

INFLATION FORECAST

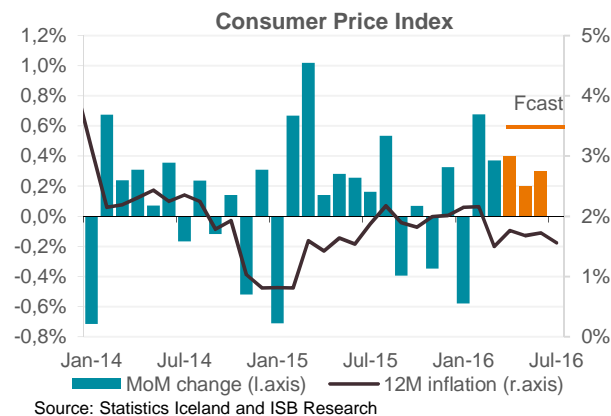
14 April 2016 | Íslandsbanki Research

Summary

- We forecast a 0.4% rise in the CPI in April
- Headline inflation will rise from 1.5% to 1.8%
- Housing, food, and petrol push upwards
- CPI to rise 0.9% in Q2/2016
- Inflation to overtake CBI target at year-end
- Inflation 2.6% in 2016 and 3.5% in 2017

| | 1m | 3m | 6m | 12m | 24m |
|-------------------------------------------------|------|------|-------|-------|-------|
| Change in the CPI | 0.4% | 0.9% | 1.4% | 3.0% | 6.6% |
| Annualised | 4.9% | 3.7% | 2.7% | 3.0% | 3.2% |
| | | | 2015 | 2016 | 2017 |
| Inflation for the year (Dec-Dec) | | | 2.0% | 2.6% | 3.5% |
| Inflation between years | | | 1.6% | 1.9% | 3.2% |
| Wage change for the year | | | 9.7% | 8.7% | 6.2% |
| Cost of own housing over the year | | | 8.9% | 9.3% | 6.9% |
| Trade-weighted ISK index (TWI) (yearly average) | | | 201.1 | 190.1 | 190.0 |

We forecast a 0.4% rise in the CPI in April

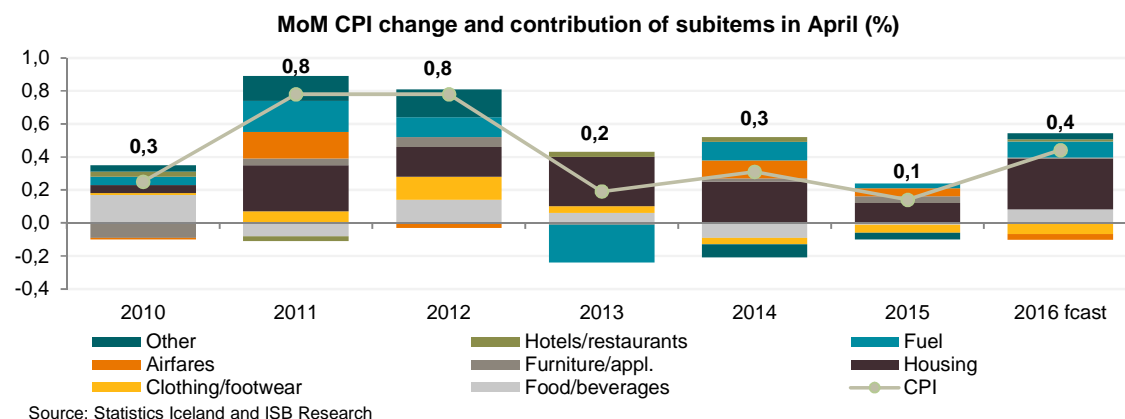


We project that the consumer price index (CPI) will rise by 0.4% month-on-month in April, raising headline inflation from 1.5% to 1.8%. If our forecast materialises, the streak of below-target inflation will be extended by yet another month. In our opinion, the medium-term inflation outlook has improved somewhat since our last forecast. Inflation looks set to remain below the Central Bank's (CBI) 2.5% target until near the end of this year. It will be somewhat above the target in

2017 and 2018, however. Statistics Iceland (SI) will publish the April CPI at 9:00 hrs. on 28 April.

