Icelandic Economic Update

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50 point cut in CB's interest rates on 18th August?

- The Central Bank of Iceland will most likely continue on its cutting cycle by lowering the policy rate by 50 bp this coming Wednesday – the policy rate will then drop to 7.5%. Economy-wise, the news has mostly been good in Iceland over the summer. Inflation has declined more rapidly than the Central Bank's inflation forecast predicted in the last issue of the Monetary Bulletin. At the same time, the ISK has continued to appreciate, Iceland's CDS is at similar level and foreign trade has yielded an ever growing surplus. However, political and legal uncertainty still persist in Iceland as the Icesave dispute is yet to be solved and the legitimacy of currency linked loans in the Icelandic banking system is still under consideration by Icelandic courts.

Moody's: Iceland on negative outlook

- Last July Moody's changed the outlook on Iceland's sovereign ratings from stable to negative following the Supreme Court ruling on FX linked loans - in addition to uncertainties surrounding the solution to the "Icesave" affair. The Supreme Court ruling adds to macroeconomic uncertainty, since the degree of losses which could be incurred by the banks is unknown. The FME (Icelandic FSA) Chairman has publicly said that the losses could amount to ISK 350 billion in the worst case scenario. Furthermore, the minister of commerce has said that the government could be forced to put up ISK 100 billion to ensure a functional banking system. Although the worst case scenario would require large sums from the Icelandic government to recapitalize the banks, less severe scenarios would largely reduce or eliminate the need for recapitalization. What makes additional injections of capital from the government problematic is that Iceland's debt level is already high – general government debt is projected to reach 150% of GDP in 2010.

Calendar

Date	Title	Period
17 August 2010	Real Estate Index (capital area)	July 2010
18 August 2010	CBI's interest rate decision & Monetary Bulletin	
20 August 2010	Auction Treasury Bonds	
26 August 2010	Consumer Price Index	August 2010

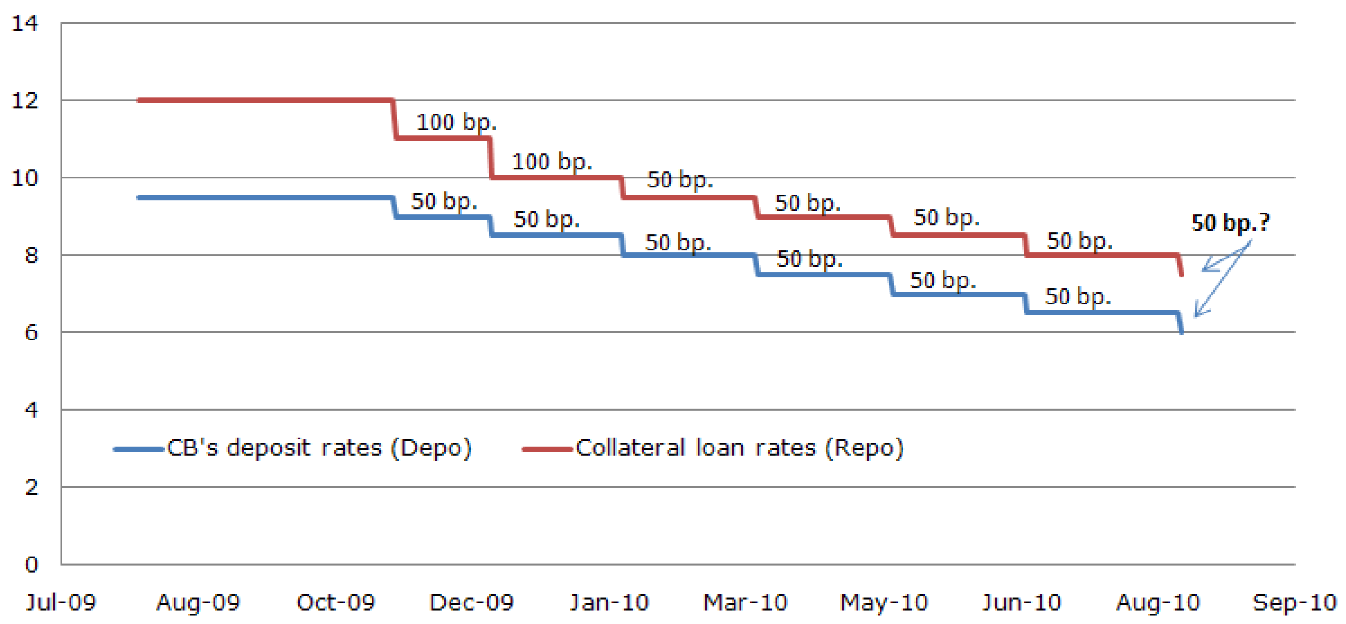
50 point cut in CB's interest rates on 18th August?

