



September 11, 2008

Central Bank of Iceland:

Board of Governors' press conference, Thursday,
September 11, 2008

Question: According to the Bank's model, was a policy rate hike an option at this point?

Chairman of the Board of Governors: As we said at our last press conference, the probability tended more in that direction than the other, but as is stated in today's monetary policy statement, economic indicators diverge widely. At this point, our options are the same as they were last time: an unchanged policy rate or an increase.

Question: This week's issue of the newspaper *The Market* states that in the past the Central Bank began cutting the policy rate right before inflation began to wane. Can we infer from your decision today that inflation has yet to rise higher, and that the peak hasn't been reached yet?

Chairman of the Board of Governors: We said in our monetary policy statement that inflation is likely near its peak just about now. We word it that way so as not to rule out the possibility of a higher monthly measurement, but we said explicitly that we believe inflation is at a peak and will unwind soon, whereupon we can lower the policy rate.

Question: Is this a sign that the Central Bank is pursuing its policy more aggressively than ever before?

Chairman of the Board of Governors: I wouldn't put it that way. I am of the opinion that the Central Bank has been very consistent. It has a specified task to undertake, and it has no interest in renegeing on that task. Furthermore, I am of the opinion that the success of the Bank's endeavours and policy cannot be measured at this precise juncture in time. That is a subject for scrutiny later on. Certainly the Central Bank of Iceland is capable of making mistakes, as is any person or institution, in Iceland or elsewhere, but what is critical is that

the Bank be consistent, that it comply with the rules that govern it, and that it work toward the achievement of the goals entrusted to it.

Question: You say that economic indicators are divergent, but if we examine the indicators that we can measure –the exchange rate has dropped, unemployment is low, output growth is greater than you projected, and inflation lies outside the 75% confidence interval you assumed in the last issue of *Monetary Bulletin* – based on these indicators, you should have raised the policy rate. Is the Central Bank being consistent, then, if it doesn't do so?

Chairman of the Board of Governors: As we said, indicators point in both directions at present. You listed the variables on one side of the equation, but we have listed both sides in our policy statement. We mentioned the tight credit market, the fact that interest rate spreads have begun to complement monetary policy, and so on. So economic indicators are indeed divergent, and in that respect, we are probably at a crossroads.

Question: You also mentioned that measures designed to stimulate the economy would be untimely at this point. Are you referring in particular to government measures; that is, government construction projects in the current year?

Chairman of the Board of Governors: Under the conditions reigning right now – in September, when fiscal budget preparation is underway – we consider it appropriate and prudent that the Bank express its view: that it is not appropriate at present to use government finance to fight a recession that has not occurred. Doing so would tend to exacerbate the problem rather than solve it. The Government has followed such conservative policy, and it has been successful in reducing Government debt. Under the current conditions, we do not consider it timely to behave as though a recession has hit and to try to mitigate the effects of such a recession by adopting stimulative fiscal or monetary measures. We mentioned this in our policy statement, and I repeat: we consider it neither prudent nor opportune nor necessary under the current conditions, whatever may transpire later.

Question: Is the Bank of the opinion, then, that the government has gotten ahead of itself with the current year's expenditure increases?

Chairman of the Board of Governors: The Central Bank never expresses itself in that manner. But as I said, the fiscal budget is being prepared, and we consider it appropriate and timely to communicate the Central Bank's viewpoint on government finances.

Question: In Parliament just this week, the Minister of Agriculture said that if interest rates weren't lowered as soon as possible, it would simply destroy agriculture and other economic sectors in Iceland. And now the policy rate is not cut but held unchanged. Do you think he is mistaken? Or do you think the Central Bank and the Government have conflicting views on what is the most beneficial interest rate policy for the Icelandic economy?

Chairman of the Board of Governors: No, I think the Minister of Agriculture is absolutely right. It is vital to bring interest rates down, and that is precisely what we want to do. But the prerequisite for policy rate reduction is that inflation be brought into line, and I am firmly convinced that the Minister of Agriculture agrees on that score. Controlling inflation is no less important for agriculture than for others, and when that has been accomplished, interest rates can be lowered, which is also critical for agriculture. So with this qualification, I think our views are entirely convergent.

Question: In the Bank's opinion, when would it be timely for the Government to adopt some sort of stimulative measures?

