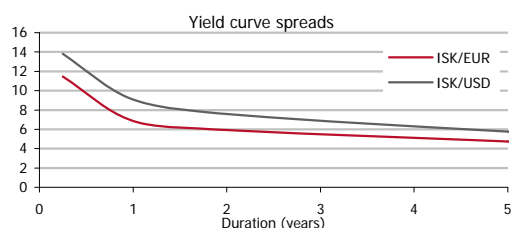
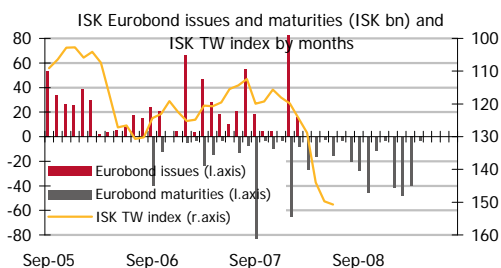
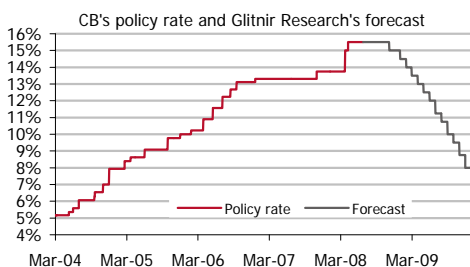
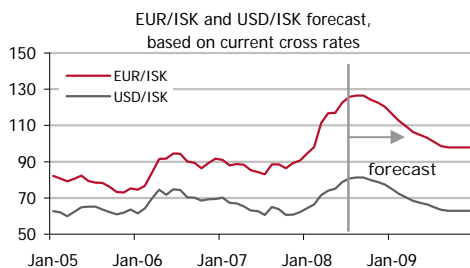
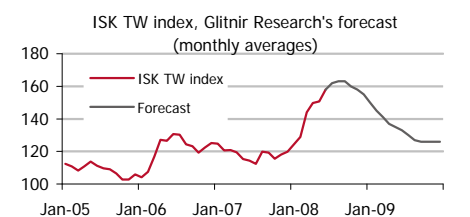


SHORT-TERM RATES AND THE ISK

GLITNIR

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GLITNIR RESEARCH'S FORECAST FOR THE ISK

	Index	EUR	USD
Q2 2008	153	119	76
Q3 2008	163	126	81
Q4 2008	158	122	79
Q1 2009	145	113	72
Q2 2009	135	105	67
Q3 2009	128	99	64
Q4 2009	126	98	63

POLICY RATES, ANNUAL AVERAGES

	Nominal yield	Annual yield
2007	13.4%	14.3%
2008	15.0%	16.2%
2009	11.5%	12.2%

THE ISK DEPENDENT ON GLOBAL CONDITIONS

Difficult conditions in global credit markets, investors' low risk appetite, the release of slack earnings reports in the US and rising CDS levels on Iceland's sovereign and banks are the main contributors to the recent depreciation of the ISK. Limited access of domestic financial institutions to international credit has resulted in the curtailed interest rate differential on the shortest contracts in the FX swap market since the beginning of March, making it more difficult for foreign investors to access high Icelandic interest rates. The ISK has depreciated by 28% since the beginning of the year for these reasons. We believe that the development of the ISK exchange rate will for the time being remain determined by conditions in global financial markets. The currency will therefore face adversity in the near term. We expect the ISK exchange rate to remain volatile in coming months, as is not unusual in tumultuous times. We forecast that the ISK will start appreciating near the end of this year as global market conditions improve. In fact the ISK can be expected to appreciate quite rapidly when access to foreign credit improves again and foreign investors gain ready access to a high interest rate differential, although it is impossible to time those changes specifically. We expect the US dollar to be close to ISK 77 and the euro close to ISK 118 at the end of this year. At year-end 2009, we forecast that the US dollar will be close to almost ISK 63 and the euro close to nearly ISK 98.

The main uncertainty factors in our forecast are the timing of when global credit markets will start to clear up. If the crisis persists, the ISK can be expected to be weaker throughout the forecast period than assumed here. In addition, when credit markets open again we are likely to see a faster appreciation in the ISK than forecast here. Other factors that can affect the ISK exchange rate in coming months are the release of six-month financial reports beginning near the end of July as well as further announcements on government borrowing to bolster the currency reserves of the Central Bank of Iceland (CBI). We believe it is imperative to grow the CBI's currency reserves, directly or indirectly, and that an announcement thereof will serve to strengthen the ISK.

THE POLICY RATE HAS PEAKED

Inflation has increased substantially of late and measured 12.3% on annual basis in May, greatly exceeding the CBI's inflation target. High inflation in recent months can be traced to the depreciation of the ISK and a global rise in commodity prices. The current level of inflation is therefore due to a rise in those subindices of the CPI which are unaffected by the CBI's high policy rate, posing a dilemma for the central bank. We believe that the policy rate has now peaked at 15.5% and expect the board of governors to keep the rate unchanged at the next rate decision date on 3 July. The board of governors of the CBI has repeatedly said that a high policy rate is intended to prevent spiralling increases in prices, wages and the ISK TW index and prevent high inflationary expectations from cementing, and we expect that message to be repeated now.

While inflationary pressure has been rising, both domestically and globally, the outlook for economic growth has worsened. New Q1 GDP figures indicate a faster cooling of the economy than the CBI assumed in its last macroeconomic forecast. There are numerous indications that growth in domestic demand has decelerated further in Q2. These include lower turnover in the housing market, a decline in house prices and a reduction in new car registrations in addition to a contraction in the purchasing power of wages, a considerable decline in consumer confidence and reports of lay-offs at numerous companies. We forecast that the CBI will embark on its policy rate reduction process in November with a 0.50 percentage point cut, bringing the rate to 15% by the year-end. We expect rapid rate cuts next year as the economy cools, private consumption contracts, the economy moves towards external equilibrium and inflationary pressure abates, and expect the policy rate to stand at 8% at the end of 2009. We previously forecast that the rate reduction process would start in September this year, bringing the policy rate to 14.75% at the year-end.

It may be argued that the CBI should lower the policy rate sooner and faster than assumed in our forecast. Domestic rates are much more effective in curbing demand now after access to foreign credit became limited and there are indications that the economy is cooling at a rapid rate. In addition, falling interest rates would hardly weaken the ISK more than already is the case as the interest rate differential is barely active at present. By keeping the policy rate so high for so long the CBI is in fact reacting to the economy's adverse external conditions, i.e. factors that remain unaffected by the policy rate, and the CBI's measures serve to drive the economy into an unnecessarily deep downturn. However, we believe the CBI does not share our view of the development and that the policy rate will therefore remain high for longer than is desirable.

FORTHCOMING RATE DECISION DATES AND GLITNIR RESEARCH FORECAST

Date	Forecast	Policy rate
03-Jul-08	unchanged policy rate	15.50%
11-Sep-08	unchanged policy rate	15.50%
06-Nov-08	0.50% decrease	15.00%

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