The drop in the rate of inflation in recent months has given the Central Bank of Iceland considerable room for further interest rate cuts. Inflation has slowed more rapidly than the Central Bank's inflation forecast predicted in the last issue of the Monetary Bulletin. Other economic factors have also been moving in the right direction since the last interest-rate meeting: the ISK has continued to appreciate, Iceland's CDS spread has narrowed and foreign trade has yielded a sizeable surplus.

Although there are numerous factors supporting a sharp interest cut at the CB's next interest-rate meeting on 18 August, Arion Research believes that the monetary policy committee will stick to a 50 bp cut. The main reason is the uncertainty caused by the Supreme Court's judgment on the legitimacy of currency-linked lending and what effect this might have on the Icelandic economy. Central Bank governor Már Gudmundsson said at the last meeting that the committee would probably have lowered interest rates more if this uncertainty hadn't been there.

If our forecast is accurate deposit rates (depo) will drop to 6% and collateral loan rates (repo) to 7.5%.

Central bank's interest rates (%)



Source: Central Bank of Iceland

Positive indicators	Negative indicators
Faster slowdown in inflation than forecast by the Central Bank - creates opportunity for significant rate cuts. **The ISK has strengthened** 2% since the last interest-rate decision. The dollar has strengthened significantly (8%) since the last meeting in June, while the euro has remained virtually unchanged. **Iceland's 5-year credit default swap spread** is currently 322 bp - at similar level. **Inflation expectations** have decreased both among the public and in the business sector. The inflation premium on the bond market has also been very low.	**Increased uncertainty over the legitimacy of currency-linked lending** and its effect on the Icelandic economy. **The Icesave dispute remains unresolved** and given the lack of negotiations there is no solution on the horizon.

Interest rate cuts cycle coming to an end ?

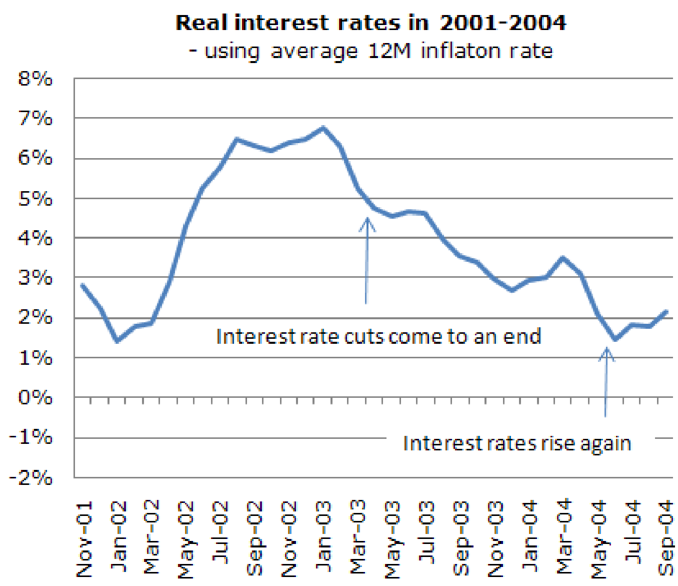
There will be four more interest-rate meetings before the end of the year. At the end of the last cycle of interest rate cuts, the CB's policy rate (repo) ended at 5.2% at the beginning of 2003. Although we are now facing more slack in the economy, and that should mean that the CB's interest rates should be cut even further in the current downturn, it is uncertain that this will be the case. As long as there are plans to relax the capital controls the monetary policy committee will have limited room to cut interest further down. At the same time, the committee seems reluctant to cut interest rates as swiftly while the Icesave dispute remains unresolved.

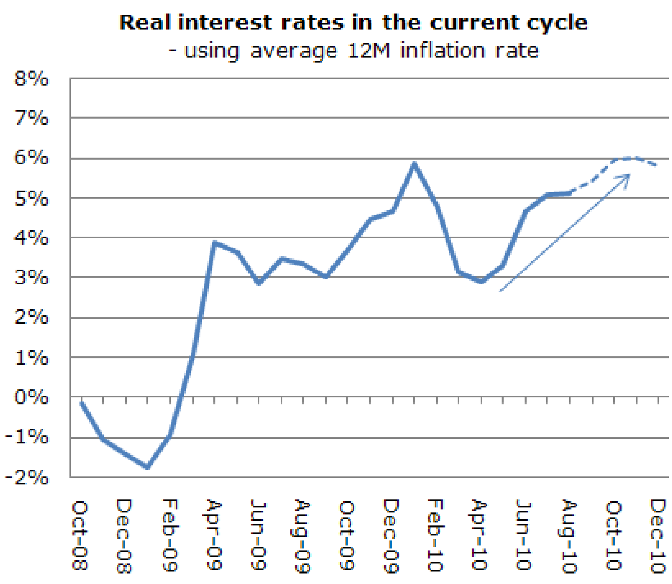
If we assume that the Central Bank will continue to lower interest rates by 50 bp at each meeting until the end of the year, then deposit rates (depo) will be 4.5% by the end of the year and collateral loan rates (repo) will be 6%. Effective interest rates (average depo and repo rates) would then be approximately 5.3%. It is therefore possible that the cycle of interest rate cuts will end in December as the Central Bank governor has hinted that the interest rate floor is around 5-6%. However, if next year inflation rate will be around zero then the effective interest rates will have to go further down to prevent tighter monetary stance.

