

This Box describes the main changes in the macroeconomic forecast since *Monetary Bulletin* 2008/1, while Box IX-1 examines the changes in the inflation forecast and the drivers of those changes. Macroeconomic adjustment according to the baseline scenario is expected to develop broadly in line with the forecast published in *Monetary Bulletin* 2008/1. Domestic demand is projected to be somewhat weaker because private consumption, residential investment, and regular business investment are expected to contract more than was assumed in the last forecast. However, large-scale investments in the aluminium and power sectors and growing public investment offset that contraction to a degree. The outlook for economic growth is less favourable for 2008, but the contraction forecast for 2009 and 2010 is similar to that projected in April.

**The policy rate must remain high longer if the inflation target is to be reached in the same quarter as in the last forecast**

Inflation is considerably higher than in the last forecast, and the policy rate must be held high for a longer period if inflation and inflation expectations are to be brought to target within an acceptable time frame. In the current forecast, the inflation target is attained in the same quarter as in the April forecast. A contraction in private consumption plays a key role in the economy's adjustment towards equilibrium. The current forecast projects that the contraction will measure nearly 3 percentage points more than was predicted in April. It is driven by the same forces as were described at that time: falling disposable income and asset prices, rising unemployment, and deteriorating financial conditions. The decline in real disposable income is estimated at 5 percentage points greater than in the last forecast, due chiefly to higher inflation, a higher policy rate, and a heavier debt burden. Unemployment is projected to rise more slowly early in the forecast horizon but reach the level projected in April toward the end of the forecast horizon.

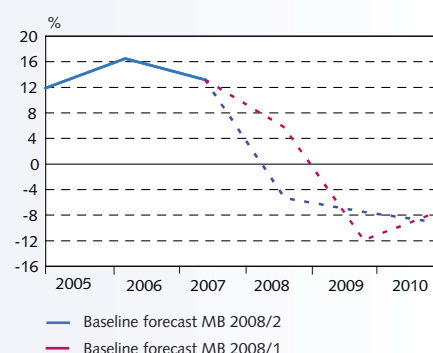
**A steeper decline in private consumption and regular business and residential investment is offset by investments in the public sector and the aluminium and power sectors**

Investments in the power and aluminium sectors during the forecast period are projected at 55 b.kr. more than previously estimated, and public investment will grow considerably as well. Regular business investment is expected to decline by 15 percentage points more during the forecast period, and residential investment by 7 percentage points more, than was assumed in the April forecast. The more sizeable contraction in private consumption will outweigh the smaller downturn in investment; therefore, domestic demand will

## Box IV-1

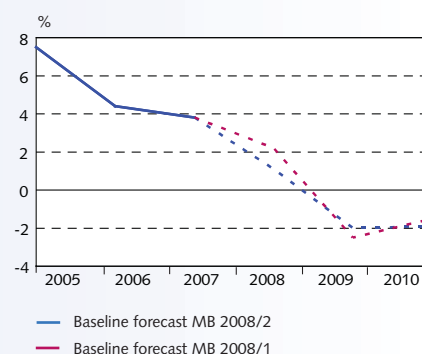
### Changes in the macroeconomic forecast from *Monetary Bulletin* 2008/1

Chart 1  
Residential investment growth 2005-2010



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2  
Economic growth 2005-2010



Sources: Statistics Iceland, Central Bank of Iceland.

shrink slightly more than in the previous forecast, with the decline concentrated in 2008. The export forecast has not changed materially, as the poorer outlook for the fisheries sector and the effect of the weaker króna on general exports tend to cancel each other out. Imports are expected to decline in 2008 in response to reduced demand. Output growth is projected at 1.1% in 2008 instead of the previously assumed 2.2%, but the outlook for 2009 and 2010 is broadly unchanged from the April forecast.