Global Economics and Forex Research
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Research Flash

Investment Ideas
Update Iceland: Króna not expected to appreciate in 2006

Private Banking

Current account deficit remains a problem

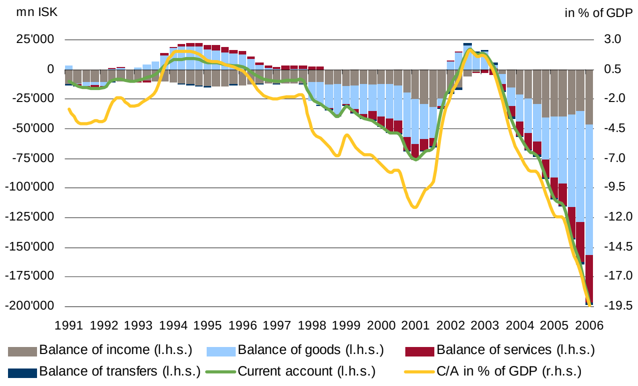
Fitch's downgrade of Iceland's Foreign and Local Currency Rating Outlook from stable to negative on 21 February 2006 can be viewed as the starting point for a depreciation of up to 30%. Fitch substantiated the rating downgrade mainly by the high current account deficit (see Figure 1; according to the OECD, currently more than 20% of GDP and even 26% of GDP according to Statistics Iceland). In this context, the rather illiquid FX market should be mentioned as a factor underpinning the depreciation as it has supported speculative transactions against the Icelandic króna. The high current account deficit comprises all components (see Figure 1). However, the trade deficit accounts by far for the lion's share of the deficit. Although the trade balance still posted a slight surplus in April 2003, the coming years saw imports record markedly stronger growth rates (see Figure 2). The trade deficit is particularly burdened by substantial upgrading in the aluminum industry by way of capital goods imports (see Research Flash Iceland, dated 13 February 2006), which have recently risen by more than 56%.

Even so, a number of factors point towards a clear reduction in the current account deficit in the coming years. First, two-thirds of the investments in the aluminum sector should be completed this summer, paving the way for slower growth in capital goods imports. Second, we also expect aluminum exports to have a clearly positive effect on the trade balance in 2007. High interest rates and falling real disposable income should result in declining imports of consumer goods, which just recently increased to 14%. A drop in the current account deficit to 9% of GDP in 2007 appears possible. However, the biggest risk to a significant deficit reduction is still uncertainty with respect to plans for further aluminum mills, which could see planned aluminum production in 2008 rise from around 0.8 million tons per year (3.4% of global production) to over 1.3 million tons per year (5.7% of global production) and make further capital goods imports necessary. However, these projects are still up in the air and would not be started until 2008 at the earliest. The recent nominal depreciation should (assuming no appreciation takes place), also have a positive ef-

Highlights

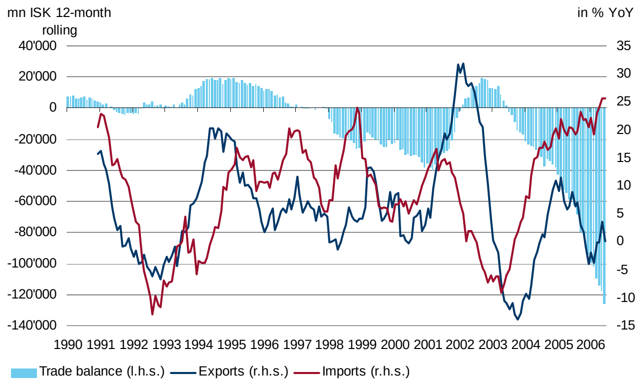
- Economic imbalances render stronger króna unlikely in 2006 and pose a risk of another correction.
- Inflation risks still exist. Higher wage demands could make considerably higher interest rates necessary over the longer term.

