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Iceland

Business cycle update

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BUSINESS CYCLE POSITION AND OUTLOOK.

Real GDP growth is heading towards 4% this year and just under 3% next year in our view, supported by a still sizeable positive net export position, rising lending growth to the private sector and a tight labour market.

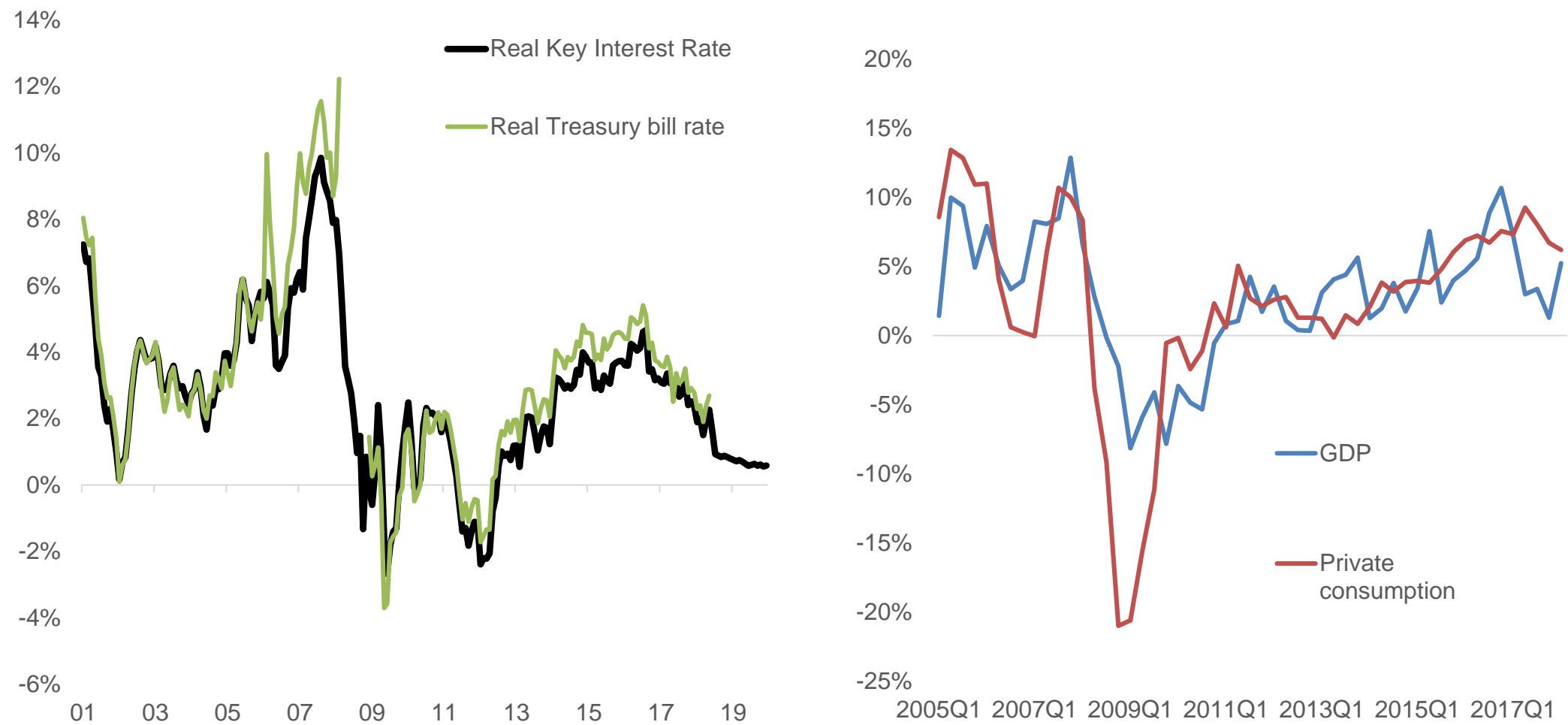
The current expansion phase is particularly long in historical context, as since 1967 the average length of the business cycle has been under 7 years long, while at the moment we are heading for 10 years of steady growth. A longer business cycle is due to the time it took to adjust the balance sheets after the banking crisis and it is helped by a low real policy rate in historical context. The peak of the business cycle was probably reached around the summer of 2017 – a bit earlier than the rest of Europe. This dynamic could imply that the timing of the next recession is one-three years away in our view.

