

This Box describes the main changes in the inflation forecast since the publication of *Monetary Bulletin* 2008/1 and compares the current baseline forecast with the probability distribution of the previous one.

The inflation outlook has deteriorated since the last forecast, particularly for the short term. In the forecast, this contributes to a narrower output gap; therefore, inflation will be lower later in the forecast horizon, because inflation will cause real disposable income and private consumption to contract more decisively than was projected in April. This will help to contain inflation towards the end of the forecast period. In the last *Monetary Bulletin*, it was assumed that the policy rate would peak at 15.75% and begin to ease downwards toward the end of the year. The Board of Governors decided, however, to raise the policy rate to 15.5% at that time. Now it is assumed that the policy rate will remain unchanged at 15.5% and the easing cycle will be delayed until the beginning of 2009. This policy rate path is sufficient to bring inflation down to target at the same time as in the previous forecast.

#### Exchange rate somewhat lower than assumed in April

The exchange rate path in the baseline forecast is similar to that in the April baseline scenario. However, it will be lower early in the forecast horizon because recent developments suggest that the króna is rather unlikely to appreciate before next year. The April forecast assumed that the measures adopted by the Central Bank and the Government to improve the functioning of the domestic financial markets would combine with high interest rates and a low real exchange rate to support the króna. This has not come to pass. However, the króna is expected to appreciate over the course of 2009 and align with the April forecast by the end of the current forecast horizon (see Chart 1).

#### The output gap will be narrower in 2008 than in the previous baseline forecast, but the outlook two years ahead is similar ...

As is discussed in Chapter IV, the outlook for GDP growth in 2008 is less favourable than was projected in April. The baseline forecast assumes that output growth over the next two years will be broadly in line with the April forecast but that domestic demand will be rather weaker during the forecast horizon. This will ease inflationary pressures. However, growth in potential output in 2008 and 2009 is projected to be somewhat less than in the previous forecast, owing to the negative effects of the credit crisis and the recent oil and commodity price hikes, which are now expected to persist longer than was projected in April. Therefore, in 2008 the output gap will be a bit narrower than in the last forecast, but the outlook for 2009-2010 is broadly similar to that presented in April (see Chart 2). The output slack will be somewhat less, however, and will peak sooner than in the previous forecast.

#### ... although unit labour costs will rise faster

Slower growth in potential output will be reflected in slower productivity growth, which will not recover until late in the forecast horizon. Furthermore, it appears as though wage hikes will be more sizeable in 2008 and 2009 than was allowed for in the April forecast, due in large measure to higher inflation and slower growth in unemployment (see Chapter VI). Heftier wage growth and less growth in productivity will press unit labour costs upwards, thereby increasing inflation.

#### The short-term inflation outlook has deteriorated once again

The short-term inflation outlook has deteriorated still further since the last *Monetary Bulletin* was published. In the current baseline

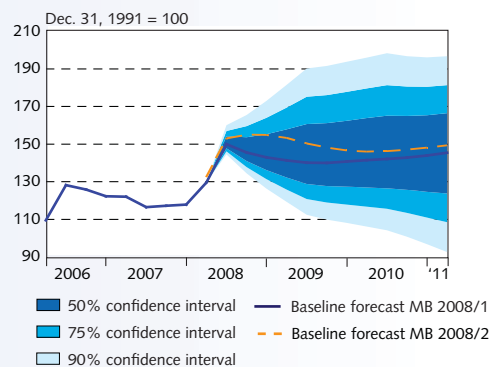
### Box IX-1

## Changes in the inflation forecast since *Monetary Bulletin* 2008/1

Chart 1

#### Effective exchange rate

Baseline forecast and confidence intervals MB 2008/1 and baseline forecast MB 2008/2

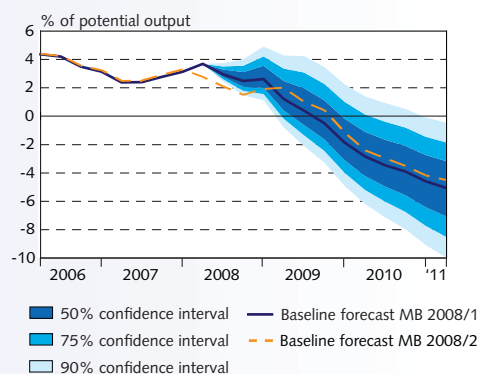


Source: Central Bank of Iceland.

