



October 28, 2008

Central Bank of Iceland:

Board of Governors' press conference, Tuesday,
October 28, 2008

Question: When was it decided that this policy rate increase would be announced this Tuesday morning?

Chairman of the Board of Governors: The final decision was made yesterday afternoon after the market close, but as I have said, the decision is based on the previously concluded agreement between the Icelandic Government and the International Monetary Fund. The formal decision, however – I assume you are asking about that – was made yesterday afternoon.

Question: Do you believe that the households and businesses in this country can tolerate this policy rate hike?

Chairman of the Board of Governors: There is no question in my mind but that such a high interest rate is very difficult for both individuals and businesses. On the other hand, the grounds for the decision have been presented, and it is extremely important that, when we are trying to re-establish a foreign currency market in this country – and it is, of course, one of the fundamental requirements of the Icelandic economy that the currency market be fully functional – then it is unavoidable under those circumstances to support the currency with the interest rate level, so to speak.

Question: Was this done in consultation with representatives of the private sector; that is, the Icelandic Federation of Labour, the Confederation of Icelandic Employers, and so on?

Chairman of the Board of Governors: To the best of my knowledge, they were consulted during the course of work carried out with the International Monetary Fund, and I haven't seen anything to indicate otherwise than that they recommended strongly that we collaborate with the IMF. It was possible to infer from previous statements by the IMF that a restrictive policy rate would be one of the foundations of that collaboration. If you are asking whether the Bank engaged in special consultation now, no, we did not. But we have to follow up on the agreement between the Government and the IMF mission.

Question: This decision has been made through an agreement with the IMF. Earlier on, you would have chosen another option. Do you agree with this decision?

Chairman of the Board of Governors: The Bank has said – of course, when this conclusion regarding the IMF was in preparation, the matter was approached from a variety of points of view, as generally happens, both from Iceland and from elsewhere – the Bank has said unequivocally that if it is the Government’s decision to enter into an agreement with the IMF, the Bank will naturally stand by that and will follow up on the Government’s decisions with full commitment.

Question: Why did you lower the policy rate on October 15? That’s not a long time ago. Was it a mistake to lower the policy rate at that time?

Chairman of the Board of Governors: I don’t think so. The Bank provided the rationale for its decision, and as such, that rationale stands. Since then, we have experienced what I mentioned in the latter half of the policy statement, that our foreign exchange market is paralysed, which hasn’t happened for decades. A paralysed foreign exchange market is much more serious today than it would have been 40 or 50 years ago. A frozen currency market is one of the gravest things that can happen to a nation, and if it does happen, it’s necessary to take all possible measures to rectify the situation. It also says in the policy statement that the situation has improved slightly since things were at their worst. Nonetheless, the Central Bank’s guidelines are still in effect, and they have a restricting effect. The inflow of foreign currency has been limited as well, although that, too, has improved. It is critical to restore normal functioning so that other parts of the economy can follow suit.

Question: When you made this decision, how much bankruptcy and unemployment did you think there would be in the country? What are your thoughts on this? What will happen next?

Chairman of the Board of Governors: That is a question I can’t answer. As I mentioned a moment ago in answer to another question, it is clear that such a high policy interest rate is very difficult for the businesses and households. I was explaining the rationale behind the decision.

Question: As you mentioned, you lowered the policy rate 13 days ago. Do you personally disagree with this demand from the International Monetary Fund that we raise the policy rate?

Chairman of the Board of Governors: When one makes a decision of this type, as the Government has done, it is of critical importance that everyone pull together in the same direction. The Central Bank intends to do this. The other Governors and I are all in agreement that we will give these decisions our full support, as we have stated. Once a decision has been made, the Central Bank will stand by it and will support it fully.

Question: You say here that a negative real policy rate provides a negative foundation for the króna when it has been floated again. Forecasts suggest that inflation will rise as high as 20% in the next few months. Will you raise the policy rate in line with that development so that the real policy rate will remain positive in order to provide the króna with that foundation?

