



**Glitnir Research's forecast for the ISK**

	Index	EUR	USD
<b>Q4 2006</b>	122	89	69
<b>Q1 2007</b>	126	92	71
<b>Q2 2007</b>	128	93	72
<b>Q3 2007</b>	130	95	73
<b>Q4 2007</b>	130	95	73

**Forthcoming rate decision dates and Glitnir Research forecast**

date		Forecast	Policy rate
08-Feb-07	Announcement	no change	14.25%
29-Mar-07	Monetary bulletin	no change	14.25%
17-May-07	Announcement	0.5% decrease	13.75%
05-Jul-07	Monetary bulletin	0.5% decrease	13.25%
06-Sep-07	Announcement	0.75% decrease	12.50%

**Interest rate differential supports ISK**

The ISK rose by nearly 5% in January. The first weeks of 2007 saw some temporary instability on the rumour that the commercial banks were considering denominating their equity in euros, but after this died down the ISK started to gain strength. Various factors are supporting the krona at present. For example, confidence in the Icelandic financial system has risen steadily since the setback early last year, and the recent announcement of their results for 2006 has presumably removed all doubt in that area. The most significant point, however, is that short-term interest rates in Iceland are one of the highest among countries with a relatively developed financial system. Therefore it comes as no surprise that foreign investors are attracted to Iceland as an investment option for carry trades. In fact, the issue of ISK eurobonds is a part of these trades, even though they are largely held by retail real money investors. ISK eurobonds amounting to ISK 65 billion were issued in January, the largest issuance in a single month since the first ISK eurobond issue in autumn 2005. Total issuance of ISK bonds now stands at ISK 326 billion, of which ISK 102 billion mature in Q3 this year.

Our forecast for the ISK remains unchanged from last month. The ISK has strengthened since then, and the outlook in the economy is now for a more gradual cooling than at the time of our last forecast, which in turn means that high interest rates could prevail for longer. On the other hand, interest rates in the major currencies now also seem more likely to be higher, so the outlook for the interest-rate differential remains much the same. We expect considerable fluctuations in the ISK over the coming months, but broadly speaking the TW index is likely to lie in the range 122-130. Currently, there seems to be fairly widespread support for our view that the equilibrium exchange rate of the ISK in the medium term corresponds to an index close to 130. If investors share this view, then it is natural that position taking in the ISK will become more attractive to them as the spot exchange rate approaches this value, since interest-rate differential is large. In the same way, investors seem to lose interest as the index approaches 120 as they see increased risk that unfavourable exchange rate movements offset the rate-differential gains to a large extent.

As the prospect of a cut in the Central Bank's interest rate becomes likely, this range is likely to shift towards a lower exchange rate of the ISK. We believe the index will fluctuate around a level of about 130 in the latter part of this year. The main uncertainty factors regarding a higher exchange rate include the possibility of further power-intensive industrial projects and other factors that could contribute to a higher policy rate than we currently foresee in the near future. Factors that could press the exchange rate down include (apart from those that could result in a policy rate) a loss of interest in carry trades on international financial markets; however, any drop in the exchange rate resulting from this is likely to be temporary.

**Policy rate peaking**

Our forecast last month, that the Central Bank will keep its policy rate unchanged after its next rate decision meeting on 8 February, remains in force, and we believe that the rate (currently 14.25%) will not go higher. The ISK has strengthened since the beginning of the year, which should militate against a further rise in the rate; on the other hand, the inflation outlook is slightly poorer and there are indications that the fall in demand could be more gradual than we previously thought. Taking these factors into account, we predict an unchanged policy rate until the spring, and that the Central Bank will cut its rate in May and bring it down to 11.5% by the end of the year. We then foresee further cuts in the rate during 2008.

The main upside risks to our forecast are the possibility of further power-intensive industrial projects, particularly if they were to be begun on a large scale in the next year or so, or that the overheating that has characterised the economy over the past couple of years could subside more slowly than we assume. The main downside risks to our forecast are that the cooling we expect over the coming months could prove to be sharper than seems likely at present and that inflationary pressure could abate more quickly than we predict. The upside risk is somewhat greater in our view, i.e. that rate cuts could start later and/or be smaller. In particular, a decision on the expansion of the aluminium smelter in Straumsvík could retard, or stop, the rate cuts expected in the latter part of the year. Changes in the exchange rate of the ISK also constitute a major uncertainty factor; such changes have large and quick effects on inflation, and thus on the Central Bank's monetary policy, if they prove to be long-term.