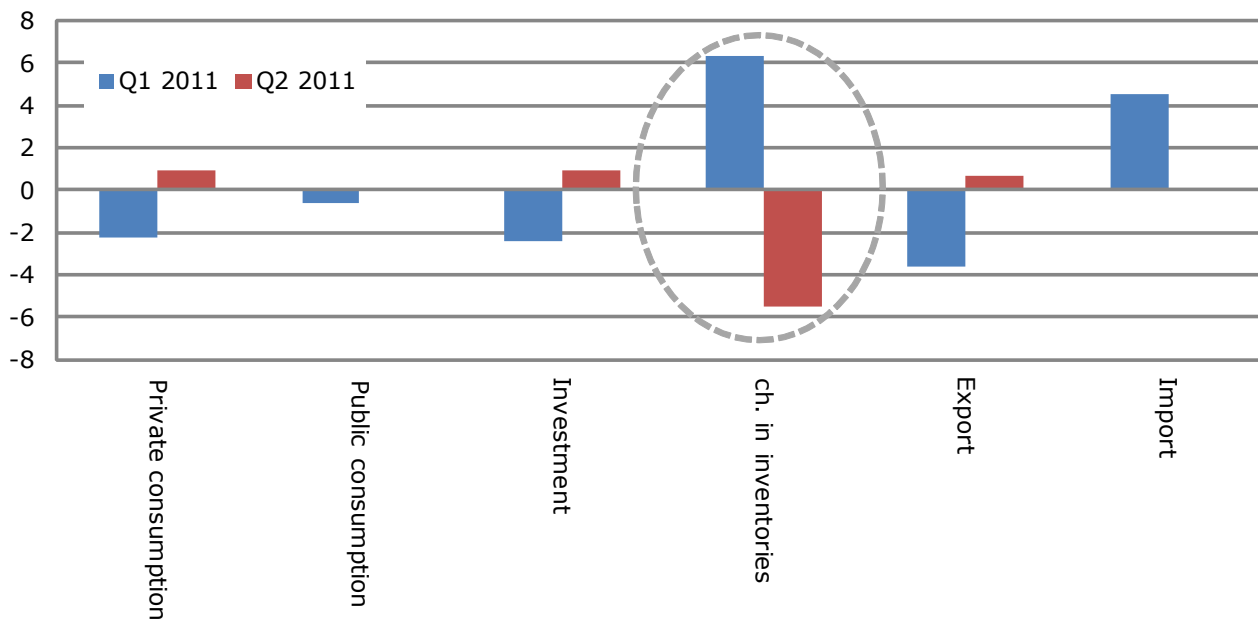
Source: Statistics Iceland

**Interpreting economic growth figures:** These figures are broadly in line with Arion Research's expectations. If we assume that Statistics Iceland's investment figures are correct, then investments are not recovering and it appears that the Central Bank of Iceland are too optimistic in their forecasts. However, there does appear to be a certain error in the preliminary figures of Statistics Iceland when investment is compared against imports of investment goods (see below). It is therefore impossible to rule out that investment is in fact higher than the published figures imply. These figures will be revised once Statistics Iceland receives more exact data. It must be also remembered that investment fluctuates and a growth rate of 1% can easily change to 10% growth in the second half of the year. Irrespective of whether investment figures are correct or not, economic growth in the second half of the year cannot be any lower if the forecasts of the Central Bank and Statistics Iceland are to prove accurate.

### Inventory decreases:

Economic growth in the first quarter was driven by an increase in inventory. In the second quarter inventory fell, a fact reflected in the negative economic growth between quarters (seasonally adjusted). In light of this, it is important not to read too much into lower economic growth in Q2 2011 as the change in inventory has an effect.

