

INFLATION FORECAST

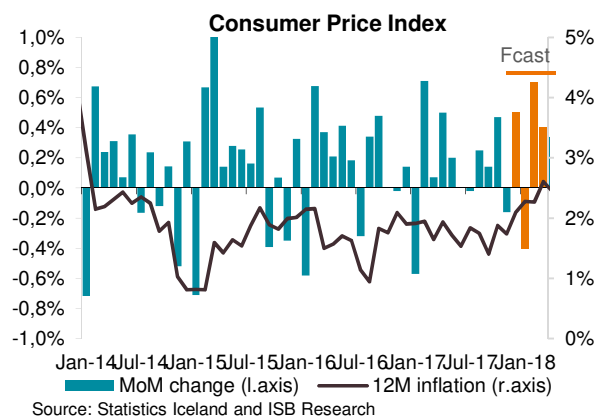
7 December 2017 | Íslandsbanki Research

Summary

- CPI to rise 0.5% in December
- Headline inflation will rise to 2.1%
- Airfares and house prices the major drivers of inflation
- Few downward-pushing items in our forecast
- Inflation 2.6% in March 2018
- Inflation 3.0% in 2018 and 2.6% in 2019

	1m	3m	6m	12m	24m
Change in the CPI	0.5%	0.8%	1.8%	3.2%	5.5%
Annualised	6.2%	3.2%	3.6%	3.2%	2.7%
	2017	2018	2019		
Inflation at year-end (Dec-Dec)	2.1%	3.0%	2.6%		
Average YoY inflation	1.8%	2.7%	2.9%		
Wage rise, YoY in Dec.	7.4%	5.2%	4.5%		
Imputed rent (owner-occupied housing costs), YoY rise	16.1%	8.0%	2.4%		
Trade-weighted ISK index (TWI) (yearly average)	160.2	159.9	159.9		

CPI to rise 0.5% in December



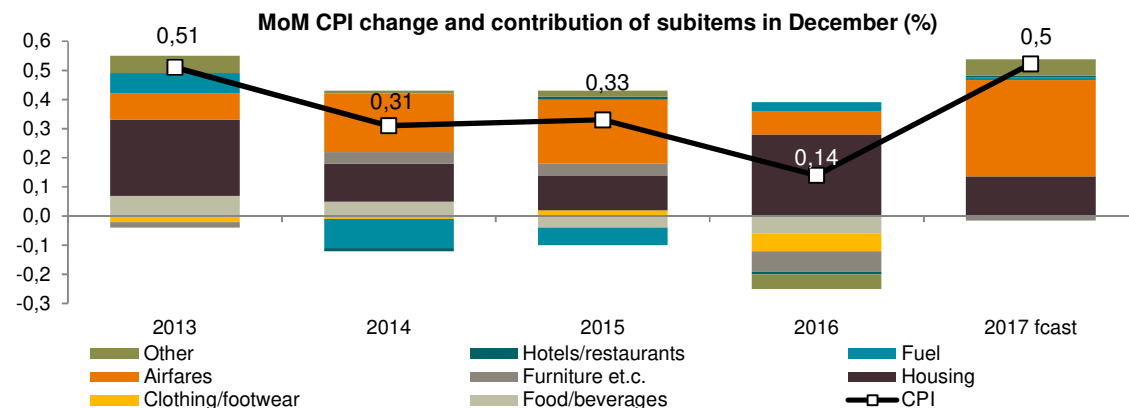
We project that the consumer price index (CPI) will rise by 0.5% month-on-month in December, raising headline inflation from 1.7% to 2.1%.

The medium-term inflation outlook is broadly unchanged since our last forecast. Offsetting a more pronounced rise in the CPI in coming months, we have revised our long-term projections for house price inflation downwards, in response to new data from the housing market. Statistics Iceland (SI) will

publish the December CPI at 9:00 hrs. on 21 December.

Will airfares take flight during Advent?