Headline inflation has been modestly rising this year, but has stayed under 3%yoy since 2014, reflecting a growing contribution of food inflation and a fairly steady impact of fuel and housing inflation.

The overall inflation rate has been undershooting our model's projections by about 0.6p.p. on average this year. This in our view means that inflation is proving slower than what historically would have happened given the level of activity and the strength of the labour market. Partly this is probably due to two critical factors: growing internal competition and growing external competition in the retail market due to the entrance of Costco in 2017.

Going forward, our model suggests an acceleration of inflation to around 4% from late this year/early 2019, which is likely to prompt a 50bp of tightening from the central bank in the coming 18 months.

LOW REAL BORROWING COSTS AND RISING APPETITE FOR SPENDING



Notes: Key interest rate deflated by current inflation and assuming no policy rate change takes place in coming quarters. Right hand chart showing real GDP and real private consumption YoY since 2005

Sources: CEIC, ADA ECONOMICS LTD

MONETARY POLICY COUNCIL STRUCTURE, RECENT COMMENTS AND OUTLOOK.

Since 2009, a 5-persons Monetary Policy Committee sets the monetary stance of the central bank, Sedlabanki. The Committee is chaired by the Governor, Deputy Governor, a senior bank official in the field of monetary policy and two external experts in the field of economics and monetary policy. The Council is appointed by the Prime Minister for a term of 5 years.

The central bank is independent and its principal objective is to maintain price stability and to keep inflation as close as possible to its target 1.5-3.5%.

As of the 1st of July, Dr Rannveig Sigurdardóttir was appointed to the position of deputy governor, replacing the long standing member Arnor Sighvatsson.

Rannveig is an economist and has completed her bachelor's, master's and doctorate from University of Gothenburg, Sweden. She was deputy Chief economist since 2002 at the bank.

During the June MPC meeting, the Council expressed the view that real GDP growth will ease slightly due to weaker export growth and less rapid increase in domestic demand, but these factors would be offset by increased public sector spending. Overall, the Bank did not change its assessment, which sees GDP growth to ease this year and inflation to be consistent with the target. The Council noted that house price inflation is high and there is no more favourable impact from the previous appreciation of the currency, but inflation expectations remain consistent with its target.

In our view the policy rate is likely to be increased by 50bp in the coming year, taking the policy rate to 4.75%, among the higher ones in Europe. This is based on our reading of the Council's assessment and due to the fact that under the assumption of unchanged policy rate the real policy rate will drop in the coming two years.

Members	Term starts	Term ends
Már Guðmundsson (Governor)	20 th August, 2014	20 th August, 2019
Rannveig Sigurdardóttir (Deputy Governor)	1 st July, 2018	1 st July, 2023
Thórarinn G. Pétursson (Chief Economist)	15 th September, 2014	15 th September, 2019
Gylfi Zoëga (Member of MPC)	23 rd February, 2018	23 rd February, 2023
Katrín Ólafsdóttir (Member of MPC)	3 rd March, 2017	3 rd March, 2022

Sources: ADA ECONOMICS LTD

ICELANDIC KRONA OUTLOOK.

The Icelandic Krona has been on a broad appreciating path against the dollar from 2015 to early 2018 and has since been on a mild depreciation path.

The balance of payment of Iceland has undergone significant changes since the 2008 global crisis. The current account swung from a deficit to a surplus, much of the turnaround is due to more moderate internal consumption and a wider service exports. As of Q118, Iceland maintained a small current account surplus, worth 3% of GDP on a 12-months rolling basis, which is narrowing due to strong domestic growth.

The capital controls have been gradually lifted and as of April 2017 most restrictions were lifted. That said, some limitations remain in place and are likely to remain in place in the foreseeable future. A special reserve requirement for new fixed income capital inflows remains in place. Use of derivatives, FX transactions between residents and non-residents without the involvement of a financial institution are restricted, as well as borrowing or lending in FX. The legacy positions related to the defunct banks and the old non-resident ISK bonds positions have been eliminated. As such, Iceland faces minimal external debt or earnings repatriation outflows.

In the first quarter of 2018, the balance of payments showed a rising capital outflow, not related to foreign direct investment or portfolio inflows. This could be reflective of a new wave of outward expansion of Icelandic businessmen abroad. This trend appears to be indicating a gentle depreciation path for the ISK, from 106 to 114 to the dollar in the coming 18 months.

