

The strengthening of the ISK: False hope of price stability

The ISK has been strengthening recently, restraining inflation pressure in the short term. Despite that, the Central Bank's MPC decided to raise its key rate by 0.25 basis points on November 4, citing that longer-term inflation pressure remained. The decision surprised analysts and market participants who had predicted unchanged rates. What added to the surprise was the fact that the CBI now predicts much lower inflation in the coming quarters than it did in August.

Will the tourists disappear like the herring?

Despite growth of 30% in tourist arrivals this year, many are worried about overinvestment in the tourism industry. But how likely is it that the tourists will disappear like the herring did in 1969, with devastating effects on the economy? Arion Research examined the data on historical developments in international tourism revenues and why some countries have experienced a sharp contraction in tourist arrivals.

Analysts

Anna Hrefna Ingimundardóttir
+354-444-6997
anna.ingimundardottir@arionbanki.is

Hrafn Steinarsson
+354-444-6910
hrafn.steinarsson@arionbanki.is

Konráð S. Guðjónsson
+354-444-6991
konrad.gudjonsson@arionbanki.is

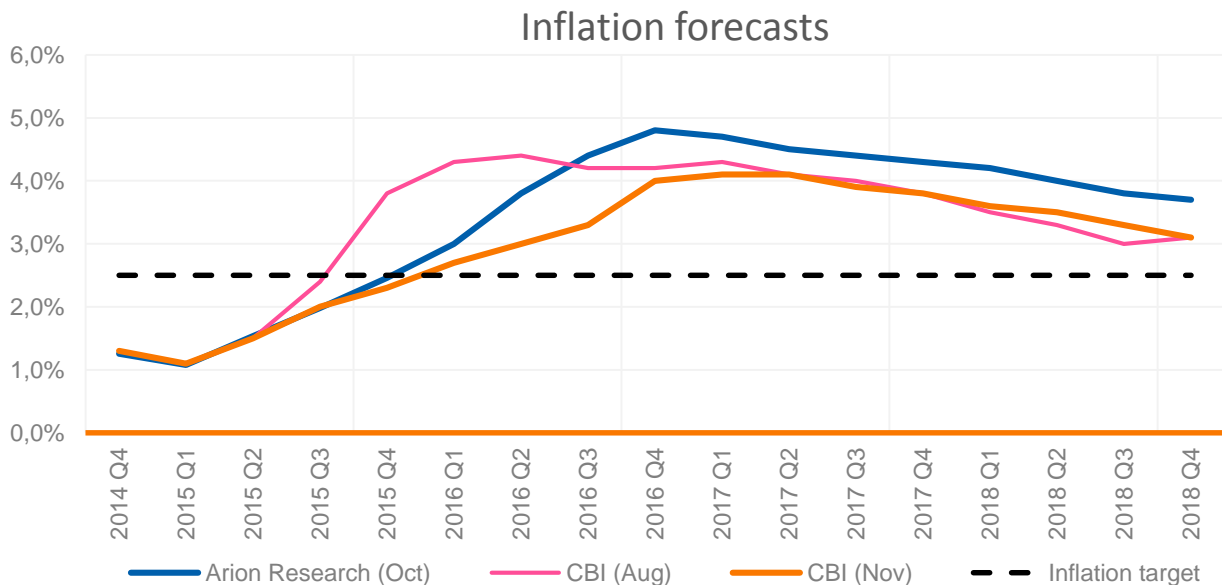
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The strengthening of the ISK: False hope of price stability

The Central Bank's Monetary Policy Committee (MPC) raised its key interest rate on Nov 4 by 0.25 percentage points, making its 7 day term deposit rate 5.75%. Analysts had predicted unchanged rates, mainly due to an improved short-term inflation outlook. Inflation has proven to be substantially lower than the CBI's August forecast assumed, which is mainly due to further decreases in prices of raw materials and oil in global markets as well as a strengthening of the Icelandic króna.

The committee believed there was still need for a tightening in monetary policy as the longer term inflation outlook had not improved much. The forecast assumes a fixed exchange rate. The consensus is still that high wage increases will lead to inflation above target early next year, when the effect of low international inflation will most likely be smaller than it is now. The MPC's statement also mentioned that the State's budget proposal entailed a more lax fiscal policy, given economic circumstances, than previously assumed.



