



INFLATION FORECAST

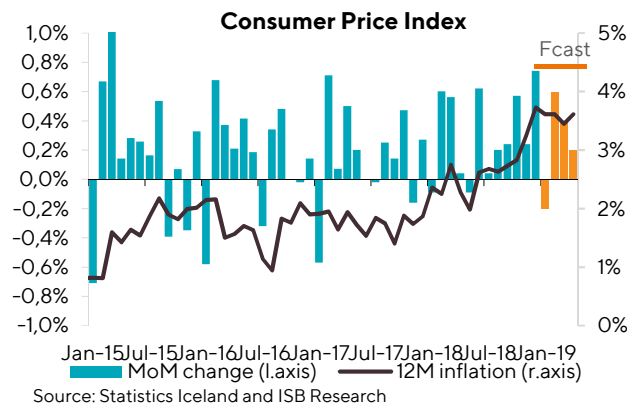
9 January 2019 | Íslandsbanki Research

Summary

- Our forecast: CPI to decline 0.2% in January
- Inflation to fall from 3.7% to 3.6%
- House prices, price list increases, and unit levies push the CPI upwards
- Seasonal sales and airfares pull downwards
- Inflation 3.3% in 2019 and 3.0% in 2020

	1m	3m	6m	12m	24m	
Change in the CPI	-0.2%	0.8%	1.5%	3.3%	6.4%	
Annualised	-2.4%	3.2%	3.1%	3.3%	3.1%	
				2018	2019	2020
Inflation for the year (Dec-Dec)				3.7%	3.3%	3.0%
Average YoY inflation				2.7%	3.6%	3.2%
YoY wage rise				6.3%	6.0%	4.5%
Imputed rent (owner-occupied housing costs), YoY rise				6.5%	4.9%	4.5%
Trade-weighted ISK index (TWI) (average)				166.7	175.2	175.0

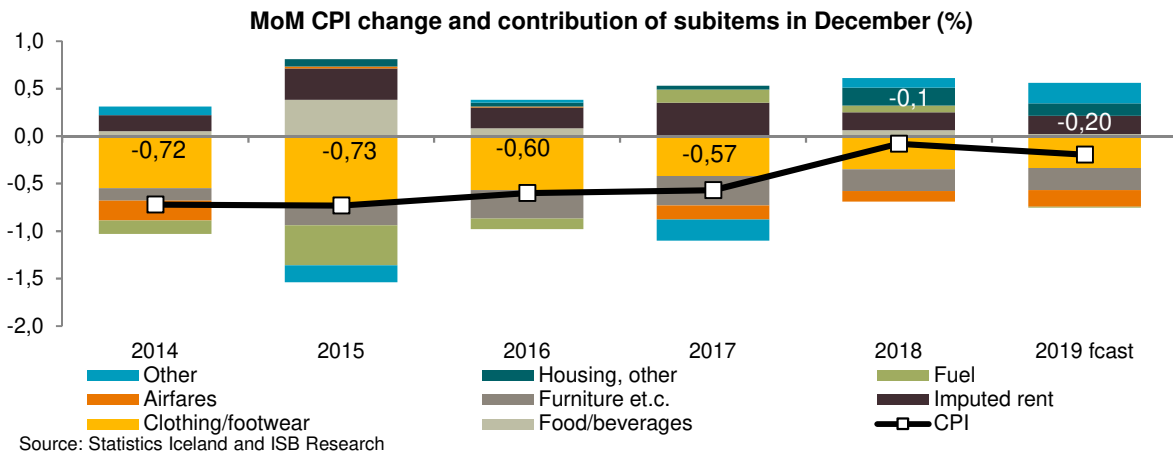
We forecast a 0.2% drop in the CPI in January



We project that the consumer price index (CPI) will fall 0.2% month-on-month in January, lowering headline inflation from 3.7% to 3.6%. The short-term inflation outlook has changed very little since our last forecast. The outlook is for inflation to measure 3.6% at the end of Q1/2019 and average 3.6% in 2019 before falling slightly, to an average of 3.2% in 2020. Statistics Iceland (SI) will publish the January CPI at 9:00 hrs. on 29 January.

Annual tug-of-war between sale effects and price list increases

The January CPI measurement is always affected by the tug-of-war between seasonal sales and falling airfares, on the one hand, and annual rises in prices of public and private services, on the other. We see no reason to expect this to change this year.





