INFLATION FORECAST

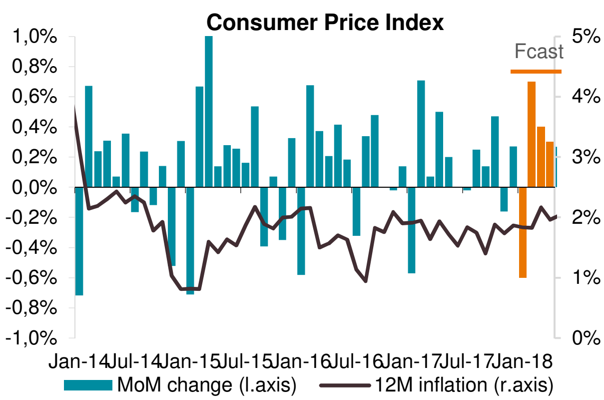
11 January 2018 | Íslandsbanki Research

Summary

- CPI to decline 0.6% in January
- Inflation subsides to 1.8%
- Seasonal sales and airfares pull downwards
- Housing, petrol, alcohol and tobacco, food and beverages push upwards
- Imputed rent declines for the second month in a row
- Inflation 2.8% in 2018 and 2.7% in 2019

	1m	3m	6m	12m	24m
Change in the CPI	-0.6%	0.5%	1.3%	2.8%	5.0%
Annualised	-7.0%	2.0%	2.5%	2.8%	2.5%
			2017	2018	2019
Inflation at year-end (Dec-Dec)			1.9%	2.8%	2.7%
Average YoY inflation			1.8%	2.3%	2.8%
YoY wage rise			7.1%	5.2%	4.5%
Imputed rent (owner-occupied housing costs), YoY rise			14.8%	6.4%	3.8%
Trade-weighted ISK index (TWI) (yearly avg)			160.3	161.9	161.9

CPI to decline 0.6% in January



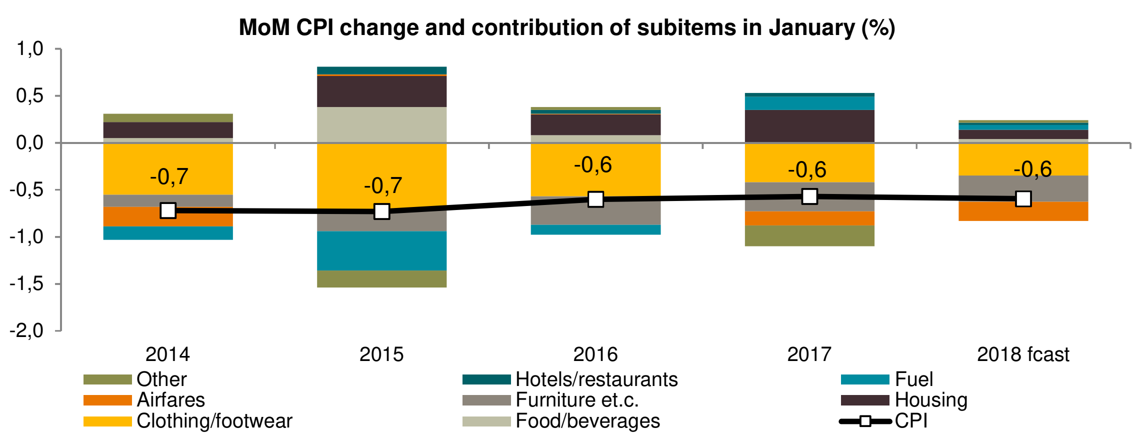
Source: Statistics Iceland and ISB Research

We project that the consumer price index (CPI) will fall by 0.6% month-on-month in January, lowering headline inflation from 1.9% to 1.8%.

Overall, the medium-term inflation outlook has improved slightly since our last forecast, owing to base effects and a relatively slower rise in house prices over the forecast horizon. As before, the outlook is for inflation to hover around the Central Bank's (CBI) target through end-2019. Statistics Iceland (SI) will publish the January CPI at 9:00 hrs. on 29 January.

