

The accompanying table shows the economic forecasts of financial market analysts at the beginning of September. Participants in the survey were the research departments of Íslandsbanki, Kaupthing Bank, Landsbanki, and Economic Consulting and Forecasting.

Analysts are now forecasting as far ahead as 2007, and disagree quite significantly about how developments will unfold that year.

The forecasters' assessment of inflation over 2005 and 2006 has hardly changed since May. They expect inflation over the year to peak in 2006 at just over 5%, then to slow in 2007 to just over 3½%. However, they foresee year-on-year rises until 2007, to almost 4½%. Inflation will therefore be some way above the Central Bank's 2.5% target over the forecast horizon, and either beyond or close to the 4% upper tolerance limit, in the analysts' view. The Central Bank's baseline forecast over 2005 is higher, but it expects inflation to decrease as soon as next year. For year-on-year inflation, there is little divergence between the Central Bank's baseline forecast and the analysts' projections this year, while the Bank forecasts a lower rate for the next two years. It should be underlined that the Central Bank assumes an unchanged policy interest rate and exchange rate over the forecast horizon. The Central Bank's alternative scenario with variable interest rates and exchange rate is very close to the market analysts' forecasts, at 4½% on average next year and just under 5% in 2007.

Analysts have revised their forecasts for output growth downwards since May, but with more divergence between the highest and lowest forecast values. On average they expect 6% growth in 2005 and 4.8% next year, falling to 1.2% in 2007. The Central Bank's output growth forecast is overall rather more upbeat: 5.5% in the current year, rising to 6.7% next year, and slipping back to 4.8% in 2007, when it diverges the most from the analysts' views.

Respondents have hardly changed their assessments of exchange rate developments since their May forecasts, nor in fact since February either. They foresee an exchange rate index around 122 twelve months ahead, with a further slide to around 130 after two years.

The Central Bank raised its policy interest rate by 0.5 percentage points to 9.5% on June 7. Analysts apparently expect that an end is in sight to the cycle of policy rate rises and forecasts

## Box 3

### Financial market analysts' assessments of the economic outlook

#### Overview of forecasts by financial market analysts<sup>1</sup>

	2005			2006			2007		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation (within year)	3.7	3.4	4.2	5.3	3.8	7.1	3.7	2.0	5.5
Inflation (year-on-year)	3.8	3.6	4.2	4.4	3.7	4.9	4.9	3.5	6.8
GDP growth	6.0	5.5	6.5	4.8	4.2	5.5	1.2	-1.0	2.5
	One year ahead			Two years ahead					
Effective exchange rate index of foreign currencies vis-à-vis the króna (Dec. 31, 1991=100)	118.8	115.0	123.0	130.5	127.0	135.0			
Central Bank policy interest rate	9.3	8.5	10.0	7.4	6.0	9.3			
Nominal long-term interest rate <sup>2</sup>	7.4	6.7	7.8	6.6	6.0	7.2			
Real long-term interest rate <sup>3</sup>	3.6	3.5	3.8	3.4	3.0	3.6			
ICEX-15 share price index (12-month change)	5.3	-10.0	16.0	13.4	-14.5	30.0			
Housing prices (12-month change)	8.8	5.0	15.0	11.9	7.0	20.8			

1. The table shows percentage changes between periods, except for interest rates (percentages) and the exchange rate index for foreign currencies (index points). Participants in the survey were the research departments of Íslandsbanki, KB banki and Landsbanki, and Economic Consulting and Forecasting. 2. Based on yield in market makers' bids on non-indexed T-notes (RIKB T3 0517). 3. Based on yield in market makers' bids on indexed HFF bonds (HFF 150644).

Source: Central Bank of Iceland.

a rate of 9.3% one year ahead and 7.4% after two years. Both forecasts are lower than those made in May. It is interesting to note how upbeat the analysts are about the timing of the start of reductions in the policy rate, given the inflation outlook that they forecast. It would appear that they expect the Central Bank to begin lowering interest rates relatively soon in spite of inflation which is not only rising but also well above the target.

Regarding equity price developments, forecasts diverge quite sharply – as they have since the beginning of this year. One analyst forecasts a drop in 2006, but the rest expect ongoing rises.

Finally, forecasters are unanimous that house price inflation will ease after the surge that has been witnessed in the recent term. However, they by no means expect real estate prices to drop over the next two years.