

Even under the most auspicious circumstances, economic developments can deviate greatly from forecasts, and analyses of the economic outlook can change as new information surfaces. This Box describes the main changes in the macroeconomic forecast since *Monetary Bulletin* 2007/3, while Box IX-1 examines the changes in the inflation forecast and the drivers of those changes. The global economic climate has been quite capricious in recent months and the domestic economy equally changeable. The uncertainty surrounding forecasting has therefore been much greater than often before.

Policy rate rises higher, remains high longer, and falls more slowly than previously forecast

The Central Bank's last forecast, which appeared in November 2007, assumed that the policy rate would follow the path that the Bank's staff deemed sufficient to bring inflation as close as possible to the 2.5% inflation target within an acceptable time horizon and stabilise it near that level thereafter. The policy rate has already deviated from that path, however, as inflation developments have been considerably more adverse than assumed in the November forecast. In March 2008, the policy rate was raised by 1.25 percentage points, to 15%. The revised forecast assumes that the policy rate will rise further and remain unchanged until the fourth quarter of 2008, and then begin to fall more gradually than in the previous forecast. Despite the increase, the real policy rate remains lower than in the previous forecast until early in 2009. Inflation is projected to peter out gradually and align with the Bank's inflation target late in 2010, or roughly one year later than in the November forecast. The policy rate will be just above 6% at the end of the forecast horizon.

Demand growth for 2007 underestimated ...

Demand proved stronger in 2007 than the previous forecast indicated. Private consumption grew by about 0.5 percentage points more, and investment contracted nearly 5 percentage points less, due in particular to increased investment in residential housing and in the aluminium and power sectors. Export growth was also considerably stronger than previously estimated mainly due to irregular aircraft exports. Output growth was therefore nearly 3 percentage points greater in 2007 than indicated in the forecast, or 3.8%. Output growth for 2005 and 2006 has also been revised upward by Statistics Iceland.

... but the strength of demand wanes sharply due to falling disposable income and adverse financial conditions

In the revised forecast, the economy is more vigorous early in the forecast horizon than in the November forecast, while tighter financial conditions, falling disposable income and asset prices, and a much weaker króna have a distinct dampening effect on demand. Private consumption continues to grow until mid-2008 but then declines swiftly. The contraction in private consumption is approximately 13% over the forecast horizon, as opposed to 9½% in the previous forecast. However, this contraction should be viewed in the context of the enormous growth of the past few years.

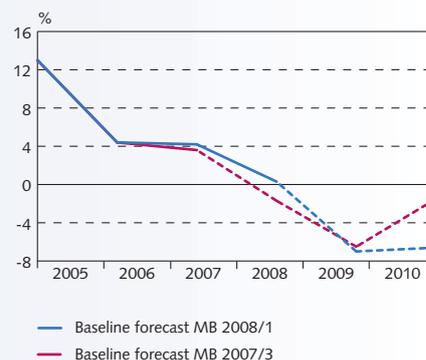
Business investment contracts much less during the forecast horizon than in the previous forecast, especially because the current baseline forecast includes construction related to the Helguvík aluminium smelter. Even excluding the aluminium and power sectors, business investment is greater early in the horizon as a result of commercial housing construction. Growth in residential investment has repeatedly outstripped expectations. The forecast assumes that residential investment will continue to grow through 2008 and then contract sharply, falling by nearly 14% over the course of the forecast horizon. This is a larger decrease than was assumed in the last forecast. The residential investment as a proportion of GDP is still quite high at the end of the forecast horizon.

Box IV-1

Changes in the macroeconomic forecast from *Monetary Bulletin* 2007/3

Chart 1

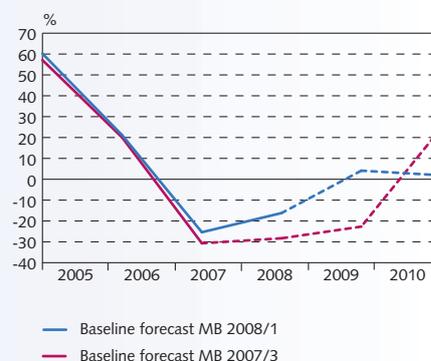
Private consumption growth 2005-2010



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2

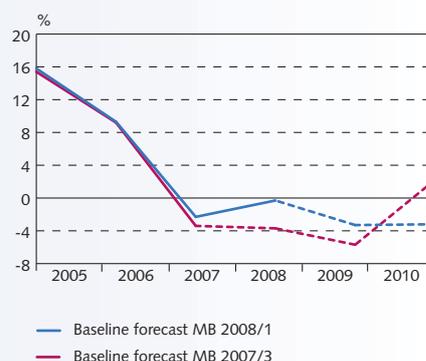
Business investment growth 2005-2010



Sources: Statistics Iceland, Central Bank of Iceland.

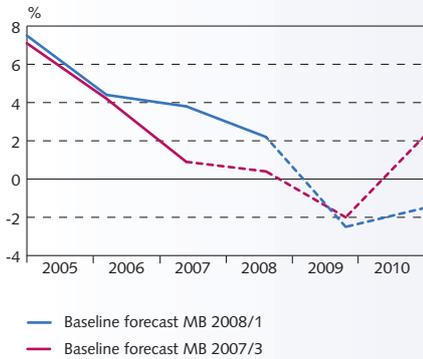
Chart 3

National expenditure growth 2005-2010



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4
Economic growth 2005-2010



Sources: Statistics Iceland, Central Bank of Iceland.

Adjustment process more prolonged – and therefore more costly

National expenditure contracts by 6½% during the forecast horizon, which is half a percentage point less than in the previous forecast. As before, a downturn in domestic demand plays a key role in moving the economy toward a sustainable equilibrium. It would be incautious to interpret a smaller contraction in the forecast as evidence that the adjustment ahead will be less costly than was assumed in November. The adjustment in the revised forecast is slower and more protracted, and it depends to a greater degree on a reduction in private consumption, which is driven by deteriorating financial conditions, a drop in disposable income, and a housing market slump. Government measures related to wage settlements stimulate private consumption and delay this adjustment (see Box V-1). Delaying the adjustment beyond the time frame assumed in the previous forecast will entail higher inflation, a more lasting contraction of domestic demand, and less scope for monetary policy to support an economic recovery later in the forecast horizon. High inflation, elevated inflation expectations, and the delay in aligning both of these with the Bank's inflation target therefore prevent monetary policy from stimulating output growth at the end of the forecast horizon to the same degree as was assumed in November. The slump in domestic demand will not be over until some time beyond the forecast horizon, while the previous forecast projected a recovery beginning in 2010.