



July 3, 2008

*Central Bank of Iceland:*

Board of Governors' press conference, Thursday,  
July 3, 2008

**Question:**

I would like to ask the Chief Economist about his statement that the rapidity of the pass-through of the recent exchange rate drop to price levels took him by surprise. Is there any particular reason for this?

**Arnór Sighvatsson, Chief Economist:**

Yes. If I may point out a Box appearing in today's issue of *Monetary Bulletin*, that article presents some five possible explanations for it. The most salient of these is that the depreciation of the króna was very rapid, and if the exchange rate falls steeply in a short period of time, the cost that businesses incur in changing their prices – there are various expenses involved, and they are discussed in greater detail in the Box I just referred to – will be very small in proportion to the profit they can earn by raising their prices.

**Question:**

Do they perhaps wait before taking advantage of these exchange rate movements?

**Chief Economist:**

This is conceivable, of course, but it's a question of the cost versus the benefits of changing prices. If I can give you an example: IKEA has said that they will not change their prices until they print a new catalogue. Why? Because it is costly to publish a new catalogue if they have to change all of their prices. They are probably hedging with forward agreements so that they can stand by the prices in the catalogue. This delays price changes. Not all companies are so well set up that they can delay price changes if they are within certain boundaries, but if their procurement costs from abroad rise substantially, can they hold out? Furthermore, it could be that there are accumulated costs that first emerge when the exchange rate falls, so the effects of appreciation and depreciation are not entirely symmetrical.

**Question:**

The Government just announced some changes to the Housing Financing Fund. What is the Central Bank's opinion of those measures?

**David Oddsson, Chairman of the Board of Governors:**

The Central Bank has already expressed its opinion of these measures. In the main, the Central Bank is in favour of making changes to the Housing Financing Fund in accordance with the declarations made by the previous Government, and in line with what is said by nearly everyone who comments formally on us – credit rating agencies and the IMF and other such bodies – and we take the view that these measures are the first step in that direction. In addition, as the Board of Governors has said, and as Governor Eiríkur Guðnason has stated, we have once again put a question mark on some of the elements of those changes; for example, the use of the fire insurance value as the reference value, etc. I trust that I don't need to repeat what was said then?

**Question:**

It's safe to say that the business sector is dissatisfied with the fact that the Bank has not begun to reduce the policy rate yet. How is it that the business community views the matter entirely differently than the Central Bank does?

**Chairman of the Board of Governors:**

I think, perhaps, that the business community doesn't actually see things differently, but they seem to think that, under these conditions, as we mentioned in our policy statement just now, the emphasis should be placed on other financial factors at this point in time and other objectives should be set aside. They seem to expect to pick up the thread again later, as though nothing had happened. We respond to this by explaining that, unfortunately, reality doesn't behave this way, and it is not possible to avoid temporary problems by tossing aside other objectives that we must keep faith with. I think, actually, that it's perfectly understandable, and of course people want to come through this as unscathed as they can; I'm not making light of that. Of course, an economy that is trying to finance its activities at current interest rates must be having a difficult time of it. But the fact is that a large part of the economy has incurred too much debt and did not take care to strengthen their equity positions and put money aside when times were good. On the contrary, many took advantage of the upswing and

incurred even more debt, and I think they were skating on thin ice in doing so. But the main point is that the economy is in a tight spot, and we aren't making light of it. We understand it very well.

**Question:**

What do you have to say to the large – and growing – group of people who maintain that, with its decisions, the Central Bank is destroying the economy?

**Chairman of the Board of Governors:**

I don't think they're correct. The economy has had to take care of itself, and most of this has happened because the banks are facing challenges in re-financing their obligations with new, cheap credit, as they had become accustomed to doing. The period of ample credit has come to an end, and it is this that has caused the fundamental change in the economy, not the fact that the Central Bank is trying to contain inflation. Moreover, the banks are not in a position to be able to relend money in foreign currency, so borrowers have to take domestic loans at domestic interest rates. This is very difficult for businesses, of course, and we are not trying to discount it.