Chairman of the Board of Governors: I don't think it's appropriate for me to discuss that at length, but in general, fiscal policy can be used to alleviate cyclical swings. Certainly, it is necessary to avoid exaggerating them during volatile times, but there is nothing wrong with taking steps to smooth them out. Having said that, we cannot give you any exact date in answer to your question.

Question: Do you have any particular period in mind?

Chairman of the Board of Governors: No, I have nothing more to say on the subject. Perhaps my colleagues would like to? (No).

Question: The króna has depreciated sharply in the past year, as we all know. It has continued to fall this month and dropped sharply today as well. This depreciation is accompanied by inflation. Isn't the Central Bank's primary weapon, the policy rate, rather a blunt blade under these circumstances? Can the Bank do anything about this aspect of inflation?

Chairman of the Board of Governors: I think this talk about the ineffectiveness of the Central Bank's weapons is groundless. On the contrary, I think the complaints about the Bank's decisions and actions indicate clearly that its weapons are indeed sharp enough to cut at this point in time. And while it doesn't give us any particular pleasure to

see them bite, we are convinced that it's necessary to use the weapons in our arsenal in order to achieve what we want to achieve. The fact is that the financial markets are volatile in most parts of the world. Today, for example, the markets were sliding all over the globe, just before this press conference began. The króna, however, is at a historical low, and there could be a number of reasons for that. The króna is a sign of what is happening in the economy, and it reflects the volatility reigning there because it is a living currency. If it didn't respond to external volatility, it would be dead.

Question: It's a question of a living or dead currency again. As you have mentioned, the Central Bank has been subjected to various types of criticism, both direct and indirect. Just yesterday it was reported that the Confederation of Icelandic Employers (SA) had demanded that another currency be adopted. Does that put the Central Bank in a tight spot?

Chairman of the Board of Governors: No, I don't think so. On the other hand, I think it would be wise if people would develop their national reconciliation ideas in a more conciliatory manner. Kindling disagreements is a poor recipe for consensus.

Question: Do you think that these insinuations by the Confederation of Icelandic Employers and the labour movement represent a vote of no confidence in the Central Bank and the Government's ability to tackle the current economic situation?

Chairman of the Board of Governors: No, I don't think so. I think that if we come to terms with the fact that we have to face the situation and not go chasing inflation – with the well-known consequences that would follow – and as is stated in the conclusion to today's monetary policy statement, if we decide to work together, we will find that this is the best way to safeguard disposable income for the long term. I am well aware that leaders on both sides of the table are passionately interested in achieving both goals – equilibrium and stability – and that they want to achieve these goals with minimal reduction in disposable income. Some reduction is unavoidable, however, while we sail through these choppy waters.

Question: As regards the reliability of the forecasts and estimates made by the Central Bank and others, it was stated on the radio some two or three weeks ago, and again today in *Morgunbladid*, that one of the most prominent segments of the domestic economy – the housing market – is subject to substantial uncertainty and that information is lacking. There is an estimated one- to two-year supply of unsold new construction on the market. How is it possible to carry out reliable

economic forecasting with such sizeable uncertainties that can even be regarded as unknown quantities?

Chairman of the Board of Governors: I don't think this has been such an unknown quantity. Far from it. I think we saw the situation as it was, and because we did, the Central Bank projected that prices would drop precisely for this reason, although there were other reasons as well, and although that forecast was criticised at the time, it is gradually materialising. For a while, property values were well in excess of construction costs. It is a simple fact that while such a situation exists, more building will take place. Contractors build as much as they can in order to bring in the profit resulting from the differential. But it can also happen that they build more than necessary, and when the market slows down later on, the resulting gap between supply and demand should come as a surprise to no one. In this case, supply far outstripped demand, and therefore the Bank projected, among other things, that real estate prices would fall.

Question: Statistics Iceland published GDP figures for the second quarter this morning. You spoke of stronger GDP growth than was assumed in your forecasts. Presumably you measure the output gap or something similar in your calculations of inflationary pressures. According to today's figures, you are correct that GDP growth is on the rise, but investment has contracted by 26%, national expenditure is down 8% and private consumption has dropped by just over 3%. What do you have to say about this? Aren't these figures more indicative of inflationary pressures than the production of aluminium, the bulk of which is exported from Iceland?

Chairman of the Board of Governors: Our Chief Economist cannot be with us today; I will give his deputy the floor.

