Cycle of interest rate hikes has begun

- At the last interest-rate meeting of the Monetary Policy Committee the ground was prepared for forthcoming interest rate hikes. On the 17th of August, the committee got the ball rolling, raising interest rates by 25 basis points. In a statement released following the decision the Central Bank said that further increases were on the agenda. While the Central Bank is certainly being consistent, the reasoning for its decision is a matter for debate.

Gap in the currency reserve

- In August the Central Bank of Iceland held a foreign currency auction whose aim was recoup the foreign currency which was used to free up trapped investors in July. One wonders then whether these "regular" foreign currency auctions have reached the end of the line for the time being, or at least in the form used on the last two occasions, since interest among investors/pension funds seems to be virtually non-existent. It will therefore be interesting to see what the next steps towards lifting the capital controls will be; presumably the Central Bank will enable interested ISK-investors to invest in more assets than government-backed bonds.

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The MPC's reasoning for the interest rate hike and Arion Research's opinion:

1. The annual inflation rate is moving further away from the Central Bank's inflation target (2.5%) and the Central Bank forecasts (in its updated economic forecast) that inflation will peak at almost 7% at the beginning of next year.

Current inflation can largely be traced to increased costs of companies which are a result of external factors such as rises in public service fees, the depreciation of the ISK and rising global commodities prices. The diagram below shows that these factors are behind almost 60% of the inflation experienced over the last 12 months. Property prices have also caused considerable inflation and this increase is not driven by a growth in purchasing power and credit expansion, as was the case in previous years.

2. High inflation expectations do not match the Central Bank's inflation targets.

Inflation expectations have risen recently in line with the deteriorating inflation outlook. However, one wonders whether the rise in interest rates is likely to dampen those expectations as current inflation is driven by cost factors which the Central Bank's main interest rate has virtually no impact on. It could be argued that the inflation outlook could worsen even further as the cost of capital in both the public and private sectors increases (see discussion below).

3. The Central Bank has revised upwards its economic forecast for 2011 and the outlook on the labour market is far brighter than originally expected.

The economic recovery has weak foundations and it appears that economic growth in 2011 will be fuelled by growing private consumption and investment. According to the Central Bank's forecast private consumption will grow by 3.8% this year; this growth rate is partly a result of temporary measures, however it could easily be less than this as the purchasing power of disposable income is hardly growing and unemployment remains high. It should also be noted that according to a survey by Statistics Iceland, almost 50% of households struggle to make ends meet. Therefore it is difficult to see how this increase in private consumption can sustain itself. Although economic indicators suggest that investments are increasing again, there has been complete stagnation in investments in Iceland; investments are just starting to climb out of an all-time low and remain well under the average of the last 50 years. It might be wondered whether the sole impact of an interest rate hike at this point is to slow down the weak economic recovery which is under way.

