ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | June 2014

GDP contracted in Q1 despite roaring domestic demand

Much to our surprise, GDP in Iceland contracted in Q1 by 0.1%. Domestic demand grew sharply faster than we'd anticipated, with large leakages via imports dragging down GDP growth. Negative growth during the quarter is therefore not indicative of weaknesses in the domestic economy; on the contrary, it can be partly blamed on the high level of economic activity. We analyze the numbers to tell you what was really happening inside the economy in Q1.

Soft current account in Q1, but no indications of BoP pressures

Weak capelin catches, energy rationing to aluminium producers and other factors contributed to a drop in the country's trade surplus in Q1. Still, the ISK remained relatively strong and stable during the quarter while the CBI purchased large sums of FX on the interbank market. We try to resolve this apparent puzzle while evaluating the impact of the soft Q1 numbers on the outlook going forward.

Inflation in Iceland – in choppy waters without an anchor

Considerable headway has been made in recent months when it comes to meeting monetary policy goals. Is that being reflected in increased trust in the Central Bank and longer term inflation expectations? We estimate the relationship between inflation expectations and the target interest rate on the one hand and measured inflation on the other hand.

The CBI accumulates foreign currency reserves

In its last meeting the Monetary Policy Committee of the Central Bank of Iceland decided to leave interest rates unchanged. The Committee also announced that the Bank will resume regular foreign currency purchases in addition to its irregular interventions. The primary purpose of these purchases will be to accumulate more unleveraged reserves.

Further appreciation in the CBI's latest currency auction

The size of the Central Bank's latest currency auction was 35.9 m. EUR at a rate of 186 krónur per euro. The participation rate of non-residents exiting Iceland continues to fall while bids from investors wanting to enter the economy remain relatively strong. As usual, the investment programme remained the popular choice.

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GDP contracted in Q1 despite roaring domestic demand

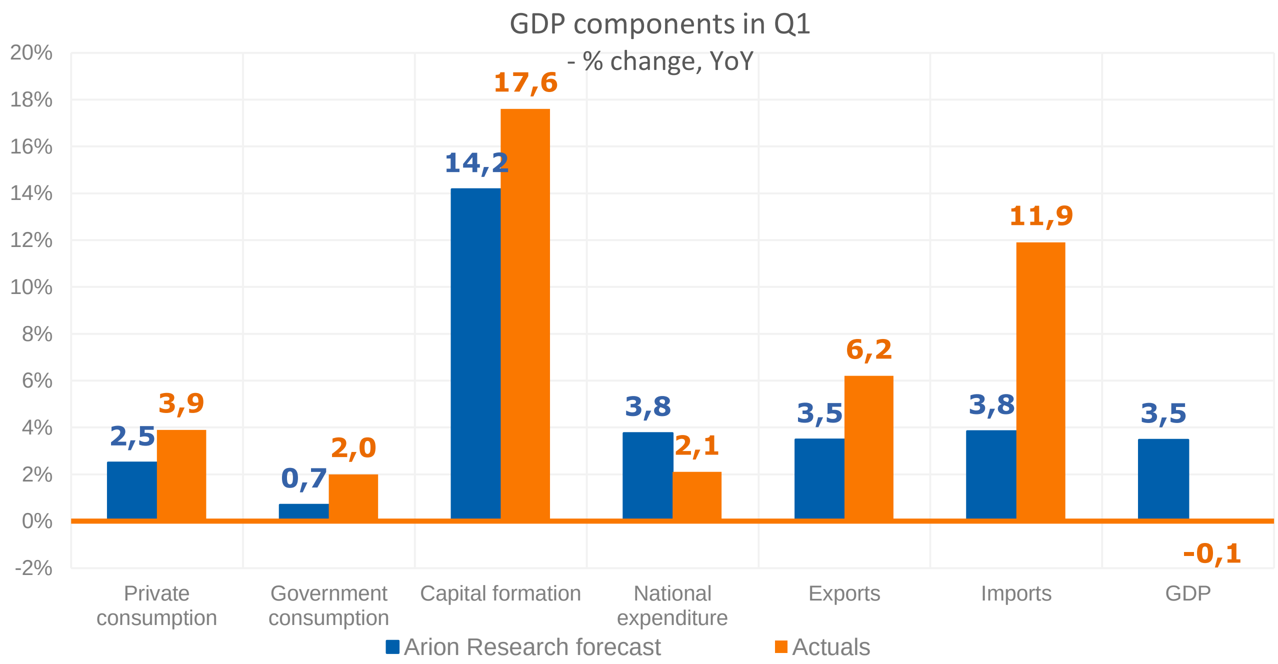
Earlier this month, StatIce released national accounts for the first quarter in Iceland. The numbers turned out to be rather odd; GDP declined by 0.1% while domestic demand increased by 2.1%. Private consumption increased by 3.9%, government consumption grew by 2% and gross fixed capital formation increased by 17.6% over the same period. At the same time balance of trade in goods and services deteriorated as exports grew by 6.2% while imports grew by 11.9%

Overview of national accounts components

Components	Change on previous year	Contribution to GDP growth
1. Private consumption	3.9	2.1
2. Government consumption	2	0.5
3. Capital formation	17.6	2.4
3.1 Regular business investment	15.1	1.4
3.2 Residential construction	30.8	0.9
3.3 Government services	10.7	0.2
4. Inventories	-2.6	-2.6
5. Domestic expenditure	2.1	2.0
6. Exports, total	6.2	3.3
6.1 Goods	1.2	0.4
6.2 Services	17.4	3.3
7. Imports, total	11.9	-5.8
7.1 Goods	7.5	-2.2
7.2 Services	19.5	-3.6
8. GDP	-0.1	-0.1

Sources: StatIce, Arion Research approximation of growth contribution of individual components.
The figures on inventories express the reduction in inventories as a percentage of GDP of the previous year.

We would be lying if we said the numbers didn't surprise us - the data turned out to be way out of step with our forecast for the quarter, and we actually had a pretty hard time deciphering what on earth was going on in the economy during the quarter. Like the table above illustrates, there were huge swings in individual components of GDP (some of them jumped by double digit percentages YoY), and changes in inventories caused the headline numbers to differ significantly from underlying developments.

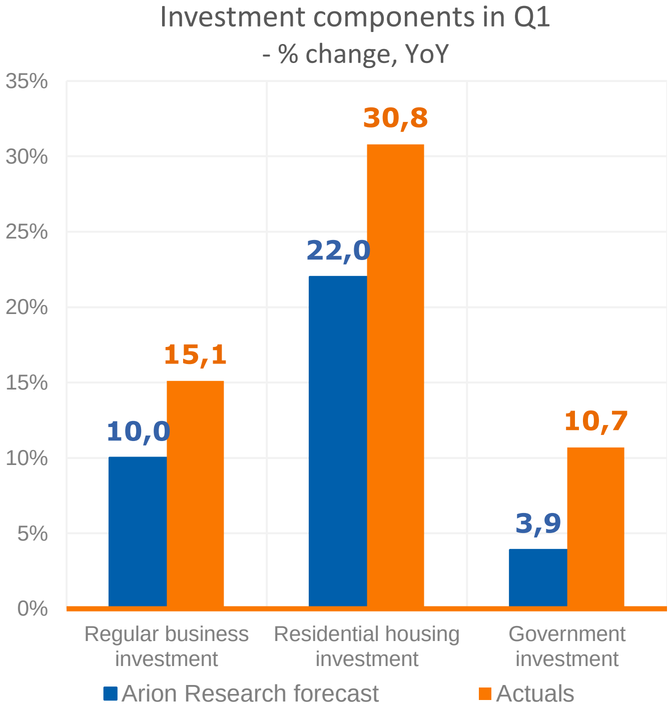


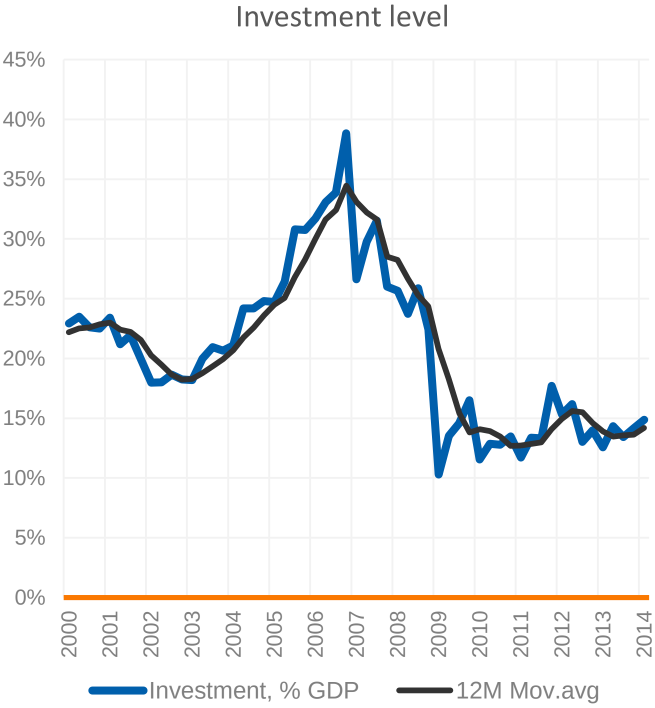
Sources: StatIce, Arion Research latest forecast