**Contribution to economic growth (%) - quarterly ch., seasonally adjusted**

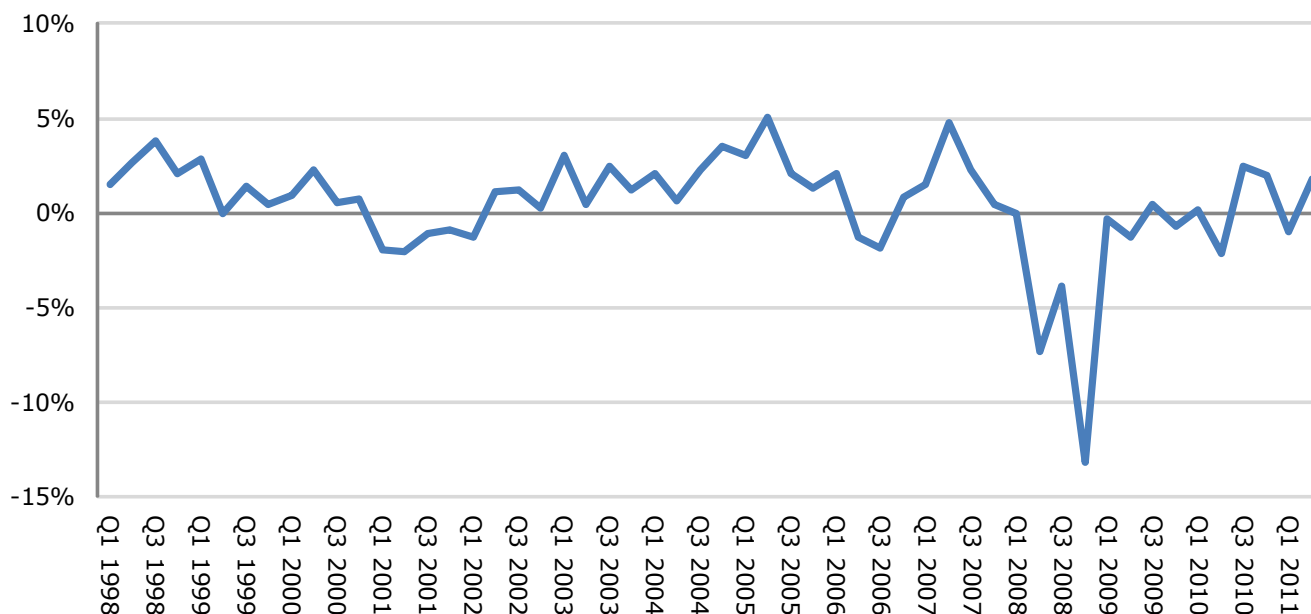


Source: Statistics Iceland

**Temporary factors continue to drive private consumption**

Private consumption grew significantly in the second quarter, up 5% YoY and 1.8% between quarters. But yet again consumption is being fuelled by temporary factors. Therefore it cannot be ruled out that private consumption might slump in the second half of the year provided that no new measures are announced aimed at buoying household spending.

**Temporary factors continue to drive private consumption - private consumption (quarterly changes and seasonally adjusted)**

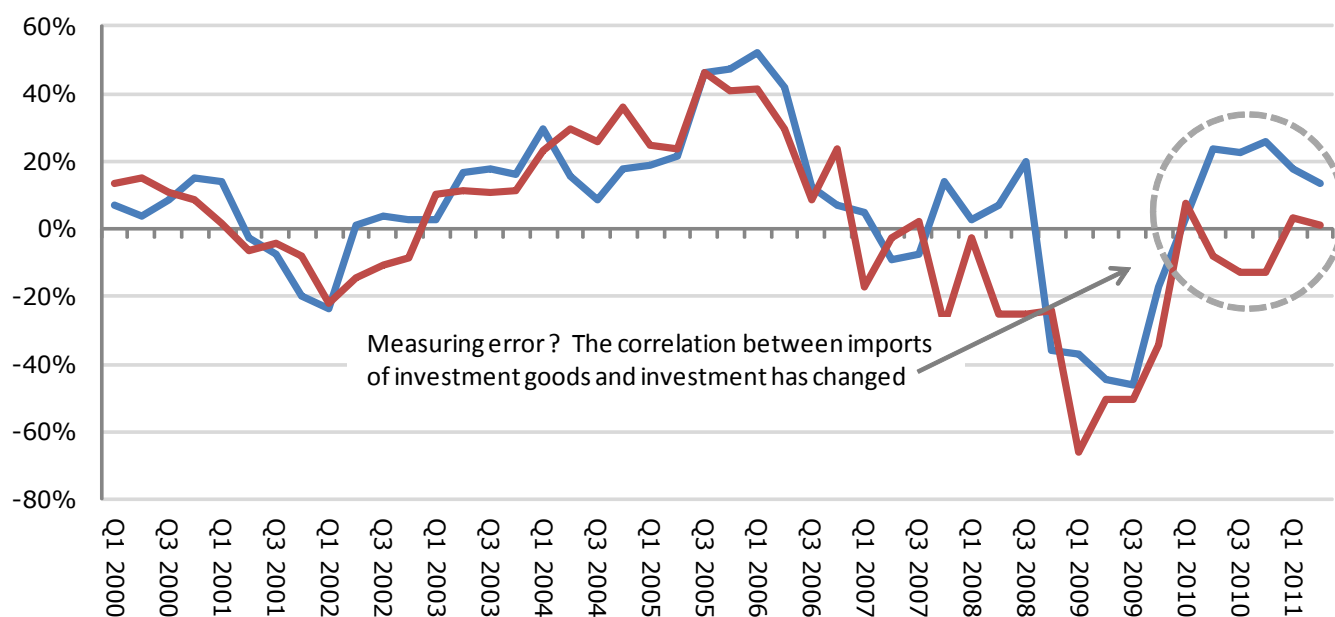


Source: Statistics Iceland

## Investments paralyzed

Arion Research is disappointed by how long it is taking to stimulate investment; figures from Statistics Iceland indicate that investment remains historically low. During the first half of 2011 investment increased by 2% from the previous year. It will be difficult for the economy to maintain growth if investment does not recover as investment creates both jobs and spurs demand. This development differs from the forecast of the Central Bank of Iceland which predicts 10% growth in investment this year. However, the preliminary figures from Statistics Iceland must be treated with caution as investment is one of the things that changes most when reviewing economic figures. This especially applies to the present situation when there does not appear to be the same correlation between imports of investment goods and official investment figures. One wonders whether Statistics Iceland might be underestimating the level of investment in the economy – or overestimating imports.

### Investment and import on investment goods - real changes between years



Source: Statistics Iceland

## Foreign trade reduces economic growth.

Foreign trade has had a negative effect on economic growth during the first half of the year. Exports remain virtually unchanged, which is not surprising since almost no investments have been made in the export sector in the three years since the economic collapse. At the same time imports are growing by 3.7% as the majority of consumer goods come from abroad.

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