

The success of monetary policy depends to a large extent on the general public's perceiving its objectives as clear and its implementation as systematic, transparent and credible. The macroeconomic and inflation forecasts published in *Monetary Bulletin* play an important role in this context. Analyses of economic developments and outlook are modified as new data become available. Assessment of the appropriate policy rate path is therefore subject to change. Ensuring transparent implementation of monetary policy requires clear explanation of the impact of new data on probable economic and monetary developments. This Box provides an account of the principal changes made to the macroeconomic forecast since the publication of *Monetary Bulletin* 2007/2. The changes to the forecast for inflation and its driving forces are discussed in Box IX-1.

### Slower adjustment to sustainable economic equilibrium and more costly disinflation than in the previous forecast

Revised national accounts figures, together with other indicators that have appeared since July, confirm suggestions made in the last *Monetary Bulletin* that the economy was operating at a higher pace than preliminary GDP estimates implied. Indications of growing private consumption in Q2 and Q3/2007, after a brief dip prior to that, have proved correct. Investment has also been above the July forecast. The adjustment of the economy to a sustainable level is therefore not as imminent as previously anticipated. The outlook is for inflation to remain higher than forecast in July until Q3/2008 (see Box IX-1 for details). Given an unchanged policy rate path, real interest rates would therefore be lower than anticipated in July. As a result, the policy rate path in the baseline forecast in *Monetary Bulletin* 2007/2 does not appear to lead to a sufficiently rapid economic adjustment to reach the inflation target within an acceptable time horizon. The baseline forecast presented here includes two further policy rate hikes, and an additional quarter's delay until rate cuts commence. Disinflation will nonetheless be slower and more costly than in the previous baseline forecast.

### Higher private consumption growth until mid-2008 than previously forecast

According to the revised baseline forecast, private consumption growth this year will be substantially higher than forecast in July. Statistics Iceland estimated Q2 growth to be double that projected in July, and grocery and payment card turnover suggests Q3 growth was even higher. Revised estimates for disposable income growth and the strength of the real estate market upswing suggest considerably greater private consumption until mid-2008 than previously forecast. After that, however, private consumption is expected to fall as in the previous baseline scenario.

### Aluminium and power sector investment is dropping in line with the previous forecast, while other business investment this year will be stronger than projected

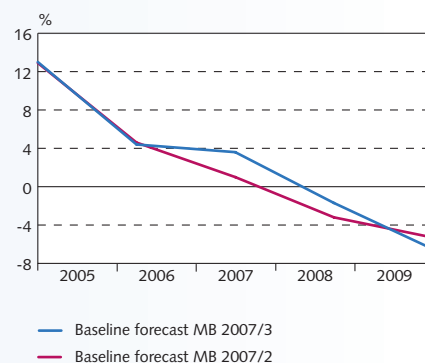
The sharp drop in investment in aluminium and power plants this year has left its mark on business investment and domestic demand, which has contracted rapidly. Gross fixed capital formation could also be expected to fall sharply, but in fact this has occurred more slowly than anticipated, as other investment has picked up at the same time as investment in aluminium and power plants has fallen. National accounts have indicated that the contraction is less than previously forecast, and a survey carried out in September among managers in Iceland's largest companies indicates substantial planned investment for the near term. Anecdotal evidence confirms these indications that investment has been more buoyant than previously forecast.