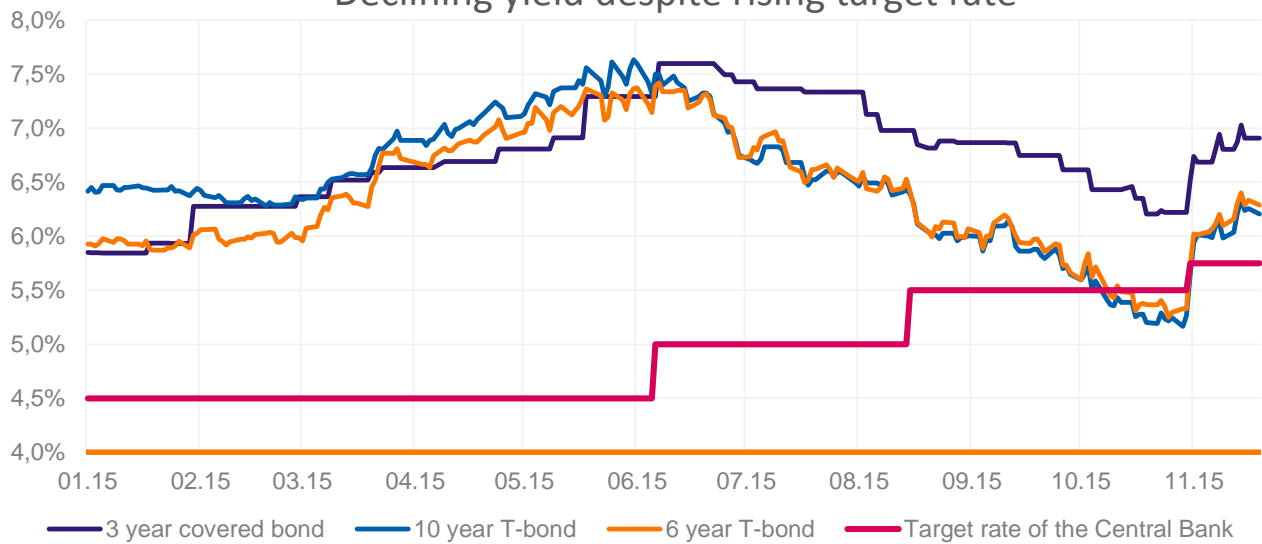
Sources: The Central Bank of Iceland, Arion Research

Analysts and market participants were taken by surprise

It came as a bit of a surprise that the MPC would increase rates by 0.25 percentage points at the same time as the Central Bank substantially lowered its inflation forecast for the coming four quarters - especially since the committee specifically stated in its last meeting that due to an improved near-term outlook it wanted to wait for a new inflation forecast before increasing rates. Perhaps rates would have been increased further had the near-term outlook not improved so drastically. However, the forecast came with a provision stating that it probably under- rather than overestimated inflation risk and that great uncertainty surrounded main inflation determinants, including the ISK exchange rate. Additionally, the CBI's forecast has not changed much when looking farther than one year ahead.

The MPC stated, as Arion Research has pointed out, that the transmission mechanism of monetary policy has been quite shaky recently. The yield on marketable debt securities lowered significantly while the Central Bank was increasing rates, although there was a noticeable turnaround after the latest decision. Therefore other options will be examined, such as some form of restrictions on large international capital flows, potentially some kind of tax or (perhaps more likely) a requirement for holding investments for a certain minimum period of time.