**Question:**

Does the Chairman of the Board of Governors agree with the statement by the leader of the Social Democratic Alliance and the Minister for Foreign Affairs, that serious mistakes were made in economic policy in past years, and even by the David Oddsson government?

**Chairman of the Board of Governors:**

No, I don't agree with that.

**Question:**

The Prime Minister has spoken of labour-intensive development projects, and I assume he means the power and aluminium sectors. Do you agree with him that this is a problem in the difficult circumstances that we are faced with? And do you take this into account in your forecasts?

**Chairman of the Board of Governors:**

This is taken into account in our forecasts, though the Chief Economist could summarise it better. There is a certain increase in those factors; that is, given what is generally believed to be in the pipeline and what is known. We don't go very far in discussing statements of this sort; however, it should be clear to everyone that it is important for the nation that we utilise the possibilities our country can offer, with

positive and appropriate consideration given to all points of view. But under the current circumstances, we must not neglect to utilise the important resources that our country has to offer. Would Arnór like to add anything concerning what was included in the forecast?

**Chief Economist:**

Nothing except that this forecast is very similar to the previous one. There was a slight addition to the project in Helguvík, but no change in the big picture. However, this does somewhat offset the contraction in other investment.

**Question:**

Our sources here at *The Market* state that you were in London last Monday, all three Governors. Was this related to possible currency swap agreements or perhaps a loan to strengthen the foreign reserves?

**Chairman of the Board of Governors:**

Your sources are clearly not good enough because all three of us weren't in London. On Monday two of the Governors were in Basel in Switzerland.

**Question:**

Was this related to a possible loan or the strengthening of the foreign reserves?

**Chairman of the Board of Governors:**

It was in connection with the meetings of central bank governors that are held at the Bank for International Settlements in Basel.

**Question:**

Is this something that needs to be done?

**Chairman of the Board of Governors:**

The Government has expressed the desire to strengthen the Bank's foreign reserves. It is important, however, that the figure, allowed by statutory authority, be considered in a certain way because it was a general framework that includes both domestic and foreign bond issues, and no time frame was indicated; rather, it was only proposed so that all of the authorisations would be available. Efforts have been made to build up the Bank's reserves. This work has been underway for a considerable period of time. For a long while – although it has been discontinued temporarily – the Bank was buying foreign currency in small, predictable increments. It had doubled its foreign reserves through other channels, and furthermore, it concluded the currency swap agreements with three Nordic central banks. If one considers this, the foreign reserves have actually been doubled – considerably more

than doubled – and second, if one considers the Bank’s foreign reserves, by most criteria, they are larger than many central banks have. However, when viewed in reference to the banking system and certain external obligations, the bank has smaller foreign reserves than some others. The Bank has taken this route, and there were no congratulations forthcoming – from any quarter – when the Bank began to increase its foreign reserves. It was even considered unnecessary by some parties who are now claiming that it should have been done sooner.

**Question:**

What about the importance of investigating a possible attack on the Icelandic króna? Is that investigation in progress, and how is it going?

**Chairman of the Board of Governors:**

As has already been said, the Bank presented its viewpoints and gathered some data, both regarding these matters and regarding a possible attack from abroad on the Icelandic financial system. The information that the Bank received was sent to the proper authorities. So the case is not in the Bank’s hands. The matter was directed to the proper channels immediately. I see that there has been a misunderstanding among the media where this is concerned.

**Question:**

Before Christmas, you projected a 30% decline in real estate prices this year. Are you still of that opinion, and what effect do you think that the changes at the Housing Financing Fund will have on that forecast?

**Chairman of the Board of Governors:**

We are still of the opinion that the forecast was basically correct. We cannot predict what effect the changes at the Housing Financing Fund will have on it, but we think it’s likely that those changes will not make a particularly profound impact.

**Chief Economist:**

I would like to correct your stated question: we never forecast a 30% decline this year. We forecast a 30% decline in real terms over a period of three years, which is quite different. Approximately 10% of that 30% has already materialised.