We would like to try to shed some light on what was actually happening during Q1 by highlighting some elements of the data:

• Private consumption growth exceeded both our and the CBI's forecasts (2.5% and 3.5% respectively) by a substantial margin at 3.9% during the quarter. Perhaps anticipation of the government's debt relief scheme is already spurring purchases ahead of its implementation, or maybe the strong growth is indicative of pent up demand. It might also be some sort of irregularity that will smooth out over subsequent quarters – it is impossible to tell at this point. The pace at which consumption is growing is slightly worrisome, as consumption growth tends to put pressure on both prices and the ISK over sustained periods of time (especially since a large part of consumption demand tends to leak out of the economy via imports, putting pressure on the balance of payments) – but at least there is no obvious sign that the increased consumption is being financed by a build-up of new debt. We would recommend following consumption closely going forward.

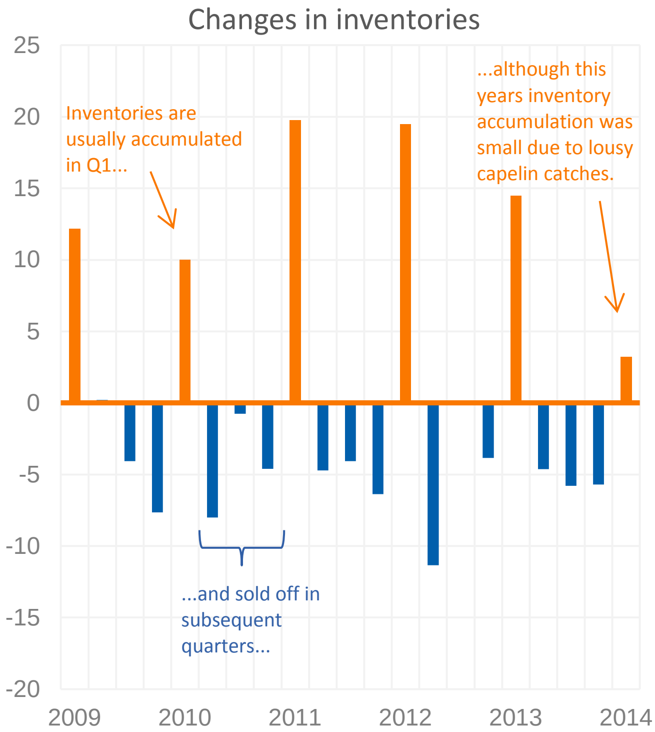
• We were pleasantly surprised to see robust growth in investment at 17.6% YoY – although the investment level still leaves plenty to be desired. It should be considered that investment is rising from a low base, so small absolute increases can yield large percentage changes. While the growth in investment was primarily driven by residential construction (there is definitely pent up demand for housing that is finally being met as housing prices catch up with building costs), both regular business investment and government investment posted strong growth as well. While the growth was strong, it fell short of being stellar; for comparison, the CBI is forecasting 19% growth of investment for the year as a whole.

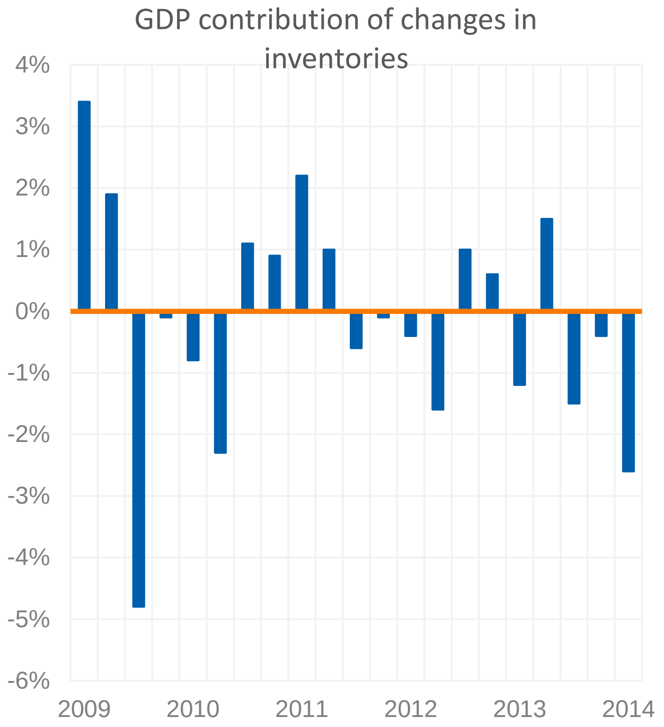




Sources: StatIce, Arion Research latest forecast

• When the strong growth in individual components of domestic demand is contrasted with the 2.1% growth in national expenditure posted in the StatIce numbers, it might seem like there is a discrepancy in the numbers. The explanation can be traced to changes in inventories. During Q1 in 2013, capelin catches were strong and stocks of fish piled up in fisheries' warehouses, while this year catches remained depressed. The decreased build-up of inventories caused both national expenditure and GDP growth to appear much smaller than underlying components suggest; StatIce estimates that growth would have been 2,6% stronger were it not for inventories. It is worth noting that inventories in the national account numbers in Iceland is solely aluminium and marine product inventories.



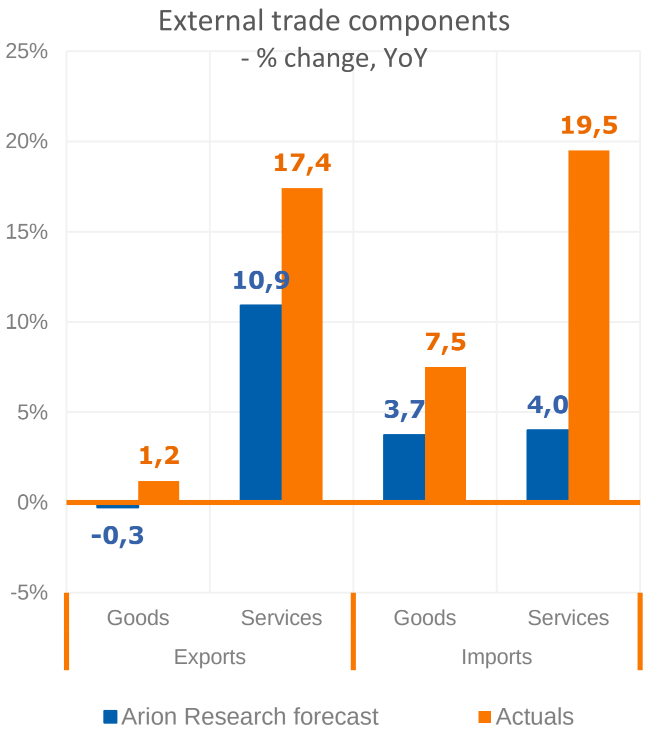


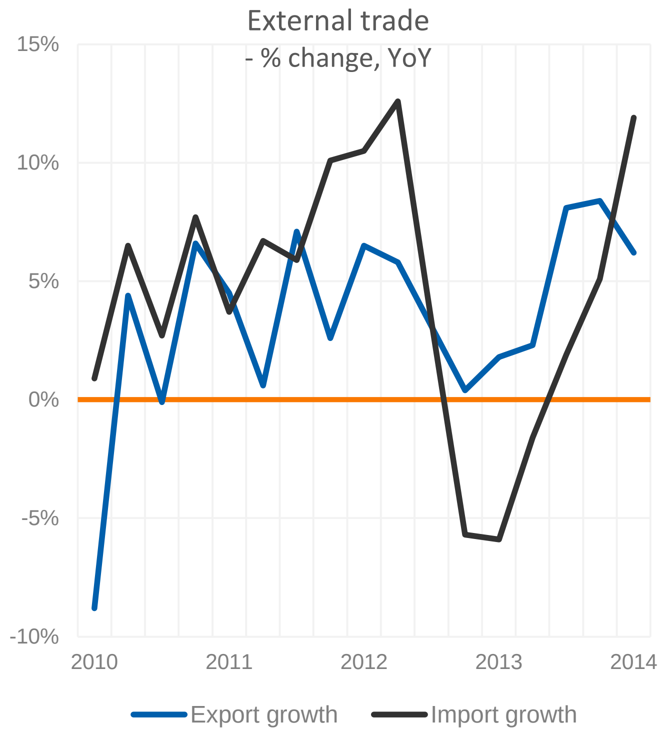
Source: StatIce

• Exports turned out much stronger than we had hoped for; despite low capelin catches and energy rationing to aluminium smelters, goods exports actually grew 1.2% during the quarter when we were sure we would see a contraction. Service exports (i.e. tourism) remained the driver, posting a whopping 17.4% increase YoY – together, exports of goods and services grew by 6.2%.

