ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | November 2014

Delayed Take-off: Economic Outlook 2014-2017

Arion Research published a new economic forecast in October. Although growth in the first half of the year was lacklustre we believe that the outlook is positive. In the near term we assume that GDP growth will be hampered by imports. However, since a large part of that is due to investments we expect to see a pickup in growth about two years down the line.

Is low inflation here to stay?

Icelanders are no strangers to high inflation. Recently though, inflation has remained below the Central Bank's inflation target. Can and will it remain so low? We examine the main drivers of inflation in Iceland historically as well as inflation prospects for the coming quarters.

How high can the real exchange rate go while still allowing for a trade surplus?

Since hitting historical lows in 2009 the real exchange rate of the Icelandic króna has appreciated by over 25%. Nevertheless, it still remains about 7% below its 20-year average. We wanted to examine how much room there was for an appreciation of the real exchange rate while attempting to maintain a trade surplus.

Firms continue on their path of deleveraging

Icelandic firms have been deleveraging steadily since the financial crisis in 2008 and their collective debt as a percentage of GDP is now similar to what it was about a decade ago. Default rates have also come down sharply. Business leaders are the most optimistic they've been in a decade so the economy seems ripe for some new, growth creating investments.

The CBI's unexpected rate cut

Analysts had been predicting that the Central Bank of Iceland would leave rates unchanged on November 5 so it came as a surprise to most when the Monetary Policy Committee decided to lower rates by 25 basis points. With lower than expected inflation the real rate has risen beyond what the MPC deems appropriate for current economic conditions. Additionally, the CBI's growth forecast for 2014 was revised downward.

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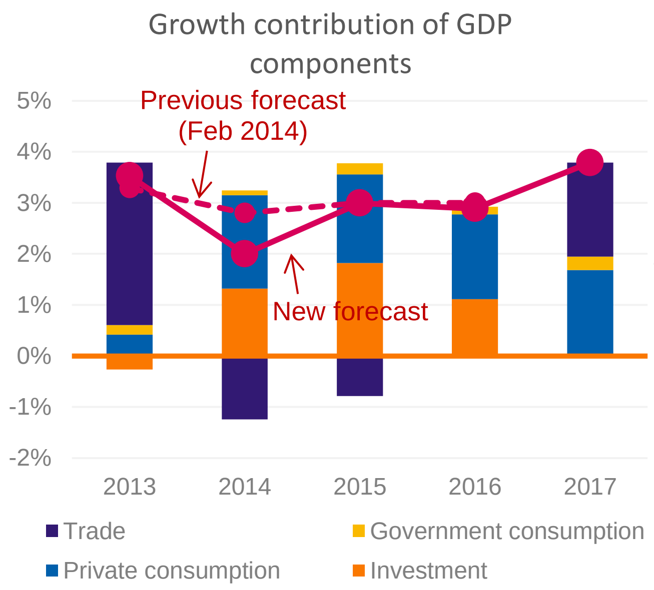
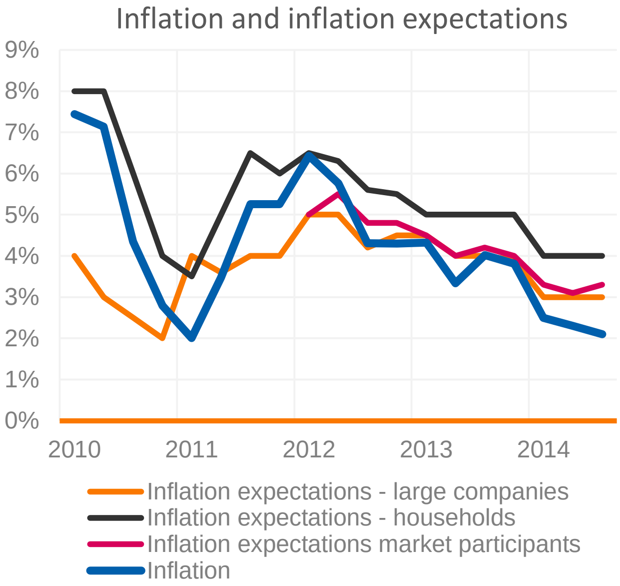
Arion Research has published a new economic forecast for 2014-2017 titled „Delayed Take-off“. GDP growth in the first half of 2014 was a disappointment at only 0.6%. However, when examining its components there are some positive signs. Investment, mainly in housing and business, is picking up, terms of trade are improving, which should support a positive current account balance, and private consumption growth seems more sustainable than before.



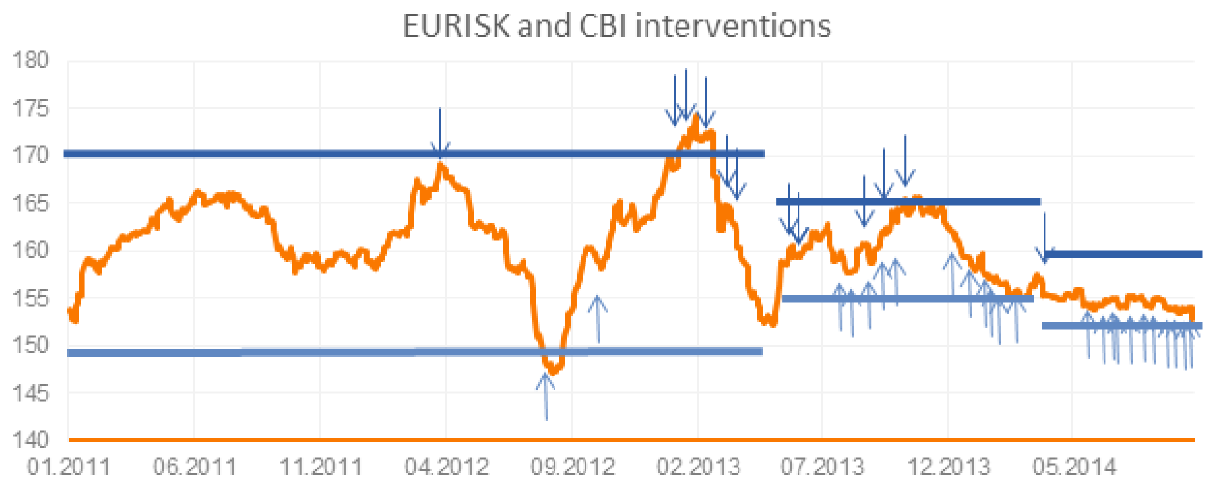


Sources: Statistics Iceland, Central Bank of Iceland, Arion Research

This year and next we expect the trade component to hamper economic growth due to stronger import than export growth. However, a part of that is due to investments which should improve growth prospects two years down the line. Inflation has remained low and has been below the CBI's inflation target for the past eight months while longer term inflation expectations of firms and households remain quite sticky at around 3-4%.