**Chairman of the Board of Governors:**

The fact is – and it’s important to realise this – that, both in Iceland and elsewhere, a quantifiable drop in real estate prices emerges more slowly than people would think. If we take a look at the number of purchase agreements that have been made, it has dropped swiftly and sharply. For a long time, people who put their property on the market

hold out for a higher price than they can realistically expect, so that if you can put it this way, is in existence; therefore, there is the danger that the Bank's forecast will indeed be borne out. The Central Bank is not trying to drive down the price of real estate with its statements. The Bank is looking at the facts it is faced with, and they are the same facts that people are facing elsewhere: in the UK, Ireland, Spain, and elsewhere.

**QUESTION:**

There are many who say you played a leading role in providing companies with the excellent operating environment that has existed in Iceland, but a growing number of people are saying that you have also played a leading in role in a situation where people are giving up on the situation here, and that you are destroying the Icelandic economy – you and the Central Bank. What would you like to say to people who talk like this?

**Chairman of the Board of Governors:**

I think, actually, that people shouldn't anthropomorphise so much, in either direction. I think I still take up a great deal of space in some people's heads, and I don't understand why. I have said before that some people have got me on the brain, and I think it's unhealthy. I would like to stress that, here in this Bank, things are done in exactly the same way as they were before I arrived; that is, in a professional, responsible, conscientious manner. The Board of Governors is the last link in the chain of procedure, and since I came there has never been a disagreement among the Governors. It's a little old-fashioned to be thinking constantly of me in connection with these things. The Bank represents itself as a single unit, and there is no dispute within the Board of Governors. We carry out our work to the best of our ability and conscience, and we believe that it is ultimately most important to bring inflation down. It's best for companies and for others as well.

**Question:**

Why are the analysts from the banks' research departments not allowed to sit here and ask questions?

**Chairman of the Board of Governors:**

That is not done anywhere in the world. Actually, I think that what could happen is that the analysts would take over the meeting, and there would be little time and space for the members of the press. This is done out of special consideration for journalists.

**Question:**

But there aren't more than perhaps three analysts who would attend.

**Chairman of the Board of Governors:**

Yes, but nonetheless, this is a press conference, and nowhere else in the world are other parties allowed to ruin press conferences. I'm not saying that analysts would do this on purpose, but I would like to add that the Central Bank holds a separate meeting with the research departments of the banks after this press conference is finished. I think this is sound procedure: that this meeting is a press conference, and it is only for members of the press. I think you all should stand with us on this, to maintain the integrity of these press conferences as such. And I say this with all due respect for the research departments because I think they are doing some excellent work.

**Question:**

The chairman of the Confederation of Icelandic Employers has declared that the game is over for the króna. What do you have to say about that?

**Chairman of the Board of Governors:**

I don't know what game he's playing.

**Question:**

As regards the exchange rate of the króna, do you think this plunge that we've seen recently is a normal correction of an exchange rate that was too high?

**Chairman of the Board of Governors:**

We have said before that the króna could be expected to depreciate. That has been stated before, but I think most people are in agreement that the recent fall in the exchange rate, when the exchange rate index hit 170, was an overshoot, as the Chief Economist mentioned a minute ago. It's important not to talk too much about the exchange rate and where it "should" be, but if you read *Monetary Bulletin*, it contains some general points of reference.

**Question:**

In connection with the question about unscrupulous characters having deliberately tried to manipulate the exchange rate of the króna, you sent information to the Financial Supervisory Authority. What was their conclusion?

**Chairman of the Board of Governors:**

We reviewed the matter with an eye to what we considered to be known and what was probable, and we sent that information to the Financial Supervisory Authority.

**Question:**

And is the conclusion the same, that someone did try to manipulate the exchange rate?

**Chairman of the Board of Governors:**

There has been no final conclusion. The available information has been investigated, and of course, in such a case, some things can never be proven, and other things are subject to debate nowadays. We sent the available information to the Financial Supervisory Authority. The Central Bank is not a judge in the matter, but it is important that the market have confidence in the parties who are in key roles concerning currency and market transactions.

**Question:**

70% of respondents to a Gallup poll are dissatisfied with the Central Bank and the Government's response to a deteriorating economic situation. What do you think of this opinion held by 70% of respondents?

