ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | February 2015

The CBI in wait-and-see mode

Much to analysts' surprise, the Central Bank of Iceland decided to leave interest rates unchanged in February. Even though the real interest rate in Iceland is higher than in most peer countries the Bank's Monetary Policy Committee decided against lowering rates, citing a harsh tone in upcoming wage negotiations as the main worry for inflation prospects.

The "old overhang" decreases by 12 bn ISK in the CBI's last announced currency auction

Arion Research had predicted increased participation in the CBI's last announced FX auction due to the Bank's amended terms, which allowed participation by more parties. While bids in the exit leg exceeded our expectations by a rather wide margin, only 20% of bids were matched. The CBI's foreign currency auctions have now decreased the size of the "old overhang" by 158 bn ISK since their start in June 2011.

The BoP gap shrinks with improved terms of trade

With rising export prices and falling import prices Iceland's terms of trade improved in 2014 and are expected to develop favorably this year as well - which bodes well for the country's current account balance. With a high level of foreign debt to service that is welcome news indeed.

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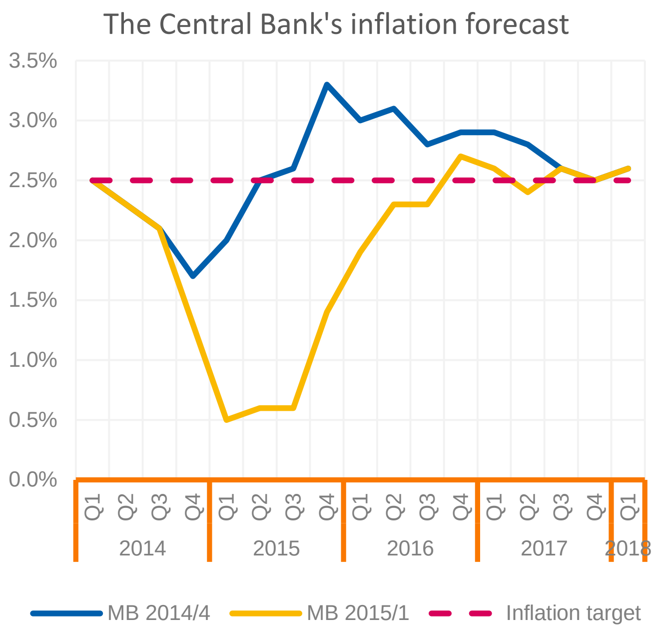
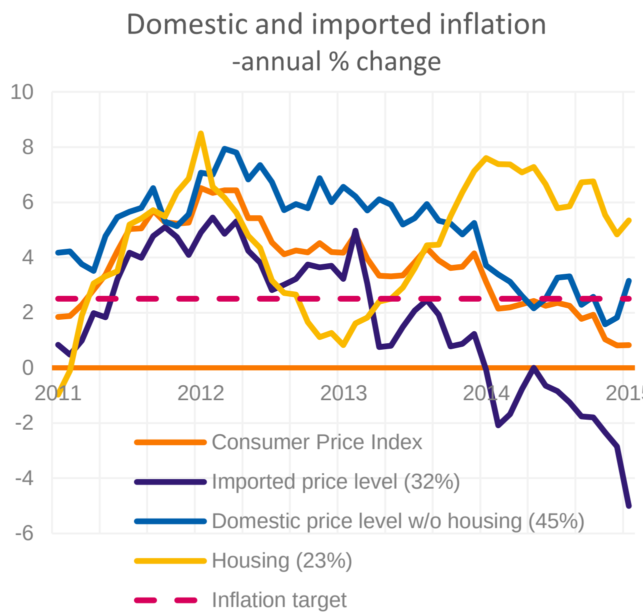
The CBI in wait-and-see mode

On February 4th the Central Bank of Iceland decided to leave interest rates unchanged. All major analysts and market participants had predicted a rate decrease of 25 bps, mainly due to lower than expected inflation and thus a rising real interest rate. At the time of the meeting annual inflation measured only 0.8%, making the real interest rate higher than before the interest rate decision in November, when a high real interest rate was quoted as the reason for the 25 bp rate decrease. Additionally, the Central Bank's inflation forecast in the CBI's *Monetary Bulletin*, which is issued concurrently with the interest rate announcement, had been lowered quite substantially from the Bank's last *MB* in November. The CBI is now predicting that inflation in Iceland will remain below target well into 2016. With such a low inflation forecast we had some trouble reconciling the interest rate decision with the data and previous reasoning of the Bank's MP committee.