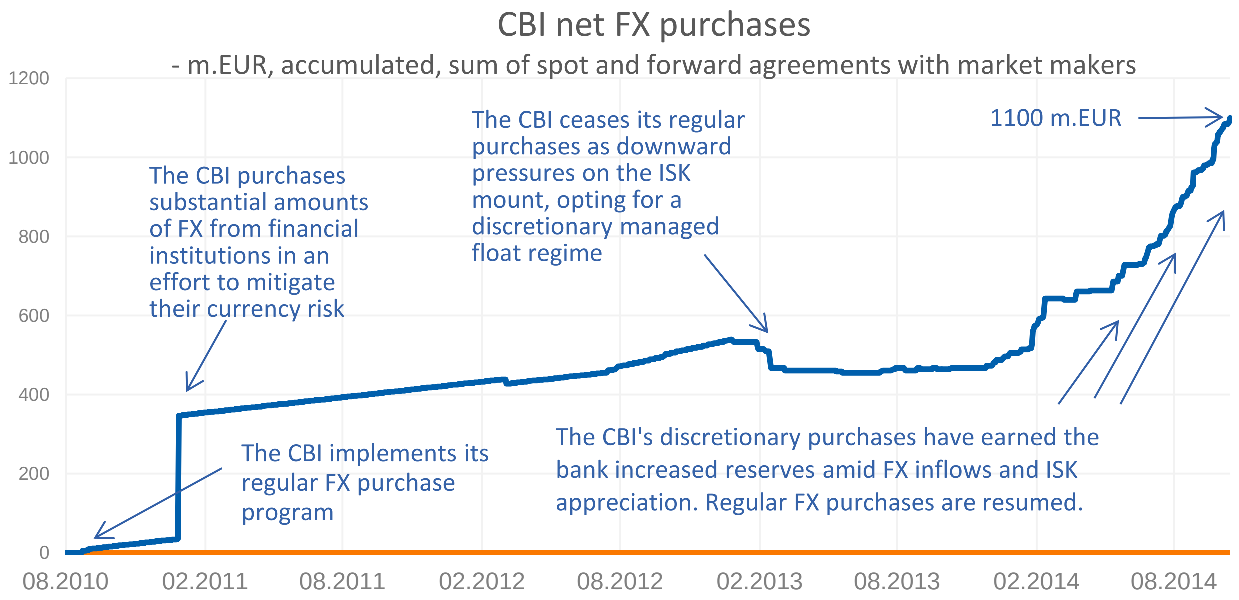
Historically the main drivers of inflation have been; ISK volatility, private consumption and wage agreements being in excess of the CBI's inflation target. Inflation expectations have proven difficult to manage and generally remain high even in periods of low inflation, such as now. Wage agreements have historically reflected these expectations by allowing for wage increases well in excess of productivity growth + the CBI's inflation target. These expectations then become self-fulfilling to some extent and fuel inflation. This tendency is one of the main causes for concern when looking at near term inflation prospects. More on that in: [Is low inflation here to stay?]

High frequency indicators, such as ISK volatility, suggest that inflation in the near term can be kept at its current low levels. However, the impending abolition of capital controls threatens the stability of the króna in the short term and is likely to put upward pressure on inflation.



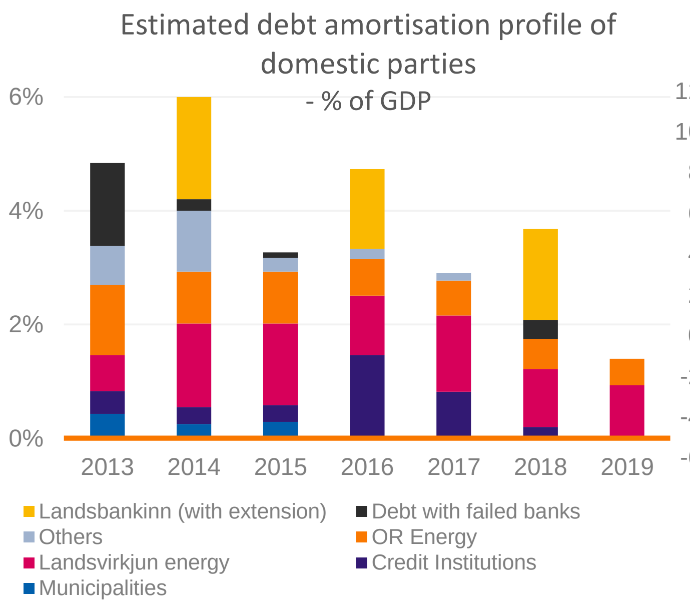
Sources: Central Bank of Iceland, Arion Research

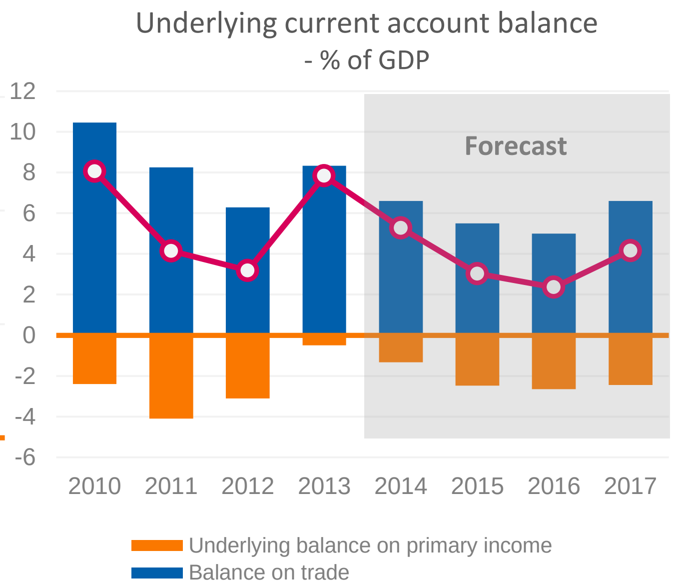
CBI interventions in the FX market have kept the ISK very stable in recent months while adding substantially to the Bank's currency reserves. Over the past four years the CBI's net purchases have amounted to about 1,100 m.EUR, with the bulk of that amount being accumulated over the past year.



