

Box IV-1

Financial market
analysts' assessments
of the economic
outlook

For each issue of *Monetary Bulletin*, the Central Bank surveys financial market analysts' assessments of the economic outlook. The latest survey was conducted in mid-March and participants were the research departments of Glitnir, Kaupthing Bank, Landsbanki and Askar Capital. The main changes from the October survey (published in November) are that analysts have revised their forecasts for inflation, output growth and real estate prices in 2007 slightly upwards. For 2008, they forecast less output growth but ongoing rises in real estate prices.

Outlook for headline inflation close to target

Analysts forecast year-on-year inflation in 2007 of 3½%, which is slightly higher than in the previous survey in October. Their forecast is for headline inflation and includes the effects on the CPI of a cut in indirect taxes and excise taxes. Their average inflation forecast is close to the Central Bank's baseline forecast, which is based on what the Bank's staff view as an optimum policy rate path for attaining the inflation target. Analysts expect the inflation target to be attained somewhat later than is projected in the Central Bank's baseline forecast. They also forecast 3½% year-on-year inflation in 2008, while in the Bank's baseline forecast, which assumes a rather higher policy rate, it is within target by then at 2.3%. On average, the analysts' forecast for year-on-year inflation in 2009 is very similar to the Central Bank's. In both cases, inflation is close to target.

Upbeat growth outlook over the forecast horizon

Financial market analysts expect that the economic adjustment will entail broadly the same output growth rate as in 2006, forecasting 2½% on average in 2007 and just over 3% in 2008. They are in broad consensus about the growth outlook, although one respondent, who estimates a high probability that investment in the aluminium and power sectors will continue, forecasts more than 4% growth in 2008. In the Central Bank's baseline forecast, output growth is significantly lower, at less than 1% in 2007 and 2008. On a longer horizon, analysts forecast output growth of just over 3% on average in 2009.

Exchange rate forecast virtually unchanged since October

The króna has been relatively stable in recent months. Analysts forecast an exchange rate index of 126 twelve months ahead and a marginal appreciation of the króna a year later. This forecast is virtually unchanged since the last survey in October. Opinions diverge widely, however, with a range of 20 points between the highest and lowest values one year ahead. Two years ahead, they narrow the index value to 120-127.

Analysts forecast rapid lowering of the policy rate

The Central Bank's policy rate is currently 14.25% after a hike of 0.25 percentage points in December 2006. The analysts' average forecast is virtually unchanged from the October survey. They forecast a policy rate of just over 11% one year ahead, just over 9% two years ahead and 8% after three years. The majority predict that the policy rate will be left unchanged on the scheduled interest rate decision date, March 29. The main change since *Monetary Bulletin* in November is that the majority of respondents now expect the Central Bank to begin lowering the policy rate in Q3/2007. In the October survey, they expected the downward cycle to commence earlier. One analyst, however, expects a hike of 0.25 percentage points and a high policy rate maintained along the forecast horizon. A fairly wide discrepancy is seen in their forecasts for the policy rate

trough over the next few years, ranging from 5.5% to 10% at the end of the decade.

Outlook for higher real estate prices over the forecast period

Equity prices have risen sharply since the beginning of the year and sentiment on the equity market appears to be upbeat. On March 21, Iceland Stock Exchange's ICEX-15 index stood at almost 7,500, having risen by 15% since mid-October. Most analysts expect equity prices to continue to climb and have revised their forecasts upwards. They forecast an ICEX-15 index value of above 8,000 on average one year ahead.

Real estate prices are now expected to rise over the forecast period, which is a marked change from the October forecast, reflecting the apparent pickup in house price inflation since the beginning of the year. On average, analysts forecast that real estate prices will increase by just over 3% over the next twelve months. None forecast that prices will fall, but one expected them to remain flat over the next twelve months, which implies a reduction in real terms.

Overview of forecasts by financial market analysts¹

	2007			2008			2009		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation (year-on-year)	3.5	2.8	4.2	3.5	2.1	4.2	2.6	1.5	3.3
GDP growth	2.4	1.5	3.4	3.2	2.3	4.1	3.2	2.6	3.5
	One year ahead			Two years ahead					
	Average	Lowest	Highest	Average	Lowest	Highest			
Inflation	3.4	2.1	4.6	3.1	2.5	3.4			
Effective exchange rate index of foreign currencies vis-à-vis the króna (Dec. 31, 1991=100)	126	115	135	124	120	127			
Central Bank policy interest rate	11.3	9.8	14.0	9.2	6.0	13.0			
Nominal long-term interest rate ²	8.1	7.4	8.5	7.6	7.0	8.0			
Real long-term interest rate ³	3.8	3.5	4.0	3.6	3.4	3.8			
ICEX-15 share price index (12-month change)	8,063	7,000	8,820	8,930	7,000	10,143			
Housing prices (12-month change)	3.1	0.0	5.0	3.2	0.0	7.6			

1. The table shows percentage changes between periods, except for interest rates (percentages) and the foreign exchange rate index and ICEX-15 index (index points). Participants in the survey were the research departments of Glitnir, Kaupthing Bank and Landsbanki, and Askar Capital. 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 Housing Financing Fund bonds (HFF150644).

Source: Central Bank of Iceland.