So why not lower rates? The main reason cited was the uncertainty pertaining to the results of wage negotiations of a considerable part of Iceland's work force, which are expected over the next couple of months. Wage increases beyond the CBI's inflation target in addition to productivity increases have been a persistent driver of inflation throughout the years in Iceland, according to the CBI. Some industries have already negotiated wages well beyond the Bank's inflation target, and the labor unions' tone in advance of upcoming negotiations is quite harsh.





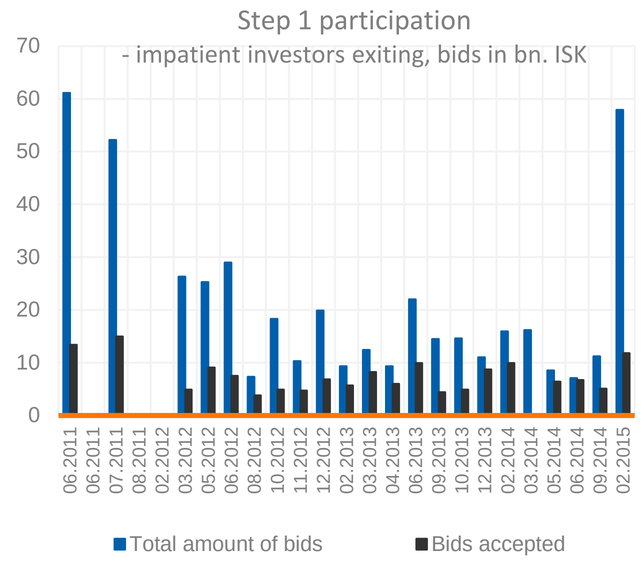
Source: Central Bank of Iceland

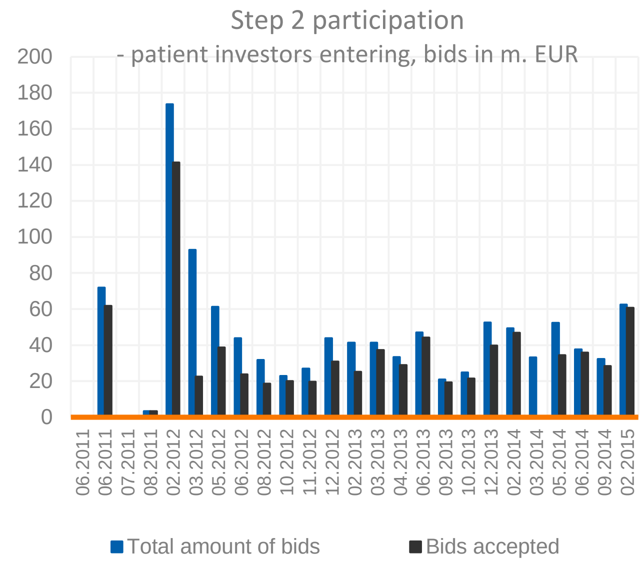
Meanwhile, the real interest rate in Iceland remains well above that of neighboring countries. We were quite surprised that the fear of high wage increases, which is not reflected in the Bank's inflation forecast or wage index forecast, would be the main driver of the interest rate decision, while the Bank is simultaneously presenting such a low inflation forecast and therefore a very high real interest rate in the coming quarters. Considering the MPC's decision, the fear of accelerating inflation is apparently much stronger than the fear of deflation. Given the fact that the confidence interval for the Bank's inflation forecast is rather symmetric, albeit slightly skewed to the upside, this made many wonder whether there was too much asymmetry in the inflation management strategy of the Central Bank. Granted, the Icelandic króna is a small and relatively easily manipulated currency so weakening the króna to spur inflation remains a viable option. However, if inflation is actually expected to remain below target over the next 18 months, one naturally wonders why rates were not decreased and if inflation is indeed the target of the Central Bank as mandated.

