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ISSUER COMMENT
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Analyst Contacts

Kristin Lindow +1.212.553.3896
Senior Vice President
kristin.lindow@moodys.com

Michael S. Higgins +1.212.553.1619
Associate Analyst
michael.higgins@moodys.com

Dietmar Hornung +49.69.70730.790
Associate Managing Director
dietmar.hornung@moodys.com

Yves Lemay +44.20.7772.5512
MD-Sovereign Risk
yves.lemay@moodys.com

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Government of Iceland

Central bank's reduced reserve requirements on capital inflows are credit positive

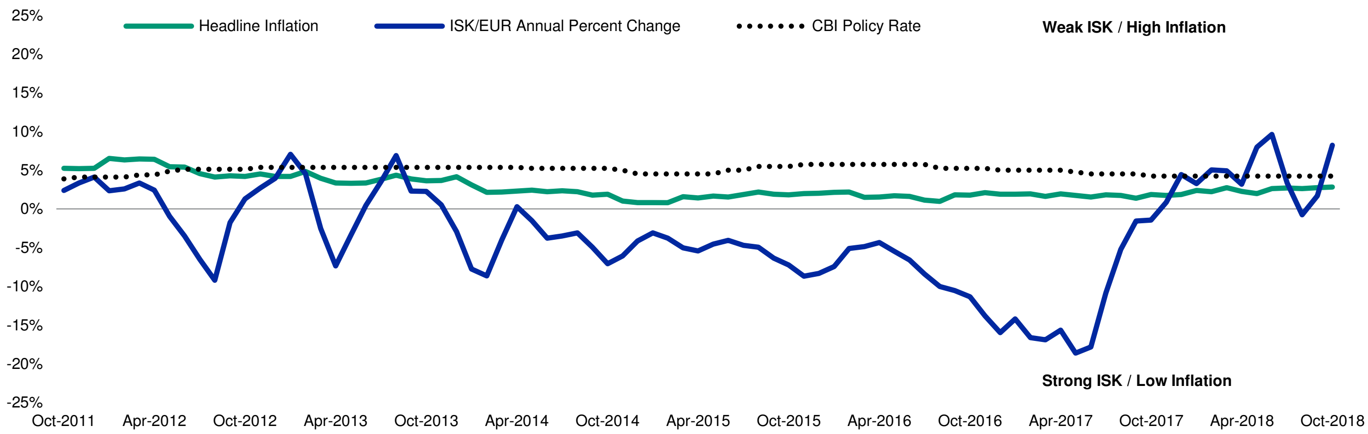
On 2 November, Iceland's (A3 positive) central bank announced that it reduced the special reserve requirement ratio for new foreign currency inflows to 20% from 40%. The bank noted that Iceland's narrowing interest rate differentials versus other advanced countries and a weaker exchange rate warranted easing restrictions on foreign currency inflows. Previously, on 11 October, the central bank announced that it was merging the Financial Stability Authority (FME) into the financial stability department at the central bank next year.

Both shifts in policy are credit positive because they demonstrate continued progress toward full capital account liberalization and the increased maturation of financial regulation and supervision processes in line with global best practices. The merger of macroprudential policy and financial market supervision will help assure that restoration of the banking system's health will be maintained. Together with the cut in the special reserve requirement, the move is a testament to Iceland's adherence to International Monetary Fund (IMF) advice at nearly every stage since the financial system collapsed in October 2008.

After its introduction in June 2016, the special reserve requirement (SRR) required foreign investors to make deposits into a zero-interest-bearing account at Icelandic deposit-taking institutions when they want to bring in capital to the country, excluding the case of fixed capital investment. The SRR has been 40% of the capital brought in ever since. This has been large enough to effectively discourage most speculative capital inflows, which could otherwise destabilize Iceland's very small financial markets and put upward pressure on the Icelandic króna's already highly valued exchange rate.