Chairman of the Board of Governors: We will publish the Bank's forecasts – perhaps on a smaller scale, though, than we would under other circumstances – when the next issue of *Monetary Bulletin* appears early in November and the forecasts are complete. We assume, following this announcement, or we suggest the likelihood, rather, that inflation will subside quickly. In spite of the considerable uncertainty attending this factor, it is not unreasonable to expect inflation to drop rather quickly next year. If so, then policy rate decisions will take that into account.

Question: Can you give us a rough draft of the next three months, and then perhaps the three months after that, and the effect that this will have?

Chairman of the Board of Governors: We hope that this measure and others – it is difficult to discuss specific issues with you at this time – the problem is that we are extracting one element from an overall agreement because it was necessary to do so. According to that agreement, this one element had to be determined before the plan would be presented to the Executive Board of the IMF. In our estimation, this had to happen no later than Thursday, and it was just as well to do it as quickly as possible so that it could begin to have an effect. I am not able to discuss other elements in the agreement apart from that which concerns this particular decision. That would be a violation of the confidentiality that we have agreed to observe until the Executive Board of the IMF has discussed the matter and, we hope, approved it around the middle of next week. For this reason, it is more difficult to discuss the longer-term picture, but we hope that with this action, with enhanced financial strength in the Bank's foreign exchange reserves and growing confidence in the measures that we are taking – and thereby, growing faith in the economy – the foreign

exchange market will gradually return to normal. As I said a moment ago, that is of fundamental importance for everything else. The problem is, as I said ... that we cannot discuss the parts of the agreement that the Government has agreed to keep confidential. That makes it a bit more complicated for us.

Question: So this particular policy rate increase is a part of the IMF agreement?

Chairman of the Board of Governors: It was a required prior action, and moreover, it was practically the only requirement, and the first, that had to be implemented before the Executive Board of the Fund made a final decision.

Question: The International Monetary Fund has been criticised very harshly for requiring a high policy rate, and some critics say that it would be possible to find other, more effective, options, such as currency controls. Was this never discussed? Was there any discussion of trying to take another route? Was this an unfair requirement on the part of the IMF?

Chairman of the Board of Governors: I think we should be careful not to present the case in terms of anyone's having made preemptory demands. This was the conclusion that was drawn, and we must abide by it. We expect that it will help to support the exchange rate of the króna. We expect inflation to subside very rapidly, as I said earlier. But incorporated into that expectation or hope is an important factor that has to move in the same direction: exchange rate developments. We are trying to provide some momentum so as to encourage things in the right direction. This enhances the likelihood that the two things will happen at the same time: that currency flow to and from Iceland will return to normal and inflation will fall quickly. There are various other factors that we are quite sure will move in a positive direction because of what has happened, such as the current account, and especially the trade account, and so on. These are factors that will clearly be easier to deal with, and other things will help to reduce inflation, such as declining demand and a negative output gap, which is not necessarily desirable in itself but is a fact, and dramatically lowered expectations. All of these will tend to bring inflation down to the desired levels.

Question: Are you concerned about losing face in the global community as a result of this back-and-forth action with the policy rate?

Chairman of the Board of Governors: Maybe that will happen, but at the moment, you can't see anything on a black background.

Question: As regards its being undesirable to have a negative real policy rate, inflation is expected to rise to as much as 20% after the first of the year. Does this mean that you assume the policy rate will rise even further before you can begin to reduce it again? When do you expect interest rates to fall below this figure?

Chairman of the Board of Governors: This decision does not mean that we expect interest rates to continue to rise, nor is it a declaration of future actions or decisions. We will examine the future and see what it brings with it, but this decision is not a declaration that we will raise the policy rate further. On the contrary, we sincerely hope that, when all is said and done, this decision will provide a firm foundation for disinflation and subsequent policy rate reductions.

Question: You defend your decision with the IMF agreement and in an announcement published on the Central Bank's website yesterday, which mentioned decisions made by the Central Bank in consultation with the Prime Minister. Is the Central Bank an independent institution under the current circumstances?

Chairman of the Board of Governors: Yes, it is, just as it has always been. But you have to realise that, with regard to the IMF agreement, if we approve such an agreement, then that must imply that Government institutions and the Government itself, even the fiscal budget and so on, must be examined in a new context. Of course, it is others' role to discuss this, not mine, but the fact is that we have agreed to participate in a given project that has conditions attached to it. If the parties involved don't abide by those conditions, the project won't be successful. There is no doubt about it: this wasn't our first choice. But as everyone knows, the situation had become extremely difficult here after the collapse of the banks.

