INFLATION FORECAST

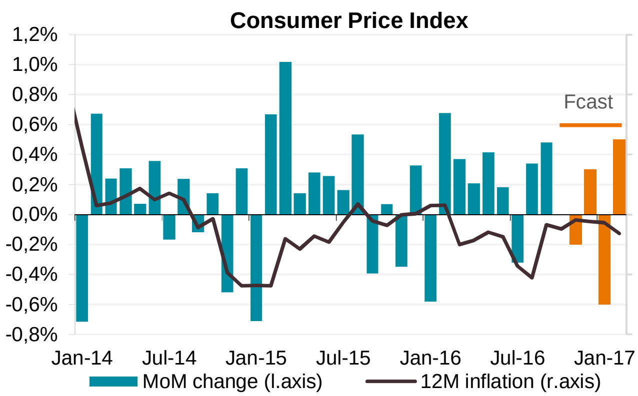
14 November 2016 Íslandsbanki Research

Summary

- We forecast a 0.2% decline in the CPI in November
- Headline inflation will rise from 1.8% to 1.9%
- Housing will push the CPI upwards
- Food, clothing, and airfares will pull downwards
- Inflation 1.9% at year-end 2016
- Inflation 1.7% in 2017 and 3.7% in 2018

	1m	3m	6m	12m	24m
Change in the CPI	-0.2%	-0.5%	0.3%	1.3%	4.8%
Annualised	-2.4%	-2.0%	0.6%	1.3%	2.4%
			2016	2017	2018
Inflation for the year (Dec-Dec)			1.9%	1.7%	3.7%
Inflation between years			1.7%	1.5%	3.0%
Wage change for the year			10.1%	6.5%	5.0%
Cost of own housing over the year			13.0%	7.5%	5.5%
Trade-weighted exchange rate index (TWI) (yearly average)			180.2	159.8	161.1

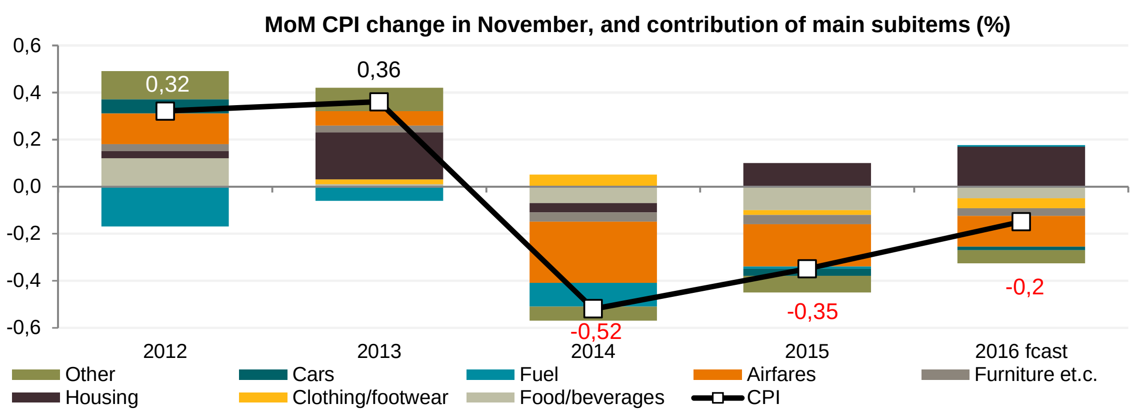
We forecast a 0.2% decline in the CPI in November



Source: Statistics Iceland and ISB Research

We project that the consumer price index (CPI) will fall by 0.2% month-on-month in November, raising twelve-month inflation from 1.8% to 1.9% if our forecast materialises.

In our opinion, the medium-term inflation outlook is broadly unchanged since our last forecast. As before, it appears that inflation will remain below the CBI's 2.5% target until end-2017. However, it will rise briskly thereafter and hover around 4.0%, the upper deviation threshold, in the latter half of 2018. Statistics Iceland (SI) is scheduled to publish the October CPI at 9:00 hrs. on 25 November.



Source: Statistics Iceland and ISB Research

Housing component the main driver of inflation

As in the recent past, we expect imputed rent, which mainly reflects developments in house prices, to be the principal driver of the rise in the CPI in November. Our survey indicates that it will rise by about 1.0% in November (0.16% CPI effect) and that the housing component as a whole will have a CPI effect of 1.17%. The housing component is the most important driver of inflation at present; in fact, twelve-month inflation in terms of the CPI excluding housing measured -0.5% in October. Furthermore, housing is the only component that has a strong upward impact on the CPI this month, although other components have a reasonably strong combined effect.