• Imports were the biggest jack-in-the-box during the quarter, growing 11.9%. Imports of goods grew by 7.5%, which is roughly twice what we had predicted but still in line with strong consumption growth. What we are really scratching our heads about is the 19.5% growth in imports of services, which is actually consistent with the bizarre current account data for the quarter. According to the current account data, it was mostly Other Services which posted unexpected growth in the quarter. It is impossible to say for certain what caused it. One possible explanation is the failed bank estates or firms with limited domestic operations, in which case it would mean nothing for the domestic economy.

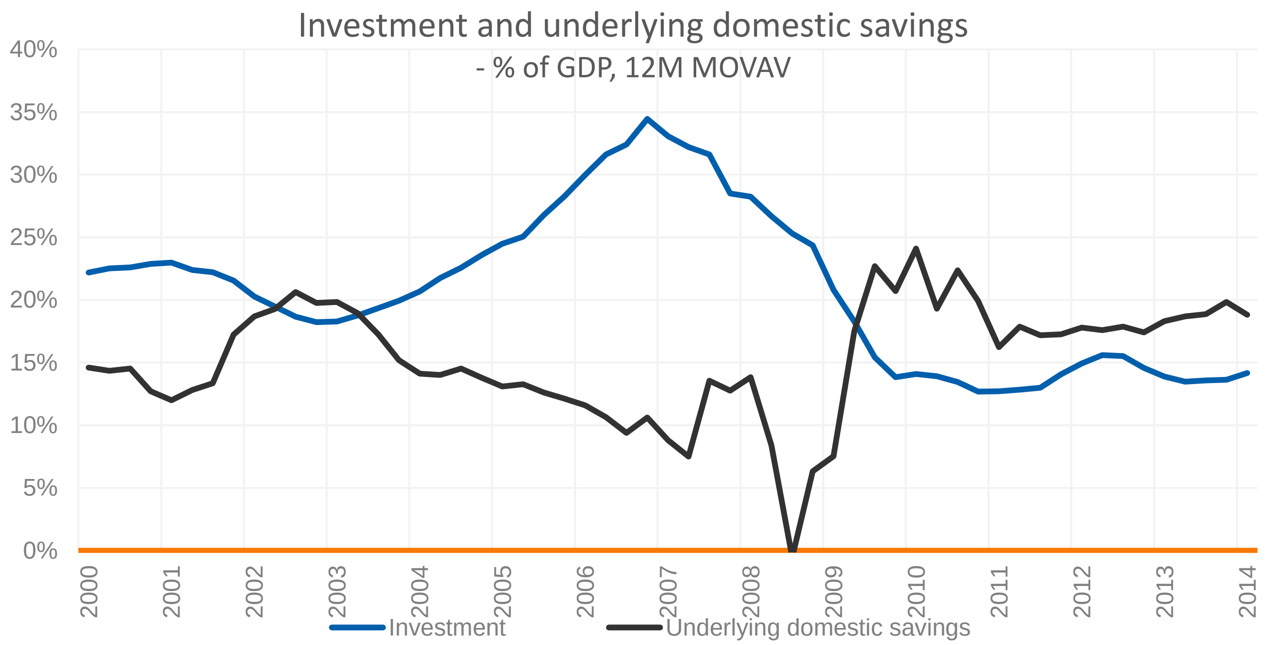
Taken together, external trade had considerable negative effect on GDP growth as imports grew faster than exports during the quarter for the first time since 2012.





Sources: StatIce, Arion Research latest forecast

To summarize: Domestic demand grew sharply faster than we had anticipated, with large leakages via imports dragging down GDP growth. Negative growth during the quarter is therefore not indicative of weakness in the domestic economy; on the contrary, it can be partly blamed on the high level of economic activity. It should also be kept in mind that changes in inventories bias the numbers, causing both domestic demand and GDP growth to seem weaker than the underlying components suggest. This means that demand pressures are on the increase while domestic savings are contracting – which is exactly what the CBI's monetary policy committee has expressed concern about.

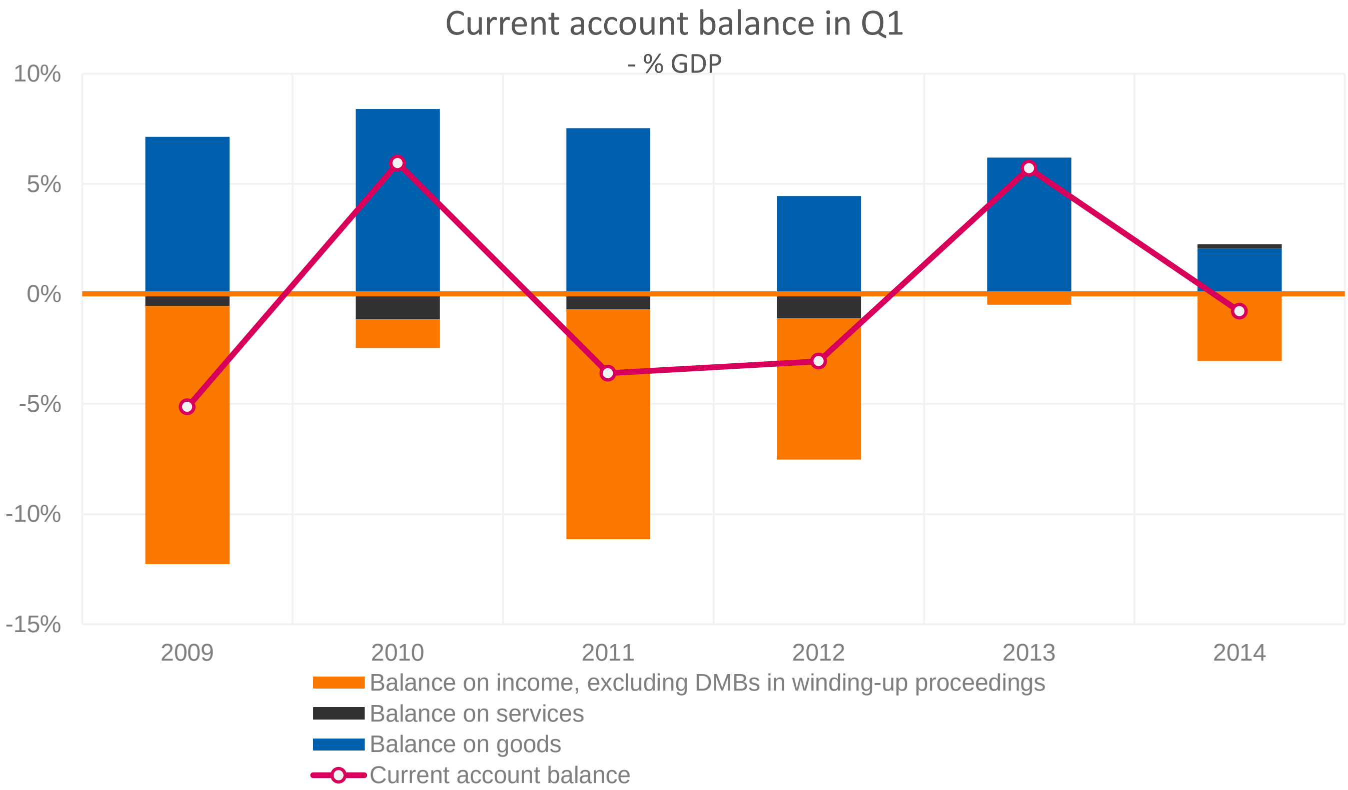


Source: CBI

While we still believe that unchanged rates until year end is the most likely path of monetary policy (after all, inflation excluding housing is almost dangerously low at 1.1%), we would guess that the probability of hikes before year end is higher due to the data described above. Still, the CBI's Monetary Policy Committee seemed less anxious about the numbers than we would have predicted, although it acknowledged that domestic demand was indeed growing at a faster pace than the CBI had predicted. The committee members were generally of the view that the economy was stronger than the figures suggested and that the volatility of import data suggested it should be taken with a grain of salt. According to the minutes of the meeting the monetary stance was broadly unchanged from the previous meeting, as key indicators had stayed roughly the same. Members agreed that there were arguments for unchanged rates as well as rate hikes, the main argument for a rate hike being the benefits of responding swiftly to a demand pickup in the economy as well as fighting high long-term inflation expectations. The end result was, however, that the appropriate course of action would be to await further data and keep rates unchanged as the full effect of the rise in the Bank's real rate had yet to be seen.

