INFLATION FORECAST

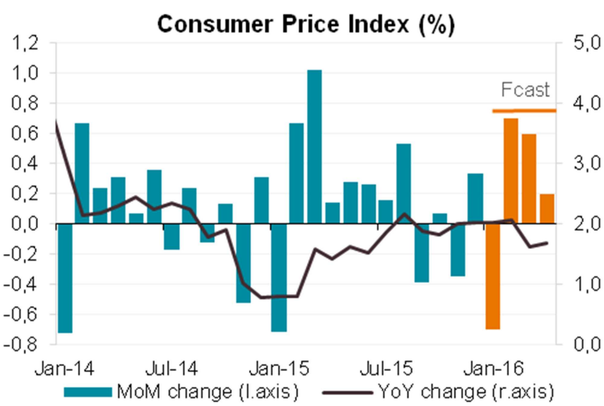
14 January 2016 | Íslandsbanki Research

Summary

- CPI to decline 0.7% in January
- Headline inflation unchanged at 2.0%
- Housing, food/beverages push the CPI upwards
- Airfares, petrol prices, and clothing/footwear pull downwards
- CPI projected to rise 0.8% in the first four months of 2016; headline inflation 1.7% in April
- Inflation 3.4% in 2016 and 3.6% in 2017

	1m	3m	6m	12m	24m
Change in the CPI	-0.7%	0.6%	1.6%	3.4%	7.2%
Annualised	-8.1%	2.4%	3.1%	3.4%	3.5%
			2015	2016	2017
Inflation for the year (Dec-Dec)			2.0%	3.4%	3.6%
Inflation between years			1.6%	2.3%	3.7%
Wage change for the year			9.1%	7.7%	6.0%
Cost of own housing over the year			8.9%	7.8%	6.9%
Trade-weighted ISK index (TWI) (avg)			201.1	192.6	192.6

We forecast a 0.7% drop in the CPI in January



Source: Statistics Iceland and ISB Research

We project that the consumer price index (CPI) will fall by 0.7% month-on-month in January. If the forecast materialises, headline inflation will hold unchanged at 2.0%, therefore remaining below the Central Bank's (CBI) 2.5% inflation target.

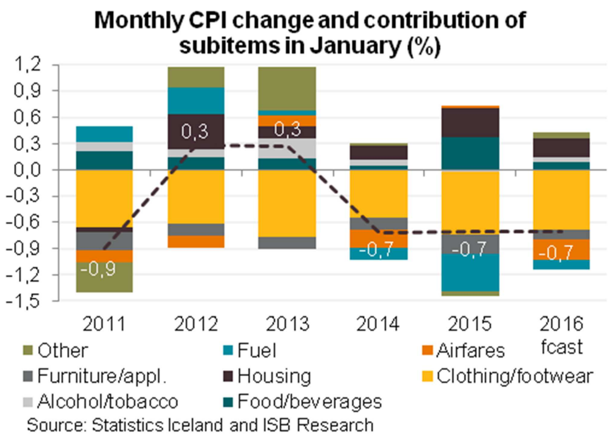
In our opinion, the medium-term inflation forecast is broadly unchanged since our last forecast. Inflation looks set to remain below target through mid-year. It will rise above the target in the autumn, however, and hover near the upper deviation limit in 2017 and 2018. Statistics Iceland (SI) will publish the CPI for January at 9:00 hrs. on 28 January.

Seasonal sales and travel component the main downward influences

In keeping with the usual January pattern, relatively strong factors will pull the CPI in both directions. This year, the downward influences will carry the day, as they have in the past two years. Seasonal sales usually have a strong temporary impact on selected consumer durables and semi-durables in January. Of these downward-pulling components, we expect clothing and footwear prices to lower the CPI by 0.68%, furniture and housewares by 0.12%, and other conventional sale items by approximately 0.05% combined.

Apart from winter sales, the main items pulling downward are related to travel and transport. The main driver here is airfares (-0.23% CPI effect), which, according to our survey, have fallen markedly in the wake of a nearly 18% increase in December. Petrol has fallen by 3.4% from the December CPI measurement (-0.11% CPI effect), in response to a steep drop in global market prices.

Offsetting these downward-pulling items are annual price list increases and various other items. This year's price list increases are modest, however, in comparison with recent years. For example, utilities and service charges for the operation of residential housing will raise the index by 0.16%, according to our forecast, but have often had a much stronger impact. Furthermore, our survey indicates a relatively small change in house prices. On the whole, we estimate that the housing component will raise the CPI by 0.22% this time.



We project that food and beverage prices will raise the index by 0.09% in January, two-thirds of it due to the seasonal rise in vegetables prices. In addition, we expect the changes in alcoholic beverage prices in connection with the changed composition of public levies to raise the CPI by 0.03%, and we expect the alcohol/tobacco component as a whole to raise it by 0.05%. We also expect the rise in restaurant service prices to raise the index by 0.04%. Other components will make less of an impact in our forecast, pushing the index upwards by a total of roughly 0.1%.

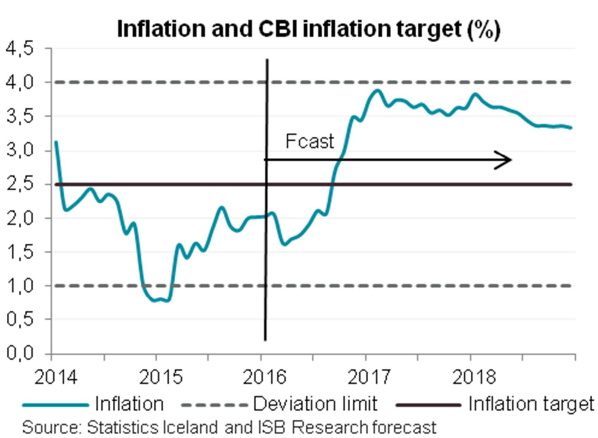
Modest inflation through the spring

We project that the CPI will rise by a total of 0.6% in Q1/2016: we expect it to rise by 0.7% in February and 0.6% in March. For April, we expect an increase of 0.2%.

In February and March, end-of-sale effects usually come to the fore, and our forecast takes account of this factor. Furthermore, we expect the housing component to rise steadily, contributing about the same to the CPI as it has in the recent past. In addition to this, airfares will probably rise again in coming months. According to the forecast, inflation will decline in Q1, bottoming out at 1.6% in March and rising slightly to 1.7% by April.

Inflation to gather pace further ahead

According to our forecast, inflation will gain momentum steadily over the course of the year. We expect it to rise to 1.9% by mid-year and overtake the CBI's inflation target by September. If this forecast materialises, a 2½-year period of below-target inflation – the longest such period since inflation targeting was adopted in 2001 – will come to an end. We forecast that inflation will measure 3.4% at the year-end. The outlook is for inflation to average 3.7% in 2017 and 3.5% in 2018. The increase in inflationary pressures is due to the continued rapid rise in domestic wage costs, the continued rise in real house prices, and the tapering-off of imported deflation, among other factors.



As usual, the ISK is the main uncertainty in our forecast. In the short run, the ISK appears more likely to appreciate than to depreciate, owing to sustained foreign currency inflows in the recent term, providing enough scope to cover potential outflows in connection with the offshore ISK auction, pension funds' increased authorisations for foreign investment, and the settlement of the failed banks' estates. Additional appreciation of the ISK could prove to be a double-edged sword, however. In our opinion, a further rise in the real exchange rate will undermine Iceland's competitive position and exacerbate the risk of a steep drop later on. Moreover, wages could rise faster in the near future than we expect, contributing to higher inflation over the medium term.

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