Sources: Central Bank of Iceland, Statistics Iceland, Arion Research

In our projections we assume that the Landsbanki bond will be extended and that the current account balance will cover a large share of other foreign debt repayments due over the next three years. This is aside from any possible currency inflow related to FDI.



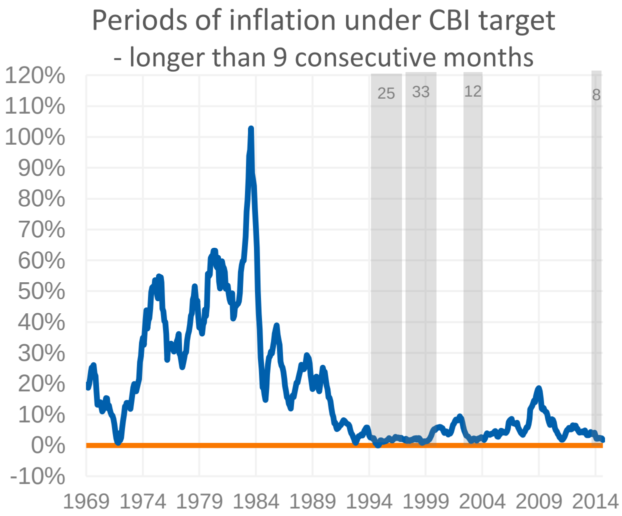


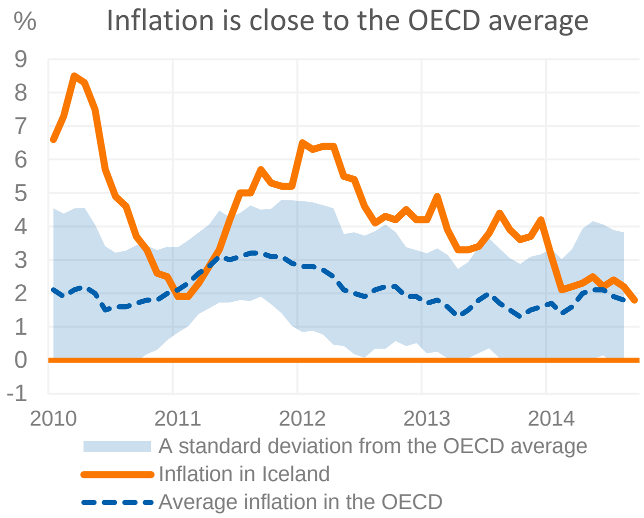
Sources: Central Bank of Iceland, Arion Research

Overall, the outlook for the Icelandic economy is quite positive even though "take off" has been slightly delayed. Meanwhile, the groundwork is being laid for healthier and more sustainable economic growth - indicators currently point to a good, but fragile, economic balance. Private consumption and investment will be the main drivers of growth over the next couple of years with increased exports kicking in towards the end of the forecast period. Risk factors remain, such as meager times ahead for main trading partners, and the possible failure to timely and sensibly remove capital controls. Despite hopes to the contrary the authorities have been silent regarding that issue over the past month.

Is low inflation here to stay?

Inflation in Iceland has remained below the CBI's target over the past nine months and is currently close to the OECD average. This is unusual both in a historical context as well as when compared to other OECD countries. How long can and will inflation remain this low?





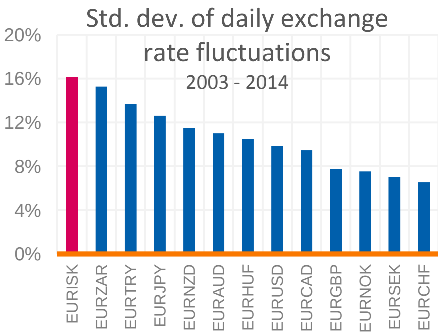
Sources: Statistics Iceland, OECD

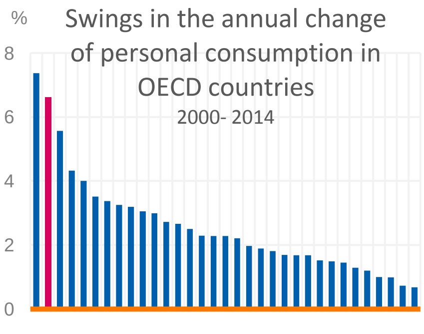
Since 1970 Iceland has only experienced three periods of inflation consistently below target for more than 9 consecutive months - in the years 1994-1999 and in 2003.

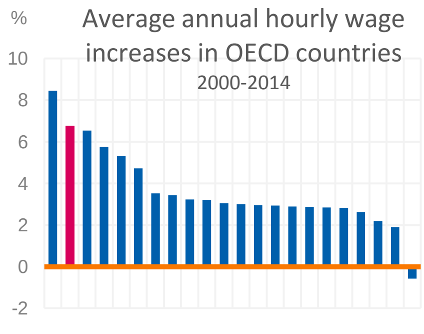
Over the past decades high inflation in Iceland has mainly been associated with three factors;

1) fluctuations in the ISK exchange rate
2) excess demand for goods and services and
3) labor market pressures.

Since 2003 the Icelandic króna has been one of the most volatile high yield currencies around. Even before the sharp depreciation of the króna in 2008 the ISK was relatively unstable. Along with exchange rate fluctuations we have seen large swings in the change of personal consumption. High and sticky inflation expectations have also lead to high nominal wage increases.