In addition to raising questions about what exactly the Central Bank is targeting this made us wonder about the transparency of monetary policy. With the inflation forecast of the Central bank so low and the reasons cited for the latest interest rate decisions still valid what factors is the committee looking at this time? In its latest statement the committee stated that due to the fact that the price of oil is beyond their control they would not take its „first round" effects into consideration when deciding on the appropriate interest rate level. However, in November falling oil prices were one of the main reasons for lower inflation, a higher real interest rate and thus a rate decrease. Is the committee only looking at domestic inflation vs. imported inflation? In any case, barring major surprises in upcoming CPI or GDP numbers, Arion Research is not expecting a rate change by the CBI until new wage contracts have been signed.

The “old overhang” decreases by 12 bn ISK in the CBI’s last announced currency auction

The Central Bank‘s last announced foreign currency auction was held on February 10th. Arion research had predicted that participation would be strong due to the Bank‘s amended terms, which were presumably intended to allow more of the „old overhang“ (foreign held liquid ISK assets) to exit in advance of major steps in the lifting of capital controls. We had estimated that these amended terms would add up to 24 bn ISK to the pool of krónur already allowed to participate. Over the past two years or so step 1 participation (impatient investors leaving the country) has been at around 10-20 bn ISK while bids in the February auction amounted to 58 bn ISK, which is the second highest amount bid since the auctions began in June of 2011.



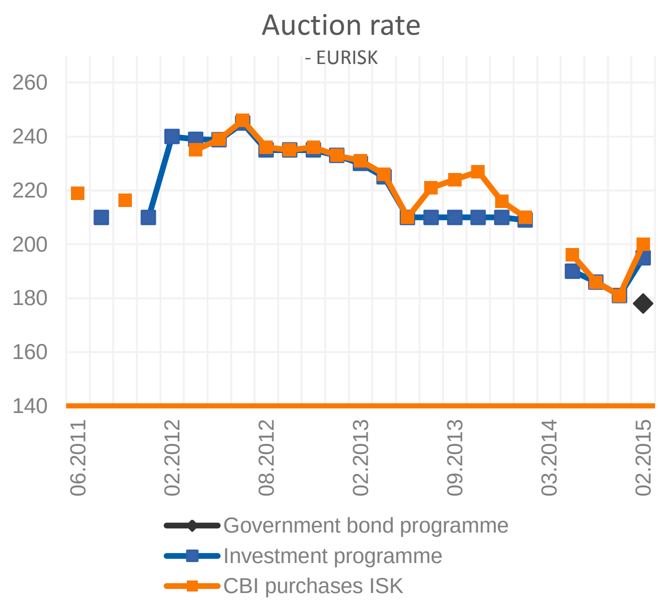


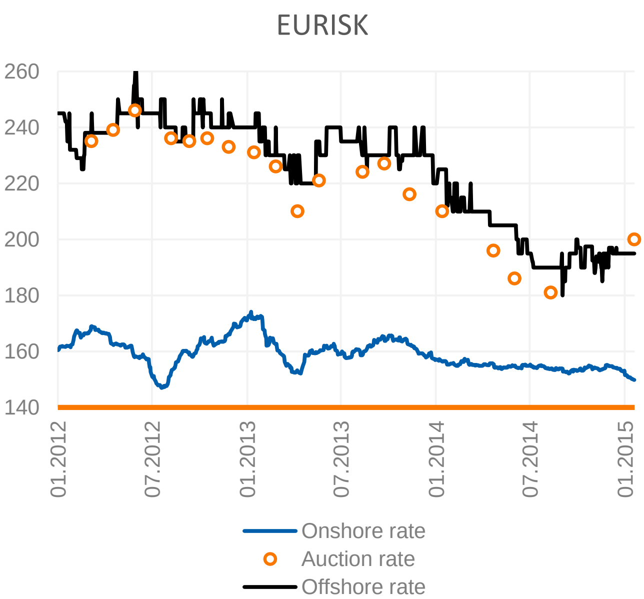
Source: Central Bank of Iceland

For the first time the CBI decided on three different rates:

- Those who bought krónur through the government bond programme received the rate 178 EURISK.
- Those who entered through the investment programme received 195 krónur per euro, but were required to purchase krónur at the onshore rate of 150 EURISK for half of their euros entering through the programme, thus receiving the average rate of 172 EURISK.
- Those who sold their krónur for euros paid 200 ISK per euro.

