INFLATION FORECAST

9 July 2015 | Íslandsbanki Research

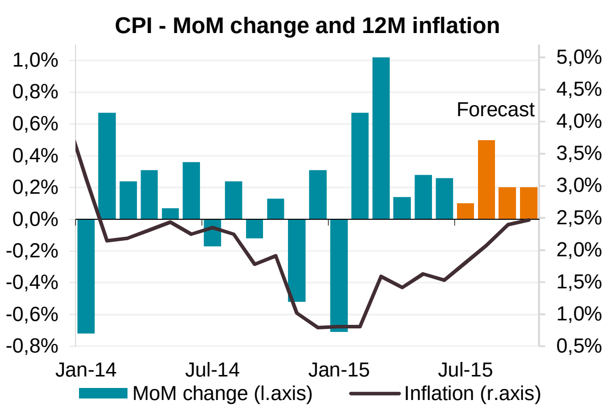
Summary

- We forecast a 0.1% rise in the CPI in July
- Headline inflation will rise to 1.8%
- Chief drivers in July are housing and airfares
- Summer sales have a downward effect
- CPI to rise 0.8% in Q3/2015
- Inflation 3.3% in 2015 and 3.7% in 2016

	1m	3m	6m	12m	24m
Change in the CPI	0.1%	0.8%	1.6%	3.5%	7.2%
Annualised	1.2%	3.2%	3.2%	3.5%	3.5%
			2014	2015	2016
Inflation for the year (Dec-Dec)			0.8%	3.3%	3.7%
Inflation between years			2.0%	1.9%	3.6%
Wage change for the year			6.7%	8.6%	7.5%
Cost of own housing over the year			5.9%	8.5%	6.4%
Trade-weighted exchange rate index (TWI) (yearly average)			206.9	206.5	207.0

We expect the CPI to rise 0.1% in July

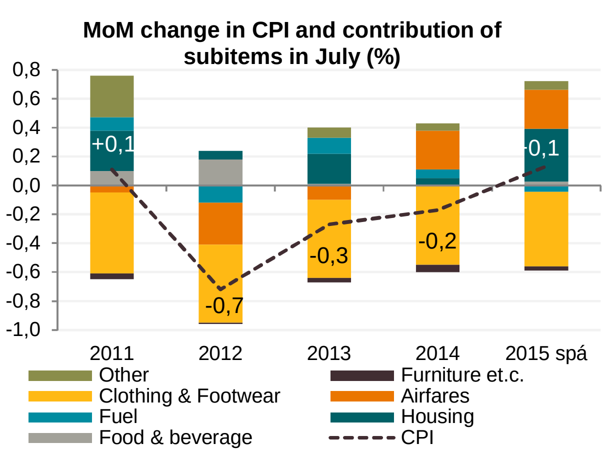
We expect the consumer price index (CPI) to rise by 0.1% month-on-month in July. If this forecast materialises, inflation will rise from 1.5% to 1.8%, thereby remaining somewhat below the Central Bank's (CBI) inflation target.



Source: Statistics Iceland and ISB Research

In our opinion, the medium-term inflation forecast has deteriorated marginally since our last forecast. We expect inflation to be below the inflation target through Q3 but to rise above it in the fourth quarter of the year. The outlook is for it to rise thereafter but remain just below 4%, the upper deviation threshold of the target, in coming years. Statistics Iceland (SI) will publish the July CPI at 9:00 hrs. on 23 July.

Housing and airfares the main drivers of inflation



Source: Statistics Iceland and ISB Research

Two factors weigh heaviest in this month's rise in the CPI – and it is indeed these factors that have changed most in comparison with our preliminary forecast: the housing component of the CPI, on the one hand, and airfares, on the other. We estimate that the housing component will rise by 1.3% MoM (0.36% CPI effect). A major factor in this is imputed rent, which we project to increase by 1.7% (0.25% CPI effect). There are signs that the house purchase agreements finalised in April and registered in the past few weeks were for much higher per-square-metre prices than older agreements. Furthermore, we expect a 2.0% rise in utilities costs (0.07% CPI effect) and a 0.5% rise in paid rent (0.03% CPI effect).

Our price survey suggests that international airfares rose by over a fifth MoM. Domestic airfares could possibly decline somewhat, however, after steep increases in the recent term. On the whole, we forecast a 17% increase in airfares (0.27% CPI effect). Among other items with an upward effect on the CPI in July are telephone services (0.03% CPI effect) and food and beverages (0.03% CPI effect).

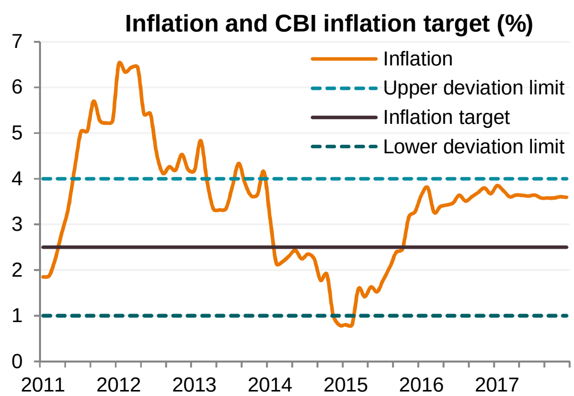
Sales effects and petrol prices push the CPI downwards

As usual, we expect summer sales to have a downward impact on the CPI in July. We estimate the CPI effect from this year's summer sales at -0.55%. The greatest impact is due to an 11.5% decline in clothing and footwear prices (-0.52% CPI effect), followed by sales of furniture and housewares, which lower the index by 0.03% in our forecast. Furthermore, petrol prices have fallen by about 1.1% (-0.04% CPI effect) in the wake of global declines.

Days grow shorter, inflation rises

We expect inflation to rise as the autumn progresses and the short days of winter take hold, partly because the period of price stagnation in H2/2015 will drop out of twelve-month CPI measurements. That stagnation was due for the most part 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.

On the other hand, inflationary pressures are mounting in the domestic economy, owing to rapid wage increases, permanent rises in real house prices, and a widening output gap, among other things. In our opinion, these factors will affect inflation measurements in the coming term, pushing headline inflation well above the 2.5% inflation target in the next few years.



Source: Statistics Iceland, CBI and ISB Research

We forecast that the CPI will rise by 0.5% in August, 0.2% in September, and another 0.2% in October. Based on these assumptions, the CPI will rise by 0.8% in Q3, and twelve-month inflation will have risen to target by October.

We expect twelve-month inflation to rise above target thereafter, to 3.3% by end-2015. It will pick up still further in 2016, rising to 3.7% by the end of that 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 case in the coming term. 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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