

Appendix 2

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 early April, and participants were Askar Capital and the research departments of Glitnir, Kaupthing Bank, and Landsbanki. The main changes from the previous survey in October 2007 are that analysts have revised their forecasts for 2008 sharply upwards for inflation and downwards for output growth. They also expect house prices to fall. Their forecasts concerning developments in the policy rate strongly resemble the policy rate path in the Central Bank's baseline forecast.

Decidedly bleak inflation outlook

The inflation outlook across the forecast horizon has worsened in the wake of the depreciation of the króna and the intensified inflationary pressure over the past few months. On average, analysts forecast that inflation will rise above 9% in 2008, which is in line with the Central Bank's baseline scenario. Most analysts expect that the inflation target will not be attained during the forecast horizon. On average, the analysts surveyed forecast 4.3% inflation in 2009 and 3½% in 2010. They expect inflation to stand at just below 4% in three years' time. In the Central Bank's baseline forecast, the inflation outlook for 2009 is more negative than in the analysts' forecasts, as the Bank expects 6% inflation. According to that forecast, the inflation target will be attained at year-end 2010.

Slowdown in output growth

The outlook is for a slowdown in economic activity concurrent with rising inflation. Analysts forecast less output growth in 2008 and 2009 than they did in the previous survey. On average, they expect growth to be minimal in 2008 and then rise to 1½% in 2009. One respondent, however, expects a contraction in both years. The Central Bank's baseline forecast assumes more growth in 2008, or just over 2%, due to the positive contribution of foreign trade, while it projects that a contraction in domestic demand will cause a 2½% output contraction in 2009. Most analysts expect the economy to revitalise somewhat by 2010, with growth exceeding 3%, which is similar to their responses in the last survey. The Central Bank's baseline forecast, however, projects a 1½% contraction.

Substantial uncertainty regarding exchange rate developments

The króna has weakened considerably in recent weeks due to financial market unrest and declining interest rate differentials in the currency swap markets. Analysts consider the exchange rate path rather stable, however, and they project that the exchange rate index will average just below 140 in 2008 and 2009. Nevertheless, their responses cover

a rather wide range. The analysts' average forecast is broadly in line with the Central Bank's baseline forecast, which projects the exchange rate index at just over 140 in both years. In the long run, the analysts forecast a generally stronger króna.

High policy rate until 2009

At the end of March, the Central Bank raised its policy rate by 1.25 percentage points, to 15%, after having kept it unchanged since November. Analysts are unanimous in forecasting that the policy rate will remain high until next year. They forecast an average of 14.7% for 2008 and just below 12% for 2009, and they project the policy rate at 7.7% three years ahead. Most analysts expect monetary policy to be tighter during the forecast horizon than the Bank's baseline forecast suggests. Two respondents stated that the policy rate would be raised on the next decision date, April 10, and the majority expect a policy rate cut in the latter half of this year. The policy rate path presented by the analysts closely resembles that used as a basis for the Bank's baseline forecast (see Chart 1).

Changed conditions in asset markets

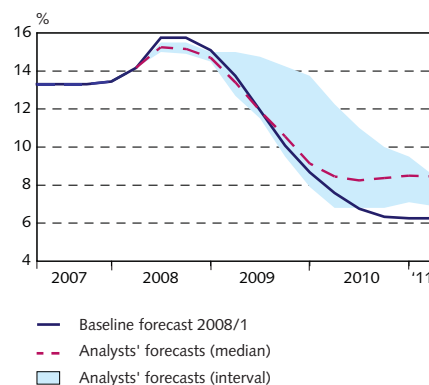
The equity market has been volatile in recent months, and the OMXI15 index has fallen. On average, analysts forecast an index value of almost 5,200 one year ahead and just over 6,100 two years ahead.

All of the analysts expect house prices to drop over the next twelve months, but real estate market activity has slowed considerably. On average, the analysts forecast a nearly 5% price decrease over the next twelve months. They are generally in agreement about the long-term outlook, and they forecast the twelve-month change at 2% two years ahead.

Chart 1

Policy rate path MB 2008/1
and analysts' forecasts

Forecasting period Q2/2008 - Q1/2011



Source: Central Bank of Iceland.

Table 1 Overview of financial market analysts' forecasts¹

	2008			2009			2010		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation (year-on-year)	9.1	7.9	10.5	4.3	3.2	7.2	3.5	2.1	4.5
GDP growth	0.2	-0.5	1.0	1.5	-2.5	3.5	3.2	1.5	4.5
Effective exchange rate index of foreign currencies vis-à-vis the króna (annual average)	139	130	145	137	128	154	136	125	150
Central Bank policy rate (annual average)	14.7	14.5	14.9	11.8	10.5	14.4	8.6	6.9	10.7
	March 2009			March 2010			March 2011		
	Average	Lowest	Highest	Average	Lowest	Highest	Average	Lowest	Highest
Inflation	5.7	3.8	9.8	4.0	2.1	5.0	3.7	2.7	4.5
Effective exchange rate index of foreign currencies vis-à-vis the króna	136	131	151	137	127	156	134	124	150
Central Bank policy rate	13.0	11.8	15.0	9.0	6.8	12.3	7.7	6.5	8.5
Nominal long-term interest rate ²	8.7	7.2	11.5	7.9	6.5	11.0	7.1	6.5	8.0
Real long-term interest rate ³	4.0	3.3	4.3	3.9	3.7	4.0	3.7	3.2	4.0
OMXI15 share price index	5,172	4,000	5,921	6,143	5,000	7,071	7,269	6,000	8,377
Housing prices (12-month change)	-4.7	-6.0	-2.9	2.0	0.0	3.0	4.2	3.0	5.0

1. The table shows percentage changes between periods, except for interest rates (percentages), the exchange rate index (index points) and the OMXI15 index (index points). Participants in the survey were Askar Capital and the research departments of Glitnir, Kaupthing Bank, and Landsbanki. 2. Based on yield in market makers' bids on non-indexed T-notes (RIKB 19 0226). 3. Based on yield in market makers' bids on indexed Housing Financing Fund bonds (HFF 150644).

Source: Central Bank of Iceland.