**Chairman of the Board of Governors:**

Wasn't it even more than that? I think 8% said they were satisfied. I haven't seen such questions about the Central Bank before, and I don't know why they're being asked, but I think that when the inflation target is 2½% and inflation is 12%, people shouldn't be satisfied with the results the Central Bank is getting. So I don't think there's anything wrong with their response, and if I had been asked that same question in that same opinion poll, I would have been among the 91%. I would not have been happy with the results the Central Bank is getting. But we should ask again when all is said and done. We think that what we're doing here – which, of course, is not terribly popular at the moment, and understandably so – when the question is asked again after the curtain falls, the answer will be different.

**Question:**

The exchange rate dropped rapidly just before the end of the first quarter, and then again just before the end of the second quarter. The banks recorded hefty exchange rate gains after the first quarter. Does this give rise to any suspicions among you as to whether the banks played a role in that steep decline in the exchange rate?

**Chairman of the Board of Governors:**

Not particularly, under these conditions, but it's interesting that this should happen. On the other hand, there could be a number of explanations other than the one you suggest. I hear that this question

occurs to you, but we have not carried out any special appraisal of the matter.

**Question:**

Do you think there is reason to?

**Chairman of the Board of Governors:**

Not necessarily, and I trust that the banks, in the extremely difficult position that they are in – the banks are in a very difficult position, and we must not forget that it's about a year since the global credit crisis began – and there was speculation at the time that the Icelandic banks would not be able to bear the strain as well as some others. But they've managed better than expected. Of course, the longer this financial crisis continues, the more difficult it becomes for everyone, businesses and banks alike, and what the Central Bank says in today's announcement is very important: that we must all adapt to these dramatically changed circumstances. With that announcement, we aren't insinuating that the banks are not doing this. I'm convinced that the banks are hard at work from morning to night, addressing these issues, because there is a great deal at stake. But the fact remains that no one can take this responsibility from the banks. I have sometimes thought, in connection with general discussion of the "big loan", as it is called – that people think it's possible to relieve the banks of this burden. It isn't. The banks themselves must bear the brunt of solving this problem, and they are fully aware of this. They have not been talking about coming to us for money to solve their problems. They're doing it themselves.

**Question:**

But the banks will leave Iceland if they feel that the Government and other authorities aren't cooperating with them. Are there no concerns about this?

**Chairman of the Board of Governors:**

I'm not concerned about their leaving. The fact is that if banks of this size were located elsewhere, their credit ratings would be lowered because they wouldn't be seen to receive the support they needed. They wouldn't have the size

**Question:**

The policy rate won't be lowered until at least the beginning of 2009, and it's being postponed so that the model will work. There have been some concerns about businesses' equity under these conditions – with this inflation level and policy interest rate, when foreign loans are no longer available – perhaps we can say that interest rates are starting to bite now that domestic financing is the only available option. Isn't it a

source of concern how fast equity is burned up under these circumstances, apart from the inflation target as such?

**Chairman of the Board of Governors:**

Of course, it's cause for concern. However, I would like to draw your attention to the fact that the assessment of when the policy rate reduction can begin is in the hands of the people who prepare the forecast, but the Board of Governors is not bound by it. This doesn't mean that the Board of Governors won't make its decisions in accordance with that assessment, but it is important to realise that while the forecast is based on the underlying available data, the Board of Governors is not bound by it. The Board of Governors can raise or lower the policy rate independent of what is said in the forecast. However, this indicates how the procedure is carried out, and as I have said before, businesses' equity is cause for concern, and I think some companies have been quite imprudent. On the other hand, we do not think it is justifiable to deviate from the objectives set for us, because if we did, that would ultimately be more harmful to businesses than standing firm.

**Question:**

In this context, it has been said that the link between exchange rates and interest rates has been severed. The Bank added an extra interest rate decision date just after Easter – 1.25%, if I remember correctly – because of the sharp depreciation in the króna and the bizarre conditions in the markets. Couldn't it be said that the model could just as easily have called for a policy rate hike, both now and on the last decision date, in view of the circumstances?