Question: Technically speaking, what is this policy rate hike supposed to do? You're not dampening an overheated economy, you're not discouraging household borrowing. Is there the hope that this will engender an influx of foreign currency that could then disappear just as quickly as it has in the recent past?

Chairman of the Board of Governors: We believe that this decision reduces the likelihood of continuing lack of confidence in our currency. Faith in the króna, with support of this kind, is a precondition for the resolution of this part of the problem – or at least a rapid, decisive reduction – so that we can, as we say here, gradually relax the

situation we have had recently – that is, a guideline for the króna in the banking system, which is restrictive for the economy. It is restrictive; therefore, it is undesirable and harmful for the long term. In the Central Bank's opinion, the shorter the duration of such restrictions, or whatever we wish to call them, the better for the economy and the people of Iceland. When 85% or more of the banking system collapses, virtually at one stroke, we mustn't be surprised to find that the resulting situation is difficult in many ways and that there may be bottlenecks and bumps in the road. What we are hoping is that, when all is said and done, most of us will be astonished at how relatively short-lived the difficulties were, given the colossal blow dealt to our banking system.

Question: This figure – 18% – how was it determined? Why not 16% or 20%, for example?

Chairman of the Board of Governors: It is always possible to ask such a question, but the main thing is that this interest rate was considered likely to provide the necessary level of resistance. One tries not to set it too high. But one can't set it too low, either, because that involves the risk that the resistance, the support, and the foundation will not be sufficiently strong.

Chief Economist: In essence, there is no particular science behind such figures. They are based on estimates, and of course, forecasts are used as references, but the actual figure and the final decision are always based on estimates.

Question: Housing loan agreements have an interest rate reset clause. Will those interest rates rise as a result of this decision, and by how much?

Chairman of the Board of Governors: I don't expect that housing loans as such will fall under this policy rate hike, and I hope this interest rate, which is based on the current situation in the economy, will not need to remain in effect for very long.

Question: A strange dispute has arisen between the leaders of this Bank and one of the richest men in Iceland, Björgólfur Thor Björgólfsson. It is a case of one person's word against another's, and there were declarations issued about the matter yesterday. Were you aware of the offer by the British Financial Services Authority to implement guarantees for IceSave in five days in return for a loan of 200 million pounds from the Central Bank?

Chairman of the Board of Governors: The problem is that Björgólfur Thor Björgólfsson was not present at the meetings held here in the Bank. On the other hand, we were – the Board of Governors – and representatives of the banks were also. We have reviewed the correspondence behind the matter, as well as the minutes of the meetings, or the meeting documents concerned, and I would like to draw your attention to what Sigurjón Árnason, the bank director, has said. He does not mention 200 million. He says: If Landsbanki had received financial assistance similar to that received by the other banks – that is, between 500 and 600 million euros – matters would have developed differently than they did. But all of this happened very quickly. On the first day, the Sunday, we were dealing with a margin call on the Icelandic banks by the European Central Bank, which was demanding extremely large sums of money – well over a billion euros – through Luxembourg because of margin calls. That was the main problem then. On that day, we heard that Landsbanki was seeking some expedited handling of the conversion to subsidiary status. We had mentioned to Landsbanki that the process had been taking quite a long time. As far as we knew, Landsbanki had been trying to implement this change since March, and we were very much in favour of it and encouraged it. By Monday, the situation had completely changed. By that time, money was flowing out of Landsbanki's funds in the United Kingdom, and Björgólfur, with all due respect to him, was not present at the discussions we had with Landsbanki here in this Bank. The question was whether 200, 300, 400, 500, or even 600 million pounds would suffice. When the withdrawals were at a peak. Perhaps we shouldn't be discussing these matters here and now. There will be a time for it later, but without a doubt, the Central Bank is very clear on the order of events.

Question: So you were aware of this offer of expedited handling, and the uncertainty related only to amounts?