The difference between the onshore and auction rates increased substantially and stood at approximately 25% after having gone down to 15% in the September auction.

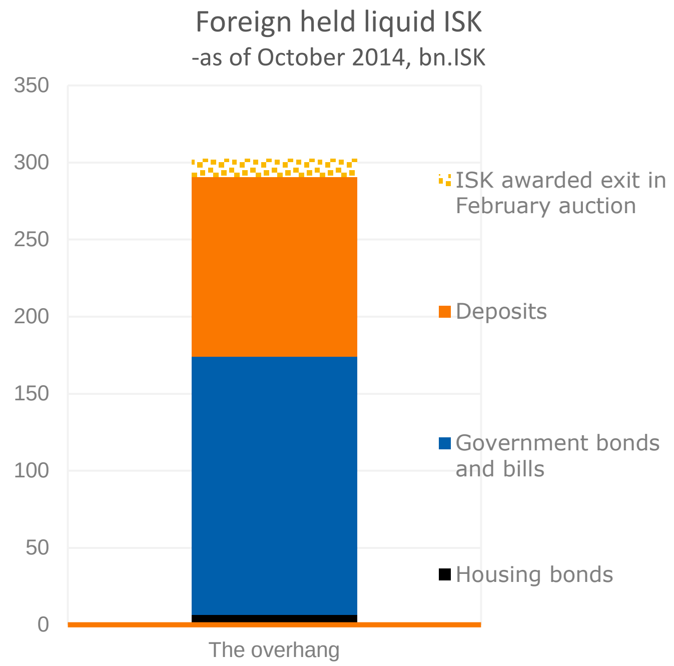


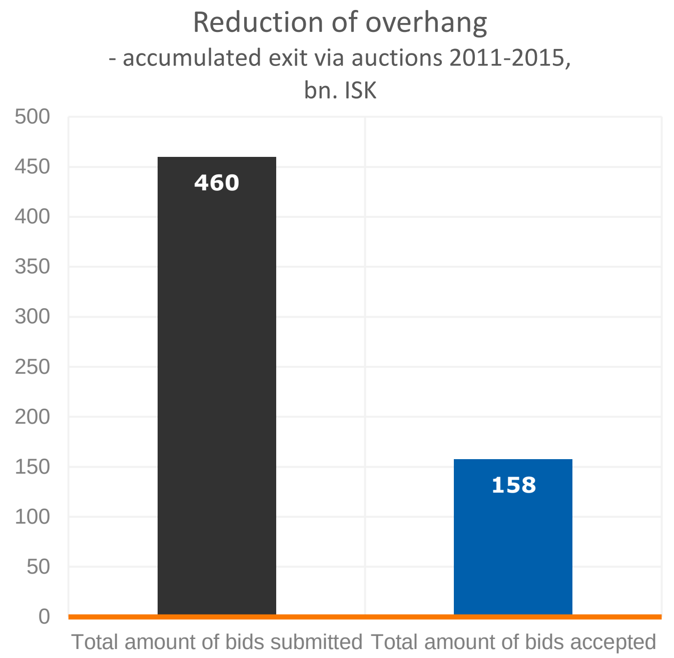


Source: Central Bank of Iceland

This development has various possible explanations; No further auctions have yet been announced and although that was also the case in September the CBI had now stated that this was the last time the investment programme was offered in its current form. Since the September auction ideas have also surfaced in the media about a rather high exit tax on all assets leaving the country, possibly making ISK holders worried that they might be forced to sell their króna holdings at an even larger discount once controls are lifted. Aside from that, a wider range of participants were allowed to join this time which means more demand for each euro offered. It is also possible that since major progress is expected on the capital controls front in the coming months euro owners interested in investing in Iceland might need a larger discount in return for committing to a five year investment in Iceland, a requirement when participating in the auctions.

