



Central Bank of Iceland:

Board of Governors' press conference, Thursday 14 February 2008

*Monetary policy statement of the Board of Governors of the Central
Bank of Iceland:*

Policy interest rate unchanged

The Board of Governors of the Central Bank of Iceland has decided to leave the Bank's policy interest rate unchanged at 13.75%. The inflation forecast in the November issue of *Monetary Bulletin* assumed an unchanged policy rate through mid-2008. Despite signs of considerable changes ahead in the Icelandic economy, the Board of Governors does not believe there is reason to depart from that forecast at this time. Inflation is still considerably above the Bank's target.

According to economic indicators, demand – private consumption in particular – grew rapidly through the end of 2007. The labour market remains very tight, and contractual wage negotiations are still underway. The króna has depreciated to levels below the path assumed in the November forecast. The short-term inflation outlook is therefore less favourable than it was in November and in December, when the Board of Governors announced its most recent policy rate decision.

On the other hand, financial market conditions have continued to deteriorate, both in Iceland and in the global markets, since the Bank's last policy rate decision. The supply of credit available to households and companies has shrunk, and lending terms have become less favourable. Equity prices have dropped significantly since the beginning of 2008, which raises the cost of capital and weakens the balance sheets of businesses and households alike. Real estate prices are expected to decline. A downturn in housing prices was forecast in November, and it could prove deeper than was predicted then, despite starting later.

These developments support the Central Bank's tight monetary policy, as they contain demand growth and reduce inflationary pressure, as well as having a direct effect on inflation through the housing component of the CPI. It is uncertain how quickly this will happen. However, it is unlikely that a sharper contraction than that predicted by the Central Bank in November will spark more rapid disinflation early in the forecast horizon. The króna could depreciate concurrent with a reduction in the supply of foreign capital. Such a combination of events could raise inflation expectations and cause wage drift, thereby delaying disinflation.

It cannot be asserted at this time that the long-term inflation outlook has changed materially since November. Uncertainty is greater than before, however, especially as regards the impact of deteriorating financial conditions – shrinking credit supply and rising interest premia – on demand and inflation. For the longer term, trends in inflation are determined largely by the interplay between exchange rate developments and the output gap. In the weeks to come, the Central Bank will follow developments in economic indicators very closely, particularly those that reflect the impact of poorer financial market conditions on lending and demand.

As before, controlling inflation and anchoring inflation expectations is vital for the economic well-being and balance sheets of households and businesses. The Board of Governors will continue to base its policy rate decisions on this fundamental consideration.

Questions and answers:

Question: How much does this decision reflect the situation regarding the ongoing wage negotiations?

Chairman of the Board of Governors: It doesn't reflect it at all except that it's clear to us that wage negotiations have not been concluded. That, of course, is a situation that generates uncertainty; we didn't have as clear a premise for our assessment of economic conditions as we would have had if wage negotiations had been settled and people could see what was on the horizon. But in other respects, we aren't involving ourselves in labour market negotiations at all, or in how the labour situation is unfolding.

Question: Is it the Central Bank's intention to steer the economy to a hard landing, as was implied in *Monetary Bulletin* in November?

Chairman of the Board of Governors: It is not the Central Bank's goal to cause a hard landing. On the other hand, we consider ourselves obligated to try to reduce the tension that has existed – and that looks likely to persist for some time. That is our goal. We would like to draw attention to the fact that when corporate leaders were asked what they considered most important in terms of company operations, the majority of them said controlling inflation was the most important factor.

Question: Is there any possibility of an extra policy rate decision date in March?

Chairman of the Board of Governors: It's not out of the question, but there are no plans for it as of now. The Central Bank has reserved the right, as I believe most other central banks have done, not to limit its policy rate decisions to pre-announced interest rate decision dates. Unless a decision is made to the contrary, we expect the next decision will take place on the next scheduled decision date. But an extra interest rate decision cannot be ruled out.