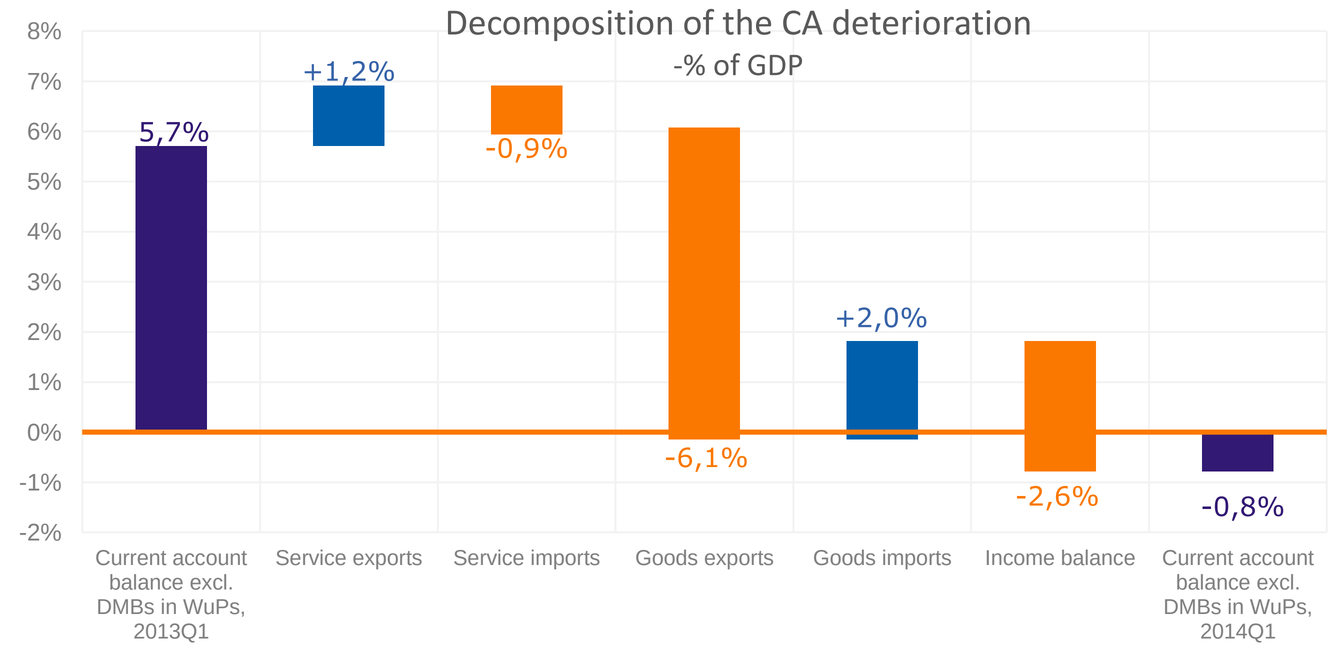
Soft current account in Q1, but no symptoms of BoP pressures

The CBI published new data on both the net international investment position (NIIP) and the balance of payments (BoP) in Q1. The current account took a turn for the worse during the quarter, dropping from a surplus of 24.5 bn. ISK in Q1 last year (5,7% of the quarter's GDP) to a deficit of 3.5 bn. ISK (-0,8% of the quarter's estimated GDP). To be honest, our first reaction is that the numbers look awful - but please keep reading, there is a caveat to all of this.



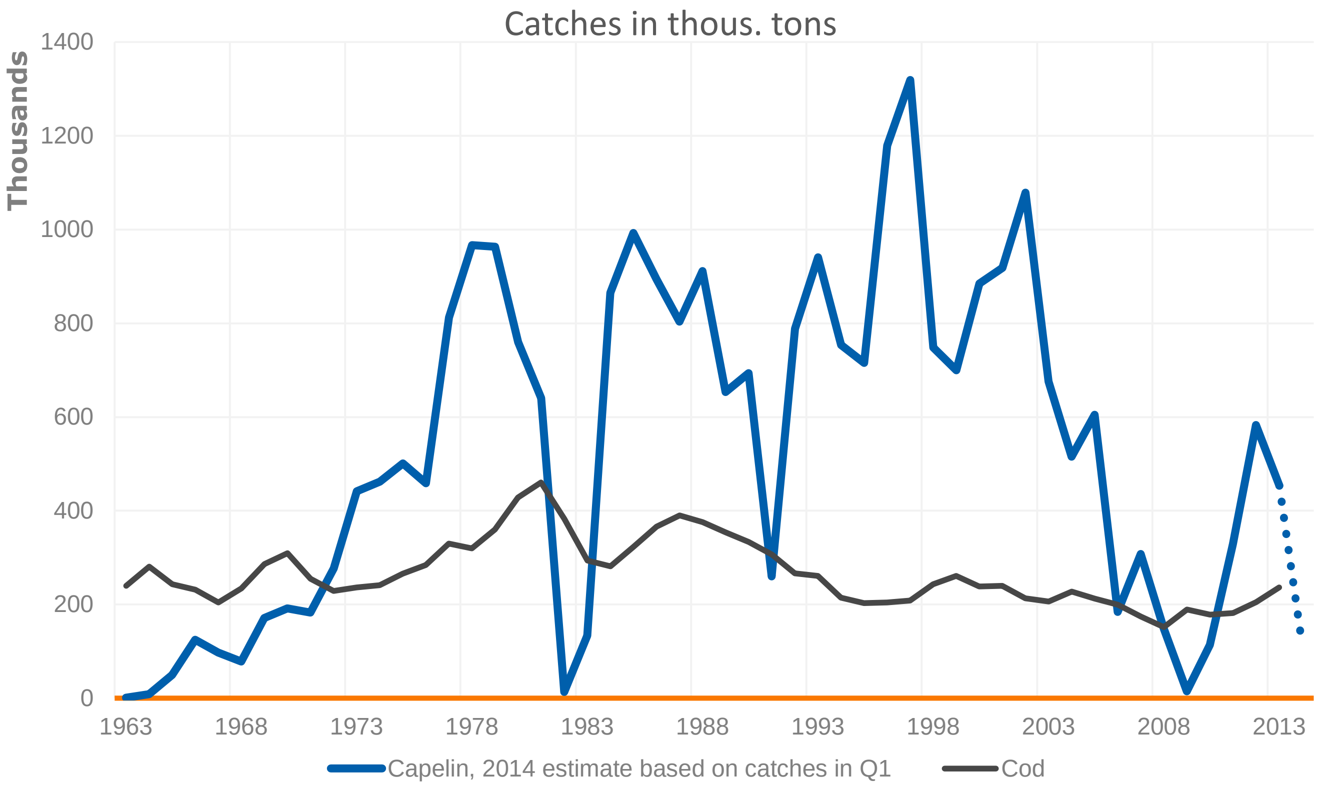
Source: CBI

As the figure below illustrates, the entire drop can be attributed to extremely weak goods exports, mostly due to a collapse in capelin catches during the quarter.



