

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-June and participants were the research departments of Glitnir, Kaupthing Bank and Landsbanki. The main changes from the previous survey in March are that analysts have revised their forecasts for 2007 upwards for inflation and downwards for output growth. One year ahead, they forecast a stronger króna, higher policy rate and greater increase in asset prices than in the previous survey.

## Box IV-1

# Financial market analysts' assessments of the economic outlook

### Deterioration in the short-term inflation outlook

The short-term inflation outlook has deteriorated since the last survey in March. Analysts forecast year-on-year inflation in 2007 of 4.4%, which is similar to the Central Bank's baseline forecast. However, the baseline forecast projects an underlying inflation rate of more than 6% in 2007.<sup>1</sup> The analysts' average forecast for year-on-year inflation in 2008 is broadly unchanged from the last *Monetary Bulletin* in March, at 3.6%. The majority expect inflation to be close to target in 2009, when their year-on-year forecast is 3% on average. The rate of disinflation is faster in the Central Bank's baseline forecast, which assumes a somewhat higher policy rate in 2008 and inflation close to the target at the end of that year.

### Output growth to pick up in 2008

Analysts have revised their March forecasts for growth in 2007 some way downwards to an average of 1.3%. The Central Bank's baseline forecast, which assumes a more rapid adjustment, puts output growth at a mere 0.2%. One survey respondent also forecasts negligible output growth in 2007. Analysts agree that output growth will pick up in 2008, rising to 3.5%. For 2009, they expect average output growth of just under 3%. The Central Bank's baseline forecast diverges quite markedly, projecting output growth of just under 1% in 2008 and a contraction in 2009. It should be noted that most analysts expect further investments in the aluminium and power sectors in the years to come.

### Stronger króna forecast until 2008

The króna has appreciated sharply in recent months. Analysts forecast an average exchange rate index of just over 120 one year ahead and roughly 125 two years ahead. Views for one year ahead differ quite widely, with forecast exchange rate values in the range 112-130. The Central Bank's baseline forecast for exchange rate developments is similar, with an average exchange rate value of just under 120 in 2008 and 128 in 2009.

### Higher policy rate across the forecast horizon

In their policy rate forecasts, the analysts are broadly in line with the policy rate path published in *Monetary Bulletin* in March. The Central Bank's policy rate has been unchanged at 13.3% since December 2006.<sup>2</sup> On average, analysts forecast a policy rate of just over 11% one year ahead, just below 7% two years ahead and just below 6% after three years. They all expect the policy rate to be lowered in the final quarter of 2007.

### No let-up in asset price increases

Equity prices have risen sharply over the past few months and the OMXI15 index has repeatedly reached record heights. On June 20

1. Based on the CPI excluding the impact of cuts in VAT.
2. A new presentation of the policy rate took effect on June 21 whereby it is now stated as a nominal discounted value and not in terms of annual yield. The policy rate is currently 13.3%, which corresponds to an annual yield of 14.25%. Analysts' survey responses have been converted to the corresponding nominal discounted rate.

it stood close to 8,200, a gain of 9% since mid-March. On average, analysts forecast an index value of almost 9,500 one year ahead and above 10,700 two years ahead.

House prices have followed the same pattern recently, reflecting the positive correlation between asset prices and the exchange rate of the króna. Analysts forecast that real estate prices will increase by just over 4½% on average over the next twelve months and continue to rise across the forecast horizon by 2-3% annually.

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

	2007			2008			2009		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation (year-on-year)	4.4	4.4	4.5	3.6	2.8	4.3	3.0	2.5	3.8
GDP growth	1.3	0.5	2.0	3.4	2.5	4.2	2.8	2.6	3.0
	June 2008			June 2009			June 2010		
Inflation	3.8	3.7	3.9	3.1	2.6	3.9	2.7	2.5	3.2
Effective exchange rate index of foreign currencies vis-à-vis the króna (Dec. 31. 1991=100)	121	112	130	125	122	127	127	125	130
Central Bank policy interest rate	11.3	11.1	11.6	6.8	6.6	7.0	5.8	5.8	5.8
Nominal long-term interest rate <sup>2</sup>	7.5	6.8	8.4	6.7	6.1	7.6	6.5	6.0	7.2
Real long-term interest rate <sup>3</sup>	3.8	3.8	3.9	3.5	3.4	3.6	3.4	3.3	3.5
OMX15 share price index	9,470	8,750	10,003	10,736	9,800	11,457	12,294	11,000	13,529
House prices (12-month change)	4.6	4.0	5.0	2.1	1.5	2.5	2.7	2.5	3.0

1. The table shows percentage changes between periods, except for interest rates (percentages), the foreign exchange rate index and OMX15 index (index points). Participants in the survey were the research departments of Glitnir, Kaupthing Bank and Landsbanki. 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.