Chairman of the Board of Governors: There was no offer of five days or anything like that. The day before, when entirely different matters were on the table, we were told as an aside that Landsbanki was seeking expedited handling and were hopeful that it would go through, but no five- or six-day figure was mentioned. And by the next day entirely different matters had arisen. By then the European Central Bank had withdrawn some of the margin calls, but the turmoil caused a run on the bank abroad, and the discussion centred on addressing that run. No mention was made at those meetings of this expedited handling Björgólfur Thor has mentioned. We have gone over this in detail.

Question: What does Björgólfur Thor mean by this?

Chairman of the Board of Governors: I can't say. Everyone is quite upset at the moment, and people are looking for culprits everywhere except in the mirror. That's very natural under these circumstances, but the Central Bank is very clear on this and can look anyone in the eye where this subject is concerned. There has been a great deal of discussion about the Central Bank recently, and very little of it is based on any solid foundation, but we are not too concerned about it.

Question: Has the Central Bank set a target for the exchange rate index, and if so, what is it? Can the Central Bank tell us the International Monetary Fund's target for the exchange rate index?

Chairman of the Board of Governors: We can't give any information about the IMF's targets for anything other than what we've already disclosed here. We were forced by necessity to disclose that information. I said explicitly that we cannot give any information about anything else. We are bound by the same confidentiality as others are. We have also said that, to the extent that the króna is traded anywhere, it is far too undervalued, and that there is every reason to expect, for that reason alone, that it will appreciate. We would also like to point out that, with this decision and others – such as strong foreign exchange reserves here in the Central Bank – measures that will be implemented later, it is likely that the exchange rate will rise. We haven't set any numerical targets like high jumpers or pole vaulters do, but this is the prevailing point of view.

Question: So there isn't any target for an equilibrium exchange rate for the future?

Chairman of the Board of Governors: There is a general objective, that the króna should appreciate and return to normal levels. As you all know, we do not adhere to an exchange rate target.

Question: You said that this 18% figure was based on some sort of estimate. I infer from this that the IMF did not mention the number 18%. What exactly was the condition set by the IMF mission?

Chairman of the Board of Governors: Your inference is incorrect. I'm not sure how you've arrived at that conclusion, but if you review your notes, you'll see clearly what was said.

Question: Are you still of the opinion that the króna is the right currency for the future?

Chairman of the Board of Governors: Yes, I am. I think that it's the best currency for the future, and I also say that it is perfectly appropriate to discuss the matter in depth. Under circumstances like those we have experienced, there is nothing strange about it if people have their doubts and their opinions on this subject, and I respect them all. The Central Bank does not intend to lead or take responsibility for those discussions. We will leave that to others.

Question: Icelanders aren't world-renowned for storming down to the town square and staging protests, but people have been gathering at Austurvöllur and elsewhere, and demanding your resignation. How would you like to answer these people?

Chairman of the Board of Governors: I would have done the cause a favour if I had shown up at these meetings because they've been rather poorly attended. I assume that means they are losing their head of steam if they can't collect a larger number than that. But I don't give it too much thought. I'd just like to apologise for not having turned up.

Question: So you're not thinking about this; you're not considering resigning from your position.

Chairman of the Board of Governors: Have you considered resigning from yours? Well, neither have I.

Question: When will restrictions on foreign currency transactions be lifted and the króna floated again? And how will you support or protect the exchange rate with the FX reserves that you will receive in part from the IMF?

Chairman of the Board of Governors: We are hoping that the strength of our foreign reserves – both that which comes from the IMF by agreement, if it is approved, and perhaps supplementary support from other sources, which hasn't been finally decided but is still being examined – and the fact that the exchange rate of the króna is very low will have an effect on large investors who might otherwise abandon the króna and move to other currencies. When they see the changes in the current account balance and so on, perhaps they will see the benefits of waiting and holding their króna positions until the króna has appreciated and it is more advantageous for them, so that they will get more for the krónur that they sell. All of this depends on one word – confidence – which is what we must create. The project now underway is a move in that direction. As confidence is restored and this support strengthens, we will gradually lift the restrictions we have had on foreign exchange transactions. To repeat once again, it is of cardinal

importance for the Icelandic economy that such restrictions be as short-lived as possible.