Sources: CBI, Arion Research calculations

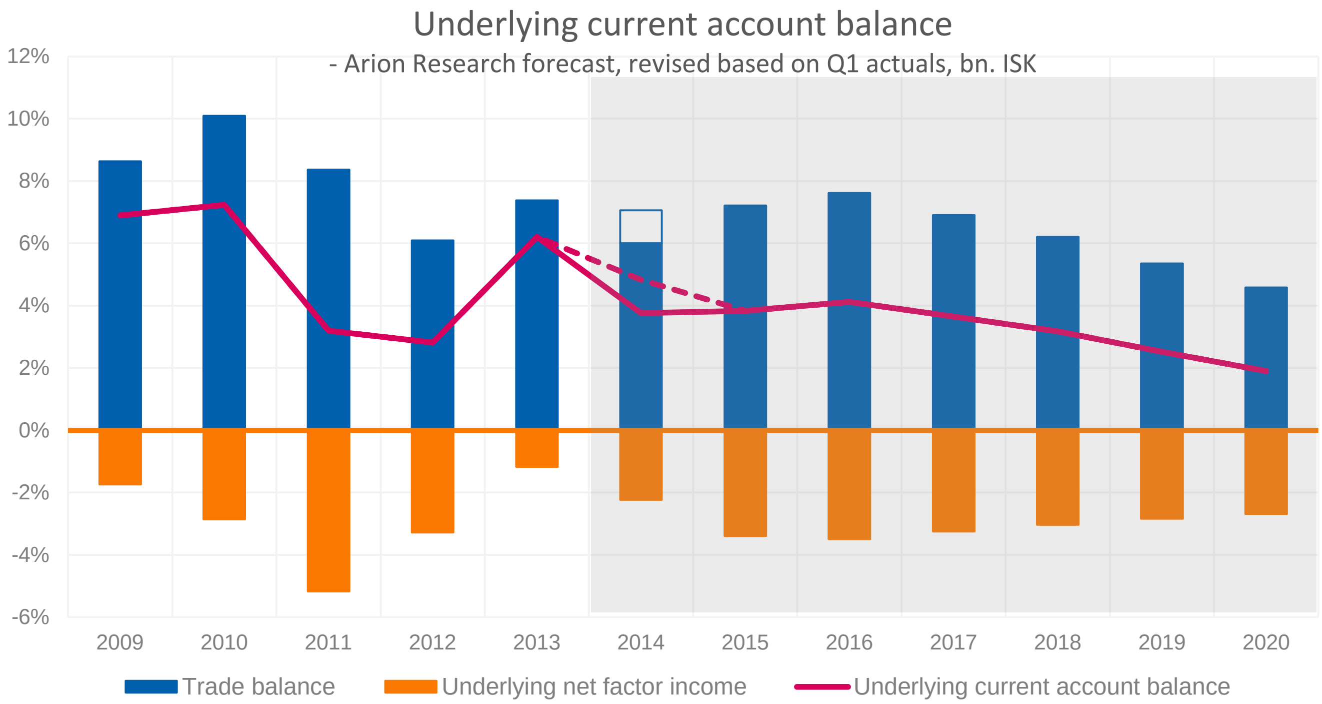
The thing is that groundfish catches (mainly cod and haddock) tend to remain relatively stable over time, while there are several stocks of pelagic fish which display much higher volatility and can be caught in the hundreds of thousands of tons one year and next to zero the next, capelin being one of them. This time around, capelin was simply nowhere to be found in the early months of the year – so deterioration of the trade balance was to be expected in Q1.



Sources: CBI, Arion Research calculations

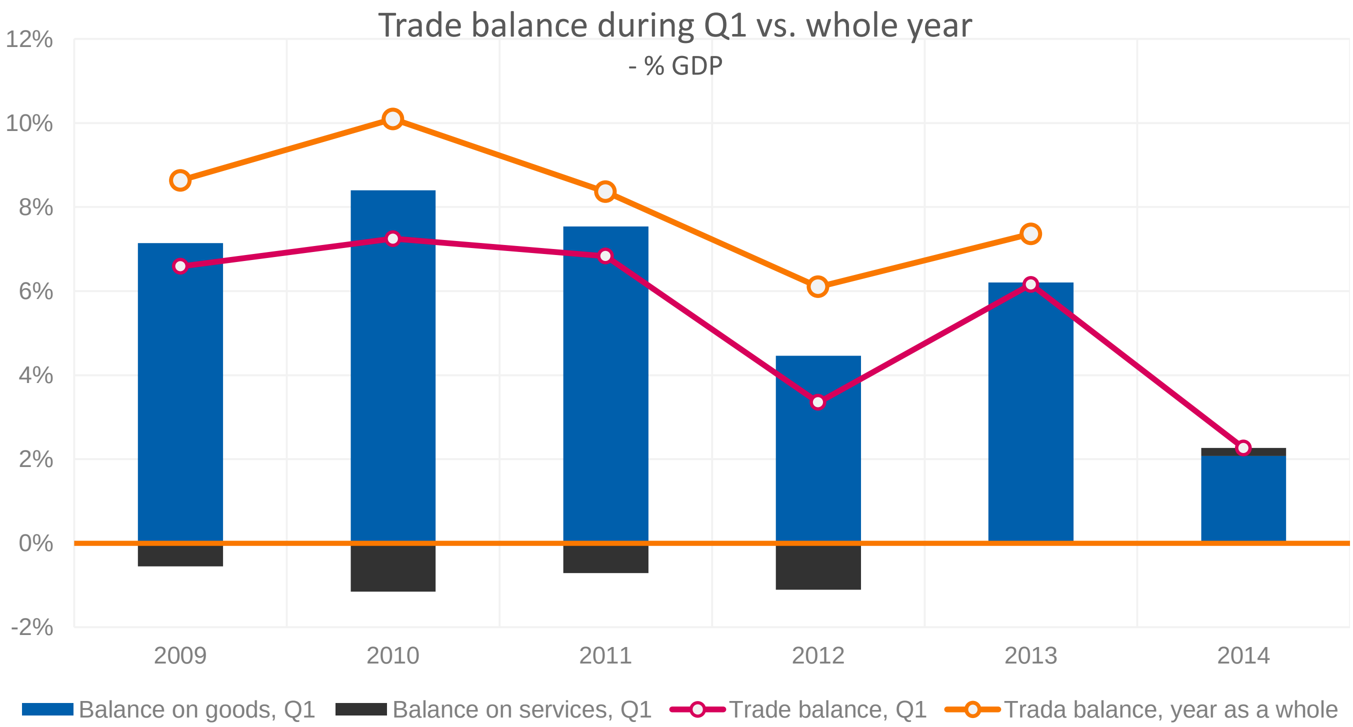
What surprised us, however, was the soft balance on services, considering that we had expected strong service exports to pick up the slack from the goods sector. The smaller than expected rise in the surplus on services can mostly be attributed to an unexpected jump in imports of Other services.

Our forecast for the year assumed that the trade surplus would remain unchanged from last year at roughly 130 bn. ISK, while the underlying current account surplus would drop to 90 bn. ISK after taking the income deficit into account. The Q1 numbers suggest that our forecast is probably off by 15-20 bn. ISK for the year as a whole, since we slightly underestimated the impact of the collapse in capelin on the goods surplus and overestimated growth in the services surplus. However, this does not change our view on the outlook going forward or affect our forecast for subsequent quarters, since the capelin season is mostly restricted to Q1, and it should be expected to rebound next year.



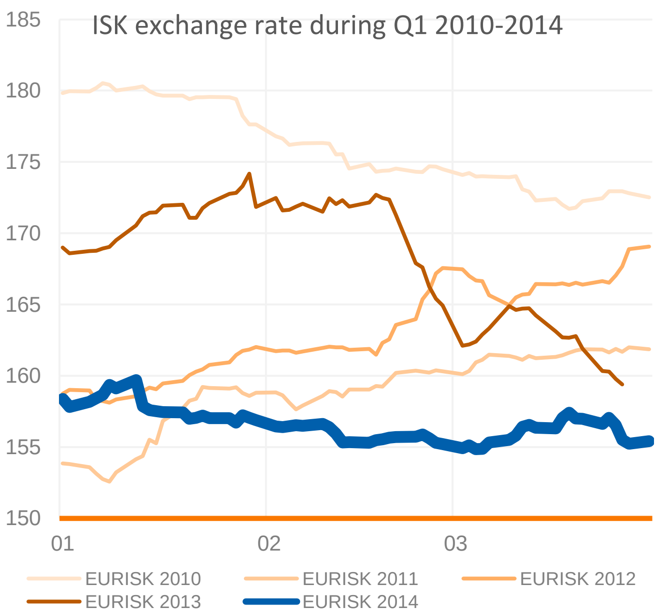
Sources: CBI, Arion Research forecast

It should also be considered that the trade balance tends to be substantially weaker in Q1 than in the year as a whole due to seasonality factors.

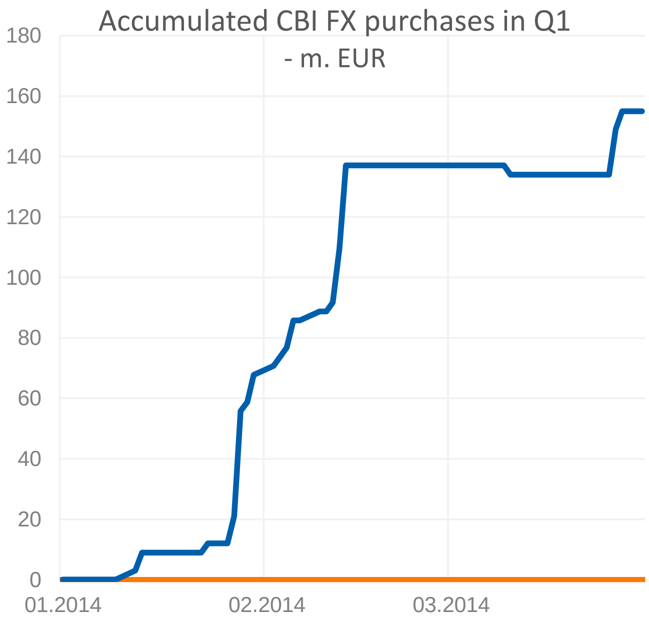


Source: CBI

Now for the caveat promised earlier. Despite the awful current account numbers, the economy's balance of payments displayed no symptoms of being under pressure – indeed, the quarter gives a shining example of just how limited the recorded current account can be at uncovering underlying flows of FX. The ISK exchange rate remained stronger than in previous years throughout the quarter, even appreciating modestly despite the CBI purchasing 150 m. EUR via forex market intervention. Considering its small impact on other macro variables, we are hardly worried about the apparent beating the current account took during the quarter.