The government has repeatedly hinted that large steps will soon be taken in the capital account liberalization process so it would have been ideal if a larger amount of ISK had been awarded exit given how high the total amount of bids to exit was. The total amount bid was approximately 19% of the „old overhang“, but only about 20% of bids were matched so the overhang was reduced by about 4%. Some had speculated that the Central Bank might use some of its reserves to match a part of what was left, but according to the Bank‘s FX reserves to such a large extent.





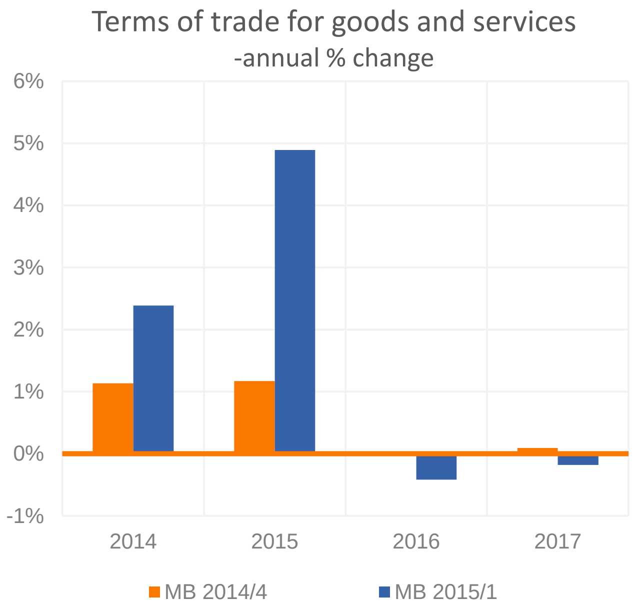
Source: Central Bank of Iceland

So far the CBI‘s foreign currency auctions have reduced foreign held liquid ISK holdings by approximately 158 bn.ISK., which is over 30% of the overhang at the time of the first auction in June 2011. With the extension of the Landsbanki bond the debt repayment profile of the country over the coming years is much lighter. The economy overall seems rather well balanced at the moment and the threat to the króna posed by foreign holders of ISK has diminished substantially over the past few years. All things considered, it looks like the economy might be ripe for the lifting of capital controls.

The BoP “gap” shrinks with improved terms of trade

According to the Central Bank‘s latest *Monetary Bulletin*, Iceland‘s terms of trade improved last year and it looks like they will improve further still this year. The main reasons for improved terms last year were higher export prices, mainly for marine products, as well as lower import prices. Inflation in Iceland‘s main trading partner countries has been very low and is expected to remain low over the coming quarters, which could actually pose a problem insofar as it reflects decreasing demand.

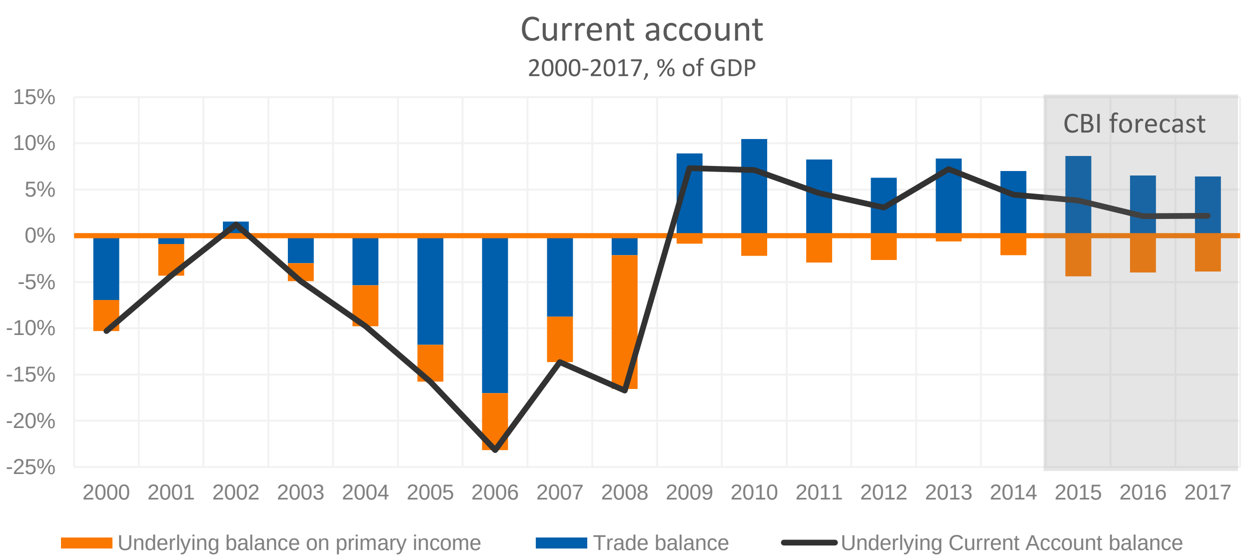
In 2014 the terms of trade improved by 2.4% according to the Central Bank, which is somewhat better than predicted in the Bank‘s *MB* last November (+1.1%). The Bank now predicts that terms of trade will improve by 4.9% this year, which is well above the Bank‘s November forecast of 1.2%



