INFLATION FORECAST

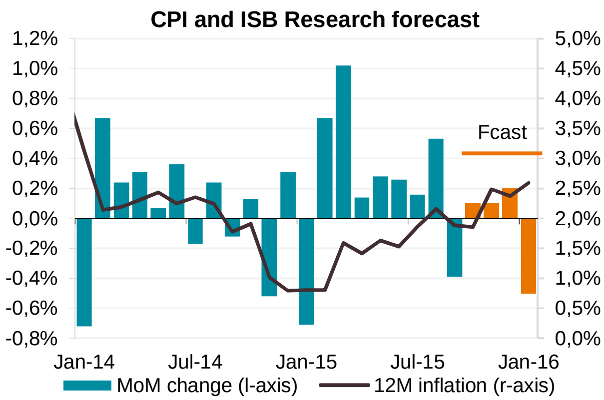
19 October 2015 | Íslandsbanki Research

Summary

- CPI to rise 0.1% in October
- Headline inflation unchanged at 1.9%
- Chief drivers are housing and airfares
- Petrol, food, and accommodation pull the CPI downwards
- 0.4% rise in the CPI through end-2015
- Inflation 2.4% in 2015 and 3.4% in 2016

	1m	3m	6m	12m	24m
Change in the CPI	0.1%	0.4%	1.0%	3.0%	6.7%
Annualised	1.2%	1.6%	2.1%	3.0%	3.3%
			2015	2016	2017
Inflation for the year (Dec-Dec)			2.4%	3.4%	3.6%
Inflation between years			1.7%	2.7%	3.6%
Wage change for the year			8.0%	7.4%	6.0%
Cost of own housing over the year			8.7%	8.3%	6.9%
Trade-weighted exchange rate index (TWI) (yearly average)			201.1	192.6	192.6

CPI projected to rise 0.1% in October



Source: Statistics Iceland and ISB Research

We expect the consumer price index (CPI) to rise by 0.1% month-on-month in October. If this forecast materialises, inflation will hold steady at 1.9%, remaining below the Central Bank's (CBI) 2.5% inflation target.

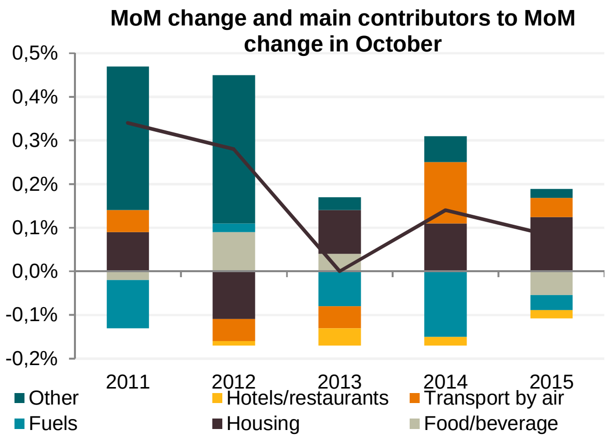
The medium-term inflation outlook has improved marginally since our last forecast, in part because of the appreciation of the ISK and our revised projection of wage developments in the latter half of the forecast horizon. We expect inflation to be just below the CBI's inflation target at the end of the year and then begin to rise afterwards. According to our forecast, it will be just above the inflation target, on average, in 2016 and just below the upper deviation limit in 2017. Statistics Iceland (SI) is scheduled to publish the October CPI at 9:00 hrs. on 29 October.

No big news in October CPI measurement?

A number of factors indicate that the October CPI measurement will be more or less bereft of exciting news. Broadly speaking, the outlook is for domestic items to push the index upwards and imported items to push it downwards. According to our forecast, chief among the items pushing upwards is the housing component, which we project to rise by over 0.4% month-on-month (0.12% CPI effect). This is due for the most part to a 0.7% increase in imputed rent (0.10% CPI effect), based on our survey of developments in market prices.

Furthermore, we expect a 3.5% rise in international airfares, with an upward impact of 0.04% on the October CPI. Other components will have a combined upward impact of 0.02%, according to our forecast.

Petrol, food, and accommodation pull the CPI downwards



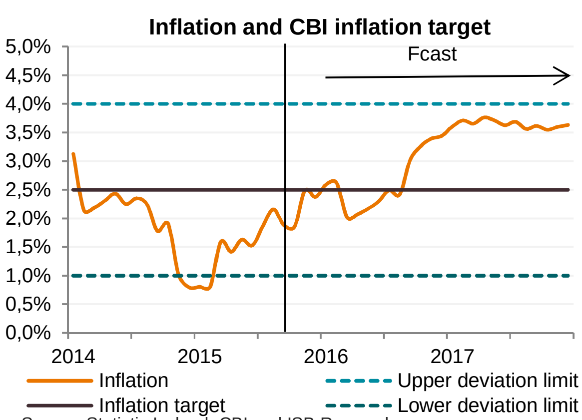
Source: Statistic Iceland and ISB Research

We expect a number of CPI subcomponents to pull the index downwards in October. Most of them are connected to the pass-through of the recent ISK appreciation to import prices, the most important being the 0.4% decline in food and beverage prices (-0.05% CPI effect). The Bónus supermarket chain has recently advertised a price reduction for various product categories, and we expect this (together with competitors' responses to both the ISK appreciation and this move by Bónus) to be the main driver of the above-mentioned decline.

Petrol prices have fallen since SI published the September CPI, and our survey suggests that a total decline of just over 1% (-0.03 CPI effect). In addition, we expect a 5% drop in hotel and guesthouse accommodation in October (-0.02% CPI effect), owing to seasonal effects.

Inflation at target by year-end

We expect inflation to rise slightly as the year-end draws near and the short days of winter set in, mainly because the 0.5% drop in the CPI in November 2014 will drop out of twelve-month inflation measurements. Furthermore, the tug-of-war between domestic cost pressures and the imported stagnation or deflation caused by the ISK appreciation and low foreign inflation looks set to continue.



Source: Statistic Iceland, CBI and ISB Research

We expect a 0.1% rise in the index in November, followed by an increase of 0.2% in December. According to this forecast, inflation will measure 2.4% at the end of the year. Our forecast assumes that the planned cancellation of import duties on clothing and footwear at the beginning of 2016 will affect prices in coming months, prompting retailers to cut prices before the year-end. Developments could mirror those in the retail electronics subsector last year, when retailers jumped the gun on the year-end excise tax reduction by lowering prices in advance. As yet, however, there are no signs of such anticipatory price cuts.

Domestic inflationary pressures are relatively strong at present. A chief cause of this is the hefty pay increases landed by a large segment of the labour market in the recent wage negotiations, although the rise in real house prices and the growing tension in many parts of the economy make an impact as well. These factors will tend to push inflation upwards. Pushing in the other direction, however, is the marked appreciation of the króna in the recent term, coupled with limited imported inflationary pressures. We expect inflation to gain pace steadily throughout 2016, rising to 3.4% by the end of that year and to 3.6% in 2017. According to this forecast, inflation will be just below the upper deviation limit of the CBI's inflation target in the latter half of the forecast horizon.

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