Policy rate setting: CBI will be forward looking, raise rates 25 bps

- We predict the Central Bank of Iceland (CBI) will raise its policy rates 25 bps at its interest rate decision on October 3. A sharp depreciation in the ISK exchange rate since the Monetary Policy Committee's (MPC) last meeting is the main catalyst in our prediction, since the inflation outlook has deteriorated due to the pass-through which is sure to follow. The minutes of the last MPC meeting indicate that the members of the committee were ready and willing to hike policy rates as soon as the exchange rate faltered.

Policy rate setting: CBI will be forward looking, raise rates 25 bps

We predict the Central Bank of Iceland (CBI) will raise its policy rates 25 bps at its interest rate decision on October 3. A sharp depreciation in the ISK exchange rate since the Monetary Policy Committee's (MPC) last meeting is the main catalyst in our prediction, since the inflation outlook has deteriorated due to the pass-through which is sure to follow. The minutes from the last MPC meeting indicate that the members of the committee were ready and willing to hike policy rates as soon as the exchange rate faltered.

Where is the CBI looking?

In our opionion, there are two conflicting points of view regarding the Bank's course of action:

- It might be **backward looking** and decide to keep policy rates unchanged, since inflation in the last few months has been lower than was predicted in Q2 and Q3.
- It might be **forward looking** and decide to continue the gradual rise in rates that has been ongoing since mid-year 2011 on account of the deterioration in the inflation outlook due to the depreciating ISK, as well as high expectations of inflation.

Whether the members of the MPC will prove to be forward looking or not, we are sure of this: Their statement will be more hawkish in response to recent exchange rate developments. Even the minutes from their last meeting support the notion that they might respond by raising rates. Despite the substantial appreciation of the ISK in the weeks preceding the last policy rate decision on August 22 and a matching improvement in the inflation outlook (albeit a temporary one), the committee debated raising rates 25 bps. The paragraph that followed is crucial:

> Four members voted in favour of the Governor's proposal, in view of the recent tightening of the monetary stance. They also considered it appropriate to wait and see how sustainable the appreciation of the króna, and therefore the recent disinflation episode, would prove to be.
>
> *-Minutes of the Monetary Policy Committee meeting, August 2012*

This clearly implies that the committee did not assume the ongoing tightening of the policy stance to be consummated in August. On the contrary, it wanted to slow down, give the economy some breathing space and see how the ISK would behave. In addition, the committee reiterated that "[…] There was […] a significant risk that high inflation expectations would lead to higher and more persistent inflation than forecasts provided for."

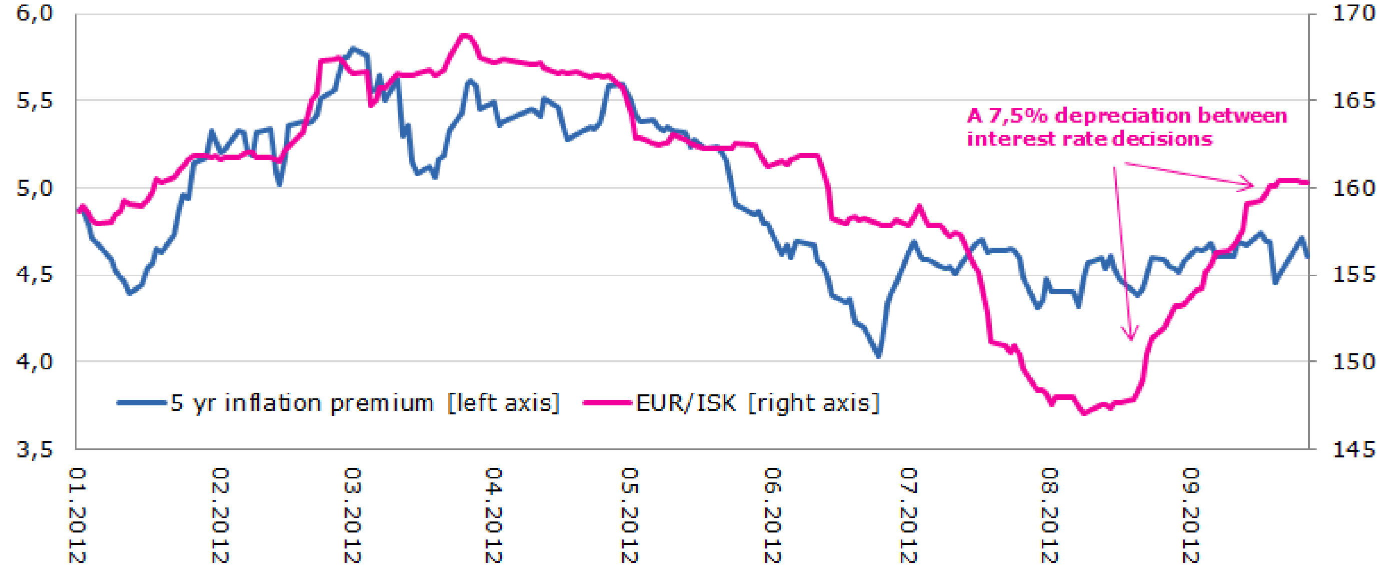
All signs point to the conclusion that the MPC is both ready and willing to address the deterioration in the exchange rate, as well as persistent inflation expectations, with a hike in the policy rate, which we believe will amount to 25 bps on October 3.