Source: CBI

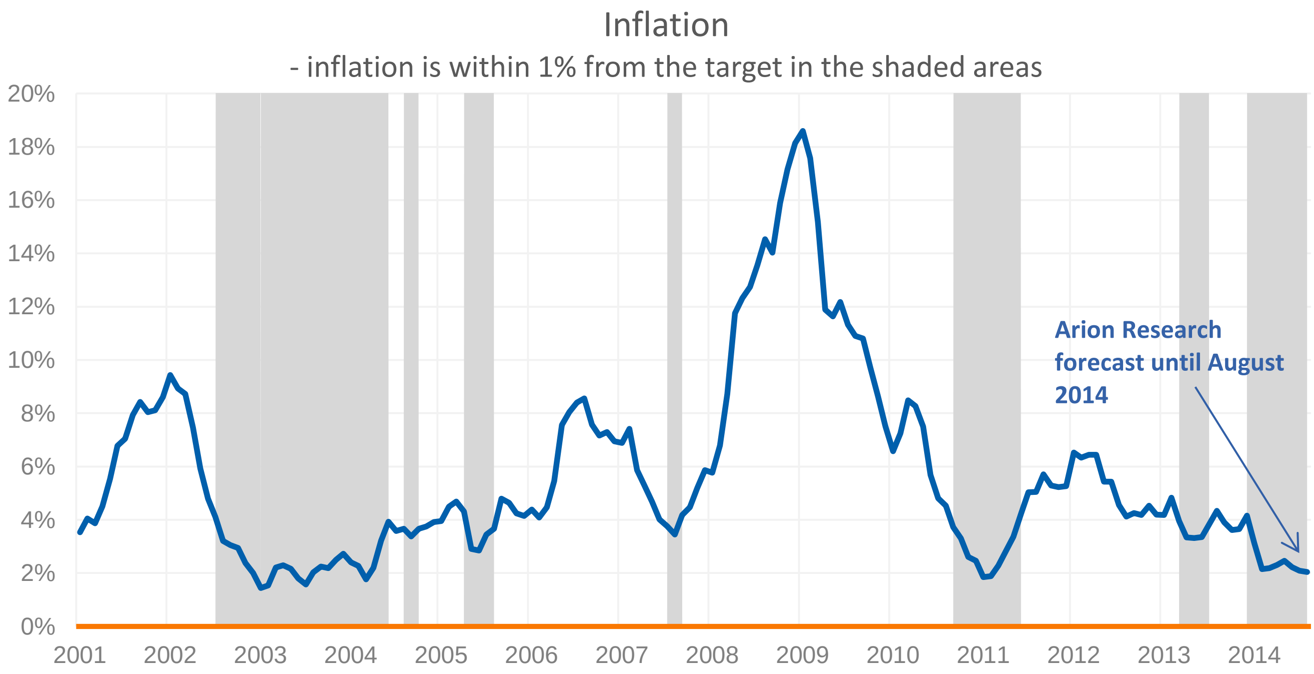


Source: CBI

This apparent discrepancy can stem from a number of sources, the most likely being:
1) The modest foreign debt maturities in 2014, resulting in domestic firms hoarding less FX during the quarter.
2) The current account might have included unusually many transactions not involving ISK changing hands, for instance due to firms with limited domestic operations or due to the failed banks, which have FX on hand to pay for all foreign services bought.
3) Unrecorded inflows of FX – errors and omissions amounted to 73 bn. ISK during the quarter.

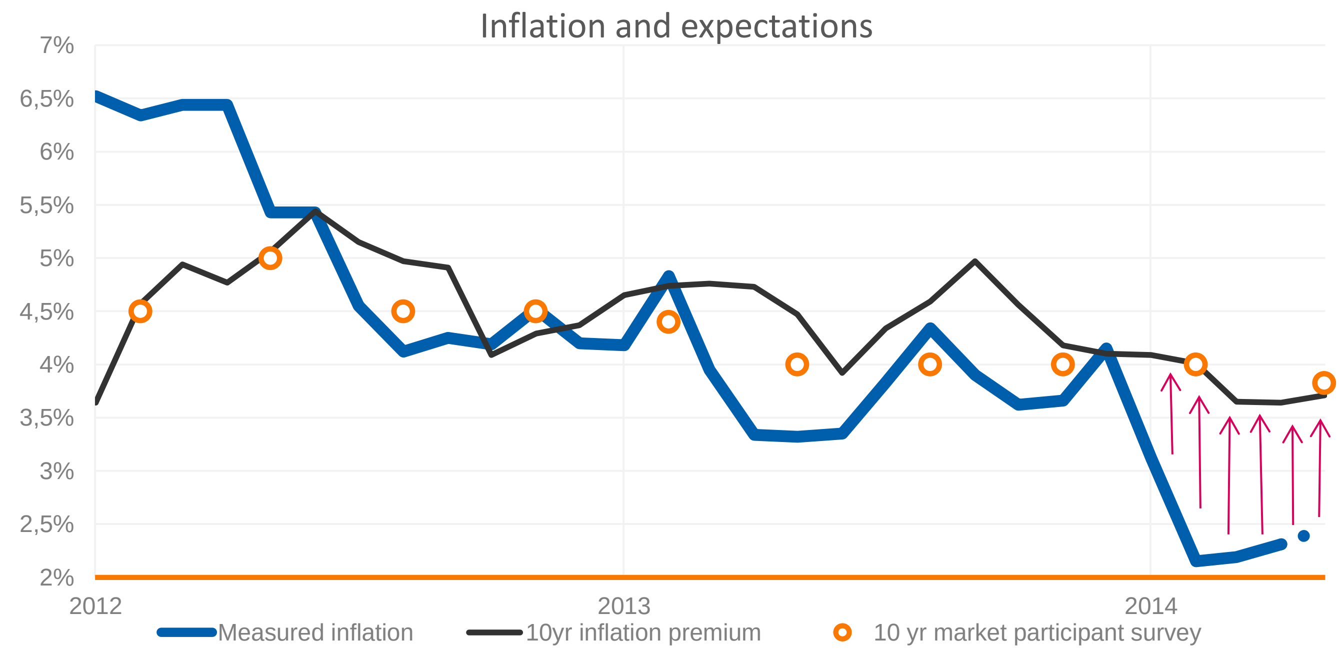
Inflation in Iceland - in choppy waters without an anchor

The Central Bank of Iceland has made some headway recently when it comes to meeting monetary policy goals. Currently we are headed for the longest period of low and stable inflation (from 1.5-3.5%) since 2004. Unfortunately the bar has not been set very high – inflation has not stayed continuously within a percentage point of the inflation target for longer than two years since an inflation target was implemented.



Sources: CBI, Arion Research

This poor historical performance has resulted in rather deep rooted distrust of the Central Bank's capacity to ward off inflation. Thus, longer term inflation expectations remain high despite success in recent months.