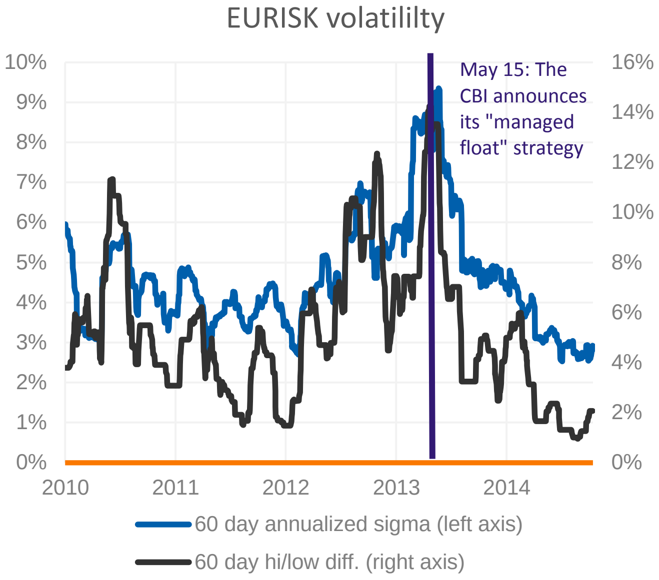


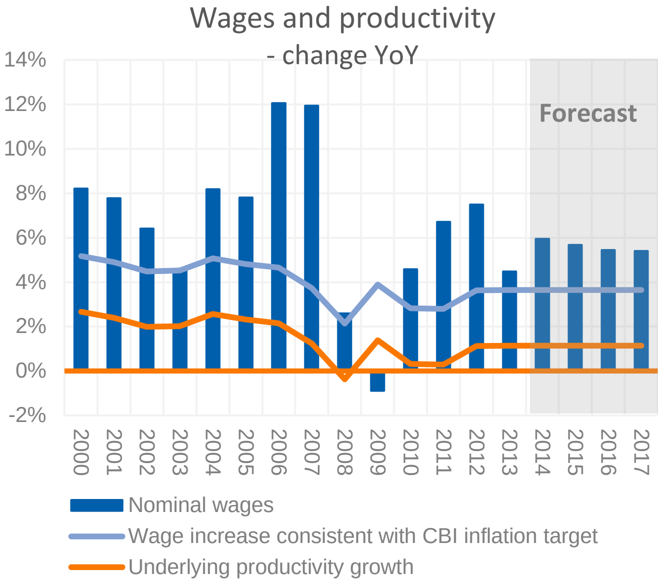




Sources: OECD, Statistics Iceland, Bloomberg, Arion Research

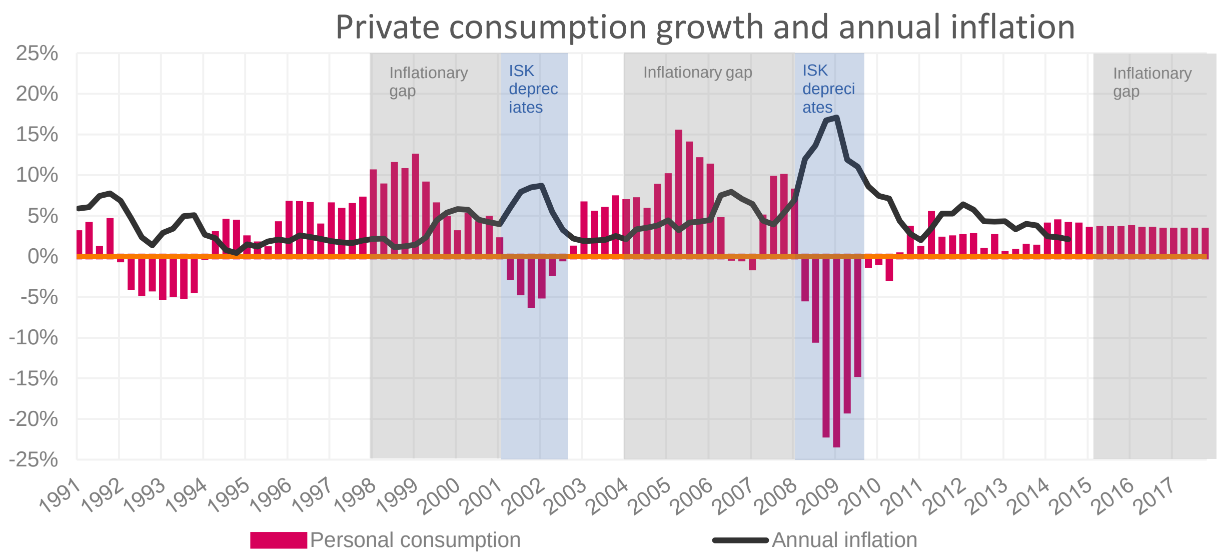
Where are we now? The Central Bank's „managed float" strategy has resulted in significantly lower ISK volatility, making it one of the world's most stable currencies over the past year or so. Last year's wage increases were not too far beyond the CBI's target, but we expect tensions in the labor market to increase and wage agreements to be farther beyond the target over the next few years.





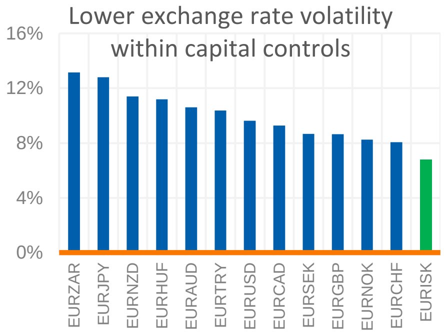
Sources: Central Bank of Iceland, Statistics Iceland, Arion Research

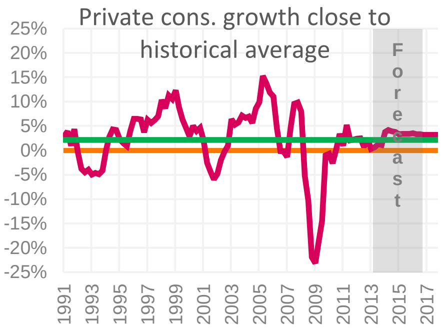
Private consumption has been picking up, but is still not growing at a very high rate in a historical comparison. Deleveraging has been going well, defaults on loans have come down considerably over the last few years and it looks like the appetite for debt financed consumption has decreased. This also serves to keep the króna more stable. In 2001/2002 and 2008 the ISK depreciated after a period of rapid growth in private consumption. Periods of strong consumer growth and increased imports, followed by a substantial current account deficit, have generally fueled inflation via a depreciation of the króna, followed by a correction in the real exchange rate as shown in the graph below.

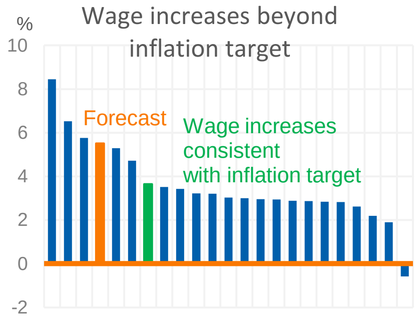


Sources: Statistics Iceland, Arion Research

Luckily, we find ourselves in a different situation today; we have had a trade surplus for the past few years, private consumption as a percentage of GDP is relatively low and we are expecting rather modest growth in private consumption over the next few years. Therefore, demand driven inflation is not as much of a worry as often before. However, should consumption grow more rapidly than assumed with an associated increase in imports and a dwindling trade surplus, or even deficit, we might find ourselves back in an uncomfortable situation.