Question: What effect does the housing component have on this? Before Christmas and again today, the Central Bank predicted that housing prices would fall. How much?

Chairman of the Board of Governors: As has been said here, the Central Bank has forecast a decline in housing prices, and as we are emphasising now in our announcement, the decline could be deeper than previously expected, despite its beginning later. And of course, trends in housing prices are a reliable indicator of trends in the general economy.

Question: How much of a drop in housing prices does the Central Bank predict?

Chief economist: Those figures weren't published. It is extremely tricky to predict trends in housing prices, and the fact is that the models we are using indicate a substantial drop in real estate prices. We don't quite believe those figures, but if I remember correctly, our last forecast implied a year-on-year drop of about 6%. So far, the

housing market has been stronger than our forecast indicated, so it will just come later.

Chairman of the Board of Governors: We see that the banks have virtually stopped granting mortgage loans – they’ve certainly slowed down quite a bit – and various other conditions that I mentioned earlier will surely press housing prices downward. But it’s extremely difficult, and even questionable, to put a number on it. Of course, people have a frame of reference in mind when they are going over the forecasts, but we haven’t publicised more precise figures than what the chief economist said just now. I think it would be inadvisable to pin it down further.

Question: People thought they could discern in your last decision that you were considering financial stability more, and not only the inflation target. But now we see growing instability, in the global financial markets and here in Iceland. With this decision, are you in some way ... one isn’t sure whether you mean that this is a factor that you’re considering. We have seen that this has been discussed widely. Mishkin has published a well-known article on it, and people have been wondering whether central banks shouldn’t take a different view of things under the current circumstances. What do you have to say about that ?

Chairman of the Board of Governors: We make brief mention of this in the announcement I read a moment ago. It mentions the fact that the outlook has worsened, and when we examine the situation in the markets, we are mainly considering the effect that market developments have on our monetary policy. That is, when there is a shortage of credit following steep stock market declines, and when the cost of capital increases, for companies and individuals alike, these things support the Central Bank’s efforts to reduce the pressures in the economy, and they create conditions conducive to disinflation. We are looking at all these factors, but we’re not necessarily making a conscious effort to heave the market up again, if that is the question. Actually, we believe it isn’t too likely, for the long term, that Central Bank measures would do that. But we’re considering the consequences of these developments, and we realise that when assets prices change sharply, this affects people’s expectations, which in turn affect how inflation develops. So that’s why – when credit supply shrinks dramatically, when the banks step on the brakes – I’m not saying they’ve come screeching to a halt, but they certainly have their foot on the brake pedal – there is no doubt that it affects factors that, in turn, affect inflation, inflation expectations, and inflation trends. This is why we examine all these factors.

Question: Today's decision has already been criticised, for example, by the CEO of Landsbanki. Is the Central Bank too small to be expected to contain inflation successfully?

Chairman of the Board of Governors: I think the Central Bank has shown that, under certain circumstances in Iceland, its monetary policy kept inflation from spiralling out of control. There aren't many economies, large or small, that have been subjected to the pressure that ours has. Some of it, of course, is positive pressure, with positive consequences, but nonetheless it's enormous pressure, pressure of various types, and it came all at once. Staggering investments, a huge injection of liquidity from all over the world – and despite all this, inflation didn't spin out of control. We believe – and we think there is good reason to believe that it's not just arrogance on our part – we believe that it's thanks to the Central Bank's tight monetary policy that things weren't worse than they were. We have seen it elsewhere, in larger countries, and we needn't have any inferiority complex where this is concerned. We saw the US Federal Reserve Bank raise interest rates 18, 19, 20 times in a row before it made any difference. They watched inflation creep up before their interest rate hikes began to yield results. It is natural that central bank measures take time to “kick in” and make themselves felt. Far be it from me to say that the Central Bank has divine power, but it is true that the Bank and its tools work in the end. And maybe criticism of the Central Bank will increase now. That's perfectly healthy, but perhaps criticism is on the rise because the restraining measures are being felt more strongly throughout the economy than they were before.