Declining yield despite rising target rate

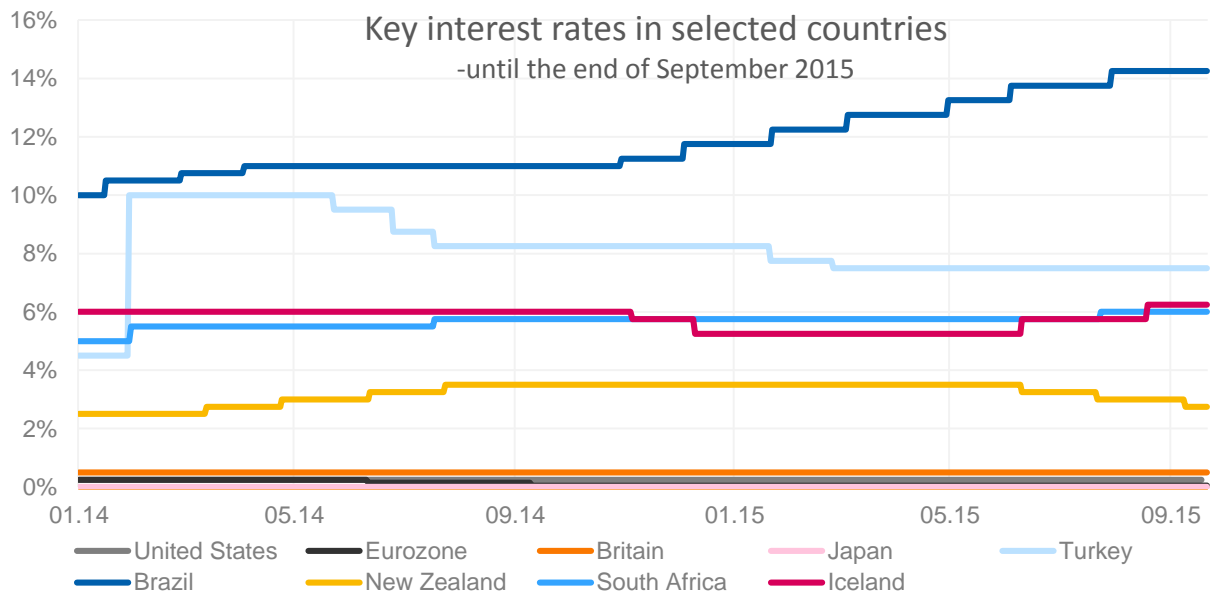


Sources: Kodiak, The Central Bank of Iceland, Arion Research

Inflow of foreign capital due to yields here or abroad?

In the Central Bank's *Monetary Bulletin* it was stated that the uncertainty surrounding the transmission of monetary policy in Iceland was in part due to unusually low interest rates internationally, which were starting to have an effect on the domestic market. Certainly actions related to quantitative easing have had contagious effects, but is it not more likely that domestic interest rate increases are starting to have more of an effect? International interest rates have been very low for quite some time and quantitative easing is not brand new.

It is not a stretch to assume that interest rate increases in Iceland have attracted investors who want to take advantage of interest rate differentials – an opportunity made even more attractive with a credible plan to lift capital controls. Not much has changed as far as international interest rates are concerned recently, while the CBI's key rate has been raised by 1.25 percentage points since June. That development has also led to a stronger exchange rate, which is certainly one of the transmission routes of monetary policy. However, as was pointed out in the latest *Monetary Bulletin*, that route is considered less than desirable due to its ungovernable nature.