Sources: OECD, Statistics Iceland, Bloomberg, Arion Research

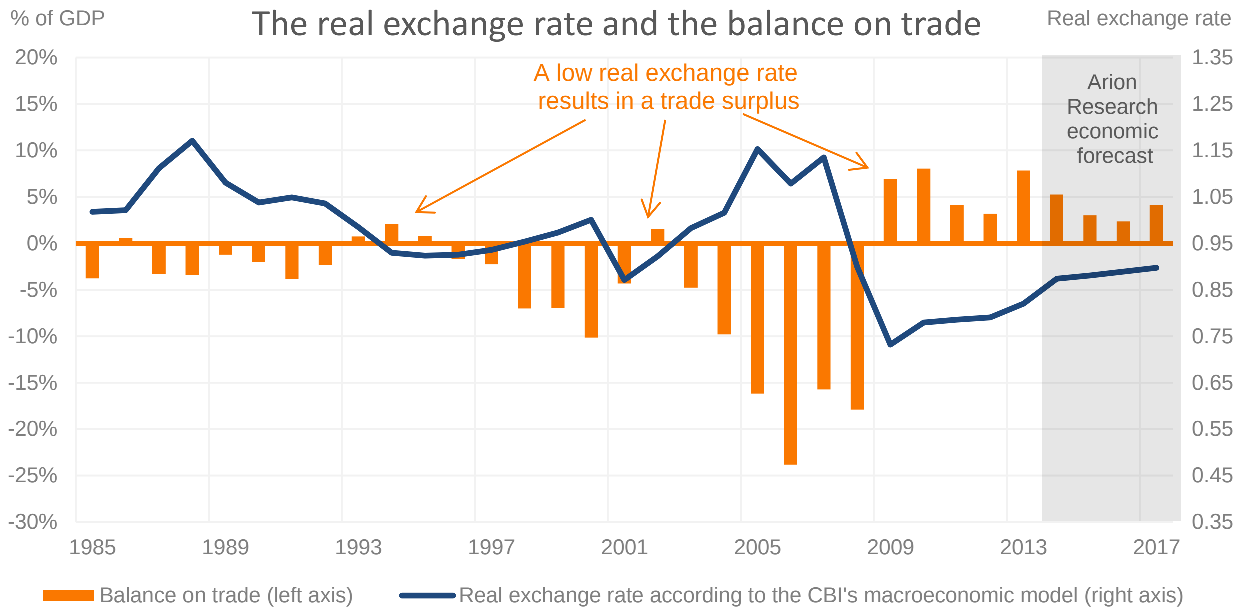
Low inflation in recent months is no doubt to some extent thanks to capital controls and the CBI's interventions in the FX market. It is difficult to estimate the possible effects capital account liberalization could have on inflation. Given the strengthening of the ISK over the past year and the Central Bank's intervention in the market being aimed towards preventing the króna from strengthening even more it is entirely uncertain that we will see a very sharp depreciation of the króna even though more volatility is to be expected for sure. Inflation in main trading partner countries is extremely low right now and expected to remain that way for a prolonged period so we are not expecting much imported inflation. Until the króna is allowed to float, at least somewhat freely, upcoming wage negotiations are perhaps the largest threat to the price level in Iceland.

How high can the real exchange rate go while allowing for a trade surplus?

Over the past year the real exchange rate of the Icelandic króna has appreciated by more than 5% - over the past 5 years it has appreciated by more than 25%. Indeed, it was at historical lows in Q3 of 2009 and despite recent appreciation it still remains below its 20-year average by almost 7%.

We wanted to examine how much room there is for a strengthening of the króna while attempting to maintain a trade surplus over the next few years. The cause of the appreciation is important – improved terms of trade or a high relative increase in productivity could result in sustainable appreciation, while appreciation due to high wage increases and consequent inflationary pressures could prove to be unsustainable.

When the real exchange rate is relatively low the position of export industries becomes more favorable while the purchasing power of Icelanders abroad is diminished. Consequently we tend to see an inverse relationship between the level of the exchange rate and the balance on trade. Over the past decades a high real exchange rate coupled with high economic growth has led to high growth in personal consumption, which usually results in import leakages. A prolonged period of trade deficits from 2003-2008 is a good example.



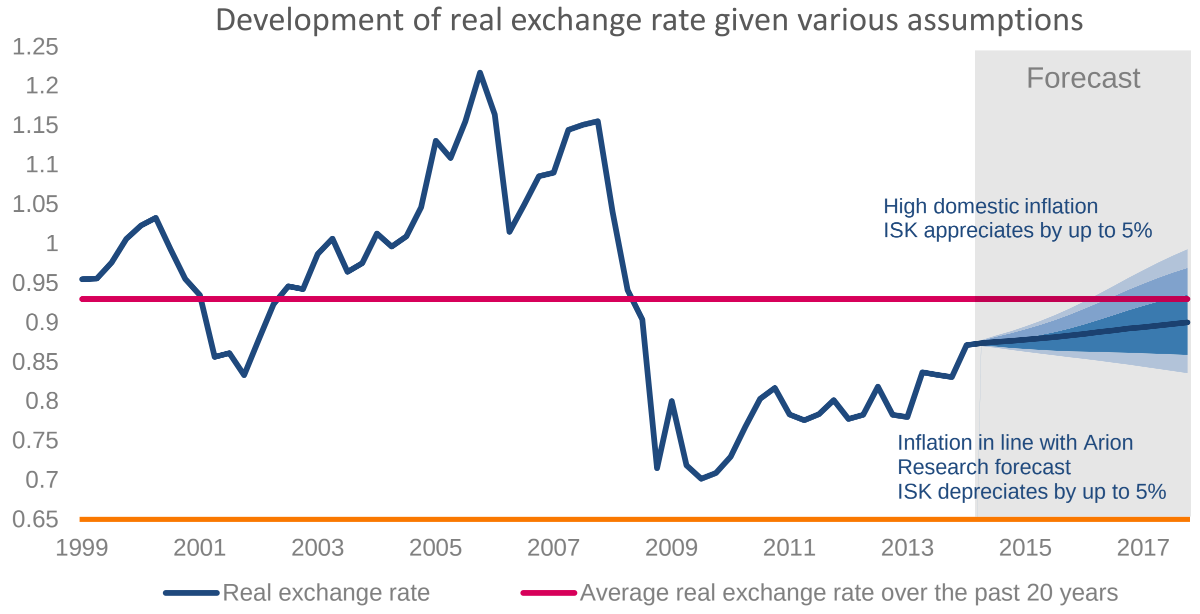
Sources: Central Bank of Iceland, Arion Research Economic Outlook 2014-2017

Arion Research is assuming a continuing but decreasing trade surplus, rather low inflation and a stable exchange rate. We also assume that wage increases will be moderately above the CBI's inflation target + productivity increases. If we factor in the CBI's assumptions about inflation in main trading partner countries we can extrapolate the development of the real exchange rate in the coming years as pictured above. In our economic forecast we assume that the exchange rate will climb slowly and that it will remain low enough in order to maintain a trade surplus.

