



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

	Index	EUR	USD
<b>Q4 2006</b>	122	89	69
<b>Q1 2007</b>	120	89	68
<b>Q2 2007</b>	118	86	66
<b>Q3 2007</b>	121	88	68
<b>Q4 2007</b>	127	93	71
<b>Q1 2008</b>	132	97	74
<b>Q2 2008</b>	132	96	74
<b>Q3 2008</b>	128	93	72
<b>Q4 2008</b>	126	92	70

**Further appreciation in the short term**

We expect the krona to remain strong in coming months and even appreciate further in the short term. However, a significant rise is unlikely in our opinion as the krona is already strong in light of the positioning of the economic cycle. A wide differential between domestic and foreign interest rates and foreign investors' substantial risk appetite along with robust faith in the Icelandic economy are all factors that could spur a further ISK rise in the short term, i.e. in the next three months or so. We expect the EUR to equal ISK86 on average in the quarter and the USD to equal ISK66.

**ISK depreciation before the year-end**

When looking further ahead, the Central Bank is likely to start lowering its policy rate in May and step up the reductions as the year progresses. Inflation is now abating rapidly and other signs of overheating in the economy will subside in coming months. The Bank will react by easing its monetary restraint. We reckon that the Bank will have brought its policy rate down to 11.5% at the end of this year and 6.5% by the end of 2008. When probable interest-rate hikes in major funding currencies are added, the differential between domestic and foreign short-term interest rates will narrow quite rapidly and serve to weaken the krona. Added to this is the wide current account deficit and large maturities of ISK Eurobonds in the latter half of this year. The total amount of outstanding Eurobonds in ISK is now ISK326bn, and ISK102bn thereof will mature in Q3 this year. We expect the EUR to stand at ISK93 on average in Q4 and the USD at ISK71.

**Risk of an overshoot**

There is some risk of an overshoot during the rate reduction process, i.e. that the ISK exchange rate will temporarily drop to a lower value than is necessary to gain equilibrium in the economy. Various factors can cause this, gregariousness not being unheard of in the FX market. With large factors, such as the current account deficit and ISK Eurobonds maturity dates creating downward pressure, the exchange rate can fall fast. Next autumn is a risky period in these matters. We expect the EUR will temporarily reach ISK97 at the beginning of next year and the USD reach ISK74.

Moreover, if something in the global economy scared foreign investors away from high-yield currencies such as the Icelandic krona, this could also result in a temporary overshoot. The timing of such events can not be predicted. However, offsetting such movements is the strength of the Icelandic economy which has shown great resilience in the face of pessimism among investors. The position of households, corporates and the public sector is strong and the foundations of the economy sound.

**Appreciation again as a period of economic growth approaches**

Economic growth is likely to revive again in 2008/2009 on the basis of growing exports, increased foreign investment, results of Icelandic companies' foreign expansion and good competitive conditions. The FX market is forward-looking and will no doubt take this early into account. For this reason we expect the krona to appreciate in 2008.

**Change in currency forecast**

The currency forecast above is somewhat different from the one we published a month ago. Unlike in our previous forecast, we now expect the krona will remain strong in coming months. When the depreciation comes, we expect to be sharper than we projected before. This is not least due to the fact that a stronger krona in the short term exacerbates tension in the direction of depreciation.

We now publish forecasts for the ISK exchange rate and policy rates in 2008. The forecast for the year 2008 reflects that the economy should then have reached acceptable equilibrium and be at the start of a new upswing. Therefore, the policy rate will then at year end be close to the policy rate that should ensure equilibrium, the said rate being estimated at 5-6% based assumptions for equilibrium economic growth and inflation.

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

date		Forecast	Policy rate
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%
01-Nov-07	Monetary bulletin	1.00% decrease	11.50%

Policy rate, annual averages:	2006	12.5%
	2007	13.3%
	2008	9.0%