

# INFLATION FORECAST

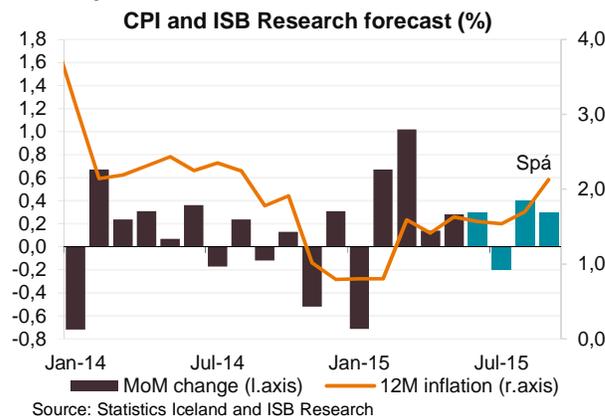
11 June 2015 | Íslandsbanki Research

## Summary

- We forecast a 0.3% rise in the CPI in June
- Headline inflation will remain unchanged at 1.6%
- Transport, travel and tourism related items explain majority of CPI rise in June
- CPI to rise 0.5% in Q3/2015
- Inflation 3.1% over the course of 2015
- Inflation 3.7% over the course of 2016

	1m	3m	6m	12m	24m
Change in the CPI	0.3%	0.5%	1.3%	3.3%	7.0%
Annualised	3.7%	2.0%	2.6%	3.3%	3.5%
			2014	2015	2016
Inflation for the year (Dec-Dec)			0.8%	3.1%	3.7%
Inflation between years			2.0%	1.8%	3.5%
Wage change for the year			6.7%	8.4%	7.5%
Cost of own housing over the year			5.9%	9.2%	6.4%
Trade-weighted exchange rate index (TWI) (yearly average)			206.9	207.0	207.0

## We expect the CPI to rise 0.3% in June

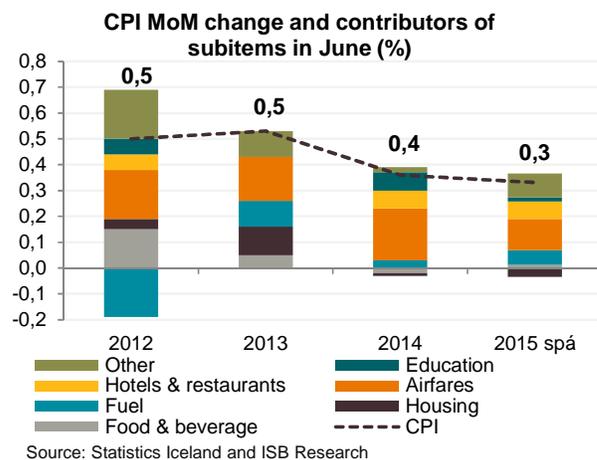


We expect the consumer price index (CPI) to rise by 0.3% month-on-month in June. If this forecast materialises, inflation will be unchanged at 1.6% and will therefore remain well below the Central Bank of Iceland's (CBI) 2.5% inflation target.

The medium-term inflation outlook is broadly unchanged from our last forecast. We expect inflation to be below the inflation target for most of 2015 but to rise above it in the fourth quarter of the year. The outlook is

for inflation to rise thereafter but remain just below 4%, the upper deviation threshold of the target, in coming years. Statistics Iceland (SI) is scheduled to publish the June CPI at 9:00 hrs. on 26 June.

## Travel-related components account for most of the rise in the CPI



CPI components related to travel and transport will be the main drivers of the rise in the index in June, the beginning of the peak tourist season. For example, our survey indicates that international airfares will rise 9% MoM (0.12% CPI effect). We also expect hotel and restaurant prices to rise 1.3% during the month (0.07% CPI effect), including a 9% increase in accommodation prices (0.04% CPI effect). Petrol prices are up somewhat since SI's last measurement – gasoline in particular, as diesel fuel has increased only slightly in price. We expect a

1.5% increase in this component in June (0.06% CPI effect).

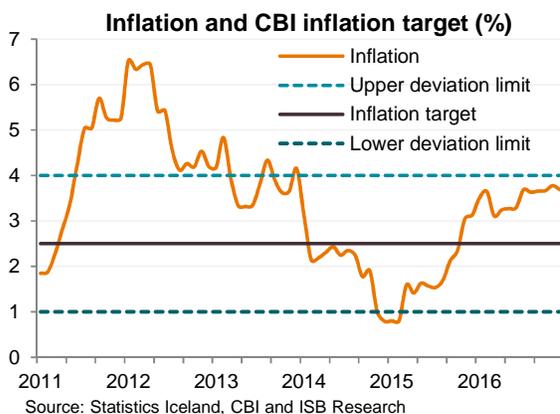
On the other hand, it appears likely that imputed rent, which largely reflects the market price of housing, will decline about 0.4% in June (-0.06% CPI effect). This is subject to some uncertainty, however, as the lawyers' strike in the capital area is still in full swing and no real estate purchase agreements have been registered in the greater Reykjavík area since Easter. That said, we do not expect SI to depart from its customary methodology in the face of a scarcity of data, and the survey we conducted using that methodology yields the above-mentioned results.

There could be some fluctuation in various food and beverage items, although we expect the component as a whole to remain broadly unchanged. The strike among BHM union members will probably have some effect as well, as the supply of various meat products has been limited of late, which increases the likelihood of rising prices for those products that can be had. Furthermore, fruit prices are likely to rise markedly, although vegetable prices could conceivably fall somewhat, after the steep increase in the past two months.

### Inflation to gain pace as time passes

We think it likely that inflation will accelerate as the year progresses, partly because the period of price stagnation in H2/2015 will drop out of twelve-month CPI measurements. That stagnation was due largely to favourable developments in petrol prices, changes in taxes and levies on consumer

goods, and modest domestic cost pressures in the wake of moderate wage settlements early in 2014.



The outlook for the next few months has improved slightly, however. We forecast a 0.2% decline in the CPI in July, a 0.4% rise in August, and a 0.3% rise in September. Summer sales will be a major driver of the decline in July and the subsequent increase in August. If our forecast materialises, the CPI will rise by 0.5% in Q3, bringing headline inflation to 2.1% at the end of the quarter.

We then expect inflation to rise above the CBI's inflation target in Q4/2015 and to measure 3.1% at the year-end. It will pick up still further in 2016, rising to 3.7% by the end of the year. According to the forecast, inflation will be just below the upper deviation limit of the inflation target for the majority of the year and will not need much of a push to rise above it.

Our assumptions concerning medium-term developments in wages, house prices, and the ISK exchange rate are unchanged from our last forecast. The rising inflation in the forecast is due largely to much more rapid wage increases than can be considered consistent with price stability; indeed, most indicators imply that this will indeed be the outcome. We also expect house prices to continue rising in real terms, thereby pushing inflation upwards. Finally, we assume that the ISK will remain stable at its current level, as it has been for nearly a year and a half, owing to the CBI's firm

management. However, given that a period of gradual liberalisation of capital controls lies ahead, greater exchange rate volatility can be expected in coming quarters; however, we consider the uncertainty about exchange rate developments to be roughly symmetrical.

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