

The accompanying table shows the survey responses of financial market analysts in mid-October. Participants in the survey were the research departments of Glitnir (previously Íslandsbanki), Kaupthing Bank and Landsbanki, and Economic Consulting and Forecasting.

In addition to the information presented in the table, analysts were asked to give an assessment of the Central Bank's policy interest rate path, i.e. on the timing of the policy rate cycle's peak and trough within the forecast horizon, and what the Central Bank's next policy rate decision would be when the current *Monetary Bulletin* was published.

The main changes from the June survey (published in July) are that analysts have revised their forecast for output growth marginally downwards and expect considerably lower inflation, a lower policy rate and stronger króna in 2007. Forecasts for 2008 are also included in the survey.

Analysts forecast sharp drop in inflation in 2007

Analysts forecast year-on-year inflation in 2006 of just under 7%, which is slightly lower than their expectations in the previous survey in June. This is roughly the same inflation rate as in the Central Bank's baseline forecast, which incorporates analysts' forecasts for the medium-term policy rate path. In 2007, survey respondents expect an inflation rate of just over 3%, while the Central Bank's baseline forecast is considerably higher, at 4½%. Their forecast of 3½% year-on-year inflation in 2008 is also slightly lower than the baseline forecast, but higher than the alternative scenario based on monetary policy responses, which is close to the 2.5% inflation target.

One of the main changes since the June survey is that, on average, analysts expect the Central Bank to have attained the inflation target one year ahead. In fact, one respondent forecasts virtually zero inflation one year ahead. It should be borne in mind that the current forecast, unlike previous ones, takes into account planned government measures to cut food prices.

Marginally lower output growth outlook over the forecast period

Analysts have revised their forecast for output growth for 2006 and 2007 slightly downwards from the June survey. On average they expect 4% growth this year and just under 1% in 2007. The Central Bank's baseline forecast projects rather more growth (1½%) next year. Forecasters are unanimous about a sharp slowdown in economic activity in 2007 and one of them expects a contraction. They also agree that the economy will pick up in 2008, although their projections differ. On average they forecast growth of just over 3½% in 2008, with one projecting a 6% figure based on the assumption of further investment in the power and aluminium sectors. By comparison, the Central Bank's baseline growth forecast for 2008 is just under 3%, while the alternative scenario based on monetary policy responses projects a contraction of almost 2%.

Króna stable across the forecast horizon

The króna has strengthened again recently and analysts have upped their forecasts for next year compared with June. They foresee an exchange rate index of 125 both one and two years ahead. The majority expect it to lie in the range 122-130 across the forecast horizon, but one projects a slightly higher value.

Box VII-1

Financial market analysts' assessments of the economic outlook

Policy rate expected to have peaked

The Central Bank has raised its policy interest rate three times since the last *Monetary Bulletin* was published in July, by 1.75 percentage points in all to 14%. Analysts have revised their policy rate forecasts downwards for one year ahead but left their forecast two years ahead virtually unchanged. On average, they expect a policy rate of just over 11% one year ahead, dropping back to around 9½% two years hence. They were also asked to forecast the next policy rate decision, and the peak and trough of the policy rate over the next two years. Most forecast no change on the scheduled interest rate decision day of November 2 and a reduction in Q1/2007, but one expects a hike of 0.5 percentage points to 14.5% and a steady high rate across the horizon. The others expect the policy rate to reach a trough in 2008, in the range 7-8.5%. One forecaster assumes that new investments will be made in the power and aluminium sectors in 2008 and that the policy rate will begin to rise again that year.

Housing prices likely to fall in 2007

Conditions in the equity market have turned around in recent months. On October 18, Iceland Stock Exchange's ICEX-15 index stood at almost 6,500, up by close to 20% since the analysts' last forecast in June. Most respondents agree that equity prices will continue to climb and forecast an ICEX-15 index value of just over 7,100 on average one year ahead. However, one forecaster believes that equity prices will drop both one and two years ahead.

For the first time, analysts expect lower housing prices on average across the forecast horizon, with a 1½% fall in 2007.

Overview of forecasts by financial market analysts¹

	2006			2007			2008		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation (year-on-year)	6.9	6.8	7.0	3.1	2.5	3.7	3.4	2.7	4.3
GDP growth	4.0	3.2	5.1	0.8	-0.2	1.7	3.7	2.3	6.0
	One year ahead			Two years ahead					
Inflation	1.8	0.3	3.2	3.4	2.1	4.3			
Effective exchange rate index of foreign currencies vis-à-vis the króna (Dec. 31, 1991=100)	125	118	130	125	117	130			
Central Bank policy interest rate	11.2	9.5	14.3	9.6	7.0	14.5			
Nominal long-term interest rate ²	7.2	3.6	9.5	6.5	3.4	8.2			
Real long-term interest rate ³	4.8	3.5	7.6	4.5	3.5	7.2			
ICEX-15 share price index (12-month change)	7,173	6,000	7,800	8,013	6,000	9,100			
Housing prices (12-month change)	-1.5	-6.0	5.0	-0.1	-3.0	2.9			

1. The table shows percentage changes between periods, except for interest rates (percentages) and the foreign exchange rate index and ICEX-15 index (index points). Participants in the survey were the research departments of Glitnir (previously named Íslandsbanki), Kaupthing Bank and Landsbanki, and Economic Consulting and Forecasting. 2. Based on yield in market makers' bids on non-indexed T-notes (RIKB 13 0517). 3. Based on yield in market makers' bids on indexed Housing Financing Fund bonds (HFF150644).

Source: Central Bank of Iceland.