Housing, food, and petrol prices rise

The housing component is by far the strongest driver of this month's rise in the CPI, according to our forecast. We expect the housing component as a whole to rise by nearly 1.1% (0.31% CPI effect). This is due for the most part to a 1.8% rise in imputed rent (0.28% CPI effect), as our survey indicates that rising house prices will have a strong effect on the upcoming CPI measurement, after having unexpectedly remained flat last month.



It appears that the hefty pay rises negotiated by the vast majority of private sector workers in recent

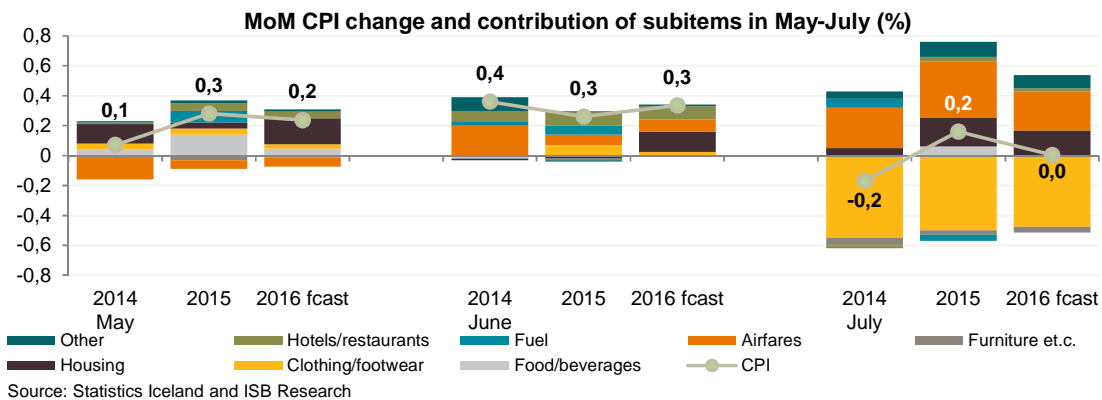
months are showing increasingly in domestic goods prices. At present, these effects can be seen most clearly in food prices, as our forecast provides for a nearly 0.6% rise in the food and beverages component (0.08% CPI effect), owing mainly to increases in the price of food items such as sweets and bread products.

According to our survey, petrol prices in Iceland have risen by approximately 3.0% (0.10% CPI effect) from the last measurement, which is broadly in line with developments in foreign markets.

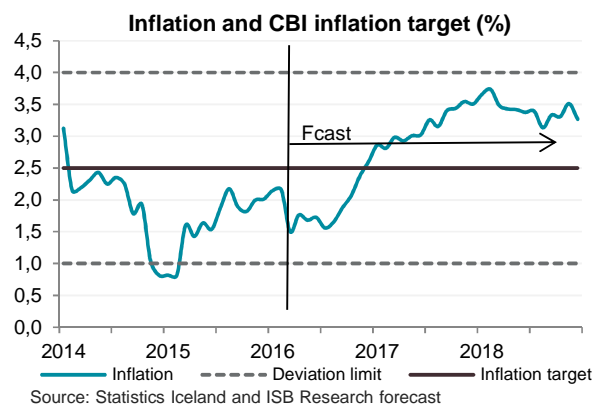
The strongest downward-pushing component is clothing and footwear (-0.07% CPI effect), followed by air transport (-0.03% CPI effect). Spring sales will make their mark on the former of these, in our opinion, and it appears that retailers still have some scope to pass on to customers the large drop in purchase prices stemming from the cancellation of excise taxes and the appreciation of the ISK. Our projections concerning air transport are based on observed developments in international airfares, which seem to have fallen slightly between months. Other components will make less of an impact, pushing the index upwards by a combined 0.05%.

