

Monetary policy statement by the Board of Governors of the Central Bank of Iceland

Central Bank of Iceland raises the policy rate

The Board of Governors of the Central Bank of Iceland has decided to raise its policy interest rate by 0.5 percentage points to 15.5%. This increase follows a 1.25 percentage point increase announced on March 25, 2008. During the first quarter of this year, inflation was 2 percentage points higher than was forecast last November, and following the recent depreciation of the króna, it appears set to rise even further before beginning to taper off once again. The March 25 policy rate increase is followed with the decision announced today because inflation expectations remain very high. They have escalated and are now higher than they have been in a long time. It is imperative that they be reduced.

The macroeconomic forecast in the current *Monetary Bulletin* indicates that the economy will contract during the forecast horizon. Such a development is an inevitable adjustment after many years of economic imbalance. Despite the projected contraction, however, average output growth for the period 2005-2010 will be quite acceptable. The inflow of foreign capital has shrunk, and funding the current account deficit will become more expensive than it has been in the past few years. Because of the high level of household and business indebtedness, the recent depreciation of the króna will contribute to a contraction of the economy. Persistent inflation will be most damaging to indebted businesses and households and can undermine financial stability for the long term. It is therefore of paramount importance that inflation be brought under control.

Low inflation is a precondition for applying monetary policy to soften contraction in the economy. The real exchange rate has approached its historical low, and the króna is undesirably weak. The real effective exchange rate may rise to its long-term equilibrium either through an appreciation of the króna or through rising prices. Under the current conditions, a prolonged low exchange rate passes quickly through to the domestic price level. There is still considerable tension in the labour market, and the output gap remains substantial. It is desirable that the króna recover from the sharp decline in March. The March 25 policy rate increase and the other measures announced at that time have supported the króna. It has appreciated as a result.

A policy rate increase in and of itself does not solve the problems that have developed in the FX swap market. Increased issuance of risk-free bonds that are accessible to foreign investors should open up other channels for currency inflow, however. The Central Bank's most critical task is to reach the inflation target as soon as possible. The demand shocks of the past few years and unusual conditions in the global financial markets delayed the process. There is no reason to surrender any ground in the battle against inflation.

Board of Governors' Press Conference Thursday April 10, 2008 - an abbreviated translation of the main questions and answers:

When the exchange rate fell the other day – and over the past few weeks – one of the explanations has been that there were speculators behind it, but I see that these forecasts of yours assume the króna will continue to be very weak. Wasn't this, then, just a necessary correction in the exchange rate?

David Oddsson

It seems to me that what we've been saying for quite a while, both the Board of Governors and the Bank's publications, is that it was likely that the exchange rate would fall sooner or later because it had been high in a historical context. On the other hand, it was expected to fall at a later point than it did. The question is whether that process was expedited. I believe that was the main issue – that is, whether that process was expedited – and the blow perhaps harder as a result, and the adjustment not as mild and gradual as we had hoped. And there's no denying, as Arnór indicated, that we were hopeful that this adjustment in the exchange rate would take place when the economy had cooled down, which would have made it more likely that the effect on the price level would be milder as a result of greater competition and less pressure on the economy.

I wanted to ask whether the Central Bank has made any decisions on foreign currency purchases or increasing the size of the foreign exchange reserves.

David Oddsson

The Government would like – and I think the opposition is also in favour of this – to borrow funds to increase the Central Bank's foreign exchange reserves. Of course, because of that we have already started to prepare the process, but no final decision has been made. We would clearly prefer that conditions were more favourable in the markets than they are at the moment, but the Government has stated its desire to do this, and naturally, we support that. We will make the necessary preparations and will follow up on it when conditions are more favourable than they are at this juncture.

Have there been any considerations concerning actual amounts?

David Oddsson

No, not yet. But I think that, in general, it would not be considered inappropriate that they be doubled, at least.

At the Bank's annual meeting the other day, you mentioned that there had been an assault on the Icelandic financial system. You even mentioned an official investigation. Four international hedge funds have been mentioned in this connection. Does something need to ... or has anything been done about this?