**Chairman of the Board of Governors:**

I think so. You could say that there were essentially two options: to keep the policy rate unchanged or to raise it. You're exactly right.

**Question:**

What do you think of the Prime Minister's idea about the dollar? Dollarising the Icelandic economy? He doesn't rule out that option. What do you think of that?

**Chairman of the Board of Governors:**

We haven't been asked to take a position on that issue. In general, I'm of the opinion that the Prime Minister talks sense.

**Question:**

As regards the inflation target in general and the high interest rates at present, do you feel that you're swimming against the tide when everyone else is concentrating on the short term – the business

community, for example – and complaints are being lodged? You say that you're trying to take a long-term perspective on the situation.

**Chairman of the Board of Governors:**

Now that's a very tricky question. You mean, are we the only ones with any sense? No, we're not trying to say that, and we understand full well that the current situation is extremely difficult. There are conflicting points of view, and it's very human to look for a quick solution. We're not trying to make light of that, and we don't want to quarrel with anyone. That is not the Bank's job. But we would like to ask that people refrain from taking action that undermines what we are trying to do and that they not doubt our integrity because the Central Bank is doing its job as sincerely and conscientiously as possible. We are doing our work in the way that we believe will be best in the long run, and actually, we are trying to do it as quickly as possible. If we begin to shirk that duty, the problem will be bigger, more severe, and more persistent later on. All of us here in the Bank are in full agreement on that score.

**Question:**

There are Glacier bonds maturing this fall, several billions of krónur, even. Is this risky for our economic system, and what affect could it have on the exchange rate? Is this taken into account, and are we prepared for the possibility that nothing will come in place of these bonds?

**Chairman of the Board of Governors:**

We have had larger maturity dates – for example, in October – but still, we're looking at about 100 billion or so for the year. It's somewhere near that figure, and in the past there's been no movement related to redemptions. Of course, we realise that there's more risk now, under the current circumstances, but certain mitigating measures have been taken, perhaps not *because* of this but with this in mind. We refer, for example, to our CD issuance and our decision to continue it, and the Government's decisions on bond issuance and the guidelines concerning the volume to be issued. It's highly likely that measures like these will mitigate the risk you were mentioning.

**Question:**

A so-called policy rate increase process has been underway for four years, and during that time, inflation has tended upwards. Did the Central Bank raise the policy rate too little and too late?

**Chairman of the Board of Governors:**

It could very well be that people will draw the conclusion that the Bank did raise the policy rate too little and too late. Actually, the Bank

itself has presented arguments to that effect. The Bank drew attention to the fact that growth here in Iceland proved much greater than was indicated by official statistics at the time, and if that information had been available earlier, the Bank would probably have raised the policy rate sooner and to a higher level. In a sense, it's an academic question, but the Bank is not trying to dodge it. On the other hand, the Bank bases its decisions on the information available at the time the decision is made. There is a great deal of ambiguity in certain information, as is well known, and GDP growth figures varied greatly. But the Central Bank has said that this could be the case, based on those figures.

**Question:**

You mentioned that the procedures here in the Bank are the same as they were before your tenure here and that there had never been a disagreement among you. It has been said that the minutes of Board of Governors' meetings and the results of votes should be published, as they are in some other banks. Do I understand you correctly, that the Governors have always been in agreement concerning the Bank's policy rate decisions?

**Chairman of the Board of Governors:**

Yes, that's correct. There has been no disagreement in our group, and in fact, we are much more transparent than many others are. For example, the Bank of England merely announces its decision. There is no press conference, no presentation, and no questions answered, and then, some weeks later, the minutes of their meetings are published. I don't know whether that is a more transparent and open procedure than ours. The US Federal Reserve and the European Central Bank do it differently, but not necessarily in a more transparent way than we do. I think the procedure according to which we prepare our interest rate decisions is very clear. A large number of Bank staff members are involved. That group gradually becomes smaller, as the actual decision approaches, and it ends with the Board of Governors alone, as is mandated by law. This is how it's done, and as I have said, there has never been a disagreement among the Governors. It can be, as in the ECB, that the decision is approached by hearing discussions – and it could very well be that the people involved in the decision have differing points of view at first – but they listen to the bank's experts and go over their data, and in the end, they come to a conclusion based on conscientious consideration.

