INFLATION FORECAST

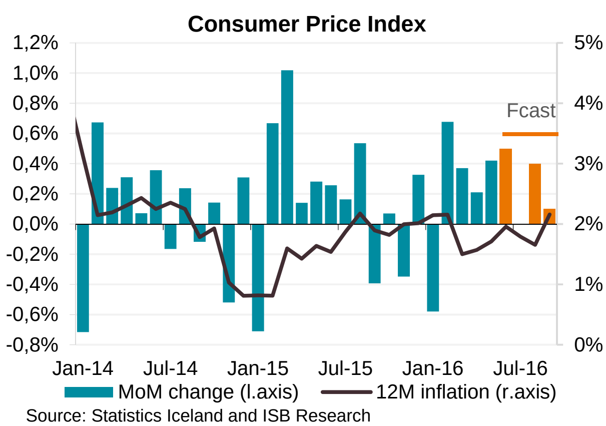
14 June 2016 | Íslandsbanki Research

Summary

- We forecast a 0.5% rise in the CPI in June
- Headline inflation will rise from 1.7% to 2.0%
- Petrol, housing, airfares, and restaurant and accommodation services pull upwards
- CPI to rise 0.5% in Q3/2016
- Inflation 2.6% at year-end 2016
- Inflation 2.4% over the course of 2017
- Inflation 4.1% over the course of 2018

	1m	3m	6m	12m	24m
Change in the CPI	0.5%	0.9%	1.0%	2.3%	5.5%
Annualised	6.2%	3.7%	2.0%	2.3%	2.7%
			2016	2017	2018
Inflation for the year (Dec-Dec)			2.6%	2.4%	4.1%
Inflation between years			2.0%	2.3%	3.4%
Wage change for the year			9.4%	6.2%	5.0%
Cost of own housing over the year			8.6%	7.5%	5.5%
Trade-weighted ISK index (TWI), average			186.4	174.9	177.6

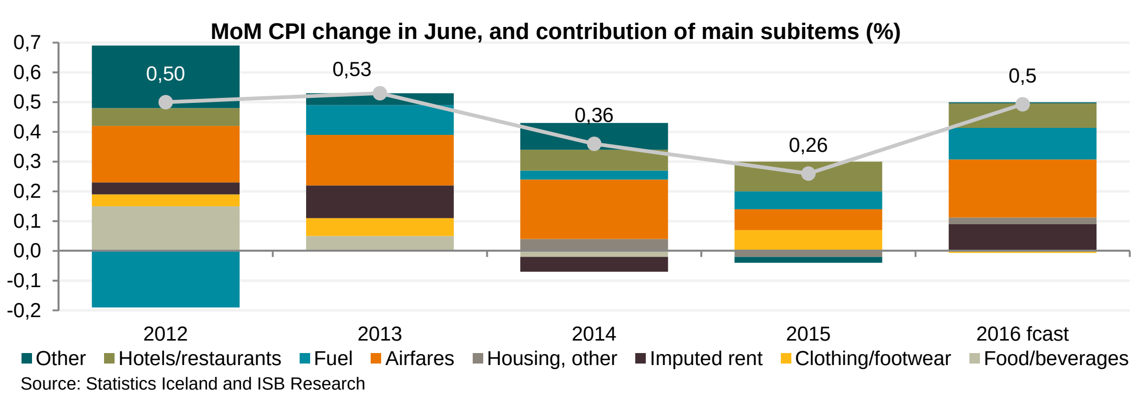
We expect the CPI to rise 0.5% in June



We project that the consumer price index (CPI) will rise by 0.5% month-on-month in June, thereby raising headline inflation from 1.7% to 2.0%, which is still below the Central Bank's (CBI) 2.5% inflation target. The medium-term inflation outlook has changed markedly since our last forecast because of changes in assumptions about the ISK exchange rate. For the most part, inflation looks set to remain below target until near the end of 2017. It will rise rapidly in 2018, however, and even surpass the upper deviation limit of the inflation target in the latter half of the year, according to the forecast. Statistics Iceland (SI) is scheduled to publish the June CPI at 9:00 hrs. on 28 June.

Petrol, housing, airfares, and restaurant/accommodation services rise

Four subcomponents will raise the CPI the most in June, according to our CPI forecast: airfares, petrol, housing, and restaurant and accommodation services. Of these, the rise in airfares weighs



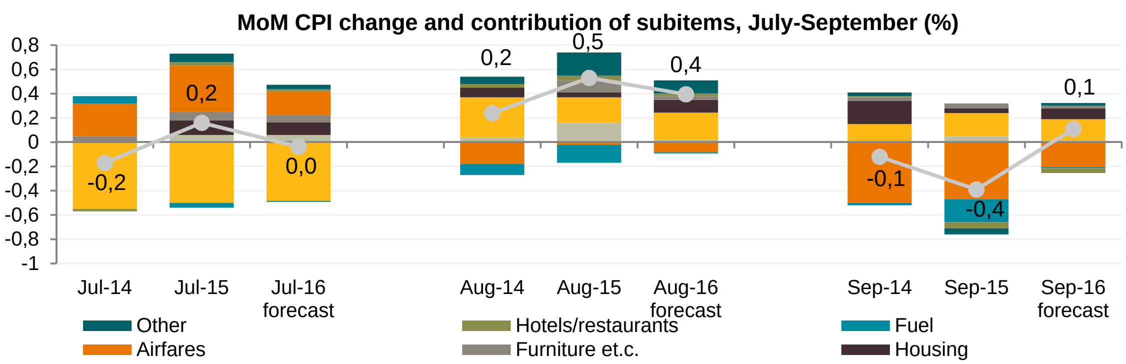
heaviest (0.19% CPI effect). To a large extent, these are seasonal effects, reflecting the peak of the tourist season. Rising petrol prices could also be a factor in increased airfares, however, as global oil prices have risen almost without interruption over the past four months, as can also be seen in a marked rise in domestic petrol prices (0.11% CPI effect).