The ISK has dampened expectations: Now is the chance

In spite of inflation expectations being well above the 2,5% inflation target of the CBI, with the Bank's market expectation survey placing year ahead inflation expectations at 4,8% in Q3, they nevertheless dropped 0,7% from the survey published in Q2. We attribute this to the fact that both firms and households in Iceland are noticeably backward looking, so expectations of inflation might have been dampened substantially by the disinflation episode of the past few months, partly thanks to the temporary appreciation of the ISK.

A considerable challenge to the effectiveness of monetary policy in the Icelandic economy is a lack of credibility on the CBI's part. Therefore, it shouldn't be surprising that the MPC seems concerned with anchoring expectations to the Bank's inflation target. In light of the help offered by the recent temporary appreciation of the ISK with doing just that, it might be tempted to seize the chance and raise rates to keep expectations from climbing again once the ISK starts giving way.

Exchange rate and inflation premium developments
- inflation premium calculated as RIKB19 yield (nominal) minus HFF24 yield (Indexed)

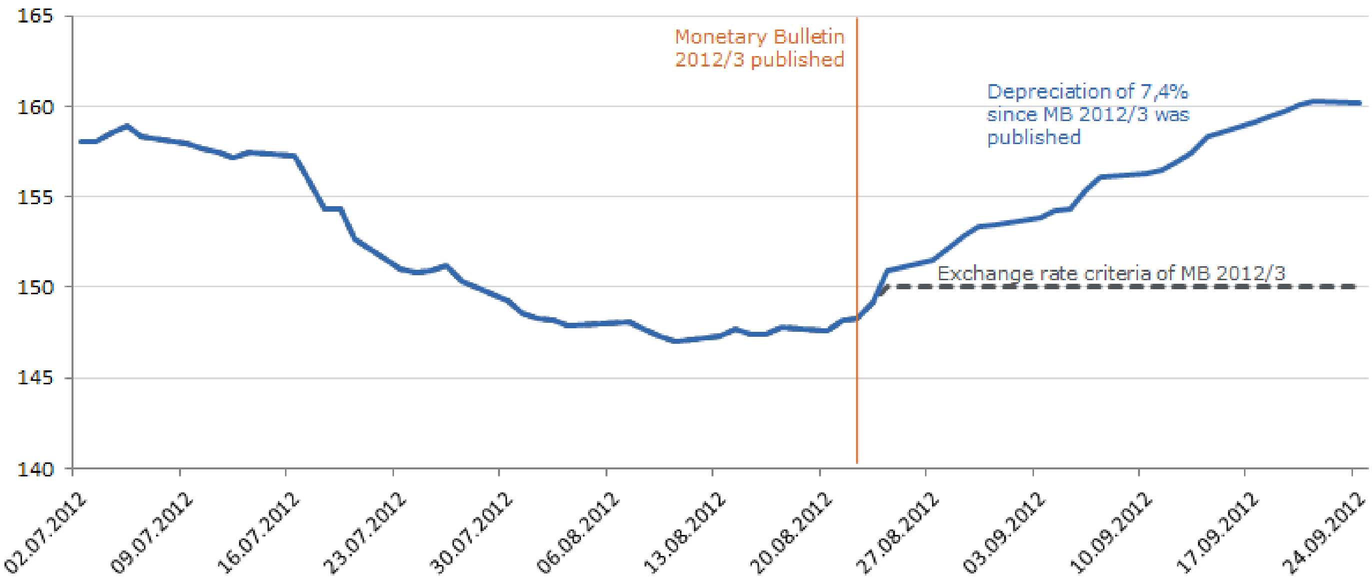


Source: CBI, calculations by Arion Research

The ISK is still the catalyst

At the last policy rate decision on August 22 the CBI kept rates unchanged and thereby paused a tightening of the monetary stance that had been ongoing since rates hit bottom during mid-year 2011. Like mentioned earlier, the inflation outlook had improved in the run up to the meeting, mostly due to the temporary appreciation of the ISK. The substantial appreciation meant that the exchange rate criteria of the Bank's updated inflation forecast was quite optimistic. The bank's model is like most other macroeconometric models (optimism in means optimism out) so the criteria made the bank's forecasted inflation outlook unrealistically optimistic as well. Unfortunately for the bank the ISK started losing ground almost as soon as their updated forecast was published, making the criteria unrealistic from the start.