Sources: Statice, CBI

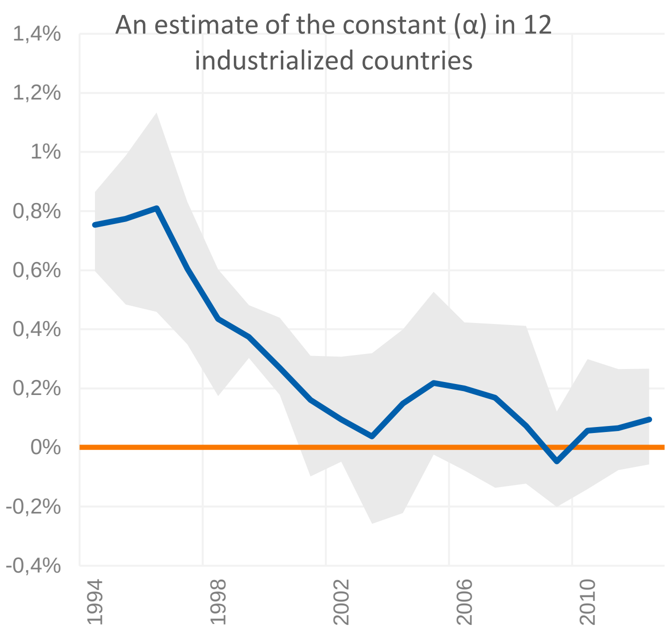
Unanchored inflation expectations

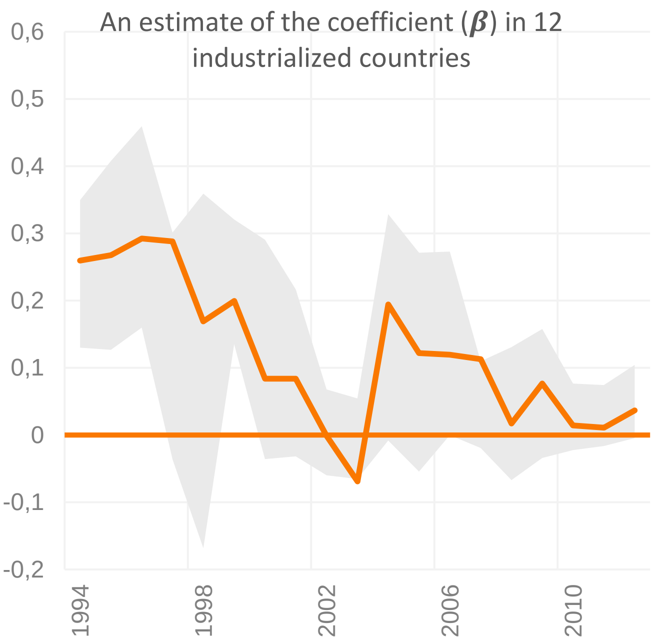
In order to get an idea of just how anchored inflation expectations are we can estimate the following relationship:

Deviation of inflation expectations from $\text{target}_t = \alpha + \beta$ x deviation of measured inflation from $\text{target}_t + \varepsilon_t$

The constant, α, represents how much of an anchor the stated inflation target provides, and the coefficient, β, represents how measured inflation affects inflation expectations. When people are generally confident in the ability of the Central Bank to meet its monetary policy goals both parameters will be close to zero.

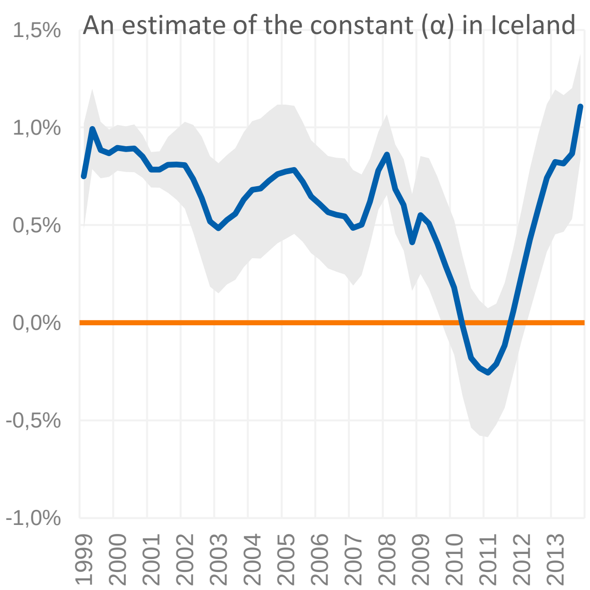
A 5 year rolling regression, using data from 12 industrialized countries, demonstrates that many countries that use inflation targeting have managed to anchor inflation expectations quite firmly to target. However, it seems as though this process has taken some time – the trust in Central Banks' abilities to safely steer economies away from inflation is not established overnight.

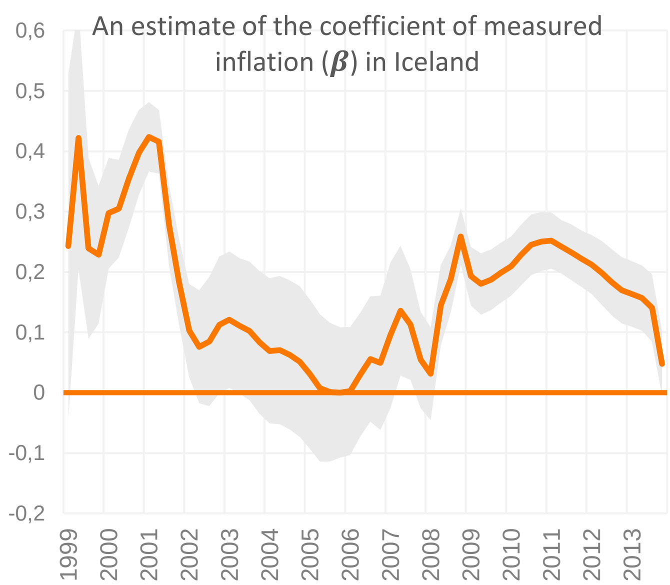




Sources: IMF, Data from Canada, Norway, Sweden, Switzerland, Great Britain, Germany, Spain, France, Italy, Holland, Japan and the United States. Inflation expectations are to five years in five years and are measured by expectations survey. The gray area shows upper and lower quartiles of the regression for the 12 countries.

In Iceland the picture looks quite different. Even though inflation has been on a downward trend since 2009 these credibility parameters have not been too close to zero and have, in fact, not simultaneously approached zero in the last 15 years. In other words, inflation expectations in Iceland have not been anchored very firmly over the past years.





Sources: Arion Research. Long term bond market yield premia are used as a proxy for inflation expectations. The gray area represents one standard deviation.

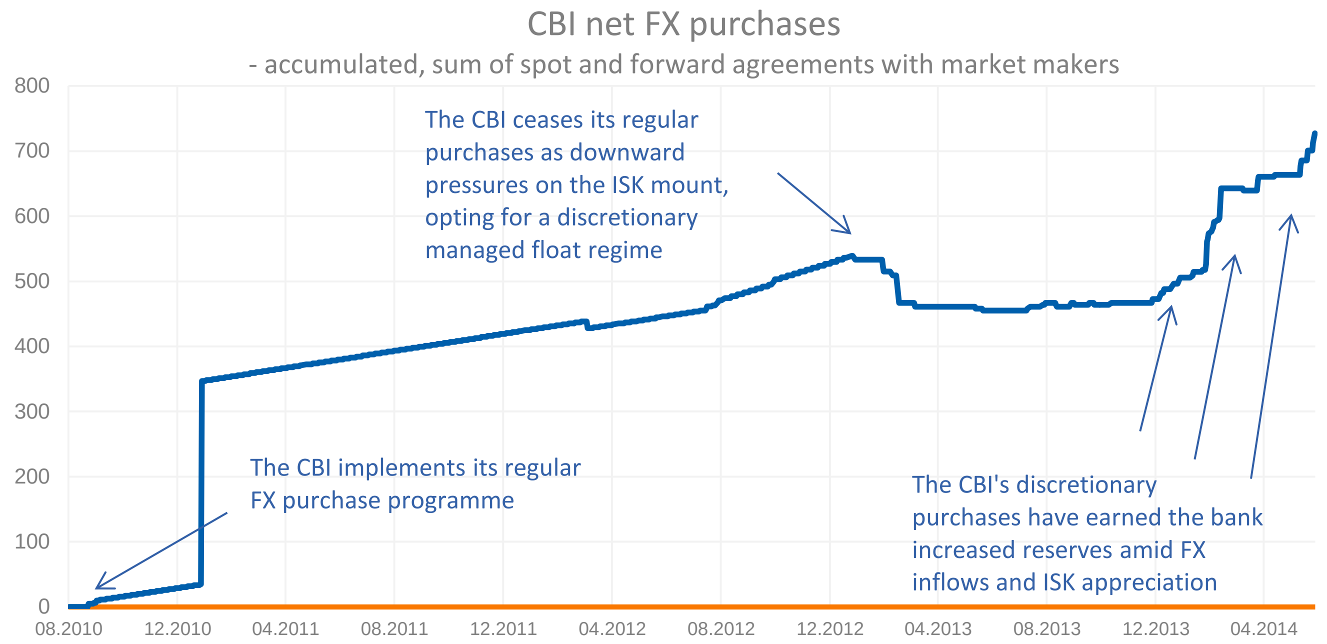
Why are inflation expectations so important?

Inflation expectations tend to be a self-fulfilling prophecy to a certain extent. When people expect high inflation they are more likely to demand higher wages, which instantly put pressure on prices etc. When inflation expectations are unanchored odds are that stimulus, whether it be fiscal or monetary, will put upward pressure on prices instead of positively affecting production and employment – in other words, its nominal effects will dominate the real effects. When expectations are firmly attached to target, however, this tends to work the other way around – demand stimulus positively affects production and employment, not prices.