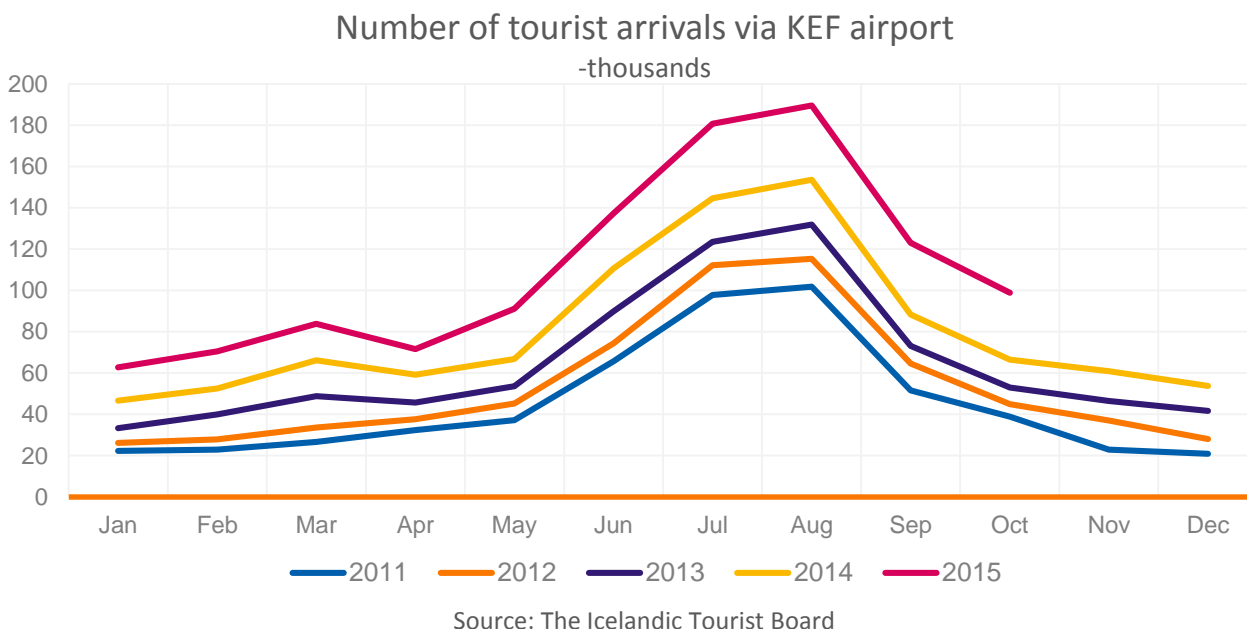


Sources: The Central Bank of Iceland, Arion Research

The CBI's real interest rates are currently higher than in most other advanced economies and as the CBI points out, no other developed countries have increased their rates recently. That has some reasonable explanations, such as the fact that the output gap is estimated to have already closed in Iceland, which is not the case for most other countries. Additionally, the growth outlook in Iceland is better while the inflation outlook is worse with much higher growth in nominal expenses such as wages. Inflation expectations are not firmly anchored in Iceland, unlike in most other advanced economies. Even though the interest rate differential has several rational explanations, when looking at conventional monetary policy, it is worth asking whether the incentive created by the use of the interest rate tool will not lead to false hope for stable prices through the exchange rate mechanism - which could, in fact, create circumstances for greater instability further down the road.

Will the tourists disappear like the herring?

The tourism industry has been expanding rapidly in recent years and while the hotel industry has been having trouble keeping up, with 84% room occupancy on average in the capital region last year, some have been worried about overinvestment. What if the tourist disappear like the herring did in 1969, devastating the economy? The increase in the number of tourists in October was 49% after four years of double-digit growth and so far this year growth has been 30%. There is no indication yet that growth in tourism is slowing down, although we are bound to face some capacity constraints at some point if we continue at this pace.

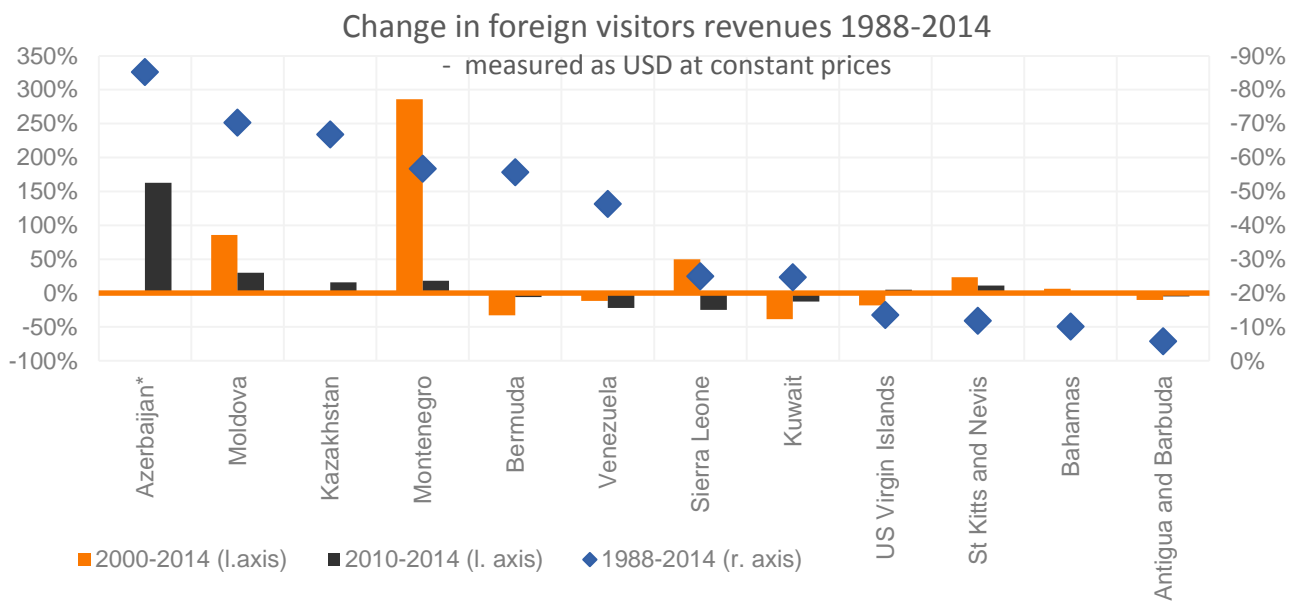


Perhaps it's no wonder that many are worried about how long this can last and what the potential consequences could be if travelers suddenly stop being interested in Iceland. However, given the experience of other countries it seems like a somewhat unlikely scenario. Various research papers have examined the main determinants of tourist arrivals in various destinations. Among the most important ones are; [infrastructure](#), transportation quality, [political risk](#) and the real exchange rate, although other factors such as the frequency of international flights had more to say when looking at small islands. Iceland ranks rather favorably in these categories, but a much stronger exchange rate could of course have adverse effects on revenues from tourism in the near future.