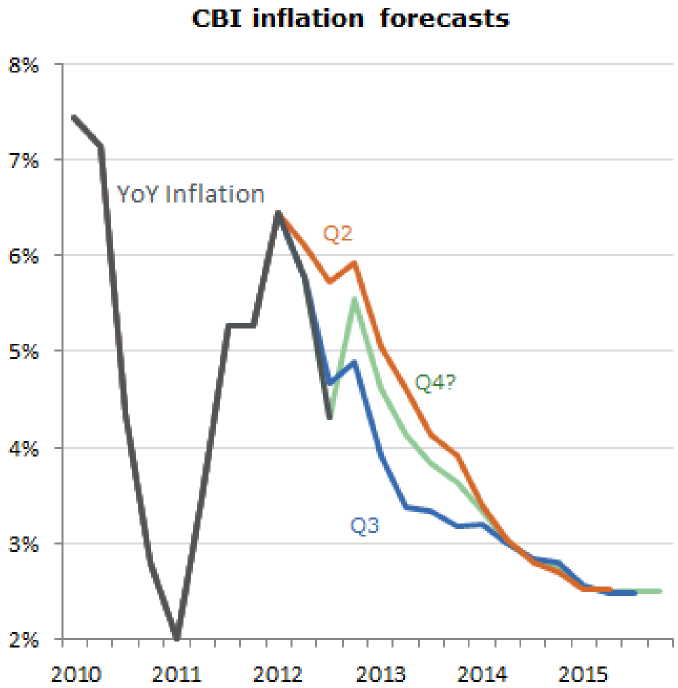
EUR/ISK exchange rate
- Sharp depreciation since the CBI's latest forecast was published in Monetary Bulletin 2012/3