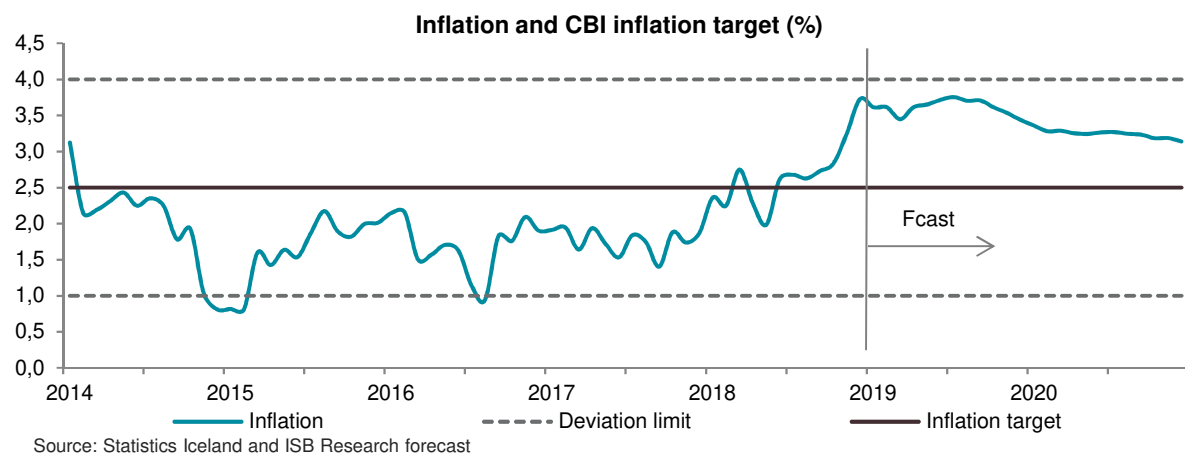
We also expect seasonal sale effects to be about the same as in the past several years. We estimate the clothing component of the CPI to lower the index by about 0.34% and the furniture and housewares component to lower it by 0.23%.

Airfares rose by nearly 24% in December, following the usual seasonal pattern. Our survey indicates that they will fall by 12% in January (-0.18% CPI effect).

The housing market still seems lively, although house price inflation has eased in recent quarters. Our survey indicates that imputed rent – largely a reflection of developments in house prices – will rise by 0.9% during the month (0.19% CPI effect).

Price lists for various public and private services generally rise at the beginning of each year, but this year's increase in utility prices looks set to be relatively modest (0.06% CPI effect). Levies on alcoholic beverages and tobacco will raise the index by 0.05% during the month, and the rise in unit levies on petrol will more or less offset the reduction in the price paid by local distributors, although our measurements suggest that petrol prices have fallen by about 0.3% since the December CPI measurement (-0.01% CPI effect).

And finally, the depreciation of the ISK in the second half of 2018 is still affecting imported goods prices to some extent.



Inflation to subside further ahead

The outlook is for inflation to remain roughly at the current level in the next few months. We expect the CPI to rise by 0.6% in February, 0.4% in March, and 0.2% in April. According to these projections, inflation will measure 3.6% in April 2019. In February and March, the effects of winter sales will subside, with the associated upward pressure on the CPI. Airfares will presumably keep falling in February, as they have in the past few years. Imported inflation due to rising goods prices should also taper off as the summer approaches, provided that the króna does not weaken again. Furthermore, we expect house prices to rise quite a bit more slowly in coming months than is projected in the January forecast.

Thereafter, we expect inflation to pick up over the course of 2019, peaking at 3.8% around mid-year, and then taper off steadily. We expect it to measure 3.3% at the end of 2019 and to average 3.2% by the end of 2020. According to this, it will remain just below the 4% upper deviation threshold of the Central Bank's inflation target, although a return to the 2.5% target will apparently take a while.



As before, the upcoming wage settlements are one of the principal uncertainties in the forecast. We expect wages to rise about as much, on average, in 2019 as they did in 2018, although there is a significant risk that rises will be larger or that other terms of public sector contracts could result in greater inflationary pressures further ahead.

In addition, we assume that house price inflation will ease as the forecast horizon progresses and that the ISK exchange rate will hold broadly unchanged at the level seen in recent weeks. In our opinion, the uncertainty about exchange rate developments is largely symmetric, as the exchange rate appears close to its equilibrium, at least in the short run.



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