David Oddsson

Yes; as far as I know, a great deal of data has been compiled. Gathering information is the prerequisite for working with authorities in other countries because an investigation of this sort doesn't take place only here. Information has to be submitted to the appropriate entities in

other places, and as far as I know, this process is still underway. Once it is complete, it will be possible to take the next steps. There are numerous indications that action has been taken against the Icelandic financial system. Of course, some of these actions are not abnormal or inappropriate in and of themselves – at least, they’re not illegal, and perhaps not even inappropriate – but it is possible to step over the line, and this is what is being looked into and investigated.

And are there indications of criminal conduct?

David Oddsson

As I said, this is not the right time to make any declarations because information is still being gathered, and then further investigation has to take place. It is difficult and complicated to prove anything, but I believe it is important that it be generally acknowledged that the matter is being seriously investigated. It is insufficient, and could even be harmful, to announce that such a thing will be investigated and then nothing is done.

Which international bodies investigate such things?

David Oddsson

In our case, the Financial Supervisory Authority (FME) carries out the investigation. FME would then contact the financial supervisory authorities in the countries where these parties are located and would collaborate with them.

This forecast that has been published – it’s rather bleak. I would like to know how you assess ... that is, since you became Chairman of the Board of Governors of the Central Bank ... how successful has the Bank been in making a positive impact on the economy?

David Oddsson

I don’t think it is possible to say anything truly intelligent about that until a longer period of time has passed ... a number of elements have worked against us, as Arnór mentioned, and of course, the inflation level is not where we would have chosen, but I expect that, based on the headwinds that Arnór showed here on the screen just now, it’s possible to say that astounding progress has been made, considering that things could have been worse, but given the limits set on us ...the limits that the inflation target sets on us, it is clear that we haven’t reached that target. But we are expecting to reach target in the third quarter of 2010.

You mention that you are considering conditions for strengthening the foreign exchange reserves. I’m wondering whether it wasn’t a mistake on the part of the Central Bank or the Government not to strengthen the foreign reserves when terms were more advantageous and the exchange rate more favourable.

David Oddsson

Well, actually, the Central Bank doubled its foreign reserves when the terms were favourable. It took some people by surprise that the Bank should do so because the theory was that, having abandoned a so-called exchange rate target, it seemed contradictory that the foreign reserves should be large. Some were even of the opinion that foreign exchange reserves were

a thing of the past. They were unnecessary, according to some “experts”. But about 15-16 months ago, the Bank began – at the request of the Government, of course – to fortify the foreign exchange reserves, and the Bank did so under very favourable conditions. So favourable that there is no cost of carry. Naturally, the Central Bank proceeds in a conservative manner when it invests because the funds invested must be accessible on short notice. This is why the Bank doesn’t necessarily insist on maximising returns, but rather on maximising security. But despite our having guaranteed maximum security with this investment, the returns are such that this increase in foreign exchange reserves actually costs the Government nothing.

Concerning the foreign exchange reserves of the Government and the Central Bank: There has been a great deal said recently about the possibility that, if worse came to worst and the banks ended up in real difficulties, the Government and the Central Bank would assist them in some way. Various methods have been mentioned. My question is this: Are there any plans on the horizon, either declarations or direct action, in order to strengthen the banks or assist them, with or without conditions attached? Also, I would like to ask if my assessment is correct, that this so-called banking crisis peaked perhaps a week ago. Can we assume that it is on the wane and that the need for such strengthening or assistance is on the wane as well?

David Oddsson

I don’t think anyone has ventured to state that the international banking crisis is behind us. There are many people who believe it could continue for some time and that, as of now, numerous elements have yet to emerge. I think it would be imprudent to assume that the international banking crisis is over. Of course, it would be nice and desirable if that were the case.

But difficulties pertaining to the domestic banks; that’s really what I mean, perhaps ...