Deputy Chief Economist: There are a number of ways to measure inflationary pressures. The conventional way is to calculate GDP in excess of potential output. It is true that domestic demand is on the wane. Another measure would be the unemployment rate but that points in exactly the same direction: that there is still considerable inflationary pressures and more than we projected. However, exports do generate income for Icelanders, so it isn't as though they have no effect on us. That in and of itself doesn't change anything, in our estimation; inflationary pressures remain, and are stronger than expected.

Question: In view of the difficulty in dealing with the inflation target, have there been any discussions between the Central Bank and

the Government about possibly revising the agreement on the inflation target?

Chairman of the Board of Governors: No, there haven't been any discussions of the kind. As far as I know, the Government is firmly dedicated to controlling inflation. I certainly hope that dedication has not waned. The Prime Minister did say at the Bank's Annual Meeting, however, that reviewing and re-examining the premises for set objectives was a possibility. This was done in Sweden, for example. The Prime Minister made reference to the fact that this was done in Sweden a year or two ago, and it did not lead to any changes there. For our part, we have stated that we have no objection to such a review; it is both necessary and beneficial.

Question: At the last press conference, you said a policy rate increase was likelier than a decrease. Was that the case this time?

Chairman of the Board of Governors: Yes, that was the general tenor of the discussion.

Question: The króna continued to depreciate after the Central Bank announced its interest rate decision this morning. Did that take you by surprise?

Chairman of the Board of Governors: I don't think the two are necessarily linked that closely. The króna has been sliding somewhat recently, independent of any policy rate decision. There is a lot of movement in the global markets at the moment, and a great deal of uncertainty, both in Iceland and elsewhere. So I don't necessarily connect the two.

Question: Has the Central Bank been concerned about increases in the banks' write-offs? I am also referring to the smaller banks in this context.

Chairman of the Board of Governors: Yes, of course we have been. We have been concerned about the banking system, as I expect most of our foreign colleagues have been about their banking systems. We are concerned that these market conditions will prevail for some time. Although it is impossible to project with certainty, there was a tangible hope that the difficulties in the financial markets and elsewhere would not continue to spread but would subside. But as yet there is no end in sight. It will end, of course, but at this point there is no light at the end of the tunnel. As a result, various credit facilities that the banks took on with the expectation of normal circumstances and normal risk levels have become more difficult to deal with under

the current circumstances. That is not a uniquely Icelandic phenomenon, either, no matter what people say. There is no doubt that the need for write-offs could increase, and if it does, it is very important that the parties involved meet that need and that they face reality without resorting to wishful thinking. This is true here in Iceland, as it is elsewhere. We are also concerned that the leaders of various banking institutions have taken excessive risk in some areas, especially in relation to lending for stock purchases and the like. During the recent Gold Rush, with its low interest rates and seemingly limitless capital, people were lulled into thinking the good times would continue indefinitely. But they didn't, and here we are.

Question: The economy is in a tight spot, and the Central Bank uses its weapons – the policy rate – to fight inflation, but there are other things amiss, as you were mentioning with respect to the banking system. In a nutshell, what is the Central Bank's message to the nation, including the Government and the private sector? How are we to resolve this?

Chairman of the Board of Governors: We emphasised in our policy statement that we mustn't side-step the problem in the hope that it will somehow evaporate; we must look it in the eye and concentrate on finding ways to solve it, at least the part of it that we *can* solve. Even though some aspects of the problem are global in nature, we cannot avoid responsibility by focusing only on those global elements. We must identify and respond to the elements within our control, and we must face the global problem as well. This is what we must do, and it is what the Central Bank wants to do. In our estimation, this is a key factor in providing Icelandic households and businesses with the firm footing they need to resist the potentially hurtful force of inflation. We must begin by bringing inflation down, and we may not give in where this is concerned. It is essential to gain that firm footing.

Question: The inflation target is set at 2½%, but with tolerance limits, or a deviation band, of plus-or-minus 1½%. The tolerance limits for the inflation target were shown in the inflation charts in the Bank's publications for the year 2005. Has it occurred to you to include the tolerance limits in the current charts, with the aim of establishing credibility sooner? You've moved within the upper tolerance limit twice but have never reached the actual inflation target.

Chairman of the Board of Governors: The tolerance limits are no secret; they are a known quantity. But the target is just what the name implies. The tolerance limits relate to disclosure requirements under specific circumstances, as you know, and this is why it is acceptable to take them into account. But we cannot focus on the

tolerance limits at the expense of the inflation target itself. To do so would be a clear dereliction of duty.