We expect the big news in the December CPI measurement to be an enormous rise in airfares. Our measurements indicate that airfares will increase by over a third during the month (0.33% CPI effect)



– or perhaps even more, according to some indicators. This will be only a temporary spike, however, and will reverse in large part in the months to follow. The travel and transport component as a whole raises the CPI by 0.39% in our forecast, with a slight rise in motor vehicle prices, petrol prices, and maintenance costs in addition to the spike in airfares.

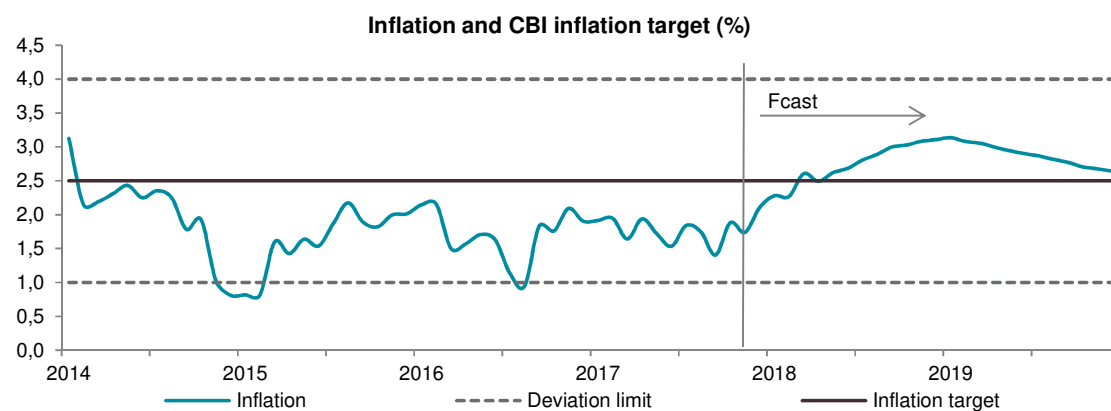
Apart from airfares, imputed rent will probably be the strongest driver (0.10% CPI effect) of the rise in the CPI in December, as our survey indicates an increase of roughly 0.5% in this component. Overall, we project that the housing component will push the index up by 0.13%.

In other respects, the forecast is relatively mundane, with few items pushing the index downwards this month. That said, we do expect a handful of items to fall in price, thereby lowering the CPI slightly in December: pharmaceuticals (-0.02% CPI effect), miscellaneous electronic equipment (-0.02%), and clothing and telephone services (-0.01% each).

Inflation to close in on the target in coming months

Inflation looks set to gain pace in the next few months. We project that the CPI will fall by 0.4% in January and then rise by 0.7% and 0.4%, respectively, in February and March, leaving headline inflation at 2.6% by March.

On average, the housing component will be the main driver of the rise in the CPI over the period, contributing about 0.16% per month. We have revised our forecast of short- and long-term house price inflation downwards, however, in light of recent indicators for housing market developments. In January, a familiar seasonal pattern will emerge: the inflationary effects of year-end rises in public unit levies and various price lists, counterbalanced by winter sales. We also expect airfares to drop markedly in January. End-of-sale effects will then make their mark on inflation measurements in February and March.



Inflation close to target in coming years

The outlook is for domestic inflation to remain moderate over the forecast horizon, as long as the ISK does not weaken unduly. We expect the ISK to remain broadly unchanged from its recent average for the rest of the forecast period. Furthermore, we expect the pace of wage and house price inflation to ease as the forecast horizon progresses and, as is mentioned above, we have lowered our house price inflation forecast for the coming term, 2018 in particular.

We expect inflation to align with the Central Bank's 2.5% inflation target in the first half of 2018, rise to about 3.1% by the end of the year, and then average 2.9% in 2019. It can therefore be said that according to our forecast, inflation will be close to the CBI's target, on average, through end-2019.

There is some uncertainty about near-term house price developments, however, given the recent changes in the housing market. We consider this the main downside risk to our forecast. On the other hand, the rapid rise in wage costs could prove more persistent over time than we have assumed. The ISK exchange rate is always an uncertainty, although we consider the associated risk to the forecast broadly symmetric.

Authors

Jon Bentsson, chief economist +354 440 4634
Bergþóra Baldursdóttir +354 440 4637
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>.