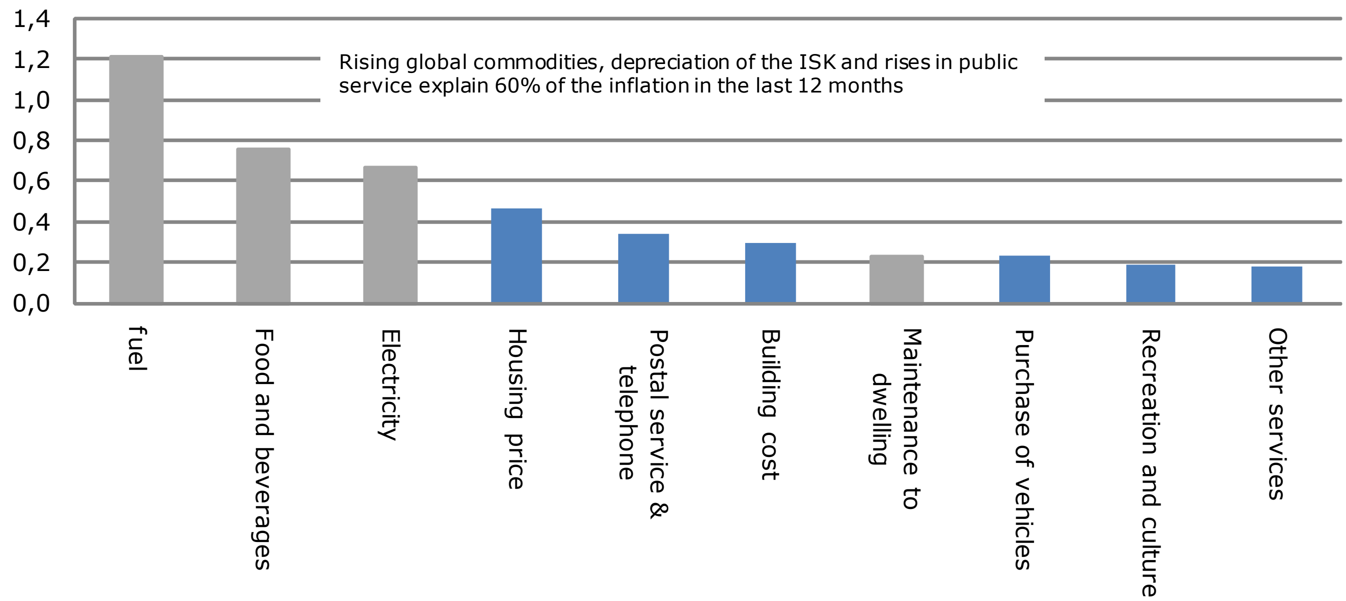
4. Narrow risk-adjusted interest rate differential with abroad could have negative effect on exchange rate of ISK and price levels.

Arion Research does not believe that changes in interest rates in Iceland will automatically have an effect on the flow of capital to and from Iceland. Higher interest rates mean that non-resident owners of ISK can sell more Icelandic currency for foreign currency as their interest income will be higher. However, it is unlikely that interest rates in this country will have a decisive effect on the flow of capital to Iceland as there are capital controls in place and the channel for capital is limited in size.

5. The effect on the Icelandic economy of turbulence on international markets and the worsening global economic outlook is far from clear.

It is highly likely that Iceland will at some point feel the effects of greater slack in the global economy. But the question is how much? It is rather risky to raise interest rates on top of so much other uncertainty in the opinion of Arion Research.

The main factors behind inflation (in the last 12 months)