Question: Kaupthing Bank has taken a different view of things than the Central Bank. Wouldn't it be a relief if it left the country?

Chairman of the Board of Governors: When you say Kaupthing takes a different view than the Central Bank, are you referring to using the euro, and that sort of thing? This is perhaps an opportunity to correct some things that have been said in that context. When Kaupthing applied to the Register of Annual Accounts about it, the Central Bank expressed the opinion that it could have a negative effect on monetary policy if financial undertakings in general began carrying out their accounting in euros. The Register of Annual Accounts has not publicised its opinion, but I think it's necessary to say that the Central Bank's opinion had no effect on the decision made by the Register of Annual Accounts. The Register of Annual Accounts operates in accordance with the law. The Central Bank's viewpoint was aimed primarily at Althingi and the government. The Register of Annual Accounts' decision to reject Kaupthing's request had nothing

to do with the Bank's opinion, and I don't think they were wrong in rejecting it, not according to law. They just went over the figures, and they decided Kaupthing did not meet the current statutory requirements. But it's being talked about all over town because their opinion has not been publicised, which is a shame, and now everybody is saying that it's the Central Bank's fault that Kaupthing wasn't authorised to conduct its accounting in euros. Their being able to carry out their accounting in euros was subject to the successful conclusion of that Dutch bank acquisition. The Register of Annual Accounts set the condition that the acquisition take place by the end of the year, and since it didn't, the conditions weren't fulfilled. That's why the request was denied, and it is preposterous to accuse the Central Bank of any involvement in the matter.

Question: But apart from that, would it be a relief to the Central Bank of Iceland if Kaupthing were to move its operations out of Iceland?

Chairman of the Board of Governors: No, it's not our goal to see any companies leave Iceland. We want them to have the best conditions possible – the most advantageous conditions possible – so that they can remain here. I think you can say that that's our opinion. That subject has not come up for discussion here, and I don't know whether it was in the offing. But I believe that these companies can enjoy excellent operating conditions here, and that the business environment is desirable and advantageous for them.

Question: Is it more or less likely that the policy rate will be lowered in April?

Chairman of the Board of Governors: We aren't willing to express ourselves on that subject beyond what we say in our announcement. It's for others to analyse that announcement. At this point in time, even though we prefer to be as transparent as possible, we can't answer that question.

Question: This decision is based on inflation as it is today. The most recent inflation measurement that you used as a basis for the decision – how old is it?

Chairman of the Board of Governors: The inflation measurement we used is the most recent that was done. But we're not looking at inflation measurements alone, and perhaps the actual measurement is least among the factors we consider. We look at everything. As we've said, we examine all of the factors that keep inflation expectations high. We look at the pressures that generate inflation, and we describe this in our report. That report is short, of course, but we draw attention

to the fact that the fundamental premises set forth in the November issue of *Monetary Bulletin* still exist. We mention the things that have changed since then, but there have been no changes in the basic premises for our opinion that interest rates are unlikely to start unwinding earlier than was assumed in November. It could well be that this decision in and of itself will have a positive effect on the exchange rate, at least for the short term, but that's another matter. The exchange rate has sagged a bit recently, despite high interest rates and a wide interest rate differential.

Question: Will a depreciation of the króna mean that interest rates will be raised?

Chairman of the Board of Governors: We've stated previously that if the króna depreciates substantially and inflation takes off, the Bank cannot rule out a policy rate hike, but we're not planning that at this point.

Question: Does this mean the Central Bank is aiming at an exchange rate target?

Chairman of the Board of Governors: No, I hope I made it clear that it isn't. I did stress that the exchange rate could affect our decision. We don't have an exchange rate target, but of course, we keep our eye on the exchange rate.

Question: When the next policy rate decision date comes, will you take into account what other central banks around us are doing? Especially in view of what is happening all over the globe?