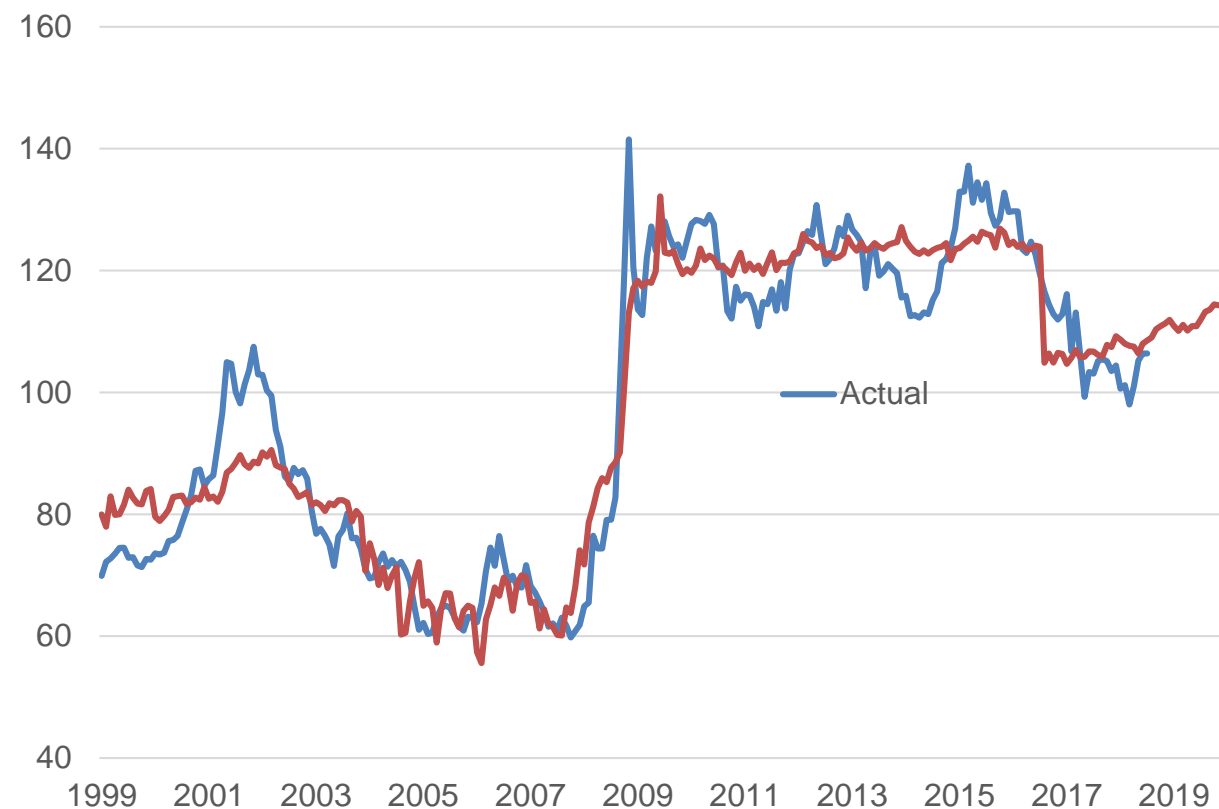
We do highlight that although our model suggests a mild depreciation bias, if the central bank raises rates as we expect and as global capital finds its way back to Iceland, in our view a brisk appreciation of the ISK will quickly materialise. On this issue, it is critical in our view to monitor the inclusion of Icelandic equities in global indices and the changes in the interest rate differential between Iceland and the US.

ICELANDIC KRONA MODEL PROJECTIONS

Our ISKUSD model is based on the paper of Ghalayini, Latifa. (2014). Modeling and Forecasting the US Dollar/Euro Exchange Rate. International Journal of Economics and Finance. Vol. 6,. 194-207. 10.5539/ijef.v6n1p194. This model was modified and adapted to our case.

It uses the following variables:

- A Purchasing power parity proxy measured as the rebased Consumer Price Index in Iceland divided the rebased Consumer Price Index in the United States.
- An interest rate differential variable measured by the difference of real immediate interest rate between United States and Iceland.
- A Business Cycle variable represented by the OECD real stock market levels in United States divided the OECD real stock market levels in Iceland.
- A monetary aggregate variable measured as the indexed level of M1 in the US divided by the indexed level of M1 in Iceland.
- A dummy variable to mark the capital controls changes introduced in 2016.



Sources: CEIC, ADA ECONOMICS LTD

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