**Question:**

You say in your policy statement that the banks should adapt the scope of their operations to the current conditions. Can you explain this somewhat better or give them some guidelines on what they should do?

**Chairman of the Board of Governors:**

It's clearly important for the banks – important for their reputation – that they avoid expanding their operations under the current circumstances. On the contrary, they should adjust to the reality we are all facing. I think they are doing this, but there's no doubt about it: it wouldn't hurt if it happened faster. It is important that the banking system be in proper proportion so as to engender confidence in its ability to thrive in its operating environment.

**Question:**

Some have said that, instead of strengthening the foreign reserves, the banks should reduce the scope of their operations and sell off assets. Do you agree?

**Chairman of the Board of Governors:**

We haven't been giving the banks orders. We have no right to do so. But we do think this is an option. Actually, I think the banks have been selling assets; there are signs that they have been doing so. But of course, they must take the initiative and have the authority to decide how to respond to the problems they experience, just like anyone else under these conditions. In the main, I think the banks are doing a good job.

**Question:**

According to the policy rate path in Monetary Bulletin, it appears as though the policy rate will be 12% in mid-2009 in accordance with the baseline forecast, and 6% at the end of the (forecast horizon). What effect will that have if, a year from now, some homeowners' mortgage interest rates are reset?

**Chairman of the Board of Governors:**

I'm not aware that we have gone over that.

**Chief Economist:**

No, we haven't studied that in particular. It is very difficult to assess, actually.

**Question:**

If interest rates are so high, then a large portion of mortgage interest rates will rise. Could it be that we'll have our own sub-prime crisis here? Because the assumptions on which people took out their loans have changed entirely, and interest rates have doubled, perhaps more than that.

**Chairman of the Board of Governors:**

I think people have to realise that most of these loans were granted at interest rates just over 4%. Since the loans were taken, the nominal value of these properties has risen by 70 to 100%. The risk centres rather on people who were taking loans, which were much higher at the very end of that period, and took loans for up to 90% or even more of the value of the property – I think there is a much greater risk in such cases. And I don't think it's possible to liken this – in any way – to the US sub-prime crisis. I think that would be extremely questionable, and it shouldn't be forgotten that these loans were granted on these terms five years ago, and in the interim real estate prices have risen almost exponentially. And even if property values fall, it is still likely that there will have been a substantial increase in real value. People should bear this in mind if they are comparing this situation with the sub-prime crisis in the US; however, the restraint could prove greater under current circumstances, as you point out.

**Question:**

Loan payments can increase quite a lot. Just due to inflation alone, payments on indexed loans have risen dramatically (mine have increased by 7,000 kr., and I don't have a large mortgage; I'm sure others' have risen more). For many people, it's a double-edged sword if interest rates rise as well.

**Chairman of the Board of Governors:**

That's exactly right, and this is why we say that the most important thing of all is to bring inflation down. That is what we are doing, and this is why.

**Question:**

If you could give the Government some advice – because there is considerable discussion of power station construction and nature conservation, and projects are being proposed farther in the future than we're talking about here – that is, the possibility of setting the economy in motion again with some stimulative measures. Doesn't the Central Bank think it's important that we rise higher on the GDP growth list than where the International Monetary Fund assumes we will be? The IMF assumes we'll share second-last place with two or three other countries, according to the last forecast. Doesn't the Central Bank think we should use our energy resources, just like others, in the middle of an oil crisis?

**Chairman of the Board of Governors:**

Here in the Central Bank we believe that a certain economic adjustment is inevitable. But we want to point out that the adjustment and the contraction that will accompany it must be viewed in the context of the substantial economic upswing that Iceland has

experienced for a number of years. We have to look at it in that context. As for the other matter, which the Governors have not discussed in particular among themselves, for my part, I hope I'm safe in saying that I think it's necessary that we utilise the resources we have – in a spirit of cooperation and in balance with other factors, of course – but we shouldn't discontinue utilising those resources. I think that would be extremely questionable.