

This Box documents the main changes in the macroeconomic and inflation forecast since the issue of *Monetary Bulletin* 2007/3 and compares the current baseline forecast with the probability distribution of the previous one.

The inflation outlook has deteriorated markedly since November, when the Central Bank published its last forecast. The most salient single cause is the large depreciation of the króna. The policy rate path presented in the last *Monetary Bulletin* will therefore not suffice to anchor inflation expectations firmly enough, a prerequisite for attaining the inflation target within an acceptable time horizon. The Board of Governors of the Central Bank has already responded to this development by raising the policy rate. With the new policy rate path, it appears as though it will be possible to bring inflation to target within the forecast horizon and stabilise it near target levels until the end of the horizon. The inflation target is attained considerably later than in the previous baseline forecast, but within a time frame similar to that in the alternative scenario that assumed a depreciation similar to the one in the current baseline forecast.

Króna much weaker than assumed in the last baseline scenario

Between November 2007, when *Monetary Bulletin* was last published, and the end of March 2008, the exchange rate declined by 27%. Though the króna is expected to recover to some extent in the next few months, the current exchange rate path is lower throughout the forecast horizon than was assumed in November. As Chart 1 illustrates, the difference is greatest early on. However, the exchange rate at the end of the forecast horizon is expected to be broadly the same as it was at the outset, while the November forecast assumed that the króna would weaken somewhat as the horizon progressed. The current exchange rate path resembles that presented in the alternative scenario in the last *Monetary Bulletin*, though the depreciation is greater. For a short part of the forecast horizon, the new exchange rate path lies outside the 90% confidence interval of the last baseline forecast.

Slack develops a year later than previously assumed

Growth in potential output for 2006 is assessed at roughly one percentage point higher than in November. The output gap for that year is therefore correspondingly less. In 2007, this gradually reversed because output growth proved stronger than in the Central Bank forecast. By year-end 2007, the gap is estimated at over a percentage point more than was assumed in the last *Monetary Bulletin* (see Chart 2). Throughout the forecast horizon, the output gap remains somewhat wider than projected in November, despite the fact that the supply of credit has shrunk and uncertainty has mounted in domestic and global financial markets (see also Box IV-1). A slack will not emerge until the latter half of 2009, roughly a year later than previously projected. Unlike the November forecast, the slack is expected to peak after the end of the current forecast horizon, or at year-end 2011. As Chart 2 shows, last November it was considered rather unlikely that the output gap would develop as is projected now.

Inflation outlook two years ahead considerably darker

In the fourth quarter of 2007, inflation proved higher than was forecast in *Monetary Bulletin* 2007/3. It has also been higher in Q1/2008, when it measured two percentage points above the November forecast. The largest single contributing factor was the above-mentioned fall in the exchange rate, though its effects will likely be felt even more keenly in the second quarter. It is also clear that the underlying growth in demand was underestimated and that

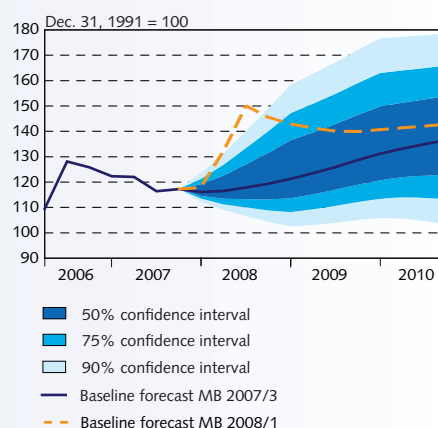
Box IX-1

Changes in the inflation forecast from *Monetary Bulletin* 2007/3

Chart 1

Effective exchange rate

Baseline forecast and confidence intervals MB 2007/3 and baseline forecast MB 2008/1

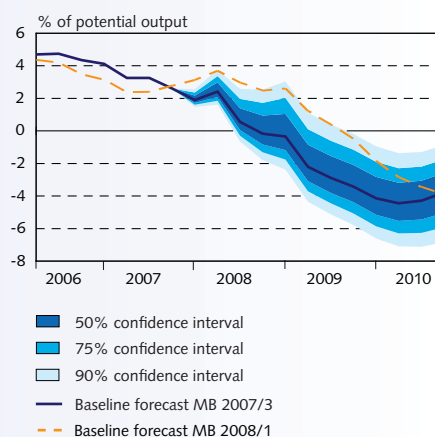


Source: Central Bank of Iceland.