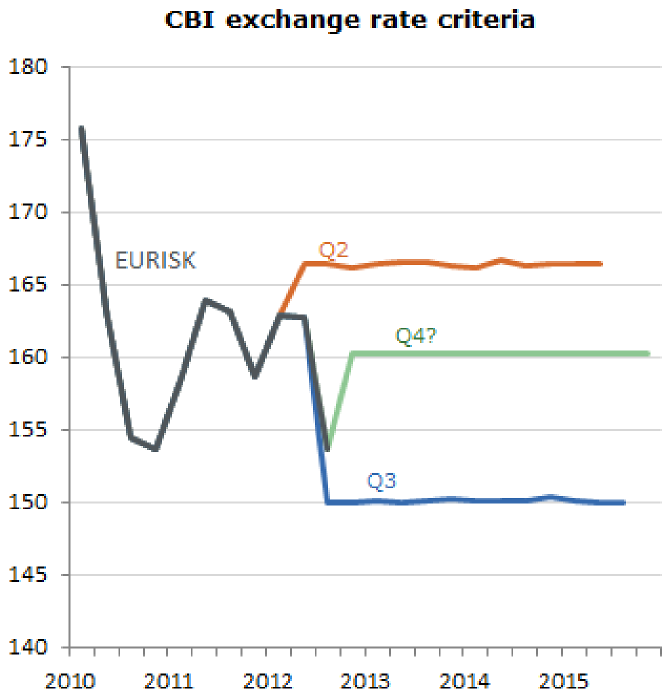


Source: CBI

Deteriorating inflation outlook

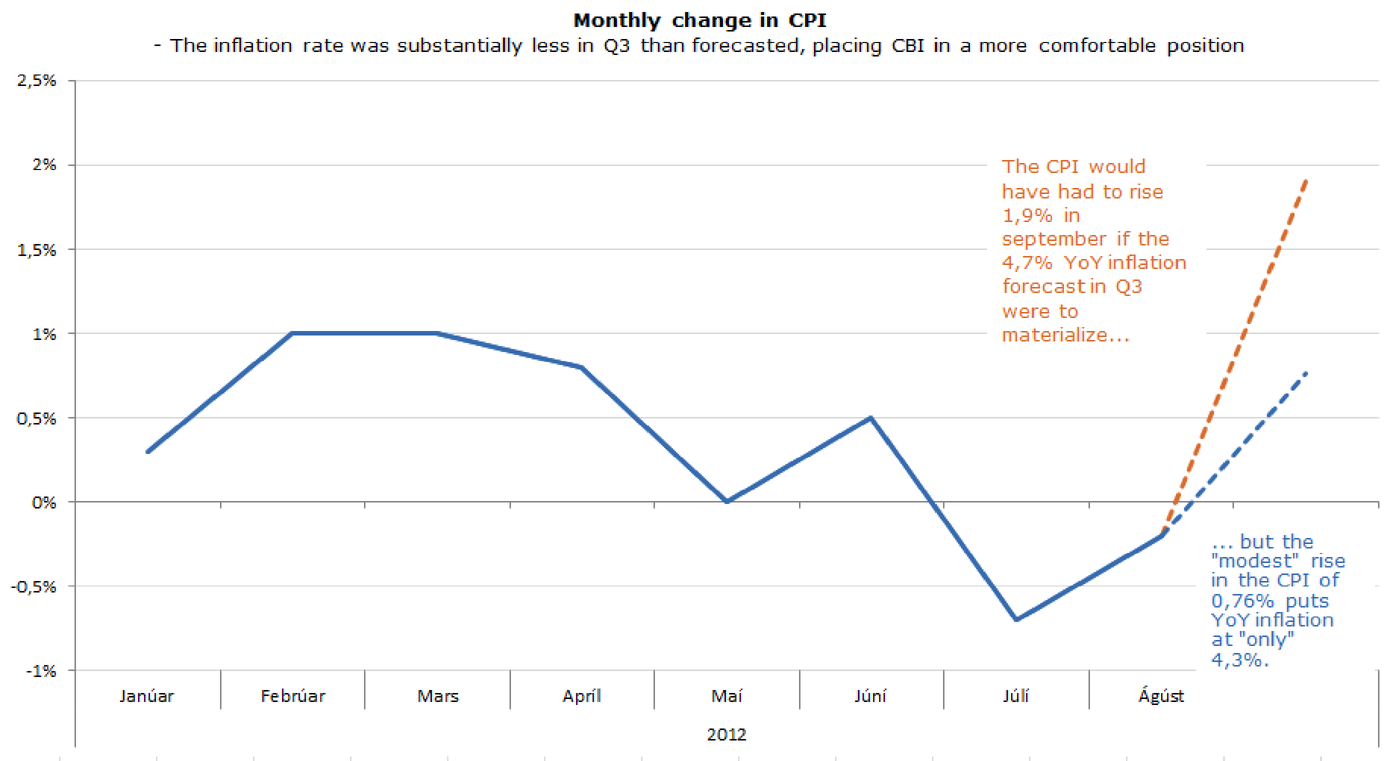
If we adopt the Bank's practice of assuming an unchanged exchange rate from the current level throughout the forecast period, we might conclude that forecasted inflation lies somewhere between the forecasts published in Monetary Bulletins in Q2 and Q3. Below we have calculated a probable inflation forecast for the outlook in Q4 that fits between the other two at a ratio corresponding to probable exchange rate criteria in Q4.





Source: Monetary Bulletins 2012/2 and 2012/3, calculations by Arion Research for Q4

It can't be overlooked, however, that the rate of inflation in Q3 has been considerably lower than the CBI forecasted in August; 4.3% instead of 4.7%. This might cause the Bank to consider the inflation outlook to be more favorable than it otherwise would have. It might even bring the MPC to think it has some headroom to halt the tightening of the policy stance a bit longer, and wait to raise policy rates until further down the road. Like stated before, however, we do not believe the scenario will unfold that way – the MPC won't be able to overlook the sizable drop in the exchange rate and will proceed to raise rates 25 bps on October 3. Additionally, we believe the bank has room for a further 50-75 bps bump before year-end.



Contacts

Ásdís Kristjánsdóttir
Head of Research
Research, Investment Banking
Tel: +354 444 6968
asdis.kristjansdottir@arionbanki.is

Thorbjörn Sveinsson
Senior Analyst
Research, Investment Banking
Tel: +354 444 6973
thorbjorn.sveinsson@arionbanki.is

Davíd Stefánsson
Analyst
Research, Investment Banking
Tel: +354 444 6965
david.stefansson@arionbanki.is

Hafsteinn Hauksson
Analyst
Research, Investment Banking
Tel: +354 444 6993
hafsteinn.hauksson@arionbanki.is

Stefán Guðjónsson
Senior Analyst
Research, Investment Banking
Tel: +354 444 6959
stefan.gudjonsson@arionbanki.is

Fannar Jónsson
Analyst
Research, Investment Banking
Tel: +354 444 6962
fannar.jonsson@arionbanki.is