Financial market analysts' assessments of the economic outlook

For each issue of *Monetary Bulletin*, the Central Bank surveys financial market analysts' assessments of the economic outlook. The latest survey was conducted in mid-June, and participants were Askar Capital and the research departments of Glitnir, Kaupthing Bank and Landsbanki. The main changes from the survey conducted in April are that analysts expect less growth during the forecast horizon and more inflation in 2008 and 2009.

Outlook for sustained high inflation well into 2009

Analysts project that inflation will be higher than previously predicted early on in the forecast horizon, as prices have risen rapidly in the recent term due to the depreciation of the króna and substantial underlying cost pressures. The outlook is for sustained high inflation until the latter half of 2009. Financial analysts forecast that inflation will average just over 11% in 2008, which is in line with the Central Bank's baseline forecast. Most of them believe inflation will subside very quickly in 2009, averaging just under 5% for the year as a whole, and fall to 3½% in Q2/2010. The majority of the analysts assume that inflation will be close to target at the end of the forecast horizon; that is, in Q2/2011. The Central Bank's baseline forecast allows for rather slower disinflation, with inflation averaging 7½% in 2009 and falling to 3½% in Q2/2010, in line with analysts' predictions. In the baseline forecast, the inflation target is attained in the latter half of the year 2010.

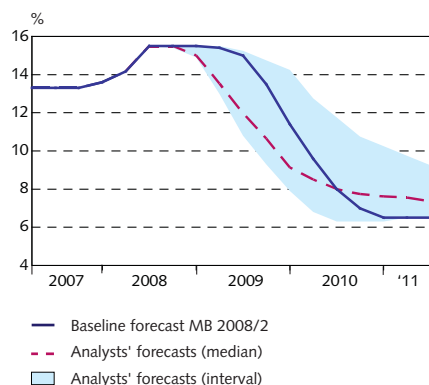**GDP growth negligible early in the forecast horizon**

There are various signs that output growth is slowing markedly, due in particular to a contraction in investment and the cooling of the real estate market. Private consumption remains rather strong, however. As in the last survey among financial market analysts, respondents assume that GDP growth will be negligible in 2008. They project an average of ½% growth in 2009, which is one percentage point lower than their previous prediction. Two survey participants expect negative GDP growth this year, and only one expects a contraction next year. They believe output growth will gain pace somewhat in 2010, averaging just over 2%. This diverges decidedly from the Central Bank's baseline forecast, which assumes just over 1% GDP growth in 2008 and a contraction of 2% in both 2009 and 2010. The financial market analysts are therefore much more optimistic than the Central Bank is.

Divergent exchange rate forecasts

The exchange rate fell steeply in March and again in June, and was extremely volatile in the meantime. Market analysts forecast an average exchange rate index of 144 in 2008 and roughly 140 for the remainder of the forecast horizon. On the other hand, they disagree about exchange rate developments, with one respondent expecting a

Chart 1

Policy rate path MB 2008/2
and analysts' forecasts

Forecasting period Q3/2008 - Q2/2011

- Baseline forecast MB 2008/2
- - - Analysts' forecasts (median)
- Analysts' forecasts (interval)

Source: Central Bank of Iceland.

substantial appreciation of the króna over the course of the forecast horizon. The Central Bank's baseline forecast projects a weaker króna during the forecast horizon and believes that the exchange rate index will average just under 150 in 2008 and 2009.

Most analysts expect a policy rate cut late in 2008

On April 10, the Central Bank raised the policy rate by 50 basis points to 15.5%. All of the market analysts believe the policy rate has peaked. Most of them expect the easing cycle to begin late this year, and they forecast the average policy rate at 15% in 2008 and 12% in 2009. The policy rate path specified by most of the analysts is very similar to the one on which the Central Bank's last baseline forecast was based. The policy rate path in the current baseline forecast assumes, however, that the policy rate will be held high for longer than the analysts expect, and that the downward cycle will be delayed until the first quarter of 2009.

Cooling asset markets

Equity prices have continued to fall in recent months, and analysts are more pessimistic than before about the stock market. On average, they predict that the OMXI15 index will be just below 5,000 in Q2/2009 and slightly above 5,800 a year later.

However, they disagree somewhat on developments in house prices during the forecast horizon. Most of them expect house prices to fall over the coming 12 months, but their responses cover a broad range. On average, they forecast that, by Q2/2009, house prices will have dropped by 3½% year-on-year; however, they expect prices to remain relatively stable from mid-2009 until 2010. Only one respondent predicted that house prices would fall without interruption over the next three years.

Table 1 Overview of financial market analysts' forecasts[1]

	2008			2009			2010		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation (year-on-year)	11.1	10.4	12.0	4.9	3.5	7.5	3.3	1.5	4.5
GDP growth	0.1	-0.5	1.0	0.5	-2.5	3.5	2.3	1.4	3.8
Effective exchange rate index of foreign currencies vis-à-vis the króna (annual average)	144	142	148	140	128	154	139	125	150
Central Bank policy rate (annual average)	15.0	14.9	15.1	12.0	10.3	14.9	8.4	6.5	11.3
	2009:2			2010:2			2011:2		
Inflation	5.1	3.0	9.8	3.6	2.1	5.0	3.2	2.5	4.5
Effective exchange rate index of foreign currencies vis-à-vis the króna	139	128	151	141	125	156	140	123	150
Central Bank policy rate	12.5	10.8	15.3	8.5	6.3	11.8	7.6	6.5	9.3
Nominal long-term interest rate[2]	8.6	7.2	11.0	7.9	6.8	10.5	7.2	6.8	7.5
Real long-term interest rate[3]	4.2	3.8	4.5	3.8	3.4	4.5	3.7	3.0	4.5
OMXI15 share price index	4,959	4,000	5,350	5,860	5,000	6,341	6,851	6,000	7,583
Housing prices (year-on-year)	-3.4	-8.6	1.6	0.2	-1.6	3.0	2.7	-3.8	6.6

1. The table shows percentage changes between years, except for interest rates (percentages), the exchange rate index (index points) and the OMXI15 index (index points). Participants in the survey were Askar Capital and the research departments of Glitnir, Kaupthing Bank, and Landsbanki. 2. Based on yield in market makers' bids on non-indexed T-notes (RIKB 19 0226). 3. Based on yield in market makers' bids on indexed Housing Financing Fund bonds (HFF150644).

Source: Central Bank of Iceland.