INFLATION FORECAST

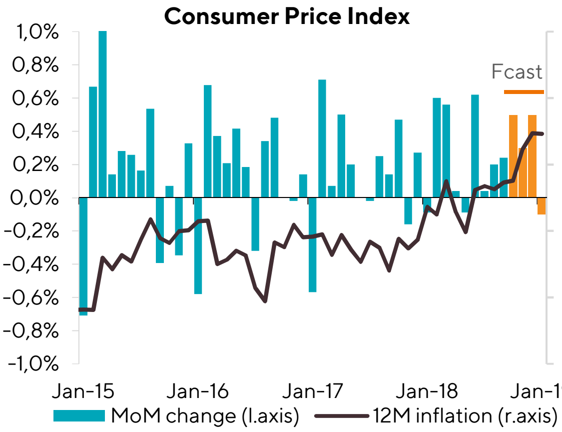
16 October 2018 | Íslandsbanki Research

Summary

- Our forecast: CPI to rise 0.5% in October
- Headline inflation to rise from 2.7% to 2.8%
- ISK depreciation and higher oil prices show in rising price level
- Food, housing, fuel, airfares among upward-pushing items
- Inflation 3.5% over 2018 and 3.4% over 2019

	1m	3m	6m	12m	24m
Change in the CPI	0.5%	1.3%	2.1%	3.5%	5.9%
Annualised	6.2%	5.3%	4.2%	3.5%	2.9%
			2017	2018	2019
Inflation at yr-end (Dec-Dec)			1.9%	3.5%	3.4%
Average YoY inflation			1.8%	2.6%	3.5%
Average YoY wage rise			6.9%	5.9%	5.4%
Imputed rent (owner-occupied housing costs), YoY rise			14.8%	7.3%	4.3%
Trade-weighted ISK index (TWI) (yearly avg.)			160.3	165.2	175

Our forecast: CPI to rise 0.3% in October

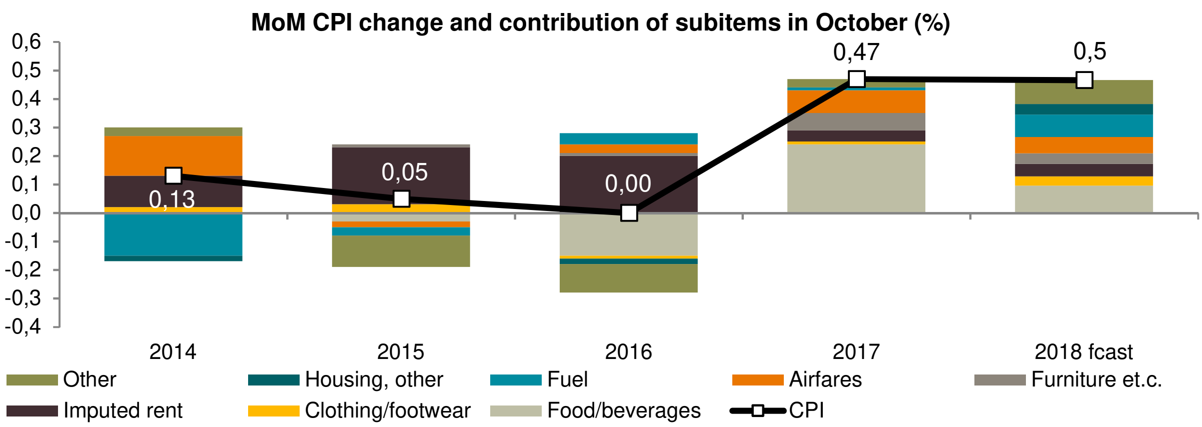


Source: Statistics Iceland and ISB Research

We project that the consumer price index (CPI) will rise by 0.5% month-on-month in October, If this forecast materialises, headline inflation will rise from 2.7% to 2.8%. The inflation outlook for the next few quarters has worsened slightly, in our opinion, because of the recent depreciation of the ISK. The outlook is for inflation to measure 3.5% at the end of 2018 and average 3.5% in 2019. Statistics Iceland (SI) is scheduled to publish the October CPI at 9:00 hrs. on 29 October.