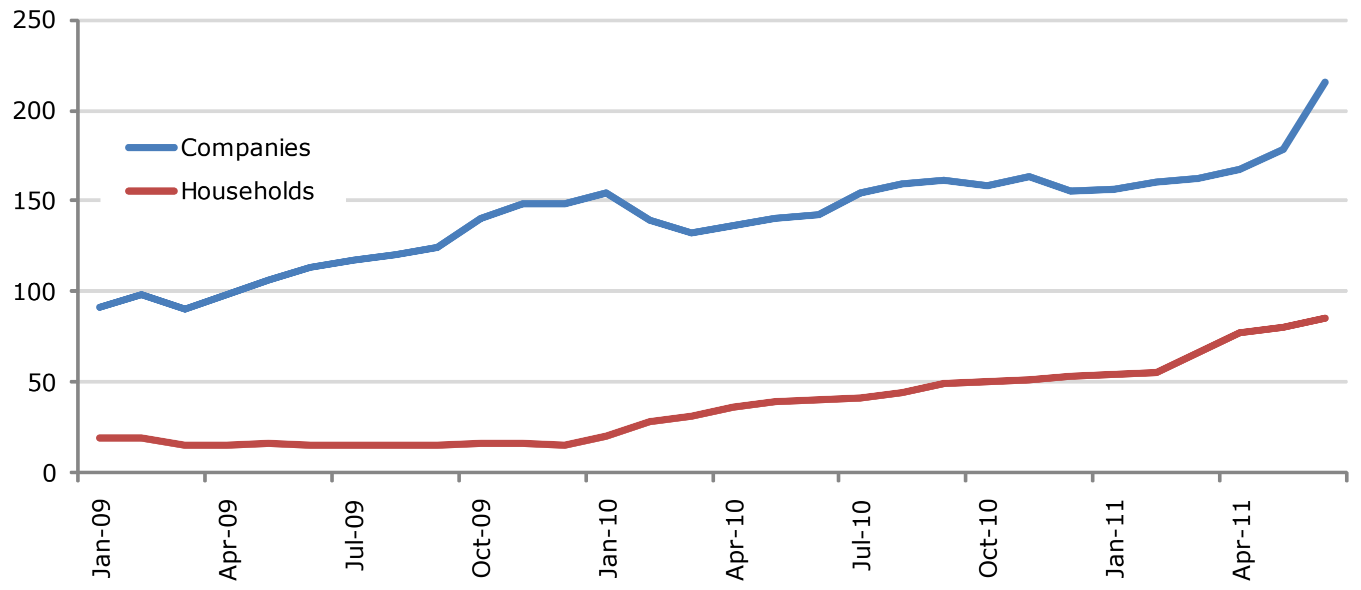
Source: Statistics of Iceland

Greater weight of non-indexed loans – interest rate hikes have deeper impact now

Non-indexed borrowing by companies and households has increased sharply since the collapse of the banks. This is linked to the restructuring of corporate and personal finances, limited access to foreign credit for companies, falling interest rates and changing attitudes towards inflation-indexing. Perhaps the most surprising thing is how much growth there has been in non-indexed loans to individuals – a threefold rise since the beginning of 2009.

This fundamental change means that the Central Bank's interest rates have a far deeper impact than they used to as an even greater proportion of non-indexed loans have floating rates. Non-indexed loans are often such that minor changes in interest rates can have a major impact on the debt burden. The graph below shows the growth of non-indexed loans to companies and households since the beginning of 2009.

Non-indexed loans (ISK bn.)



Source: Central Bank of Iceland

Arion Research has roughly estimated the effect of rising policy interest rates on the interest expenses of the Treasury (net, i.e. taking into account the Treasury's interest income), companies and households.

Interest rate change	1%	2%	3%
Central government	1.080	2.160	3.240
Corporations	2.154	4.309	6.463
Households	852	1.704	2.555
Total	4.086	8.172	12.258

In millions ISK
Source: CB of Iceland. Arion Research estimate.

Higher interest expenses of the Treasury are calculated on the basis of bills rolled over by the Treasury and bond RIKH 18 which is non-indexed and bears floating interest. Given the reaction on the bond market, one wonders whether this is in fact too optimistic and whether the real costs are in fact higher.

The Central Bank of Iceland out on its own – policy change among other central banks?

Although the fall-out from the current global economic climate has yet to be felt to the full, there are strong indications that the global economy is beginning to slow down again. Central banks in Britain, Sweden and the United States have all revised their economic forecasts downwards and recent economic figures point to more slack in the economy. Furthermore, the Norwegian central bank decided to keep its interest rates unchanged. The European Central Bank also appears to have stopped raising interest rates for the time being; it was not long ago since it was widely expected that interest rate hikes would continue through to the end of the year. This places several central banks in a difficult position because at the same time as interest rates are at a historical low, inflation is beginning to rear its head. The Bank of England, for example, expects inflation to peak at 5% later this year, while its main interest rate is 0.5%.

The Central Bank of Iceland therefore appears to be ploughing its own course when compared with banks in Iceland's neighbouring countries. At the same time as the Central Bank of Iceland chooses to start raising interest rates, central banks elsewhere have stopped, at least for the time being. They are doing this in the face of considerable inflation because of the great economic uncertainty in the world – the economy clearly gets to enjoy the benefit of the doubt.

Gap in the currency reserve

In August the Central Bank of Iceland held a foreign currency auction whose aim was recoup the foreign currency which was used to free up trapped investors in July. The Central Bank had acquired almost ISK 15 billion in "offshore krónur" in return for €69 million (taken from the currency reserve) in the first leg of the auction. The second leg of the auction attracted little interest from investors (purchasers receive indexed Treasury bonds as payment for the foreign currency) ; the Central Bank recouped a mere €3.4 million, and the currency reserve thus shrank by €65.6 million (ISK 10.7 billion at the official exchange rate) in one fell swoop. One wonders then whether these "regular" foreign currency auctions have reached the end of the line for the time being, or at least in the form used on the last two occasions, since interest among investors/pension funds seems to be virtually non-existent. It will therefore be interesting to see what the next steps towards lifting the capital controls will be; presumably the Central Bank will enable interested ISK-investors to invest in more assets than government-backed bonds.