We also wanted to look at alternative scenarios – what if wage increases exceed our predictions, increasing inflation in turn? Is there room for the exchange rate to appreciate further if we want to maintain a trade surplus? We looked at a few possible scenarios considering variations in the development of the exchange rate, domestic inflation and inflation in countries of main trading partners.

1) A continuing low real exchange rate: We assume that domestic inflation will be in line with or lower than our forecast, which assumes an annual average of 2.8% in the years 2015-2017.
2) An increase in the real exchange rate: We assume that wage increases will be above the CBI's target, inflation will be around 3.7% in 2015-2017 and that the nominal exchange rate will stay constant or appreciate by up to 5%.

The blue areas in the graph below represent the different scenarios previously described, which additionally assume that inflation in main trading partners countries will be slightly above, below or in line with the CBI's latest *Monetary Bulletin* forecast.



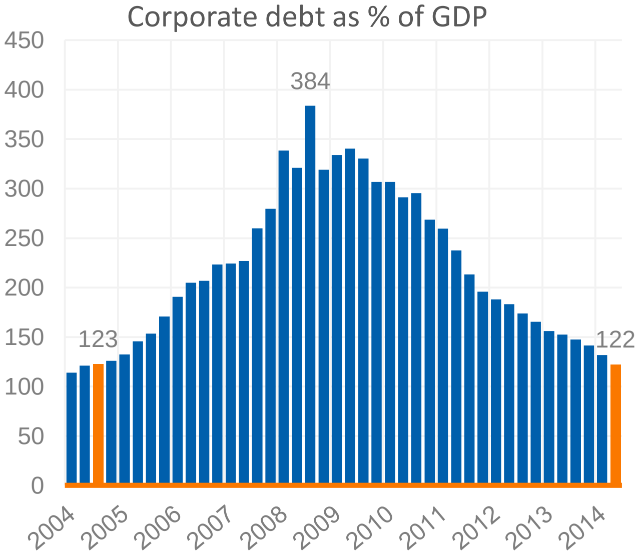
Sources: Central Bank of Iceland, Arion Research

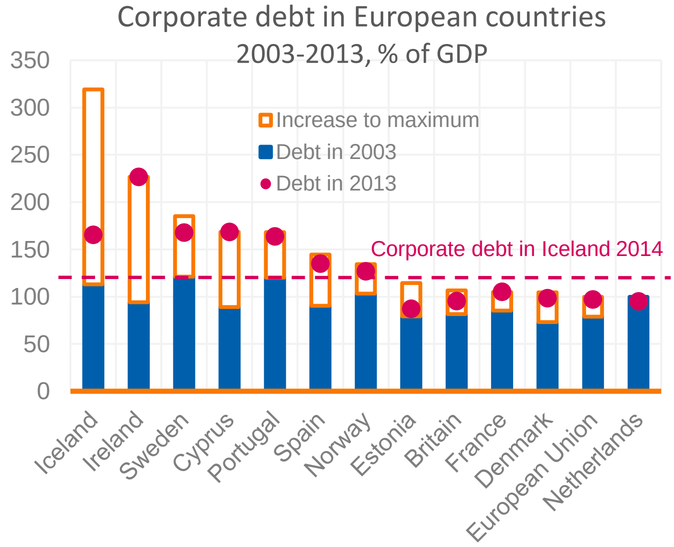
The graph above demonstrates that should inflation be beyond our predictions the real exchange rate could appreciate to its 20-year average in 2017 or possibly earlier. If the nominal exchange rate appreciates as well the real exchange rate could go beyond the long term average, which could threaten the trade surplus in the coming years. We willingly admit that reality is slightly more complicated, especially when dealing with all the uncertainties related to the capital controls. Other factors, such as terms of trade and changes in productivity also affect the real exchange rate. Evaluating what the “optimal” exchange rate is at each point in time is not an easy task. This nevertheless points to the conclusion that there is little room for high wage increases, high inflation or a substantial appreciation of the króna if we want our export industries to remain competitive and imports driven by personal consumption growth to be kept in check. Conditions for the abolition of capital controls could also be compromised if the real exchange rate appreciates much farther.

Firms continue on their path of deleveraging

Arion Research recently published a report on corporate debt in Iceland and how the balance sheets of companies have been developing recently overall. Corporate debt in Iceland reached an extremely high level as a percentage of GDP in 2008, a whopping 384%. Since 2008 corporate debt has exhibited a rapid downward trend and just over the past year it has decreased by 23% in nominal terms. Although the size of the hump in the graph below to the left is to some extent explained by holding companies' massive accumulation of debt in the run-up to the financial crisis and subsequent write-offs this development must be considered positive.

In 2003 corporate debt in Iceland was just over 100% of GDP, similar to peer country debt ratios, while the maximum in 2008 went well beyond that of other European countries. At the beginning of 2013 corporate debt was around 165% of GDP and according to the most recent numbers for 2014 it is down to 122% of GDP.

