

New data call for a reassessment of current economic conditions and outlook. This Box describes in some detail the main changes in the inflation outlook and its key determinates since *Monetary Bulletin* 2007/2 was published. It also compares the current baseline forecast with the probability distribution of the previous one.

Inflation has recently been higher than forecast by the Central Bank in July. Revised national accounts suggest that the deviation can be traced to greater output gap and stronger underlying cost pressures than previously estimated. The inflation outlook has therefore worsened since July. This implies that the policy rate path in the last issue of *Monetary Bulletin* will not be sufficient to bring inflation down to target within an acceptable time frame. The revised policy rate path is therefore higher, and policy easing is delayed by one quarter. With this interest rate path, inflation is at target in Q3/2009 and remains there for the remainder of the forecast horizon.

### Exchange rate developments broadly in line with the July forecast

Despite turbulence in global financial markets and substantial short-term exchange rate volatility, since July the króna has followed a path broadly in line with the forecast in *Monetary Bulletin* 2007/2. It is only slightly weaker than was forecast then, but as Chart 1 illustrates, over the next three years it is projected to follow a course very similar to the one in the July forecast. The króna therefore remains fairly strong through 2008, whereupon it will begin to depreciate as the interest rate differential with abroad narrows and the economy cools down. At the end of the forecast horizon, the exchange rate index will be at a level similar to that forecast in July.

### Wider output gap despite faster potential output growth

As was discussed in the last issue of *Monetary Bulletin*, various indicators suggested that the output gap was wider in 2006 than preliminary data from Statistics Iceland implied, particularly with regard to labour market developments. Another possible sign of a larger output gap is the fact that inflation in the first half of 2007 was higher than previously forecast. According to the revised national accounts, output growth in 2006 was 1½ percentage points higher than estimated by Statistics Iceland in March (see also Box IV-3). As a result, last year's output gap is estimated to be nearly a percentage point higher than was estimated in July. Moreover, the outlook is for output to grow faster this year. The output gap for 2007 is therefore estimated to be 1½ percentage points wider than in the July forecast. As Chart 2 shows, this much deviation from the July forecast was considered rather unlikely at that time.

As in the last forecast, total factor productivity and labour productivity have been revised upwards. Potential output growth is therefore greater than previously projected across the entire forecast horizon. This, together with declining output growth, will cause a gradual narrowing of the output gap over the course of the forecast horizon. Around mid-2008 the gap will have closed, roughly one quarter later than previously forecast. At the end of the forecast period, the slack will be somewhat greater than was projected in July, and beginning in mid-2010 it will begin to decline once again, as output growth starts to pick up. From mid-2008, however, the current output gap estimate remains within the 50% confidence interval of the July forecast.

### The inflation outlook has worsened since the last *Monetary Bulletin*

Inflation for the third quarter of 2007 proved virtually identical to the July forecast. However, it appears as though it will approach 5% in Q4, over a percentage point higher than was projected in July,

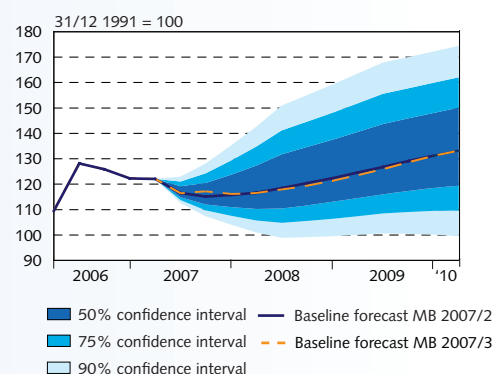
## Box IX-1

### Changes to the inflation forecast from *Monetary Bulletin* 2007/2

Chart 1

#### Effective exchange rate

Baseline forecast and confidence intervals MB 2007/2 and baseline forecast MB 2007/3

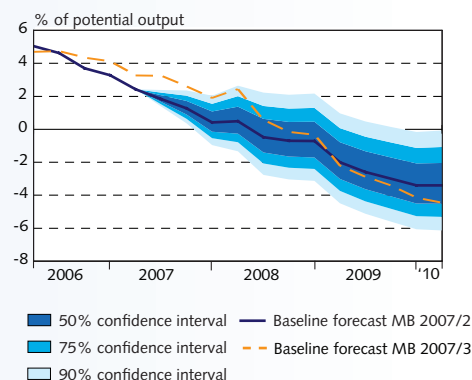


Source: Central Bank of Iceland.