## Box IV-3

### Changes in the macroeconomic forecast since *Monetary Bulletin* 2007/2

Chart 1

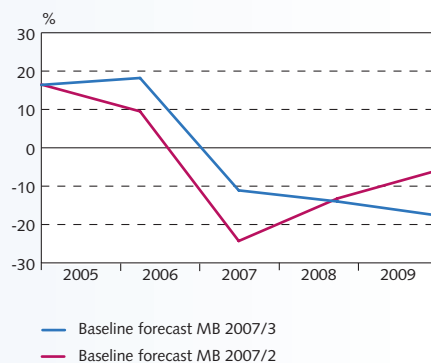
Private consumption growth 2005-2009



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2

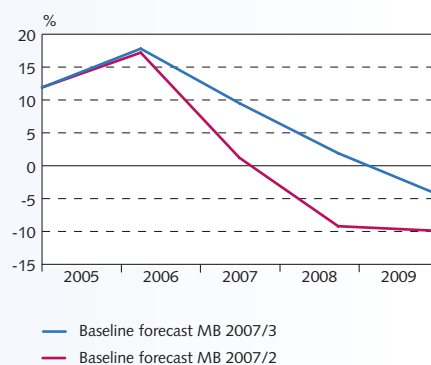
Business investment growth excluding the aluminium sector 2005-2009



Sources: Statistics Iceland, Central Bank of Iceland.

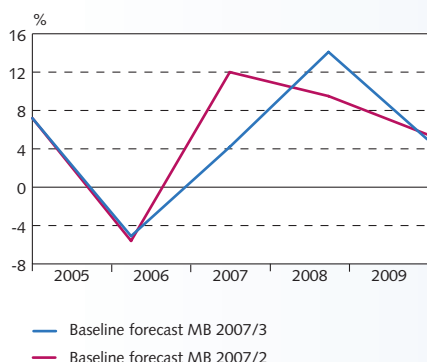
Chart 3

Residential investment growth 2005-2009



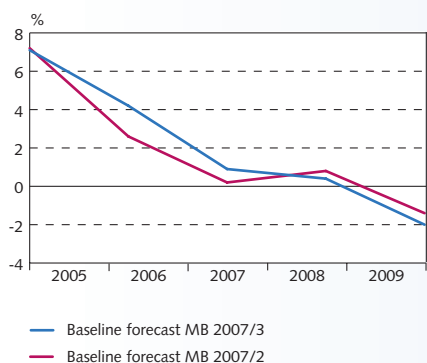
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4  
Export growth 2005-2009



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5  
Economic growth 2005-2009



Sources: Statistics Iceland, Central Bank of Iceland.

Construction of commercial and office space, for instance, appears to be at a high. Accordingly, the baseline forecast has been revised upwards, with general business investment – i.e. excluding aluminium and power plant construction – retaining significant momentum, despite rising domestic financing costs.

### Markedly stronger residential investment growth than predicted in the last *Monetary Bulletin*

The outlook for residential investment has changed significantly from the baseline scenario presented in the July *Monetary Bulletin*. Statistics Iceland has estimated that residential investment grew 11% in Q2/2007. The outlook is for a 10% growth this year and continuing positive growth until the final quarter of 2008, whereas in July only modest growth was forecast for 2007, followed by a substantial contraction during the remainder of the forecast period. As yet there are no signs that such a sharp reversal is imminent, as the real estate market has actually been gathering momentum since the beginning of this year. This is also reflected in a greater rise in housing prices this year and a more modest deflation of housing prices in the coming years than projected in July.

### The outlook for exports in 2007 has deteriorated since July ...

Most factors point in the same direction when it comes to exports: a delay in increased aluminium exports, poorer than expected catches in the last fishing year, and larger TAC cuts for the current fishing year than anticipated in July. As a result, the outlook for exports has deteriorated significantly since July. Rather than expanding at a rate of 12%, the outlook is now for a growth rate of only 4%. Next year, however, aluminium exports are expected to grow substantially.

### ... but prospects for GDP growth early in the forecast period have nevertheless improved

Stronger than anticipated domestic demand in 2006 and 2007 has boosted GDP growth both years. GDP growth last year was 1½% higher than indicated by Statistics Iceland's preliminary estimates, which were published in March. According to the baseline forecast, GDP growth will also be somewhat higher this year than forecast in July, although offset to some extent by a less favourable trade balance. As imports contract considerably less next year than forecast in July, economic growth will be lower even though national expenditures contract less and aluminium export growth is higher. On the other hand, tighter than previously projected monetary policy early in the forecast period will deepen the contraction in 2009.