Chairman of the Board of Governors: Yes, we will take that into account. It's appropriate that we do so because it could affect the interest rate differential between Iceland and other countries. It has been stated that all banks are lowering interest rates. It is true that the US Federal Reserve has cut interest rates very rapidly, for reasons we mentioned earlier. The Bank of England has cut interest rates somewhat, but the Governor of the Bank said recently that there is little reason for a substantial further cut in the base rate – I believe that was how he put it. The European Central Bank has not cut its rates. It seems to have abandoned its path of raising its policy rate, if you can put it that way, but it hasn't cut it. Neither has it given any clear indication that it intends to do so. The Swedish Riksbank, though it affects a smaller area, just raised interest rates a few days ago. So different banks are making different decisions, but naturally we keep track of what is happening around us, especially the things that affect factors like the interest rate differential.

Question: The managing director of the Confederation of Icelandic Employers, said yesterday that if there were a policy rate cut of at least 0.5% it would be like a wet rag in the face of the parties to wage negotiations. Is this a wet rag?

Chairman of the Board of Governors: I don't think so. Of course, everyone must evaluate it for himself, but we are certainly not trying to complicate the wage negotiation process. Actually, we believe that one of the things that could generate the most trust between the parties would be a low, stable inflation rate. There is nothing that weakens negotiations, nothing that pulls the rug out from under wage agreements, as much as inflationary pressure and the instability that accompanies it. And I speak from long experience.

Question: Icelanders are currently carrying 80 billion krónas in overdraft loans at the highest interest rates in the domestic market.

Chairman of the Board of Governors: Overdrafts are the type of lending terms no one should use for an extended period of time. People should do everything in their power to avoid carrying an overdraft. That figure is probably inflated, though, because it includes regular credit card balances at the end of each month, and those cards – or those debts – don't carry overdraft interest rates, even though they're reported together. I don't remember exactly what the proportion is. But if we exclude credit cards, that figure drops dramatically, so we should be careful when we talk about it.

Question: The Prime Minister and other government ministers intend to meet with the CEOs of the Icelandic banks later today in order to discuss how to react to negative press coverage of the Icelandic economy. Has the Central Bank been asked to participate in this in any way?

Chairman of the Board of Governors: The Central Bank met with government ministers recently and explained its viewpoints on this subject. We also reported on the information we have gathered from numerous meetings and discussions with the world's largest banks, especially in this part of the world, and with credit ratings agencies and the like. We explained our viewpoints to the ministers, and we encouraged them to speak directly to the commercial banks. We have been in close contact with them over the past several days and weeks. We've had frequent meetings with the parties involved, so we believe the matter is well in hand. Of course, we are concerned – I can't deny it – that the global markets should be as intractable as they have been, and we are concerned about the fact that there are, as yet, no signs of

their opening up again. It's a difficult subject to make predictions about, but unfortunately, at the moment the situation is that the short supply of credit available to banks – Icelandic and foreign alike, but particularly Icelandic banks because of their CDS levels at this point – this shortage of credit could persist for quite a while. We explained this to the government, and I assume that the meeting with the banks is a follow-up of our meetings with government leaders.

Question: Does the Central Bank believe the banks are in a precarious position?

Chairman of the Board of Governors: We think the banks are well positioned in comparison with other similar banks; they are well funded, and they have prepared themselves very well. But it is also true that over the next two or three years their funding needs will be quite considerable, so they have to be prepared to withstand it if the markets are slow to open up. We have closely monitored the banking system, and we have spoken with government ministers, as I said. Since you ask, I think it's appropriate to say that we gave full account of the situation as we see it.

Question: Do you still assume there will be a rapid series of policy rate cuts in the second and third quarter of this year?

Chairman of the Board of Governors: You could say that we still stand by the scenario we presented in November, as we stated in our announcement this morning. We will follow economic indicators