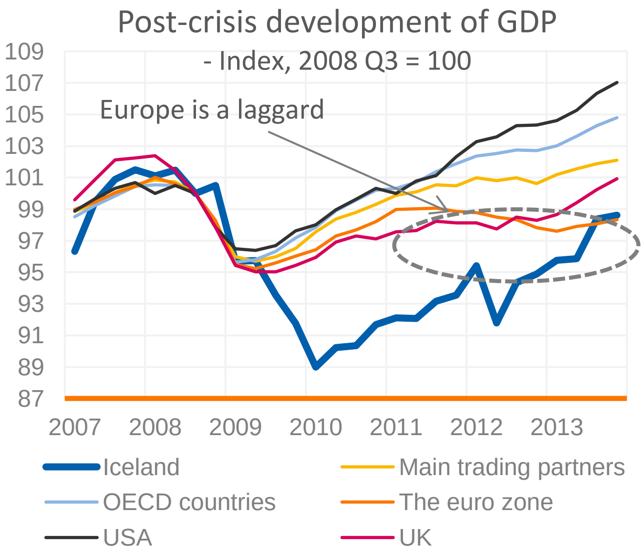


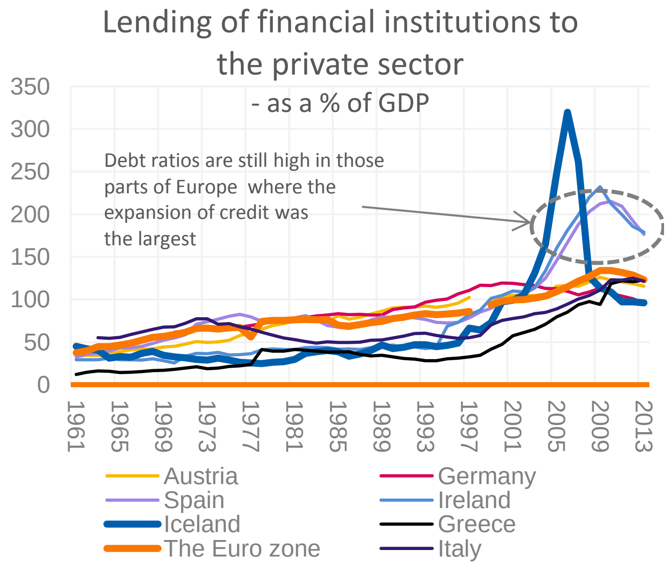


Sources: Statistics Iceland, Central Bank of Iceland

The question is: does debt need to come down even further? Is there a risk of stagnation in the near term or have we reached enough progress so that firms may start investing again, bringing about more economic growth? We have written about private sector deleveraging [before](#) and referred to the McKinsey report from 2010 about financial crises. Our belief that there is room for a healthy pickup in investments, especially in business and real estate, has only been reaffirmed by the latest economic indicators. Furthermore, the latest data indicate that those are indeed the most recent developments.

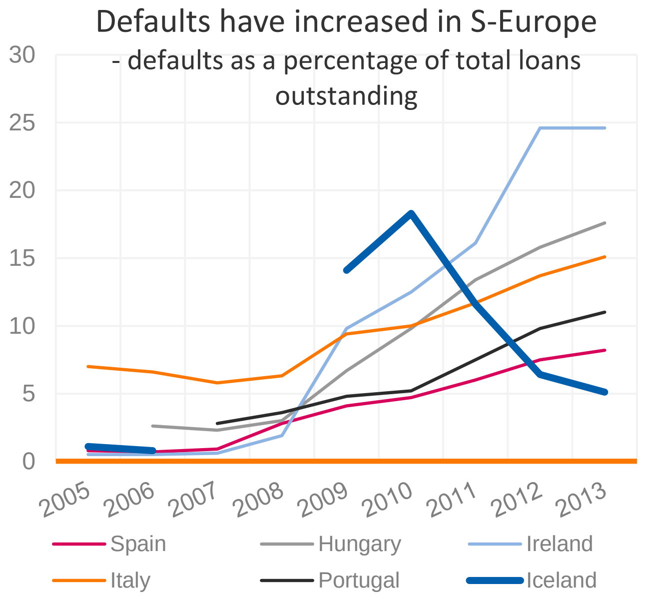
How has the economy fared during this period of sharp deleveraging? Many countries went through a V-shaped period of contraction after the financial crisis, Iceland's being more extreme than that of most others. While Iceland has been growing relatively rapidly over the past two years, the euro zone has been lagging noticeably behind.

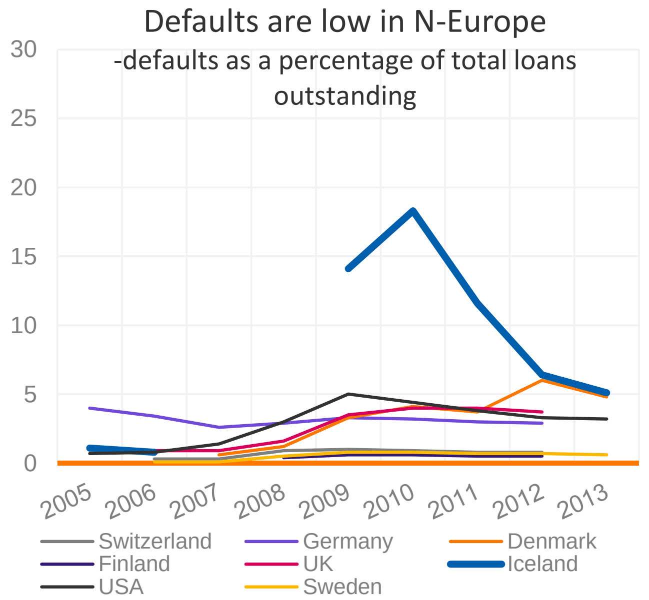




Sources: World Bank, Central Bank of Iceland

Lending of financial institutions has increased rather steadily except in Iceland, Spain and Ireland where it spiked in the years before the crisis. Iceland's debt ratios have come down quickly while those in Spain and Ireland remain high. However, the amount of loans outstanding does not tell the whole story – the quality of loans must be taken into consideration if we are to examine the effect leverage ratios can have on growth. Regardless of its levels, are debtors able to service their debt?