David Oddsson

Well, unfortunately, those difficulties are connected to the international financial crisis, and I think it is extremely impetuous to speak of the banks as though they will need to be rescued in short order. There’s nothing to indicate that this is the case. The banks themselves have declared that, based on their current liquidity position, they are not dependent on accessing foreign markets. There is nothing to indicate otherwise than that the liquidity position of Iceland’s banks is similar to or perhaps better than the liquidity of comparable banks elsewhere. So I think we shouldn’t get ahead of ourselves where that is concerned. Also, with regard to the foreign exchange reserves and the size of the banks, it must be borne in mind that the banks’ primary task is to take care of themselves. When the banks were privatised and sold, there was no Government guarantee attached. If there had been, they would have been sold at a much higher price.

So the banks’ primary task is to take care of themselves, and not to expect that if they expand their operations on their own initiative, that the public is required to act swiftly to increase Central Bank’s foreign exchange reserves. Such an undertaking is very expensive in itself, because of the method of investing foreign reserves. It is extremely costly to maintain very large foreign reserves. People must not forget this and speak as though the responsibility for the banks lies anywhere else than on their own shoulders. And I think they realise that, for the

most part, the banks are responsible for their own operations. It's important that this not be misunderstood.

One question to follow up on what you were saying: Would you say it was irresponsible of the Prime Minister to declare at the Central Bank's annual meeting, and elsewhere as well, that the Icelandic Government will stand behind its banks no matter what, as though a sensible government were in power?

David Oddsson

I think that what the Prime Minister said was perfectly appropriate. He said that the Icelandic Government would behave in the same way as sensible governments do elsewhere. I think, of course, that the general rule in a free and open market economy is that banks are responsible for their own operations. However, it is assumed – and enshrined in law – that central banks are lenders of last resort. This is a role set by rule for the Central Bank of Iceland. And of course, it's a rule that the Central Bank of Iceland will abide by. If the banks are lacking equity – are insolvent – we are forbidden to help them. It would be illegal for us to assist them if they were insolvent. But there is nothing to indicate that the Icelandic banks are going that route. They have been exceptionally profitable – quarter after quarter, year after year. People mustn't forget that the banks have demonstrated excellent performance. If we look, for example, at non-performing loans, they are at historical lows. That, at least, indicates that risk appetite hasn't gotten out of control, as members of the foreign press have been writing. We need to take care not to start parroting what we read from abroad.

Continuing on from that, foreign institutions have suggested that the Icelandic Government purchase the banks' liabilities in order to restore the global market's confidence in them. Is this a realistic idea?

David Oddsson:

No, I don't think it is realistic, as this assumed that it would be necessary to purchase the equivalent of 24 billion euros. We have mentioned doubling the foreign exchange reserves from about 2 billion euros to 4 billion. We can't use the same money twice. And that amount would still only total one-sixth of what would be needed. So I think that was an idea that someone just tossed out; I don't think it was a considered opinion. And I think it's no longer being suggested.

The Prime Minister recently requested a theoretical appraisal of monetary policy, the Central Bank's policy tools. Do you view this as a vote of no confidence concerning what you have been doing here?

David Oddsson:

No, not any more than what was done, for example, in Sweden. There was just such an appraisal of the policy of the Swedish central bank, which is very similar to our policy, so we have nothing against this – quite the contrary, actually – it's good that people engage in scholarly discussion of the Central Bank's monetary policy. I'm not concerned about that kind of discussion.

Do you believe the policy rate is making a dent in inflation?

David Oddsson:

I believe that, before all is said and done, it will do so. But in Iceland, as well as elsewhere, when events work against us, it takes longer than we would wish. We have seen this in large economies – that it can take a long time. The US Federal Reserve Bank raised the federal funds rate perhaps 18 or 19 times.