Upward-pushing items: spoiled for choice

Our forecast of October's month-on-month change in the CPI is a good example of the old adage "Little strokes fell great oaks." No single item is the obvious driver of the rise in the CPI; instead, the overall price level appears to be trending upwards. Pass-through from depreciation of the ISK since the beginning of September is an important factor, of course, not least because of its impact on the price of food, petrol, and other high-turnover items.



Source: Statistics Iceland and ISB Research

We estimate that food and beverage prices will rise by 0.9% (0.10% CPI effect), owing mainly to higher imported food prices. Furthermore, we expect the housing component to push the CPI upwards by 0.08%. Our survey indicates, however, that imputed rent, which is by and large a reflection of house prices, will rise by only 0.2% (0.04% CPI effect). The rise in paid rent and home maintenance also affects this item.

Fuel prices have risen by 2.4% since SI's last measurement (0.08% CPI effect). The weakening of the ISK and the rise in global oil prices are the main drivers here, and they probably play a leading role in the 4% hike in airfares (0.06% CPI effect), which our survey indicates has taken place since the September CPI measurement. In addition, we estimate that motor vehicle prices will raise the index by 0.04%.

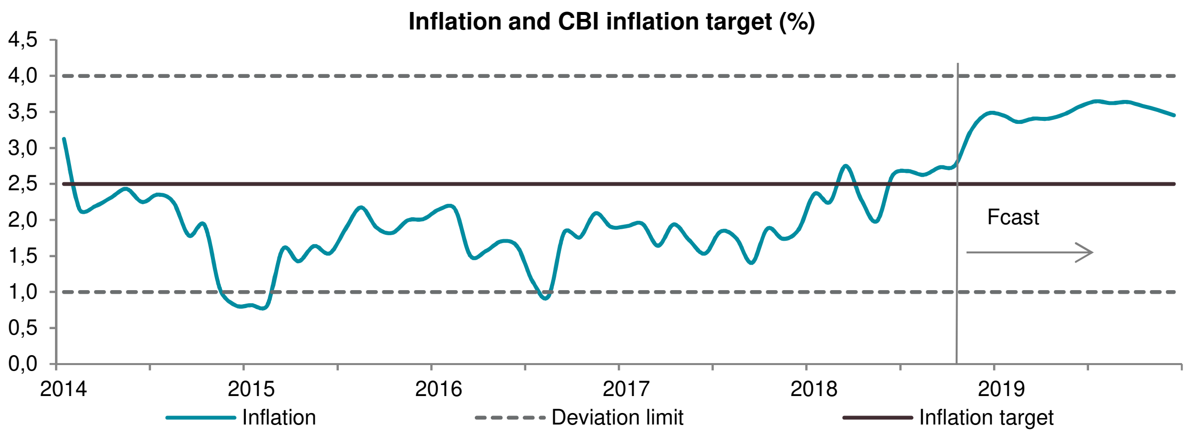
We also expect import prices — such as clothing and footwear (0.03% CPI effect) and furniture and housewares (0.04%) — to be somewhat higher in October, together with miscellaneous recreational goods (0.03%).

Accommodation and telecom push downwards

Few items will push the CPI downwards, according to our forecast. Chief among them are accommodation prices (-0.02%) and post and telecom services (-0.01%).

Inflation on an upward path in coming quarters

The more than 8% depreciation of the ISK since the beginning of September has changed the short-term inflation outlook distinctly for the worse. We expect the CPI to rise by 0.3% in November and 0.5% in December, followed by a 0.1% decline in January. If this forecast materialises, inflation will measure 3.5% at the year-end. Exchange rate pass-through from the ISK depreciation will affect matters in November and December, whereas in January the usual suspects will come into play, with seasonal sales pushing downwards and price lists and public levies pushing upwards.



Source: Statistics Iceland and ISB Research forecast

Thereafter, we expect inflation to remain broadly stable well into 2019 and then begin to taper off slowly in the second half of the year. The disinflation in H2/2019 is due primarily to a slower rise in house prices further ahead and a stable ISK, which we expect to hover around the current level for the bulk of the forecast horizon.

Apart from uncertainty about the ISK in coming quarters, the most prominent uncertainties in the forecast centre on two factors: wages, which could rise faster than we anticipate (see the table above); and house price inflation, which could slow down more than we have assumed in this forecast.

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