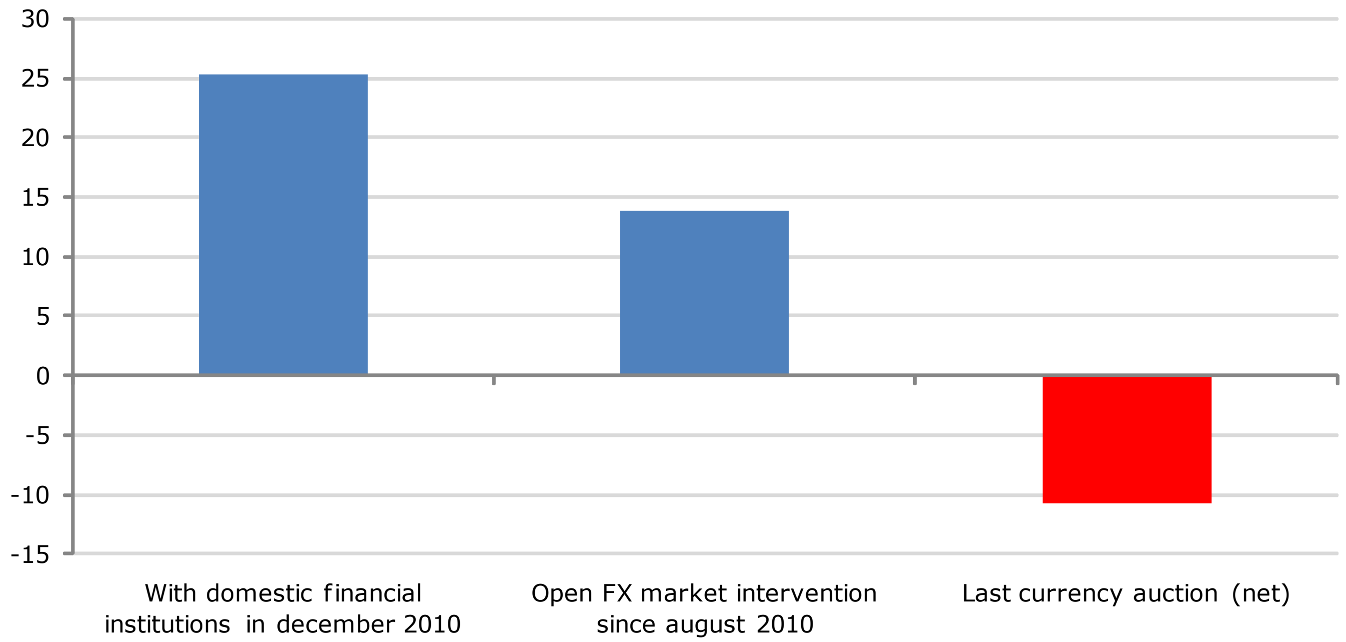
Emptying the vacuum cleaner

The Central Bank has sucked up a large proportion of the capital entering the interbank ISK market over the last year. Since August 2010 the total turnover on the interbank market amounts to ISK 77 billion. The Central Bank has bought more than half of that sum, or ISK 39 billion (based on current euro exchange rate). As a result the ISK has possibly appreciated less than it would have done otherwise, or may have even depreciated.

Excluding the FX transactions between the Central Bank and Icelandic financial companies in December (totalling ISK 25 billion), the Central Bank has amassed ISK 14 billion in its weekly purchases in one year.

Assuming that the Central Bank continues to buy foreign currency at the same rate, it will take about 10 months to make up for the currency it "lost" in the last foreign currency auction.

Central Bank's FX purchases (ISK bn.)



Source: Central Bank of Iceland

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