Source: Central Bank of Iceland

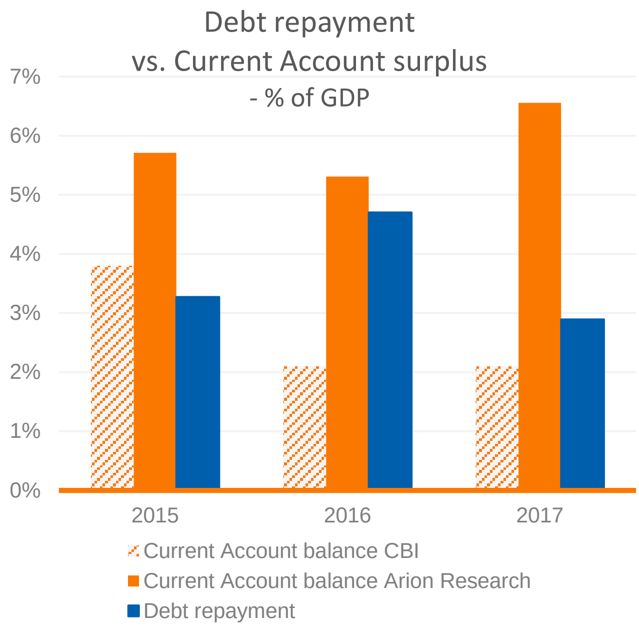
The improved outlook is mostly due to low oil prices so the terms of trade are expected to worsen slightly in 2016 when forward contracts indicate that oil prices will rise again. Of course the terms can take a sharp turn if, for instance, the exchange rate fluctuates substantially following the removal of capital controls or if oil prices rise sharply.

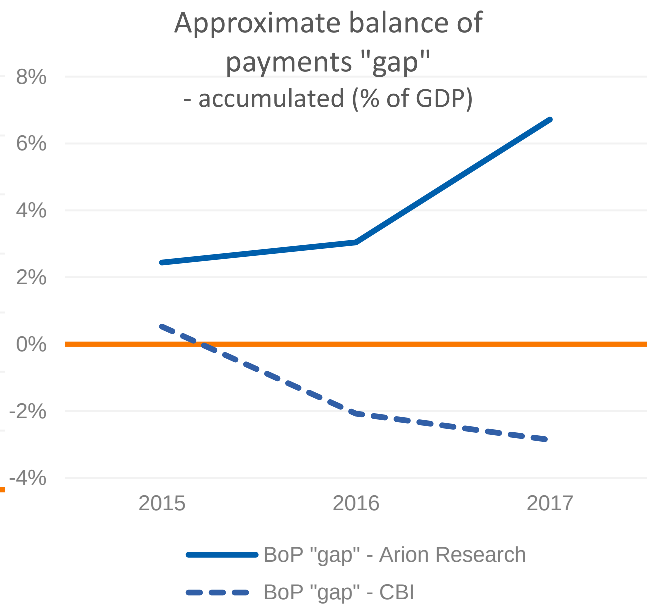
Foreign currency received for exports not only goes towards the purchase of imports, but also the repayment of foreign debt. The cost of debt has been high in Iceland since the financial collapse so a decent current account surplus would be preferable to increased leverage or the reliance on foreign investment. Altough imports are expected to rise over the coming quarters the expectation is that tourism will continue to flourish with the associated service exports. That, coupled with improved terms of trade, should allow us to show a trade surplus in the coming years.