Chart 2

#### Output gap

Baseline forecast and confidence intervals MB 2008/1 and baseline forecast MB 2008/2

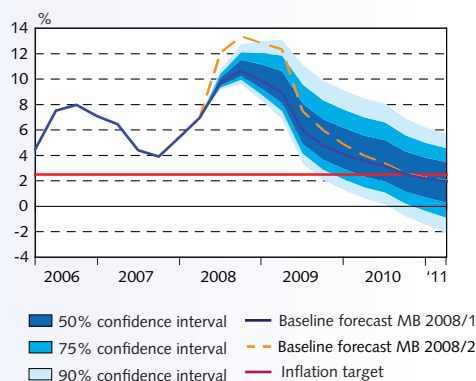


Sources: Statistics Iceland, Central Bank of Iceland.

Chart 3

#### Inflation

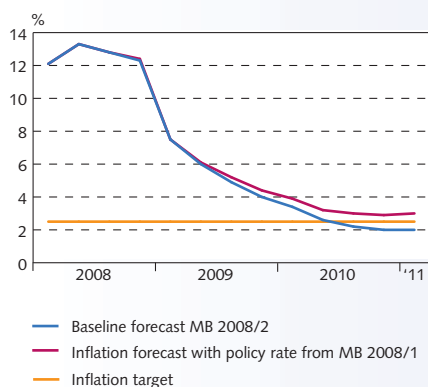
Baseline forecast and confidence intervals MB 2008/1 and baseline forecast MB 2008/2



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4  
Inflation

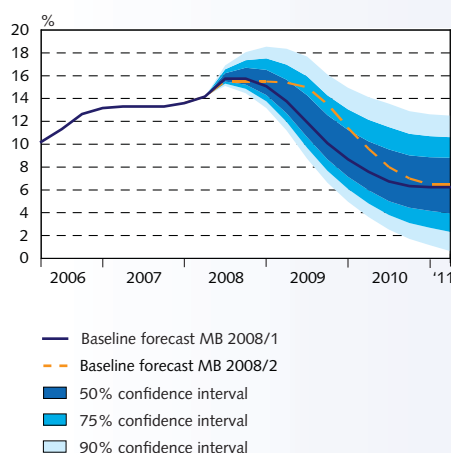
Baseline forecast and forecast with policy rate from MB 2008/1



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5  
Policy rate

Baseline forecast and uncertainty bands MB 2008/1 and baseline forecast MB 2008/2



Source: Central Bank of Iceland.

scenario, inflation peaks in the third quarter of 2008 at just over 13%, as opposed to 11% in the April forecast. As Chart 3 illustrates, in April it was considered extremely unlikely that inflation would be so high this year.

According to the revised baseline forecast, inflation will remain very high well into 2009. It will begin to taper off rather quickly towards the end of that year but will exceed the level in the April forecast until 2010. The Bank expects inflation to align with the inflation target in the third quarter of 2010 and hover just below target at the end of the forecast horizon. It will then rise back to the target level by year-end 2011.

### The impact on the policy rate path in the baseline forecast

The worsening inflation outlook eases monetary policy restraint by reducing the real policy rate. Counteracting this, however, is the fact that conditions on the domestic and international financial markets have deteriorated, with the result that households' and businesses' overall financial conditions have probably deteriorated slightly in spite of a lower real policy rate (see Chapter III).

In the last *Monetary Bulletin*, it was assumed that the policy rate would peak at 15.75% in Q2/2008; however, the Board of Governors of the Central Bank raised the policy rate to 15.5% in April and decided to hold it unchanged at its interest rate decision meeting on May 22. In order to analyse whether the policy rate path published in the last *Monetary Bulletin* would have sufficed to bring inflation to target within an acceptable time frame, it is assumed that the policy rate peaks at 15.5% and then follows the path in the last *Monetary Bulletin* beginning in Q4 (the policy rate path in the April forecast yields virtually the same result). As Chart 4 indicates, inflation tapers off rather more slowly than in the baseline forecast and bottoms out at around 3% early in 2011, whereupon it begins to rise again. The inflation target would not be achieved during the forecast horizon, and inflation might pick up once again by the end of the forecast horizon. Therefore, the policy rate path in the April forecast would not have anchored inflation expectations firmly enough.

According to the policy rate path in the current baseline forecast, the policy rate remains unchanged at 15.5% until the first quarter of 2009. It falls off gradually until mid-year and then is lowered more rapidly. It remains considerably higher than was projected in April until mid-2010 but ultimately aligns with that forecast. At the end of the forecast horizon, the policy rate will probably be slightly below its neutral stance. However, the policy rate path in the new baseline forecast is within the 50% probability distribution of the previous forecast for most of the forecast horizon (see Chart 5).