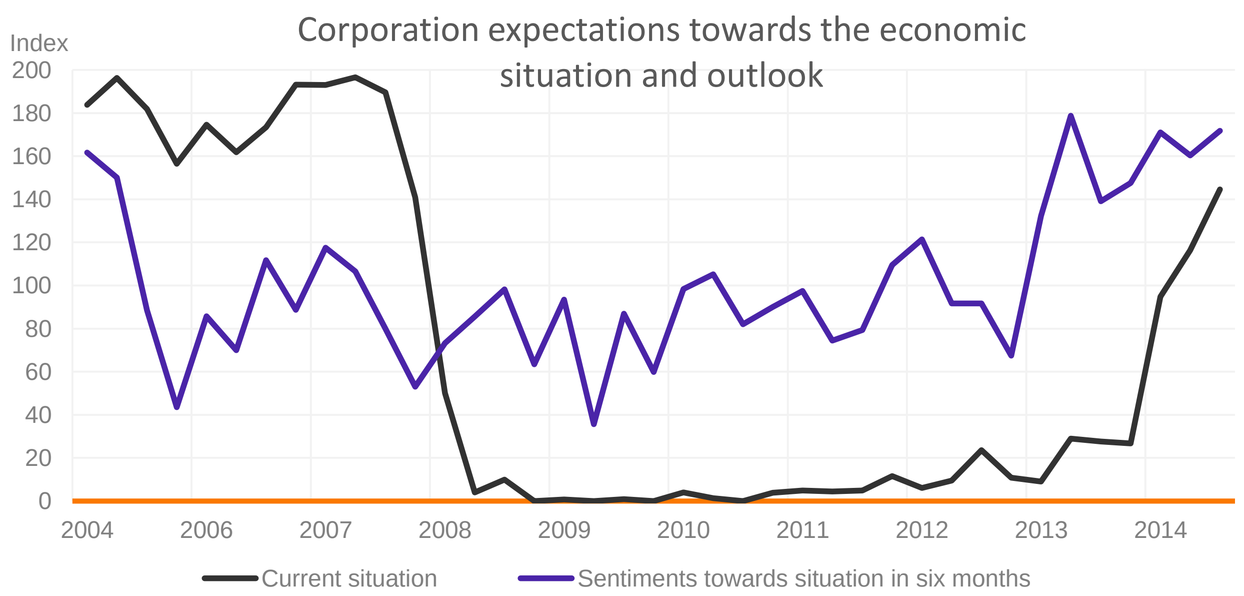




Source: World Bank

In Southern European countries defaults have been increasing steadily since the crisis while defaults in Iceland have been on a downward trend since its highs of 18% in 2010. In 2013 the default ratio was only 5%, similar to Denmark and closer to Northern European countries in general. In Ireland and Spain for instance we are seeing low GDP growth, high debt levels and also high levels of default. Where deleveraging has been successful and/or the quality of debt has been increasing we have seen higher economic growth numbers.

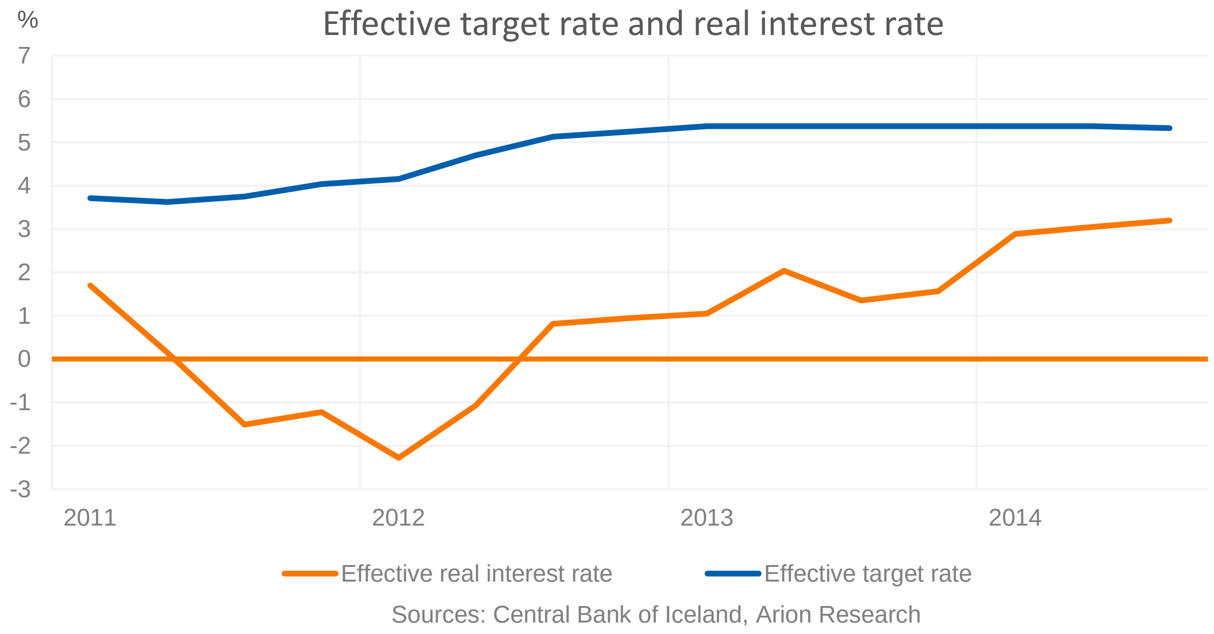
Arion Research is not the only optimist around. Recently the expectations of executives of the 400 largest firms in Iceland have shot up. Last September Capacent Gallup conducted a survey which indicated that 32% of business leaders believed that economic conditions were good, which is an impressive increase by 25 percentage points between years. In addition, 46% of those surveyed believed that conditions would be improved in six months while only 30% thought that would be the case one year ago. The index is currently close to its 2004/2005 levels.



Sources: Central Bank of Iceland, Capacent Gallup

Analysts had been predicting that the Central Bank of Iceland would leave rates unchanged on November 5 so it came as a surprise to most when the Monetary Policy Committee decided to lower rates by 25 basis points. In past announcement the tone has been rather hawkish and the committee has insinuated rate hikes if anything, citing rapid growth in domestic demand as the main worry. On October 1 the committee said this for instance: “*As before, robust near-term growth in domestic demand and growing tension in the labour market could generate increased inflationary pressures… and necessitate an increase in the Bank’s nominal interest rates*.” It can be argued that economic indicators since published do not necessarily give rise to a 180 degree turn in one’s stance on interest rates. However, growth forecasts in various trading partner countries have recently been revised downward, which negatively affects our prospects as far as terms of trade and the competitiveness of our export industries are concerned.

In August the Central Bank was predicting GDP growth of 3,4% in 2014, but has now revised that forecast downward to 2,9%. According to the CBI’s *Monetary Bulletin*, growth is expected to pick up next year, but is then expected to subside again in 2016 with the decreasing effects of the government’s debt relief scheme and slower growth in industrial investment. The CBI still believes that we are on the verge of closing the output gap, but nevertheless determined that other factors weighed more heavily at this point in time when determining the appropriate interest rate level.



Inflation has been decreasing and has remained below target over the past nine months, which means that unchanged nominal rates have led to an unexpected rise in the real rate - to a level above what the MPC believes appropriate given the current business cycle position and near-term prospects. Inflation expectations have also come down rapidly in Iceland in recent months – high and sticky inflation expectations have often been mentioned as a hindrance to lowering rates. Additionally, the króna has remained very stable and there is no indication that the Central Bank would fail to keep it that way in the near future.

The MPC’s statement hints that rates might be cut again if the results of upcoming wage negotiations are not too far beyond the inflation target + productivity increases. Alternatively, the MPC might be forced to increase rates again as pay increases well beyond the benchmark could fuel inflation. Either way, it's apparent that the MPC views upcoming wage agreements as a cause for concern going forward.