(unclear due to sound interference) ... inflation, it is still considerably high there, but for the moment the Federal Reserve has taken another tack, and we hope and expect it won't mean that the US will succumb to inflation; there's no real reason to expect such a thing. The Federal Reserve has a long, solid history. Actually, not too long ago, the Fed raised interest rates to something like 19 or 20 per cent in order to bring inflation into line, between around 1977 until the 1980s or around that period. So we're not alone in having to take some aggressive action in order to get results. As I've said before, ultimately these mills are going to grind well.

How favourable would conditions have to be in order for it to be possible to strengthen the foreign reserves?

David Oddsson:

Well, it's not possible to give some mathematical formula for it, and we don't want to state exactly how we will go into the market because if we aren't careful, terms could get worse. So it's important that people realise that we will go to the market when we see fit; we won't just jump up and take whatever is out there. The Republic of Iceland is debt-free on a net basis, and we are of the opinion that such a borrower should receive good terms. We do not consider ourselves authorised, as the agents of the Icelandic Government in this matter, to borrow funds on terms other than we consider acceptable in order to strengthen the foreign reserves. We see now that the CDS levels on the Icelandic Government have been falling. They have been disproportionately high, and I believe this downward trend will continue.

The Central Bank is very interested in the exchange rate, and you say yourself that a policy rate hike alone won't solve the problems that have developed in the FX swap market. Doesn't the Central Bank need to resort to some realistic action in this market in order to support the króna?

David Oddsson

That is exactly what we did. We took various steps other than using the conventional tools that we have – and the Government has come in as well. We launched a new series of certificates of deposit, and there was very strong demand for those CDs yesterday. The overall size of the series was 50 billion krónur, and there was demand for roughly 67 billion or so. Because of that response and those trades, the quote was revived in the swap market. The swap market came to life again, and the interest rate differential was quoted at between 6 and 7 per cent, if I am not mistaken. What this tells us is that this action taken by the Bank – and others as well – resuscitated the swap market. So you're absolutely right; we do need to resort to more extensive measures. And the Board of Governors has said that this 50 billion króna CD series will be expanded to 75 billion in the next auction, this coming Wednesday.

In various foreign media it was said recently that other central banks were implying that they wanted to release themselves from responsibility for us here in Iceland. What do you have to say about that – that the leaders of other Nordic central banks are making light of their interactions with us and with one another, according to the agreement signed a few years ago in Stykkishólmur?

David Oddsson

We enjoy an excellent co-operative relationship with the Nordic central banks – we have very regular interactions and positive, effective collaboration, which I value greatly. On the other hand, what you may be referring to is that the central banks in the Nordic countries thought a number of analysts made too much of the Memorandum of Understanding that was signed in Stykkishólmur in 2003. As the Central Bank of Iceland has always said, the MoU provided for a certain level of collaboration and consultation in a financial crisis, and we are of the opinion that such a financial crisis has not yet come to pass. It was then stated, in a press release about the MoU, that naturally one of the considerations was that, in a crisis, financing could be provided between banks. Various analysts interpreted this to mean that Nordic banks were obligated to provide financial assistance if such a situation were to materialise. Here in this Bank, we have never taken that view, and we have never encouraged it. On the contrary, we have corrected this misapprehension at every opportunity. As regards collaboration, it is as set forth in the MoU, and moreover, at that turning point back in 2003, credit lines were closed between the banks because it was thought that many things had changed: exchange rate support was not implemented in the same way as before, and so on. So I take the view that the Nordic central banks wanted to ensure that there was no automatic agreement in force that obligated the banks to pump money back and forth to one another. If this were done, it would have to be on the basis of a bilateral agreement between two individual banks; this is supported by statutory authority, I'm sure. I was not present at that meeting in Stykkishólmur in 2003. I don't know if my colleagues wish to add anything on that.

Where is the Government most likely to borrow money if it decides to double the foreign exchange reserves?

David Oddsson

That would take place, generally speaking, in the market. We are convinced that there's no real shortage of money available to the Government, and at this point we think we could secure funds quickly – virtually whenever we choose – but if we did that, we might have to accept terms that we find unacceptable. But the funds are there, and it would be easy for us to obtain them. In the current climate, there are plenty who are willing to lend to a debt-free government. In this financial climate, investors need to find shelter for their funds, but we are not willing to borrow at any price offered to us.

