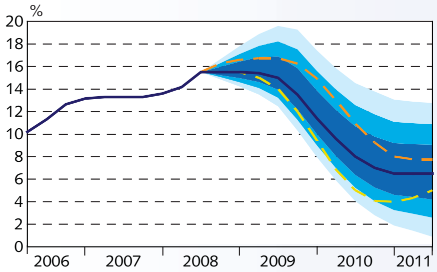
Box IX-2

Alternative scenarios

Chart 1

Policy rate - alternative scenarios

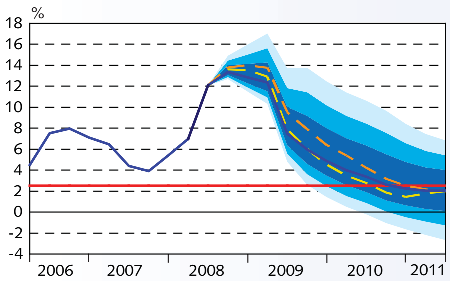


- Baseline forecast
- Alternative scenario with exchange rate depreciation and further wage increases
- Alternative scenario with a weaker housing market and exchange rate
- 50% confidence interval
- 75% confidence interval
- 90% confidence interval

Source: Central Bank of Iceland.

Chart 2

Inflation - alternative scenarios



- Baseline forecast
- Inflation target
- Alternative scenario with exchange rate depreciation and further wage increases
- Alternative scenario with a weaker housing market and exchange rate
- 50% confidence interval
- 75% confidence interval
- 90% confidence interval

Sources: Statistics Iceland, Central Bank of Iceland.

Unforeseen shocks or changed assumptions concerning important underlying factors in the forecast can cause economic developments to deviate substantially from forecasts. It is therefore important to assess the sensitivity of forecasts to deviations in key economic variables. Potential deviations are numerous, but the uncertainties that are considered most important are examined more closely in alternative scenarios.

As in the last issue of *Monetary Bulletin*, the two most important uncertainties in the baseline forecast centre on more adverse exchange rate developments than are assumed in the baseline scenario and the interaction of these developments with wage inflation, on the one hand, and a sharper-than-expected contraction in the domestic housing market, on the other.

Further exchange rate decline and heftier wage rises could necessitate a higher policy rate

As was discussed in the last *Monetary Bulletin*, there is a considerable risk that a spiral of falling exchange rate and rising wages could develop, with severe consequences for the inflation outlook and for general economic stability. In order to prevent such a vicious cycle, the Bank emphasised that monetary policy intervention might be required in order to anchor inflation expectations firmly. That message is still relevant.

As in April, the króna is weaker in this alternative scenario. The exchange rate index is around 170 for the remainder of the year and then falls off to the 150-160 range for the rest of the forecast horizon. It is also assumed that wages will rise by an additional 4 percentage points over and above the baseline forecast early in 2009, in an attempt to compensate for the decline in real wages that will occur this year. It would be easy to argue for even greater wage hikes and, consequently, an even steeper depreciation of the króna, although these would be offset by rising unemployment and the policy rate provided for in the baseline forecast.

As was the case in the comparable alternative scenario in the last *Monetary Bulletin*, a weaker currency and larger wage increases will combine to push inflation higher. The outlook two years ahead, assuming the policy rate path set forth in the baseline forecast, is therefore unacceptable. In order to prevent a continuing spiral, the policy rate is raised to 16.75% at the beginning of next year and is held considerably higher throughout the forecast horizon than in the baseline scenario (see Chart 1). In spite of this, inflation will be some 2 percentage points higher than in the baseline forecast in mid-2009. However, the policy rate path in the alternative scenario ensures that inflation is brought to target by the end of the forecast horizon (see Chart 2).

A deeper housing market slump offers the possibility of a more rapid policy rate reduction

The latter alternative scenario presents the possible monetary policy response to an even faster cooling of the domestic housing market. As was described in the last *Monetary Bulletin*, house prices have begun to decline around the world, and construction sector activity has fallen off as well. There are signs of a similar development here in Iceland.

As in the April forecast, this alternative scenario assumes that the credit crisis and rising risk premia will cause nominal house prices to drop similar to the alternative scenario in April. The decline in real prices is similar to that described in April, nearly 40% over the course of the forecast horizon. As was described in the April issue of *Monetary Bulletin*, this development is in line with the housing market contraction in the Nordic market in the early 1990s. It is also consistent with other OECD nations' experience of housing market corrections in the wake of sharp increases (see Chapter IV and Box IV-2). This alternative scenario also assumes that residential investment will contract more than in the baseline forecast, to about 3% of GDP by the end of the forecast horizon. As a result of the contraction in the construction industry, unemployment among construction workers will rise higher than in the baseline forecast, although some of these workers will leave Iceland. According to this scenario, unemployment will approach 6% at the end of the forecast horizon, roughly 1 percentage point higher than in the baseline forecast. It is assumed that this rapid cooling of the domestic real estate market will be accompanied by an even weaker króna than in the baseline forecast. Therefore, in the alternative scenario the exchange rate remains low throughout the forecast horizon, about 5% below that in the baseline forecast.

The weaker króna limits the Central Bank's scope to lower the policy rate, even though the residential housing market – and the economy as a whole – contracts faster than in the baseline forecast. Early on, the effect of a lower exchange rate dominates the effects of a more rapid economic downturn. Inflation is therefore somewhat higher than in the baseline forecast until mid-2009, whereupon it begins to fall more quickly. The policy rate remains unchanged until Q1/2009 but is then lowered more rapidly than in the baseline forecast. By the end of the forecast horizon, it is about 1.5 percentage points lower (see Chart 1). This allows for the attainment of the inflation target at the end of the forecast horizon, roughly one quarter earlier than in the baseline scenario (see Chart 2).

Credibility affects the need for monetary policy response to deviations

The alternative scenarios provide a concise view of the problems that monetary policy faces in the battle against inflation. On the one hand, the Central Bank is faced with the chronic inflation caused by the second-round effects of the depreciation of the króna and rising prices of oil, food, and other commodities. On the other hand, the Bank must deal with a deep economic contraction that it would be desirable to mitigate. However, it has little scope to do this because inflation expectations are high and unstable.

The alternative scenarios should not be viewed as forecasts, however, but rather as tools that can shed light on the effect that the main uncertainties in the baseline forecast could have on inflation and the possible monetary policy responses to deviations from the forecast. The strength of the response required will be determined to an extent by the credibility of monetary policy. If there is a general lack of confidence in the Central Bank's will and ability to hold inflation close to target, a firmer response is needed. The alternative scenarios show how the Central Bank could respond to uncertainties in a systematic and predictable manner. Therefore, they play the important role of informing the market and the general public about how monetary policy is conducted, which should enhance its effectiveness.