The restriction was especially helpful in recent years when current-account surpluses were large, contributing to króna appreciation. The restriction allowed the central bank to keep its relatively tight monetary policy stance unchanged. Through 2016-17, subdued global oil prices and the lagged effects of króna appreciation kept inflation low (see Exhibit 1).

Exhibit 1
Iceland's inflation has remained moderate as the króna appreciated
(Percent)

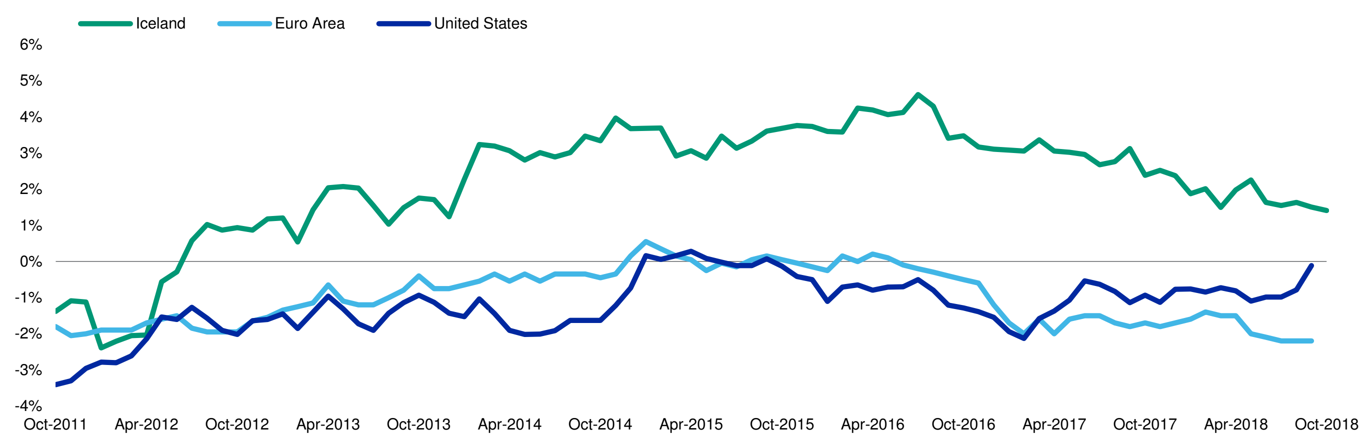


Sources: Statistics Iceland, Central Bank of Iceland and Moody's Investors Service

Now that the current account surplus has narrowed sharply and upward pressure on the currency is no longer a concern, since the exchange rate depreciated by more than 20% against the dollar in recent months, there is room to lower the SRR. Investors that previously held the larger amount in the special deposits will be refunded their money.

We believe that the government's cautious decision to maintain the special reserve requirement, albeit at a lower rate, relates to the risks posed by upcoming wage rounds. Initial demands are for very large increases amounting to 40% nominal increases over three years. Ultimately, we do factor in a high probability of wage increases in excess of inflation plus productivity growth, the normal formula for calculating wage increases that would maintain competitiveness. If such high wage increases are awarded, the resulting upward pressure on inflation is unlikely to be offset by appreciation of the króna and low oil prices, as was the case during the last major wage round three years ago. This makes it likely that the central bank will tighten monetary policy at a rate faster than either the US or the European Central Bank, raising the interest rate differentials again (see Exhibit 2) and potentially spurring fresh capital inflows. We expect that keeping a special reserve requirement in place will deter excessive inflows, thereby preserving financial stability.

Exhibit 2
Iceland's inflation differentials have narrowed sharply but are expected to widen again in 2019
(Real interest rate,* percent)



Note: Real interest rate is calculated as the nominal policy rate less headline inflation
Sources: National sources and Moody's Investors Service

The central bank's ability to lower the SRR despite the risk of higher inflation reflects the improvement achieved in monetary policy transmission since the crisis, the economy's narrower current-account surpluses and more market-determined exchange rate. In our view, these developments further demonstrate Iceland's progress in restoring macroeconomic and external normalcy 10 years after its crisis.

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