The rise in the housing component (0.11% CPI effect) is due largely to an increase in imputed rent (0.09% CPI effect), but we expect a slight rise in paid rent as well (0.02% CPI effect). The busy summer tourist season is also reflected in a significant increase in restaurant (0.04% CPI effect) and accommodation services (0.05% CPI effect).

Very few components will pull the CPI downwards this month, according to our forecast. Among them are meat, vegetables, clothing, furniture and housewares, pharmaceuticals, and overseas package tours, which we project to lower the CPI by a combined 0.09% in June.

Inflation broadly unchanged in coming months

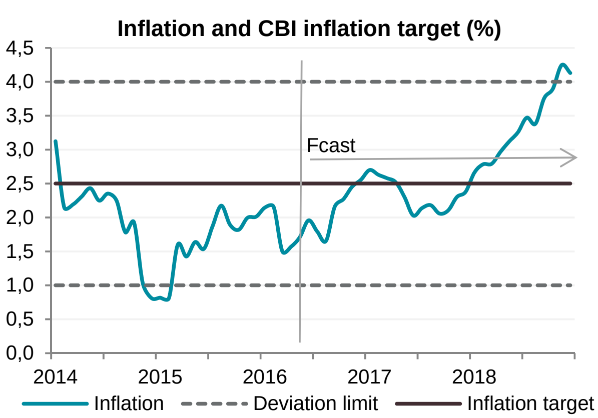
We forecast an unchanged CPI in July, a 0.4% increase in August, and a 0.1% rise in September, leaving headline inflation at 2.2% by the end of Q3.



Source: Statistic Iceland and ISB Research

As before, the housing component will be the main upward-pulling factor in coming months, with a CPI effect of 0.14% per month, on average. July figures will be affected by seasonal sales, on the one hand, and increased airfares, on the other. This will turn around in August and September, however, with end-of-sale effects pulling upwards, offset by reduced airfares.

Inflation close to target until year-end 2017

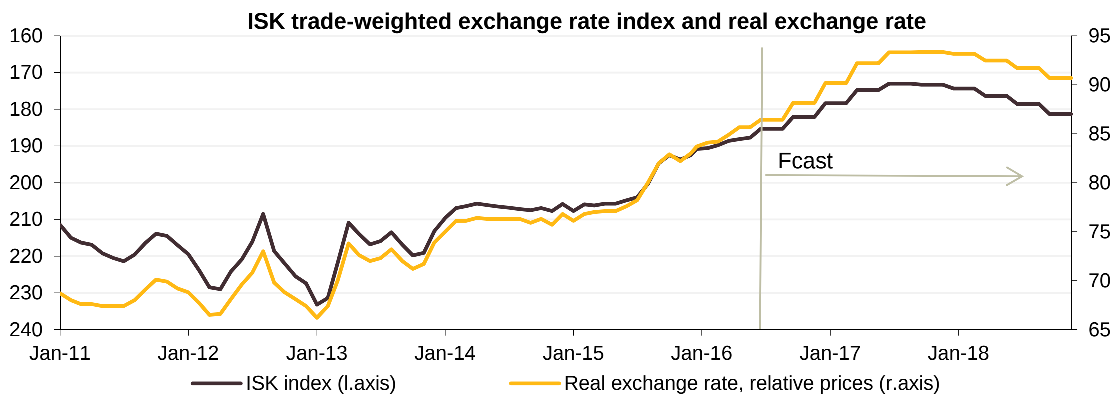


Source: Statistics Iceland and ISB Research forecast

In the fourth quarter of the year, inflation will rise somewhat, according to our forecast, to about 2.6% by the year-end. This will put an end to the longest period of below-target inflation – 33 months, if the forecast materialises – since the adoption of inflation targeting in 2001. Inflationary pressures could subside temporarily thereafter, however, owing mainly to a slowdown in wage increases and the continued appreciation of the ISK. For 2017, the outlook is for an average inflation rate of 2.3%. In 2018, however, we expect inflation to rise steadily, in response to a turnaround in the exchange rate. We expect inflation to average 3.4% in 2018 and perhaps rise to around 4.0% by the end of the year. The last time inflation was that high in Iceland was at the end of 2013.

ISK appreciation to contain inflation in the near term

The exchange rate is one of the main determinants of inflation developments in Iceland, and the nearly 10% appreciation of the ISK in the past year has played a major role in keeping inflation under wraps in spite of rapidly rising wages and other domestic cost pressures. As is mentioned in our most recent macroeconomic forecast, we expect the ISK to appreciate in the near future. We project the appreciation at roughly 4% in the latter half of 2016, followed by an additional 5% in early 2017. In our opinion, the appreciation will be based on continued trade-related foreign currency inflows, with FX purchases by the CBI and outflows due to residents' expanded foreign investment authorisations containing the rise.



Source: Central Bank of Iceland and ISB Research forecast

The probability of a currency depreciation will increase as the second half of 2017 progresses, owing to a narrowing current account surplus, weaker GDP growth, and lower real interest rates, among other factors. We expect the exchange rate to fall by approximately 5% in the latter half of the forecast horizon, but it goes without saying that the timing and size of such a depreciation are highly uncertain. In spite of this turnaround, the ISK will be nearly 3% stronger at the end of the forecast horizon than it is now, according to our forecast.

Because of the above-described assumptions concerning the exchange rate, inflation will be considerably lower early in the forecast horizon than in our previous forecasts, which assumed a constant exchange rate. Conversely, it will cause inflation to be higher in the latter half of the forecast period than we have previously projected.

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