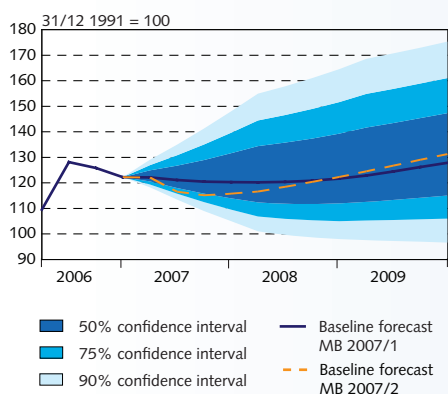


Box IX-1

Changes in the baseline forecast from Monetary Bulletin 2007/1

Chart 1
Effective exchange rate

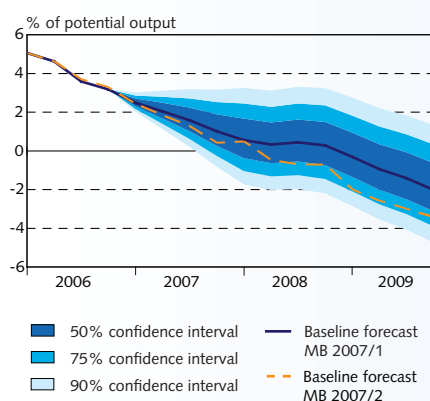
Baseline forecast and uncertainty bands MB 2007/1 and baseline forecast MB 2007/2



Source: Central Bank of Iceland.

Chart 2
Output gap

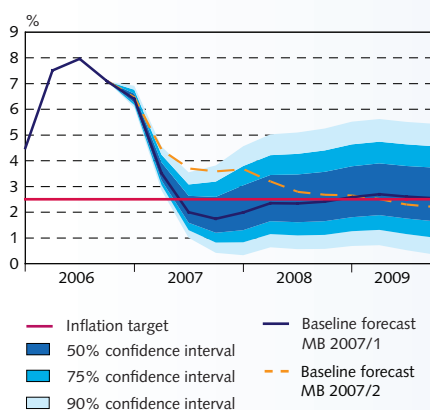
Baseline forecast and uncertainty bands MB 2007/1 and baseline forecast MB 2007/2



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 3
Inflation

Baseline forecast and uncertainty bands MB 2007/1 and baseline forecast MB 2007/2



Sources: Statistics Iceland, Central Bank of Iceland.

As new data become available, the economic position and outlook are reassessed and forecasts revised accordingly. This Box describes the main changes in the macroeconomic and inflation forecast since *Monetary Bulletin* 2007/1 in March and compares the current baseline forecast with the probability distribution of the previous one.

The main finding is that a rather tighter monetary stance is now needed to bring inflation to target within an acceptable horizon. Leaving the policy rate path unchanged from the March baseline forecast would have meant an even slower return to the inflation target, inviting the risk that inflation expectations would move above target again at the end of the horizon. A crucial factor is the faster depreciation of the króna in the current baseline forecast.

Faster depreciation than in the previous baseline forecast

In March, a minor appreciation of the króna was forecast for the first part of the horizon, gradually unwinding in the latter part of 2008. However, the króna has appreciated by more than was forecast and is currently roughly 10% stronger than at the beginning of this year. As Chart 1 shows, such a strong appreciation was considered fairly unlikely in March. Given the high real exchange rate, the expected persistent current account deficit and higher global long-term interest rates than in the last forecast, underlying downward pressure on the króna has probably increased since the last *Monetary Bulletin*. The current forecast assumes a faster depreciation. At the end of the horizon the exchange rate index stands at 133, having weakened by more than 12% over that period instead of only 6% in the March forecast.

Output gap turns negative earlier due to less output growth and revised potential output

The potential output of the economy has been revised since March. Estimated depreciation of the capital stock has been revised, which changes the underlying growth potential of the economy. The capital stock will hence grow more rapidly than was expected in March. This also implies faster growth of total factor productivity and labour productivity over the next few years. The output growth forecast for 2007 and 2009 has been revised downwards, but is broadly unchanged for 2008. Thus the output gap will close more rapidly and is forecast to turn negative in mid-2008, almost half a year earlier than in the March forecast (Chart 2). Slack will increase until the end of the forecast horizon, then begin to reverse afterwards.