Seasonal sales weigh heavier than year-end price hikes

The January CPI measurement always reflects two opposing factors: the downward impact of winter sales, and the upward impact of annual rises in utilities costs, unit levies, and private services prices.



Source: Statistics Iceland and ISB Research

We expect the former of these to outweigh the latter by a sizeable margin this year, as utilities and unit levies rose only moderately at the turn of the year.

January sales, now in full swing, appear similar in depth to those in recent years. Sale effects will have the most pronounced effect on clothing and footwear (-0.35% CPI effect), followed by furniture, housewares, etc. (-0.28%) and recreation and culture (-0.08%).

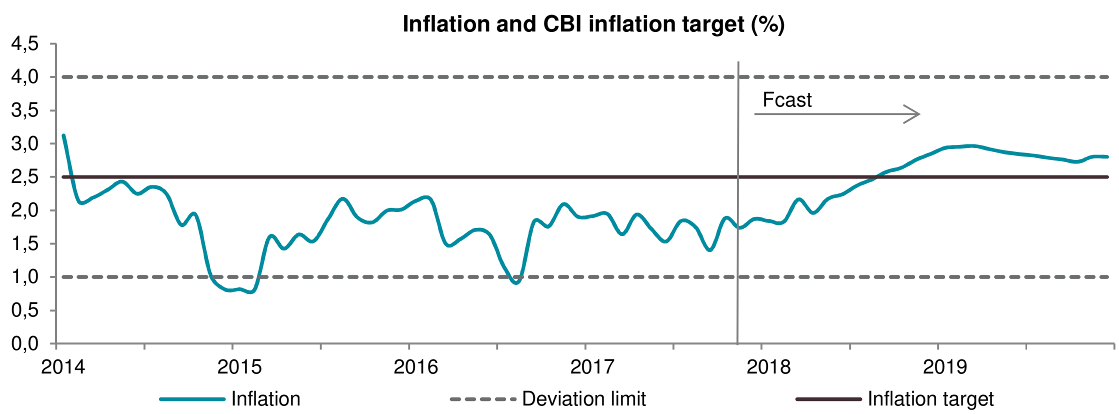
Apart from seasonal sales, the traditional January reduction in airfares will weigh most heavily in the decline in the CPI during the month (-0.20%).

According to our forecast, relatively few components will push the CPI upwards in January. The housing component is chief among them (0.10% CPI effect), owing to rising utilities prices, paid rent, and maintenance costs. On the other hand, imputed rent, which is mainly a reflection of developments in house prices, will decline marginally in January (-0.04% CPI effect). As is well known, imputed rent has been the main driver of inflation in the recent past, so a two-month consecutive decline in this item is newsworthy.

Other items pushing upwards this month include petrol (0.05% CPI effect), alcoholic beverages and tobacco (0.04%), and food and beverages (0.04%). The first two of these will rise largely because of an increase in unit levies. We also expect an increase in hotel and restaurant prices and in the component *Other goods and services*, with each of the two pushing the CPI upwards by 0.03%.

Inflation to approach the target in coming quarters

Inflation looks set to pick up slightly in the next few months. We expect the CPI to rise by 0.7% in February, 0.4% in March, and 0.3% in April. According to these projections, inflation will measure 2.0% in April 2018.



Source: Statistics Iceland and ISB Research forecast

On average, the housing component will be the main driver of the rise in the CPI over the period, contributing about 0.12% per month. We have revised the increase in house prices downwards in our short-term forecast, however, in view of recent developments in the real estate market. End-of-sale effects will have their usual impact on inflation measurements in February and March. We do not see signs that other components will make a strong impact on the CPI in the next few months, although the general price level will probably trend modestly upwards.

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 exchange rate to remain broadly unchanged from its recent average for the rest of the forecast period. We also expect the housing market to cool and wage pressures to ease as the forecast period progresses.

We expect inflation to align with the CBI's 2.5% inflation target in Q3/2018, rise to about 2.8% by the end of the year, and then average 2.8% 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. And as always, the ISK exchange rate is uncertain. Given that developments in external trade have been quite a bit less favourable in the recent term, uncertainty about the ISK has shifted towards the downside, although in our view, the outlook has not changed significantly.

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