Chart 2

Output gap

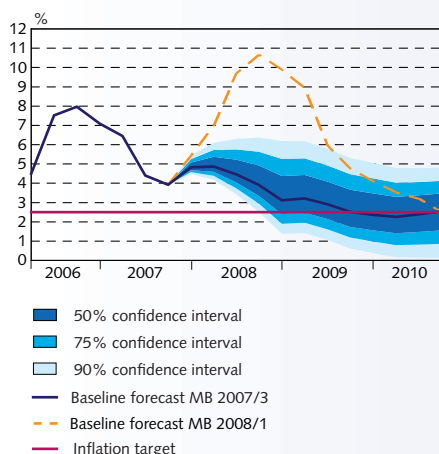
Baseline forecast and confidence intervals MB 2007/3 and baseline forecast MB 2008/1



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 3
Inflation

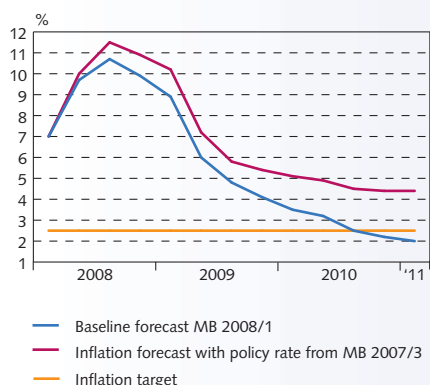
Baseline forecast and confidence intervals MB 2007/3
and baseline forecast MB 2008/1



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4
Inflation

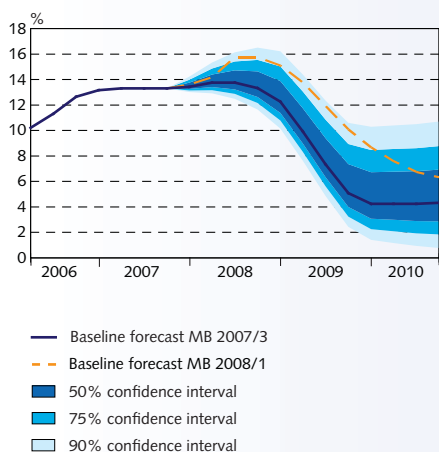
Baseline forecast and forecast with policy rate from MB 2007/3



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5
Policy rate

Baseline forecast and confidence intervals MB 2007/3
and baseline forecast MB 2008/1



Source: Central Bank of Iceland.

underlying cost pressures were similarly underforecast. Furthermore, global prices for various commodities and food products have increased substantially and are expected to rise even further.

Because inflation was much higher at the beginning of the forecast horizon than the November forecast indicated, the near-term inflation outlook is considerably gloomier. Inflation is forecast to approach 10% in the second quarter of 2008, instead of 4½%, and peak in the third quarter at nearly 11%, seven percentage points higher than was projected in November (see Chart 3). Thereafter it is expected to taper off, but much more slowly than in the November forecast, largely because of substantially higher inflation expectations during the forecast horizon. However, inflation is projected to reach target in the third quarter of 2010, more than a year later than indicated in the November forecast.

According to the probability distribution of the November forecast, the very high inflation now projected for this year was considered virtually inconceivable at the time. Inflation does not move inside the 50% confidence interval of the probability distribution until near the end of the forecast horizon.

Impact on the policy rate path in the baseline forecast

Because inflation and inflation expectations are higher than was forecast in November, monetary policy restraint as reflected in the real policy rate will be less than in the last baseline forecast. Offsetting this, however, is the fact that credit spreads have risen and households' and businesses' access to credit has shrunk to a measurable degree recently. Hence financial conditions have become worse, as is discussed in Section III.

With the policy rate path published in November, inflation would have risen even higher than in the baseline forecast, as the exchange rate would probably have continued to decline. Disinflation would also have been slower, and inflation would be just over 4% at the end of the forecast horizon instead of aligning with the target, as in the baseline forecast. Thus the policy rate path presented in November would not have sufficed to anchor inflation expectations firmly enough.

Though the policy rate is somewhat higher than in the last baseline forecast, the policy rate path is similar to that assumed in the alternative scenario from the last *Monetary Bulletin*, which described the response to a sudden decline in the exchange rate. The current baseline forecast assumes that the policy rate will be raised by 0.75 percentage points and remain unchanged until the fourth quarter of 2008, whereupon it begins to ease. In the current baseline scenario, the policy rate is lowered rather later and considerably slower than was assumed in November. This is primarily because of the significant deterioration in the inflation outlook as a result of the depreciation of the króna and the greater underlying demand and cost pressures previously mentioned. In addition, the neutral policy rate (the policy interest rate that neither stimulates nor restrains the economy) has been revised upwards in view of recent experience. Until now, the neutral policy rate has been estimated at 5½-6½% (that is, neutral real interest in the range of 3-4%, plus the 2.5% inflation target) but is now thought to lie closer to 6½-7½%. The neutral rate is estimated to be somewhat higher in Iceland than in the US and the euro area but close to that in New Zealand, a country that resembles Iceland in many ways, including high return on capital and a low propensity to save. The policy rate is therefore somewhat higher at the end of the forecast horizon than in the November forecast, though it remains within the 75% confidence interval of the previous forecast for most of the horizon (see Chart 5).