Governor Ingimundur Fridriksson: I would like to correct your statement that we have never attained the inflation target. Inflation was at or below target for a while in 2003 and 2004, before the beginning of the upswing whose after-effects we are dealing with now.

Question: The króna is very volatile, and the banks will be publishing their earnings reports soon. Do you have any reason to suspect that the banks are violating the Central Bank's rules and limitations concerning foreign exchange balance?

Chairman of the Board of Governors: No, quite the contrary. We reviewed that this morning, and we saw nothing to indicate any non-compliance by the banks. Their foreign exchange balance is at the upper limit, but they do comply with Central Bank rules as far as I know.

Question: Examining the exchange rate index shows that it rises just before the end of each quarter. Are the banks steering this exchange rate volatility?

Chairman of the Board of Governors: I wouldn't say that. The Central Bank evaluates the situation in view of the rules it has set, and whether those rules are being followed. Beyond that, it is useless to pursue the subject.

Question: If the banks adopt the euro as their accounting currency and carry out their accounting in euros, would that temper the volatility of the króna, in your opinion?

Chairman of the Board of Governors: I don't wish to speculate on that, but I would like to point out that if the banks had had the euro as their accounting currency, they may not have recorded a profit in the first two quarters of 2008.

Question: There has been considerable discussion of statistics. One of the things mentioned by Member of Parliament Steingrímur J. Sigfússon in a recent interview with *The Market* is that we should revive the National Economic Institute immediately. What is your opinion of that?

Chairman of the Board of Governors: I disagree. The subject was discussed for some 15 years before the Institute was finally closed.

So many things have changed since then. The National Economic Institute did a number of very good things, and it was effective in many ways, but in those days the Institute and its predecessor were “the only game in town,” so to speak. Today the knowledge they possessed is far more widespread. There are a number of very strong institutions – the banks and their research departments, the Icelandic Federation of Labour (ASÍ), employers’ associations, the Central Bank, Statistics Iceland, a number of university departments – all of which have grown in size and expertise, so that the National Economic Institute had become redundant, which is why it was closed by Parliament.

Question: The predominant message is that inflation comes largely from abroad at present. You say the policy rate is effective, but it one could say that the infection is in the left leg, while you are treating the right leg with the policy rate. So it is natural that complaints will be heard, even if they don’t necessarily solve any problems.

Chairman of the Board of Governors: Where does inflation come from, and where does it go? Some want to pass it through, to use a common phrase that’s not readily understood. But where does inflation go then? Where does it originate? Inflation is higher in Iceland than it is in most other places. Of course it is high in some economies, and unfortunately it is on the rise in most of them. But the fact remains that in Iceland inflation is much higher than we can tolerate, and there is little doubt that, although external factors have both positive and negative effects on inflation, the roots of our inflation problem lie primarily at our doorstep. In a sense, that is good news because it means we can dig up those roots and tackle the problem at the source, which is what we are doing.

Question: Have you changed your ideas about when you can begin cutting the policy rate?

Chairman of the Board of Governors: In the main, no, we haven’t. As we say in our monetary policy statement, we assume that inflation is near its peak at present, but we will continue to look forward. We make reference to the last issue of *Monetary Bulletin*, which appeared in July. The next issue is forthcoming later in the autumn, and at that time, based on developments in the interim, we will have further premises on which to base our expectations for the future.

Question: Do you have an opinion on what the equilibrium exchange rate of the króna should be?

Chairman of the Board of Governors: That's complicated. Certainly not where it is now.

Question: In your opinion, is there any danger of over-cooling in the Icelandic economy?

Chairman of the Board of Governors: We have said that it is necessary to slow down in order to achieve equilibrium after such a long upswing, but we haven't been predicting that we'll dip below the freezing point in the process. We don't expect that, and it is not a thing to be wished for. But even though we may experience an economic contraction – which we consider a necessary adjustment in the wake of the recent upswing – we do not believe we are headed for an over-cooling of the economy.

Question: The currency swap agreements concluded this spring: when do they expire?

Chairman of the Board of Governors: At the time the agreements were announced, I do not recall that an expiry date had been mentioned. My colleague can corroborate that, I believe?

Ingimundur Fridriksson: Everything that has been published about those agreements and everything that was intended for inclusion in the press releases from the participating banks appeared in the press in May. Anything you need to know should be easily found in the press releases from that time.