Chart 2

#### Output gap

Baseline forecast and confidence intervals MB 2007/2 and baseline forecast MB 2007/3

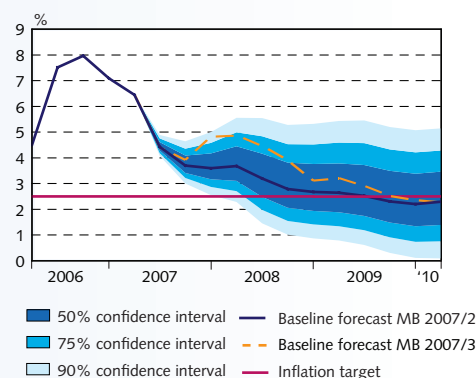


Sources: Statistics Iceland, Central Bank of Iceland.

Chart 3

#### Inflation

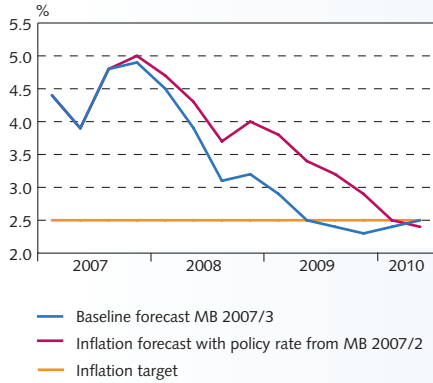
Baseline forecast and confidence intervals MB 2007/2 and baseline forecast MB 2007/3



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4  
Inflation

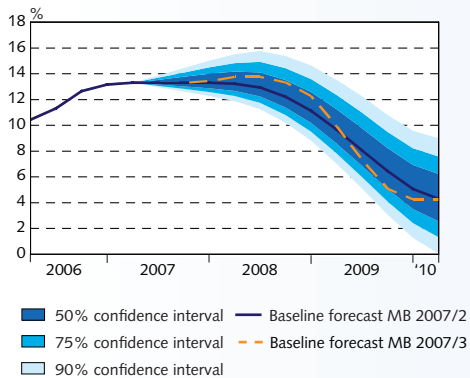
Baseline forecast and forecast with policy rate from MB 2007/2



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5  
Policy rate

Baseline forecast and confidence interval MB 2007/2 and baseline forecast MB 2007/3



Source: Central Bank of Iceland.

and remain around that rate in Q1/2008. According to the probability distribution of the July inflation forecast, this was considered an unlikely development (see Chart 3). Inflation will remain higher than in the July forecast until mid-2009, with the inflation target attained in Q3/2009, roughly six months later than projected in July. Thus inflation will not move into the 50% confidence interval of the July forecast until the latter half of 2008.

The main cause of the deterioration of the inflation outlook is the higher capacity utilisation described above. This emerges in various ways; for example, private wage costs seem to have risen much faster over the past two years than originally thought, and house prices have remained unexpectedly robust. Both of these factors stimulate private consumption, as well as directly affecting headline inflation.

### Impact on the policy rate path in the baseline forecast

The fact that the outlook for inflation and inflation expectations has deteriorated since July implies that the monetary stance has eased, as reflected in a declining real policy rate. The króna is projected to begin depreciating towards the end of the forecast horizon, and unit labour costs are expected to rise faster than is consistent with the inflation target until mid-2009. The resulting cost pressures will prevent inflation from moving towards the target quickly enough, assuming the policy rate path in the July issue of *Monetary Bulletin*, despite the slack developing from the middle of 2008. As Chart 4 shows, disinflation would proceed much more slowly with the policy rate path presented in July. Inflation would remain above 3% throughout 2009 and would not reach the target until the very end of the forecast horizon.

With the króna depreciating in the latter half of the forecast horizon, the policy rate path needs to be higher than forecast in July so as to anchor inflation expectations firmly enough to attain the inflation target within an acceptable time period. As Chart 5 illustrates, the revised policy rate path brings inflation to target nearly one year earlier than would be possible if the policy rate followed the path envisaged in July. This is nonetheless later than projected in July, as was discussed previously. The policy rate will begin to ease around mid-2008, approximately one quarter later than forecast in the last issue of *Monetary Bulletin*. It will remain higher than in the last forecast until year-end 2008 and then fall more rapidly than assumed in July. The policy rate will be close to the level in the July forecast in the first half of 2009 and below it throughout the remainder of the forecast horizon, with a rate close to 4½% at the end of the forecast in both cases. It is always within the 50% confidence band of the July forecast, however. A relatively low policy rate at the end of the forecast horizon will underpin the recovery from 2010.