If the foreign reserves were to be doubled in the near future, would that suffice to enhance confidence or to meet the possible crises that these funds are supposed to provide backup for?

David Oddsson

I won't make any promises on that score. But I want to reiterate that we are not taking the path that the Government wants us to take just to save the banks. We don't think the situation requires that. We believe the banks are able to stand behind their own commitments, and we do not want to fuel any rumours that I believe have been started – that our banks are in such trouble.

Central banks in other countries have been increasing liquidity in their financial systems because there is a sort of bottleneck. Why doesn't the Central Bank of Iceland respond similarly, as the US Federal Reserve and the European Central Bank have done?

David Oddsson

The Central Bank of Iceland has indeed responded in such a manner. It has both expanded and changed the terms for lending here in the Bank. Our weekly collateralised lending has increased from 100 billion krónur per week to a peak of 350 or 360 billion krónur per week. It's impossible to say otherwise than that, in this respect, the Central Bank has fulfilled its role perfectly well. We haven't had any problems with the financial system not functioning because the Central Bank has not lent any support, as it is supposed to within sensible limits. The Bank has to receive the collateral that it deems sufficient and, just as the ECB and the Federal Reserve have done, the Central Bank of Iceland has been more flexible in its considerations regarding collateral than has previously been the case, under other circumstances. We haven't gone farther than those large banks have, but neither have we done less.

I understand that the policy rate in Iceland is higher than in any other developed country. What is your opinion of that?

David Oddsson

It's a shame that this should be the case, but sometimes it takes the devil to drive the devil out. I'm convinced that not too long from now, when inflation has come back down, others will agree with me. That's how it is with all such ills, no matter what they are called. If the usual dose of medicine isn't strong enough, it will have the opposite effect, the bacterium will develop a tolerance for it, and the dose will have to be stronger the next time. What we are doing is administering the dose that is needed to drive this illness out. It isn't terribly popular at the moment, but it is absolutely unavoidable.

What you said regarding the Memorandum of Understanding from 2003 was interesting – that credit lines were closed because, if I understood you correctly, there was not as much emphasis on the exchange rate. Now, however, the emphasis on the exchange rate has increased, and the question is whether it is necessary to negotiate these so-called credit lines now, under the current circumstances.

David Oddsson

Under the current circumstances, we haven't taken money out of the Bank in order to support the exchange rate. We haven't done that; it was last done here in 2001; isn't that so? But we haven't done so since because our goals are different now. We haven't used the Bank's resources in an attempt to intervene in the development of the exchange rate. But we have never said that we would not do so; we have never said it's out of the question. Banks with an inflation target have done so, as New Zealand did just 4-5 months ago. I don't think the New Zealanders were successful in that endeavour, and here in the Central Bank we have no interest in throwing good money after bad, as it were.

Ingimundur Fridriksson

That MoU was grounded in a fixed exchange rate policy and assumed that Central Banks would have access to borrowed funds at need in order to defend a fixed exchange rate.

David Oddsson

Actually, the entire global system was heavily based on such things. As an example, for a period the IMF – its existence – was based on such criteria.

I'd like to ask you about the tax cuts you mentioned a moment ago. Given what the Central Bank has said previously about how the Government behaves with respect to economic affairs, it sounds as though the Government is working against your objectives. What is the Bank's opinion of this under the current circumstances, in the face of such headwinds?

David Oddsson

As regards the tax cut decision, we believe the Government is trying to time it so that it will be as conducive as possible to supporting our objectives. It is important that central banks not complain about the government; most of them try to avoid it. We're not giving the Government a grade for its performance; that's not our assignment. We think it is important, with all such decisions made by the Government, that their scope and timing take into account what we are trying to do here. But it is not our role to tell the Government what to do.

If you don't have any further questions, I would like to thank you for your excellent questions.