Source: Central Bank of Iceland

As we have mentioned before in previous newsletters Iceland’s foreign debt repayment profile improved markedly when an agreement was reached on the Landsbanki bond extension, without which debt repayments would have weighed heavily on the country's currency reserves. The repayment profile for the next four years is currently about half of what it was in the past four years, measured as a percentage of GDP.

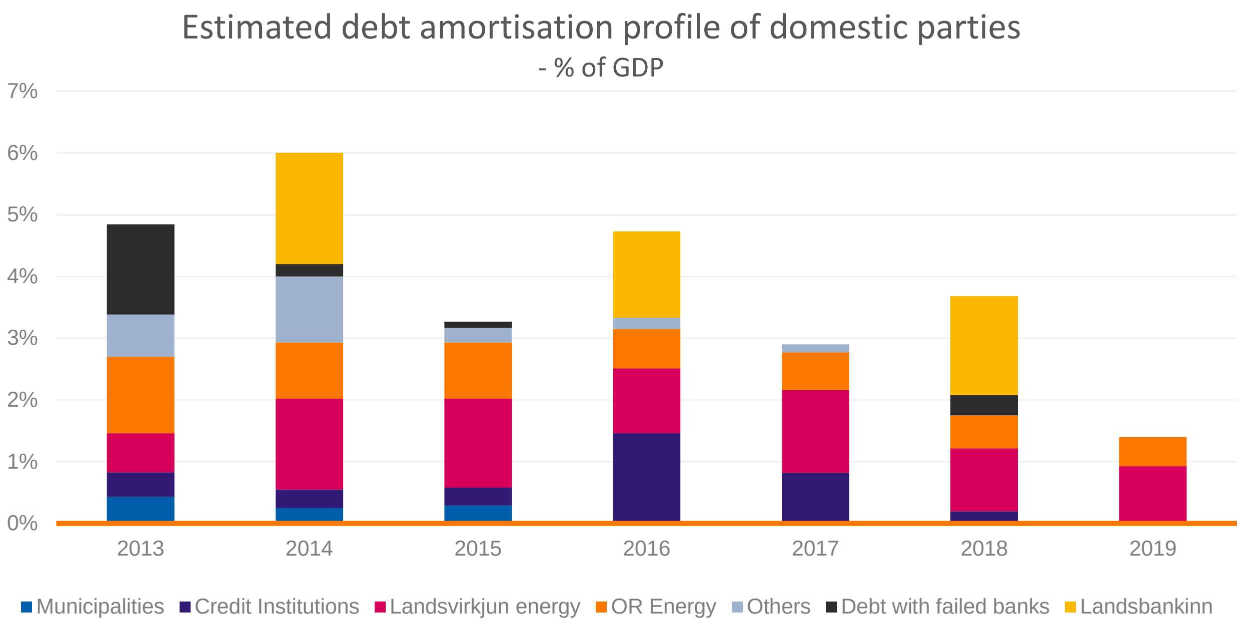




Sources: Central Bank of Iceland, Arion Research

Even when looking at the Current Account balance in the CBI's latest forecast, which is rather conservative, it does not look like there will be a large BoP gap over the coming years. When looking at the Current Account alone it does not assume any foreign direct investment, which makes the picture even less worrisome - over the past four years FDI has amounted to a little under 6% of GDP on average so it seems quite likely that foreign investment would cover any possible gap. Additionally, a large chunk of the payments due in 2016-2017 are instalments of debts of financial institutions, mainly the banks, which are likely to be mostly refinanced and thus will probably not result in a large net outflow of foreign currency.

With the extension of the Landsbanki bond, an improved outlook for the terms of trade and a likely current account surplus in the coming years, Arion Research believes that any fear of a balance of payments crisis in the next few years has been quelled.



Source: Central Bank of Iceland