Question: Will the Central Bank intervene in the foreign exchange market? Have you engaged in any discussions with the parties that have brokered and issued the glacier bonds that are in the system and that many investors would like to unload?

Chairman of the Board of Governors: The Board of Governors has not had any formal discussions with such parties, but it has tried to engender in certain parties a sense of security about their krónur, with certificates of deposit, facilities concerning accounts here in the Bank, and the like. These are measures that we don't want to resort to under normal circumstances but are aimed at engendering a sense of calm and confidence. In doing this, we are not in competition with the banks. Quite the contrary. We assume that those who have invested their money here with us temporarily will see the advantage of having it in the regular banking system.

Question: Wasn't it said that there will be some intervention in the foreign exchange market when the króna is floated again?

Chairman of the Board of Governors: You could say that recent measures have represented intervention – that is, we have taken money from our reserves and put it in the market – and this has been a necessary move. If all of the demands that people have been making in television interviews recently had been met and the Central Bank had wavered, and we had tossed good money into the inferno for one or two days' joy, then they wouldn't have had this money to meet the basic requirements we must meet: that is, to ensure that the Icelandic Government never defaults, and to see to it that goods can be imported to the country for a protracted period of time even if no foreign currency comes in, which of course could never happen. So that when individuals are publishing letters as they have done, and when they have ideas about how the Central Bank and the Government should have invested 2-3 billion euros to merge two or three banks, thereby taking indirect responsibility for all foreign liabilities and ending up defenceless later on when the collapse came.

Question: What is the actual exchange rate today? Aren't we, in essence, rescuing a useless currency?

Chairman of the Board of Governors: No, we aren't. We are restoring normal foreign exchange activity after the collapse of the banking system, and we will be successful.

Question: Need that take a long time?

Chairman of the Board of Governors: In retrospect, it will seem to have taken an unusually short period of time. Looking forward, however, it will seem to take an uncomfortably long time.

Question: You mentioned borrowing a moment ago. What is being done on that end? Can anyone provide you with information on it, and what amounts are involved?

Chairman of the Board of Governors: We have been in contact with various central banks recently, as we were before all this happened. And in the wake of recent events, we have resumed communications with various central banks with whom we have had a positive relationship, but the general rule is that one doesn't reveal the details of such communications before there is something conclusive to reveal.

Question: But surely that will happen soon?

Chairman of the Board of Governors: We hope that it will happen quickly, in view of the dramatic turn that events have taken.

Question: First, the latter Landsbanki offer, which came before the Government took over Glitnir. Did it not merit a response? Was it a poor offer? And second, was the Glitnir takeover 3-4 weeks ago a fateful mistake, in view of subsequent developments?

Chairman of the Board of Governors: No, but it was a very unfortunate thing that Glitnir should become insolvent. It was a situation that generated considerable turbulence elsewhere. The rescue effort was not a mistake, but the idea that Landsbanki submitted at about 9:00 or 10:00 on Sunday evening – I understand that they have published those letters, and I encourage you to study them and tell me whether you would have recommended that we and the Government act in accordance with them. I'm sure that the vote would have been unanimous if you had read that material.

Question: You mention that you hope inflation can fall quickly and that it could happen in a relatively short time. Is there any way to provide a time frame for it? What do you mean by "quickly," and what is "a short time"?

Chairman of the Board of Governors: Some have been saying that inflation could drop to 4½% by the end of next year. That would be very helpful, and it could possibly fall even lower. But that doesn't mean that we won't continue to face a number of other difficulties.

Question: So we're talking about two or three quarters, at least, before we begin to see inflation taper off?

Chairman of the Board of Governors: I think we will see some movement relatively soon, but of course all of this is subject to uncertainty. We already see a number of factors that should tend to reduce inflation very quickly, but as we have said, it is essential that the exchange rate should move in the right direction. This is what we are working towards.

Question: When you lowered the policy rate the other day, did the IMF mission that has been working here have any comment to make on that move? Was it considered consistent with the work being done at that time and the goals toward which that work was aimed?

Chairman of the Board of Governors: I don't recall any comments on that point. The Board of Governors was responsible for that decision and neither can nor wishes to point the finger at others where it is concerned.