Modest inflation until late in the year

The outlook is for the CPI to increase by a total of 1.4% in the first half of the year. We expect it to rise by 0.2% in May and 0.3% in June, making for a headline inflation rate averaging 1.8% over the first half of 2016. We expect the CPI to hold unchanged in July. The housing component will weigh heaviest among upward-pushing items in coming months. We project it to rise by 0.7% per month, as it has done, on average, over the past twelve months. Summer sales will offset the seasonal rise in the air transport component and other upward-pushing items in July. In other respects, the chart below illustrates the main determinants of inflation in coming months.



Rising inflation in H2



We expect inflation to pick up steadily over the second half of the year, rise above the CBI's 2.5% target at the end of the year, and measure 2.6% in December. Further ahead, the outlook is for an average inflation rate of 3.2% in 2017 and 3.4% in 2018. The increase in inflationary pressures is due to the continued surge in domestic wage costs, the sustained rise in real house prices, and the

tapering-off of imported deflation, among other factors.

ISK appreciation would reduce inflation

As usual, the ISK is the major uncertainty in our forecast. We expect the exchange rate to remain unchanged in the coming term. In the short run, however, it appears more likely to rise than to fall, owing to sustained foreign currency inflows in the recent term, providing enough scope to cover potential outflows in connection with the offshore ISK auction and increased foreign investment by resident entities once the capital controls have been lifted.

Further appreciation would cause inflation to be lower than we have projected here; for instance, our forecasting model indicates that if the ISK strengthens by 5% from now until the year-end, headline inflation will measure 2.0% at that time and will be somewhat lower in 2017 as well. Additional appreciation of the ISK could prove to be a mixed blessing, however. In our opinion, a further rise in the real exchange rate will ultimately erode the competitive position of Iceland's tradable sector and exacerbate the risk of external imbalances and a steep currency depreciation later on. Moreover, wages could rise faster in the near future than we expect, contributing to higher inflation over the medium term.

Authors

Ásta Björk Sigurðardóttir +354 440 4636

Jón Bjarki Bentsson +354 440 4634

Head of Research: Ingólfur Bender +354 440 4635

research@islandsbanki.is

<http://www.islandsbanki.is/English/>

LEGAL DISCLAIMER

This report is compiled by Islandsbanki Research of Islandsbanki hf.

The information in this report originates in domestic and international information and news networks that are deemed reliable, along with public information, and Islandsbanki Research's own processing and estimates at each time. The information has not been independently verified by Islandsbanki which therefore does not guarantee that the information is comprehensive and accurate. The views of the authors can change without notice and Islandsbanki holds no obligation to update, modify or amend this publication if assumptions change.

This publication is only published for informational purposes and shall therefore not be viewed as recommendation/advice to make or not make a particular investment or an offer to buy, sell or subscribe to specific financial instruments. Islandsbanki and its employees are not responsible for transactions that may be carried out based on information put forth in the report. Before making an investment decision, recipients are urged to seek expert advice and get well acquainted with the investments market and different investment alternatives. There are always financial risks related to investment activities, including risk due to international investments and fluctuations in the exchange rate of currencies. Investors' investment objectives and financial position vary. Past performance does not indicate nor guarantee future performance of an investment.

The research report and other information received from Islandsbanki are meant for private use only. The materials may not be copied, quote or distributed, in part or in whole, without written permission from Islandsbanki.

This report is a short compilation and should not be considered to contain all available information on the subject it discusses.

Supervisory body: The Financial Supervisory Authority of Iceland (www.fme.is).

UNITED STATES

This report or copies of it must not be distributed in the United States or to recipients who are citizens of the United States against restrictions stated in the United States legislation. Distributing the report in the United States might be seen as a breach of these laws.

CANADA

The information provided in this publication is not intended to be distributed or circulated in any manner in Canada and therefore should not be construed as any kind of financial recommendation or advice provided within the meaning of Canadian securities laws.

OTHER COUNTRIES

Laws and regulations of other countries may also restrict the distribution of this report.

Further information regarding material from Islandsbanki Research can be accessed on the following website: <http://www.islandsbanki.is>.