The Monetary Policy Committee of the Central Bank of Iceland seems to be focused on longer term inflation expectations these days. The fact that they remain high has made committee members averse to lowering rates in the near future. Before that becomes an option they would like to anchor expectations more firmly to target.

The CBI accumulates foreign currency reserves

There was not much particularly noteworthy in the last statement of the Central Bank's Monetary Policy Committee on June 11. Besides leaving rates unchanged the Committee stated that the Bank would focus on continuing to accumulate unleveraged foreign currency reserves. Even though the CBI has been a net buyer of foreign currency in recent months we have seen a high degree of exchange rate stability and inflows of currency are expected to be high over the summer months due to what will most likely be a very active tourist season. The CBI states that therefore, the Bank will resume regular foreign currency purchases to the tune of 3 million euros per week. The amount will be re-evaluated in the fall or possibly earlier if circumstances warrant. Although this will be in addition to discretionary intervention in the market, performed in order to maintain exchange rate stability, these measures are not primarily meant to affect the ISK exchange rate, but mainly to accumulate unleveraged forex reserves.



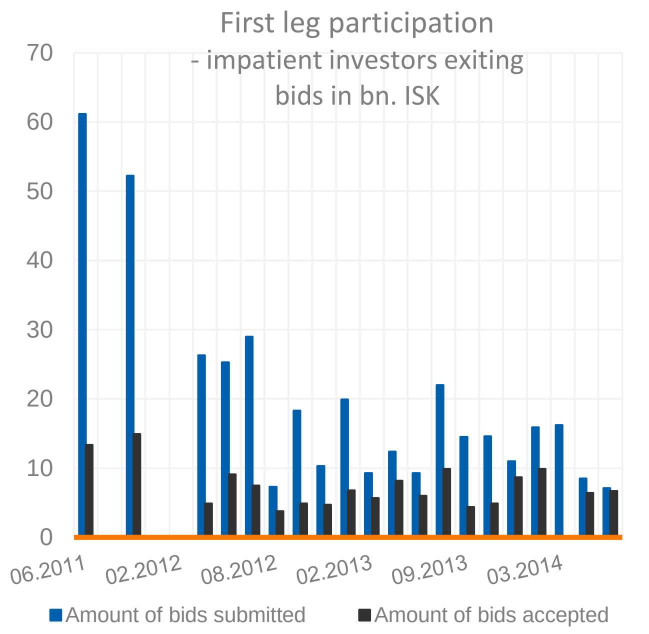
Source: CBI

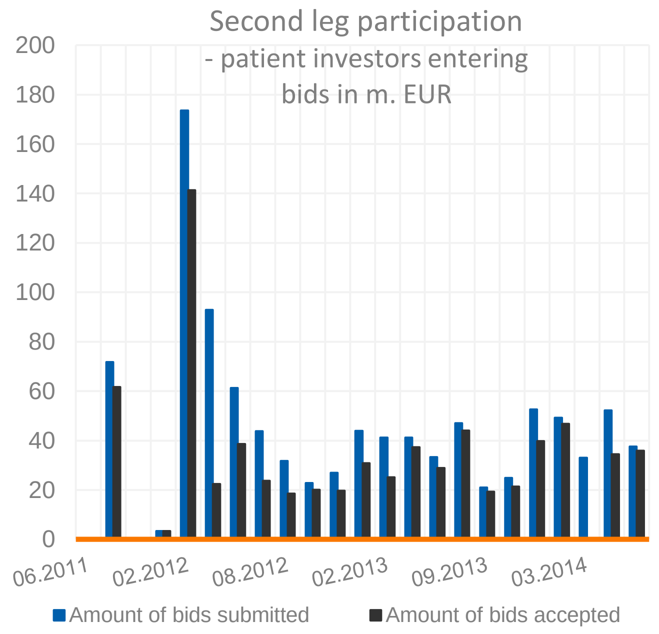
As can be seen in the graph above, the Central Bank has purchased considerable amounts of currency over the past few months. Since the Bank introduced a managed float regime in May 2013 the bank has purchased a net amount of approximately 42 bn. ISK worth of foreign currency, 35 bn. ISK of which has been in 2014.

The MPC has repeatedly voiced concerns over a contraction in public saving, i.e. a contraction in the current account balance. Monetary authorities can promote public saving either by raising interest rates or weakening the real exchange rate. We wondered whether the Bank's intervention in the FX market meant that the committee intended to temporarily weaken the real exchange rate, instead of raising interest rates, in order to encourage public saving. However, the CBI governor pointed out that depreciating the real exchange rate could fuel inflation, which ceteris paribus would call for an interest rate hike. Thus, using one tool to replace the other would be questionable.

Further appreciation in the CBI's latest currency auction

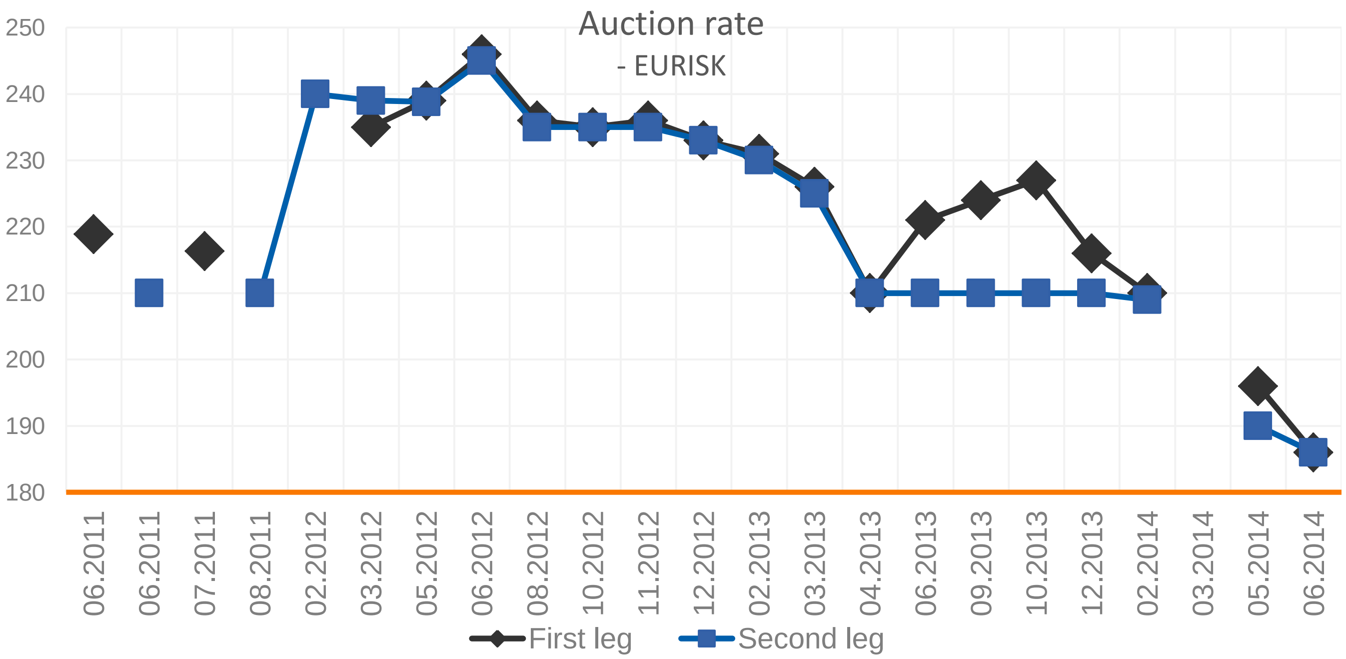
The size of the Central Bank's currency auction, held on June 24, was 35.9 m. EUR, measured by funds matched, which is slightly below the 2013-2014 average of 44 m. EUR. The participation rate of non-residents exiting Iceland continues to fall while bids from investors wanting to enter the economy remain relatively strong.





Sources: CBI, Arion Research compilation

The auction rate has been appreciating steadily and dropped to 186 against the euro, the lowest since the auctions were intiated, down from a high of 245 in mid-year 2012. The discount investors are willing to accept is also decreasing, from over 35% in 2012 to roughly 16% in the last auction. This might be another indicator that outflow pressures are subsiding and that non-residents are content with their ISK positions. Earlier this year, the governor attributed the appreciation to strategic bidding, but it seems to be persistent enough to actually constitute a reliable price signal / indicator of subsiding outflow pressures. Hopefully, all these factors will turn out to be conducive to lifting capital controls going forward.



Sources: CBI, Arion Research compilation

As usual, the investment programme remained the popular choice in the second leg, with hardly any capital flowing into government bonds. Since investors taking advantage of the investment programme need to bring matching funds in through the on-shore interbank market, we would expect to see some inflows in the coming weeks, either putting upward pressure on the ISK or allowing the CBI to accumulate reserves.