Slower disinflation than forecast in *Monetary Bulletin* 2007/1

Inflation in Q2/2007 turned out higher than was forecast in March, even though the króna appreciated. The forecast for Q2/2007 was 3.5% but the actual rate was one percentage point higher. An even wider divergence is seen for Q3/2007, when the current forecast falls just outside the 90% confidence bands of the March forecast (Chart 3).

Most of this discrepancy is explained by soaring house prices. In March, house prices were forecast to remain virtually unchanged over 2007. Rising petrol prices, higher wage rises and growing wage drift have contributed as well. Persistent inflationary pressures may also indicate that the robustness of the economy in 2006 was underestimated. There are numerous indications that domestic demand growth and output growth were higher than is shown in the preliminary national accounts figures. If so, underlying inflationary pressures would have been underestimated in March, which is reflected in underforecast inflation in the first quarters of this year.

The outlook is therefore for slower disinflation in 2007 than was expected in March. Inflation in Q4/2007 is currently forecast

at 3½%, instead of less than 2% in the March forecast. From the second half of 2008, however, the inflation outlook is broadly the same as in the previous forecast. Thus inflation will move onto target somewhat later, in the first half of 2009 instead of Q3/2007.

Impact on the policy rate path in the baseline forecast

Because the inflation rate has fallen more slowly and inflation expectations have been higher than was expected in March, the real policy rate has edged down since the last *Monetary Bulletin*. The monetary stance is therefore not as tight as previously forecast. In order to offset the weaker real policy rate, higher starting rate of inflation and faster forecast depreciation of the króna, the output gap needs to be closed more rapidly with a larger degree of slack later in the forecast horizon.

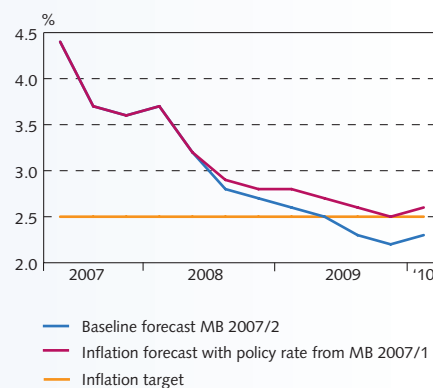
However, it would seem difficult to prevent a delayed adjustment back to the inflation target by tightening the monetary stance, since underlying cost pressures are so strong that this can only be achieved with a substantially greater cost in the form of lost output. The stance is therefore tightened by postponing the downward cycle of the policy rate by one quarter and implementing it more slowly. Nonetheless, the policy rate will begin to decline more rapidly later along the horizon and end at a lower level than was forecast in March. This policy rate path is sufficient to bring inflation to target in the first half of 2009, as mentioned above, which will prevent a resurgence of inflation and inflation expectations in spite of a fairly fast depreciation of the króna in the second half of the forecast horizon. The policy rate path used in the baseline forecast in the March *Monetary Bulletin* would have resulted in even slower disinflation, creating a risk that inflation expectations would have moved above the target beyond the horizon (Chart 4).

According to the revised path, the policy rate remains unchanged until early next year, when it gradually lowers. It is just over 11% in Q4/2008, compared with just under 10% in the last *Monetary Bulletin*. In Q4/2009, on the other hand, the policy rate is down to 5% in the current forecast, almost 1 percentage lower than projected in March. The policy rate path lies within the 50% confidence limits of the March forecast (Chart 5).

Chart 4

Inflation

Baseline forecast and forecast with policy rate from MB 2007/1

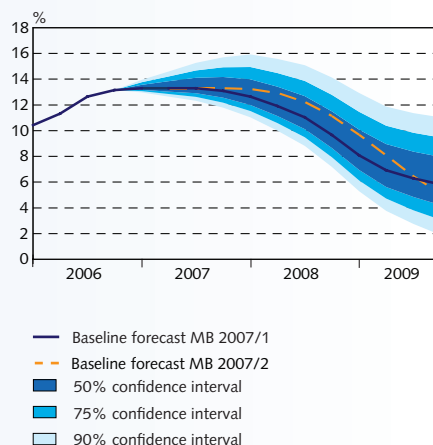


Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5

Policy rate

Baseline forecast and uncertainty bands MB 2007/1 and baseline forecast MB 2007/2



Sources: Central Bank of Iceland.