Figure 1
Current account balance (12-month rolling)



Source: OECD; IMF; Bloomberg;Credit Suisse

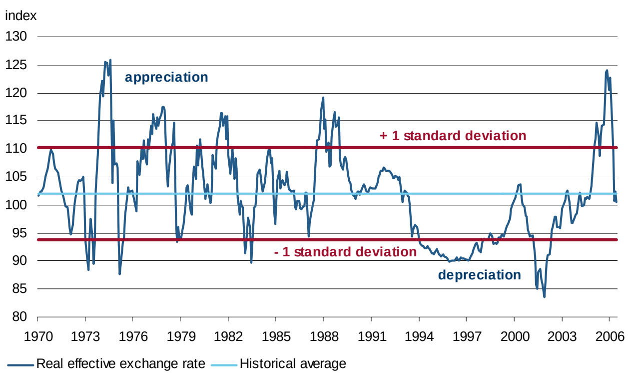
Figure 2
Trade balance (12-month rolling)



Source: Statistics Iceland, Bloomberg, Credit Suisse

Figure 3

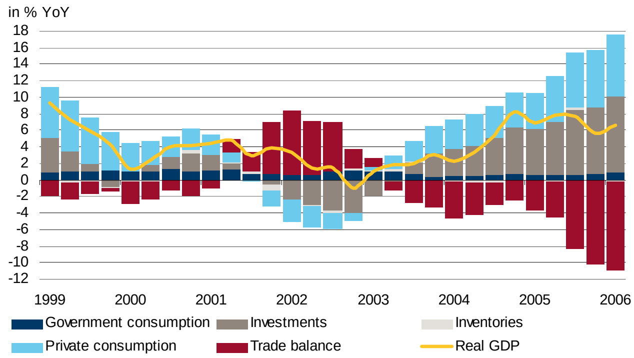
Real effective exchange rate (REER)



Source: OECD, Bloomberg, Credit Suisse

Figure 4

Real GDP growth (4-quarter rolling)



Source: Statistics Iceland, Bloomberg, Credit Suisse

fect on the trade balance. The real effective exchange rate[1] recently returned to its historical average (see Figure 3), and should lead (due to higher competitiveness) to declining imports as well as rising exports. However, this is expected to take place with a substantial time lag. The consecutive marked rise in imports (28% YoY) following a 46% YoY rise in May, comes as no surprise, however, if one takes a look at the macroeconomic correlation between the exchange rate and imports. Depreciation, for example, tends to initially lead to a rise in import prices, and consequently, a rise in imports. Import demand, however, wanes only after a certain time lag (J-curve effect). Hence, the clear increase in imports is considered to be temporary.

Growth expected to stagnate in 2008

Iceland's economic growth continues to be carried by private consumption and investments. Strong consumption (Q1 YoY of 12.6%) is supported by low structural unemployment of around 2%. By contrast, the strong investments (31% of GDP) are attributable to the enormous aluminum projects. Earlier-than-planned aluminum projects led to a larger volume of investments in 2006 than originally had been expected (Q1 YoY of 37%). The large macroeconomic imbalances in the Icelandic economy become evident (apart from the large current account deficit) if one takes a look at the breakdown of GDP by component (see Figure 4). Alongside the large positive contribution made by investments and private consumption, foreign trade makes a considerably negative contribution. Although we expect the improvement in the current account (and hence, the net export contribution to GDP) to result in a much lower negative contribution in 2007, the negative inflationary development on the back of higher key interest rates should lead to a marked decline in private consumption. By contrast, investments, in light of the ongoing aluminum projects in 2006, should continue to rise in 2006. Public-sector consumption should grow at a slightly faster pace in 2007 as the Icelandic government is likely to take on projects for the US military at the Keflavík NATO base. We share the Central Bank of Iceland's view that economic growth is set to shrink considerably to 1% in 2007 before slipping into stagnation.