Minimal easing of the tight monetary stance

It is interesting to compare the tight monetary stance this time around with the stance adopted in the last cycle of interest rate cuts from 2001 to 2003. Real interest rates indicate how tight the monetary stance is and there are several methods of gauging real interest rates. The method used here assesses real interest rates from the point of view of annual inflation and the Central Bank's average effective interest rate over the last 12 months (although we normally prefer more forward looking measures on real rates).

In recent months real interest rates have been rising and, given the inflation outlook, this is likely to continue (provided that the Central Bank will not cut rates by more than 50 bp per meeting).





Source: Central Bank of Iceland

Moody's: Iceland on negative outlook

Last July Moody's changed the outlook on Iceland's sovereign ratings from stable to negative following the Supreme Court ruling on FX linked loans in addition to uncertainties surrounding the solution to the "Icesave" affair.

The Supreme Court ruling adds to macroeconomic uncertainty, since the degree of losses which could be incurred by the banks is unknown. Although the banks have undoubtedly performed risk analysis of different scenarios it is still unclear what proportion of currency-linked loans will be deemed illegal. The banking system will clearly cope with the correction of currency-linked loans to households. However, if a significant proportion of corporate loans are also deemed illegal it will be a heavy blow for the banks – this could force the Icelandic government to recapitalize the banks.

The FME (Icelandic FSA) Chairman has publicly said that the losses could amount to ISK 350 billion in the worst case scenario. Furthermore, the minister of commerce has said that the government could be forced to put up ISK 100 billion to ensure a functional banking system.

Whether the worst case scenario will materialize depends on how many loan types will be deemed illegal and which terms will be used instead of the initial terms. This will not become clear until the Supreme Court has reached a decision – most likely in the autumn. The only indication so far is the recent ruling by a local court that ISK interest rates will replace the initial (much lower) rate – if the Supreme Court reaches the same conclusion, the worst case scenario is averted.

First casualty – will there be any more?

On 13 July 2010 Askar Capital declared itself bankrupt following the Supreme Court ruling. The ruling was the last nail in the coffin of the small investment bank which barely survived the economic collapse. The firm's exposure to FX linked car loans through its subsidiary Avant left the board no option other than to announce its bankruptcy.

Two vital factors significantly increase the ability of the three main banks (Arion, Islandsbanki, NBI) to weather the storm:

- Firstly, the three main banks bought their loan portfolios from the old banks at a significant discount as loan losses were foreseen. For example, Islandsbanki claims to have bought the loan portfolio from its predecessor Glitnir at a 47% discount. Arion Bank's discount was even larger or 67% on average (note that the bank took over some loans to holding companies at a relatively high or even 100% discount).

- Secondly, the banks have an equity buffer of 16% (CAD). The 16% minimum limit set by the FME after the collapse can be seen as high by many standards but the limit was set to meet any uncertain events such as the FX linked loan ruling.

Although the worst case scenario would require large sums from the Icelandic government to recapitalize the banks, less severe scenarios would largely reduce or eliminate the need for recapitalization due to the factors mentioned above. What makes additional injections of capital from the government especially problematic is that Iceland's debt level is already high – general government debt is projected to reach 150% of GDP in 2010.

Iceland's credit rating: Heading towards junk ?

The last rating action on Iceland was implemented on 23 April 2010, when Moody's changed the outlook from negative to stable. The reasoning at the time was the elimination of any doubt over the ability to refinance the state's foreign obligations in 2011-2012. Iceland is still clinging on to its status as a nation with an investment grade rating with Moody's and S&P, however only a notch away from junk status.

The table below shows Iceland's credit rating with the different ratings agencies.

	Foreign currency		Local currency		
Term	Long	Short	Long	Short	Outlook
Moody's	Baa3	P-3	Baa3	P-3	Negative
S&P	BBB-	A-3	BBB	A-3	Negative
Fitch	BB+	B	BBB+	NR	Negative
R&I	BBB-	NR	NR	NR	NR

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