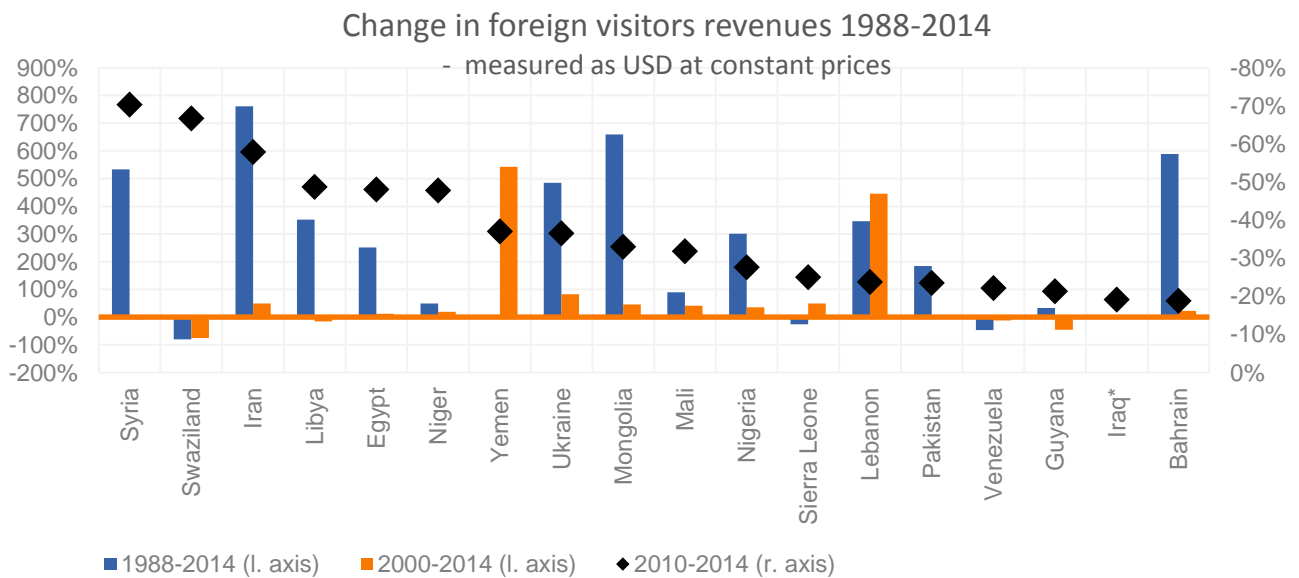
Which countries have had a sharp contraction in tourism in recent years?

The tourism industry the world over has experienced consistent growth in past few decades, with some exceptions. Examining those cases could help shed some light on Iceland's risk of a sharp contraction in the tourism industry going forward.

Below we have summarized how revenues from tourism have developed in certain countries since 1988. To simplify, we have only included countries where tourism's direct contribution to GDP has been over 3% sometime during the period. In a sample of 147 countries, only 11 have experienced a drop in tourism revenues. The largest drop was in Azerbaijan, probably due to the dissolution of the Soviet Union, thereafter Montenegro, where the Balkan war and division of Yugoslavia most likely played a part. Apart from small tropical islands there has also been a contraction in Kuwait, Sierra Leone and Venezuela. It is logical to assume that political instability and deterioration of infrastructure have affected tourism negatively in those countries.



Over the past years “major events” have been a deciding determinant for tourism in certain countries. Perhaps unsurprisingly, war ravaged Syria has experienced the largest drop in tourism revenues when looking at the period from 2010-2014, followed by Iran. Other countries on the list with increased instability and political risk are e.g.; Yemen, Mali, Nigeria, Lebanon, Pakistan and Iraq. Sierra Leone, which experienced a serious Ebola outbreak during the period, is also on the list.



When examining the data there appears to be a logical explanation for most recent contractions in tourism around the world – mostly explained by political risk or other major safety concerns. Given Iceland’s ranking on the [Global Peace Index](#) (ranked as the most peaceful country in the world), it doesn’t look like travelers should be too worried about political risk at least in Iceland in the near future.