Labor market carries inflation risk

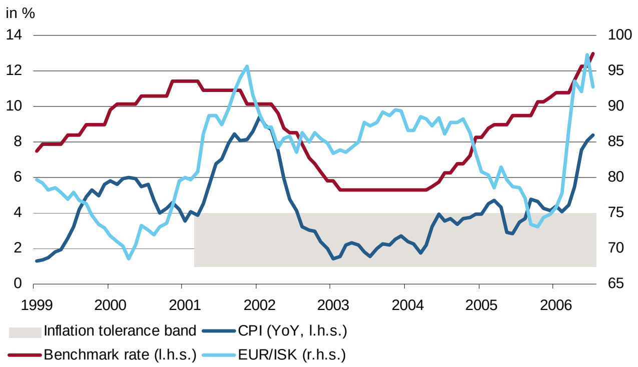
Since 2004, strong private consumption has generated signs of an overheating Icelandic economy, which in late 2004, was reflected in inflation breaking out of the central bank tolerance range. Until February 2006, 70% inflation was driven by the cost of housing. It was only the strong Icelandic króna which prevented (via moderate wage demands) even higher inflation (see Figure 5). However, the marked depreciation of the króna has been reflected in the CPI since March. Imported inflation (gasoline, food, automobiles, alcohol and tobacco) and the (depreciation-related) shift in demand towards the now relatively cheaper domestic goods now account for just under 50% of inflation. We expect inflation to peak at over 10% YoY in the spring of 2007. Further inflation pressure could emerge in the coming months from the job market. In the past months, the strong króna has supported the central bank's restrictive monetary policy (through moderate inflation expectations and wage demands); however, on the back of clearly higher inflation expectations, there is now the risk of larger wage increases. The tight job market (unemployment of below 2%) and the high degree of unionization are also driving inflation. The Central Bank of Iceland has recently accentuated this risk factor.

Although the Central Bank of Iceland has raised nominal interest rates by 325 bps since April 2005, real interest rates dropped from 6.1% to 3.8% during the same period. Together with expected wage increases in connection with the depreciation of the króna, monetary policy has, de facto, actually been expansionary. This has caused Iceland's central bank to repeatedly make hawkish statements in recent weeks and to leave open the prospect of further interest rate hikes. In fact, inflationary risks recently led the central bank to schedule an extraordinary meeting on 16 August. Regular meetings, during which a decision is made regarding key interest rates, usually

1 The real effective exchange rate is a trade-weighted real exchange rate. The real exchange rate pairs of those countries with which Iceland conducts foreign trade of any kind whatsoever, are factored into the calculation.

Figure 5

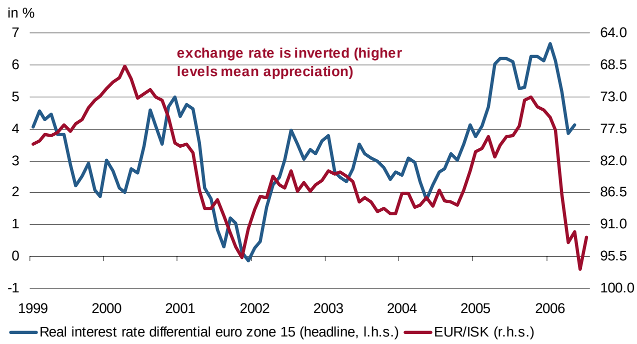
Inflation, key interest rate and EUR/ISK



Source: Statistics Iceland, Central Bank of Iceland, Bloomberg, Credit Suisse

Figure 6

Icelandic króna vs. euro and real interest rate differential



Source: Central Bank of Iceland, ECB, Eurostat, Statistics Iceland, Bloomberg, Credit Suisse

take place every two months. However, this meeting was scheduled to be able to react in a timely manner. The next meetings are scheduled for 14 September and 2 November. We expect the central bank to raise rates by at least 75 bps at the first two meetings.

Risk for a weaker króna remains

Despite the sharp depreciation in February 2006, there is still a potential risk of further depreciation. The current account deficit in the first quarter reached an all-time negative high of around 20% of GDP. A significant improvement could be thwarted by a number of planned aluminum projects and weaker marine exports. Moreover, the real interest rate differentials have narrowed. Although we expect the real interest rate differentials to increase in the coming months, these should be slowed down by higher inflation in Iceland and further interest rate hikes, for instance, in the euro zone. Higher wage demands could even amplify this effect. The negative economic outlook for 2007 and 2008 and a large volume of expiring króna-denominated bonds in 2006 could bring the króna under downward pressure in the coming months. In the past few weeks, the Icelandic króna has performed positively, driven by more dovish statements by the Fed's Bernanke following the release of the latest US CPI data. However, this reflects carry trades in the Icelandic króna which, in the event of recurring interest rate speculation in the United States, could react extremely sensitively (negatively) to hawkish US comments. A consolidation of the króna is possible. Nevertheless, within the next months the risk for a further correction remains due to the macroeconomic imbalances. We recommend restraint. A major reduction in the country's macroeconomic imbalances in the upcoming months would support the consolidation of the króna.

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