

The accompanying table shows the survey responses of financial market analysts in mid-November. Participants in the survey were the research departments of Íslandsbanki, Kaupthing Bank and Landsbanki, and Economic Consulting and Forecasting.

On this occasion, analysts were asked specifically for the first time about the inflation outlook one and two years ahead. They were also asked to give a more detailed assessment of the Central Bank's policy interest rate path than before, i.e. on the timing of the policy rate cycle's peak and trough within the forecast horizon, and at what values.

The main changes from the survey in September is that analysts now forecast somewhat greater output growth this year and in 2006, as well as a smoother inflation path, a higher policy rate and a stronger króna.

### **Analysts expect higher inflation than in the Central Bank's baseline scenario**

As in September, analysts expect inflation to remain some way above the 2.5% target across the forecast horizon. Their estimates for inflation over the year and year-on-year in 2005 are virtually unchanged and in line with the Central Bank's forecast, which is hardly surprising so late in the year. Over 2006 and 2007, forecasters expect inflation to average 4.4% and 4.2% respectively, while the Central Bank's baseline scenario is one percentage point lower in both instances. Analysts expect year-on-year inflation (between annual averages) of just under 4% in 2006, rising to 4½% in 2007, compared with the Central Bank's baseline scenario of 3.3% and 3.6%. It should be underlined that the Central Bank assumes an unchanged policy interest rate and exchange rate over the forecast horizon, while the analysts do not.

### **Opinions divided over the growth outlook**

Analysts' forecasts for output growth in 2005-2006 have been revised upwards since September, but are unchanged for 2007. Individual forecasts diverge quite widely. On average they expect 6.3% growth in 2005 and 5.3% next year, falling to 1% in 2007. The Central Bank's output growth forecast is more even: 4.7% in the current year, 6.6% next year and 4.1% in 2007.

### **Comparison with the Central Bank's alternative scenarios**

It should be reiterated that the Central Bank's baseline scenario inevitably diverges from the analysts' projections, because it assumes an unchanged policy rate and exchange rate across the forecast horizon. The Bank's scenario based on a variable interest rate and exchange rate shows higher inflation than the baseline scenario, although it is still lower than the average forecast by the survey respondents. They assume a greater depreciation of the króna than in the alternative scenario, which is based on uncovered interest rate parity derived from the differential between their forecast policy rate (see below) and foreign forward interest rates. There is less divergence between the analysts' forecast and an inflation path based on the same exchange rate path but an unchanged policy rate.

### **Forecasters expect the króna to depreciate less ...**

Survey respondents have changed their assessments of exchange rate developments significantly and expect the króna to be stronger than they had forecast in September both one and two years ahead. They foresee an exchange rate index of 112 twelve months ahead

## **Box VIII-1**

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

and 124 after two years. The exchange rate index stood at just over 102 on November 16.

### ... but a greater increase in the policy rate ...

The Central Bank raised its policy interest rate by 0.75 percentage points to 10.25% on October 4. Analysts expect further hikes and forecast an average rate of more than 11% one year ahead, moving back to just below 8% after two years. They were also asked to forecast the peak and trough of the policy rate over the next two years. The majority of respondents expect the policy rate to peak before mid-2006 at roughly 12%, reaching a trough in the second half of 2007 in the range 7½-10%. One respondent diverged quite sharply from the rest by forecasting a peak of 10.75% shortly, followed by a gradual decline towards 6% at the end of 2007.

### ... and modest asset price rises

On November 16, the ICEX-15 share index stood at almost 5,000, so respondents do not expect a great rise in equity prices over the next year, but rather slower increases than have been witnessed recently. The increase two years ahead is forecast at 12%. One forecaster believes that equity prices will drop and has put this view forward for some time.

Finally, respondents were unanimous about modest increases in real estate prices over the next two years, since the market has already begun to cool quite markedly. None expects real estate prices to decline.

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

Average	2005			2006			2007		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation (within year)	3.8	3.7	4.0	4.4	3.6	5.7	4.2	2.9	6.1
Inflation (year-on-year)	4.0	3.8	4.0	3.9	3.7	4.1	4.6	3.5	6.8
GDP growth	6.3	5.5	7.6	5.3	4.2	7.3	1.0	-0.9	2.2
	One year ahead			Two years ahead					
	Average	Lowest	Highest	Average	Lowest	Highest			
Inflation	3.9	2.9	4.6	4.6	3.1	7.5			
Effective exchange rate index of foreign currencies vis-à-vis the króna (Dec. 31, 1991=100)	112.0	107.0	115.0	124.0	118.0	133.0			
Central Bank policy interest rate	11.3	9.0	12.0	7.9	6.0	10.0			
Nominal long-term interest rate <sup>2</sup>	7.7	7.5	8.0	6.9	6.5	7.2			
Real long-term interest rate <sup>3</sup>	4.1	3.6	4.6	3.6	3.3	4.0			
ICEX-15 share price index	5,166	4,487	5,689	5,564	4,263	6,258			
Housing prices (12-month change)	5.8	3.0	10.0	6.0	3.0	10.0			

1. The table shows percentage changes between periods, except for interest rates (percentages) and the exchange rate index for foreign currencies and the share price index (index points). Participants in the survey were the research departments of Íslandsbanki, Kaupthing Bank and Landsbanki, and Economic Consulting and Forecasting.

2. Based on yield in market makers' bids on non-indexed T-notes (RIKB 13 0517). 3. Based on yield in market makers' bids on indexed HFF bonds (HFF 15 0644).

Source: Central Bank of Iceland.