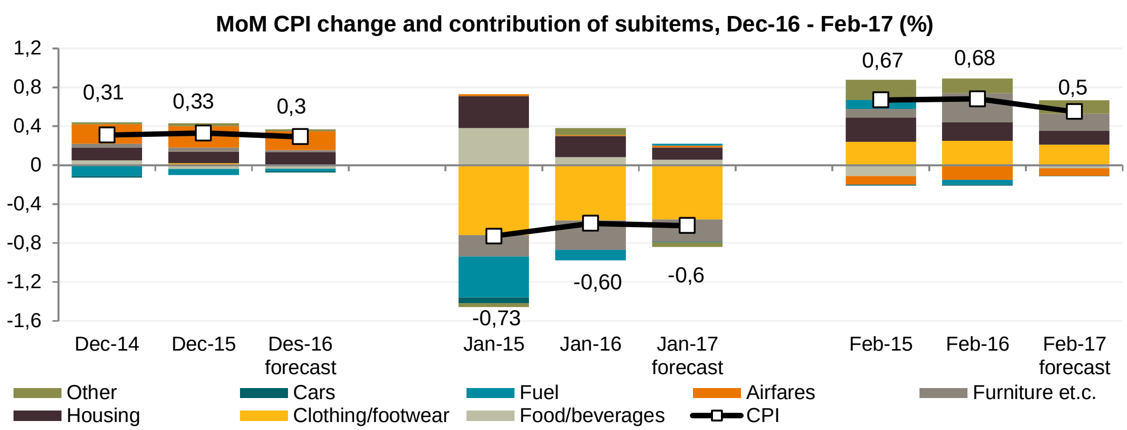
Food, clothing, airfares, and housewares pull the CPI downwards

Offsetting the above-mentioned upward effects are reductions in various CPI subcomponents in which the appreciation of the ISK plays a major role, as the currency has strengthened by about 12% in trade-weighted terms since mid-year. In addition to this are some seasonal effects. Both of these factors show in the decline in airfares, which is one of the main downward-pulling CPI components this month (CPI effect -0.13%).

The ISK appreciation is the main determinant of the reduction we expect to see in the price of food and beverages (-0.05% CPI effect), clothing and footwear (-0.04% CPI effect), and furniture and housewares (-0.03% CPI effect) in November. We also expect a continued decline in telephone services (-0.02% CPI effect), owing to stiff competition in that market. Other items carry less weight, lowering the CPI by a combined 0.05% in November.

Inflation broadly unchanged in coming months

The outlook is for inflation to remain broadly at current levels in the next few months. We expect the CPI to rise by 0.3% in December, fall by 0.6% in January, and rise again in February, by 0.5%. According to these projections, inflation will measure 1.9% at the end of the year and 1.7% in February 2017.

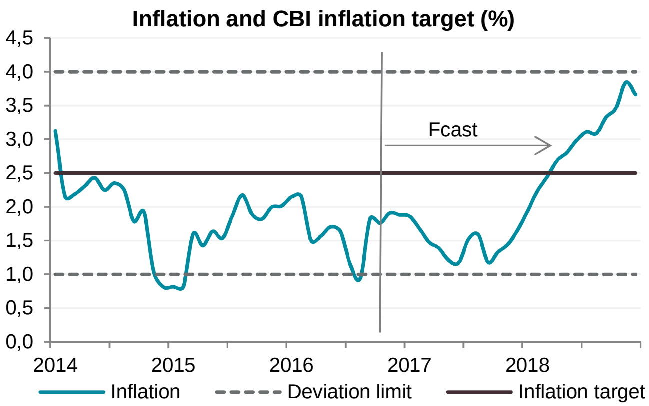


Source: Statistic Iceland and ISB Research

On average, the housing component will be the main driver of the rise in the CPI over the period, contributing about 0.13% per month. In December, airfares will push strongly upwards, following the usual seasonal pattern. Then, in January, strong seasonal sale effects will kick in, as will the planned cancellation of customs duties on various imported goods and the expected reduction in utility company OR’s fees for electricity transmission and cold water. We expect food prices to fall somewhat early next year, as they have in recent years. Price list increases, which often affect the CPI in January, look set to have a modest impact this time round. In February, seasonal sale effects will reverse in part and food prices will rise again, according to our forecast.

Inflation below target throughout 2017

The outlook is for domestic inflation to remain moderate, as long as the ISK does not lose ground. We expect inflation to average 1.6% in 2017 and to measure 1.7% by the end of that year. We project that it will pick up thereafter, overtaking the Central Bank's (CBI) 2.5% inflation target in Q2/2018 and hovering near 4.0%, the upper deviation threshold of the target, in the fourth quarter of the year.



Source: Statistics Iceland and ISB Research forecast

The ISK exchange rate is the main determinant of the medium-term inflation developments provided for in this forecast. We assume that the ISK will continue to strengthen through Q3/2017, by almost 5% from the current level. We then expect it to weaken again, as the real exchange rate will be quite high, GDP growth and demand pressures will start to ease, and trade-related foreign currency inflows will begin to abate, cutting into the current account surplus. A weaker currency will bring higher inflation, although the outlook for more moderate rises in wage costs and house prices in the latter half of the forecast horizon will cushion the impact.

On the other hand, there is significantly more uncertainty than before about near-term developments in wages, given the growing unrest in the labour market, and we have adjusted the wage assumptions in our inflation forecast upwards as a result. We now expect wages to rise by 6.5% over 2017 and about 5.0% in 2018. We also expect house prices to rise 7.5% next year and 5.5% in 2018.

As we see it, there are various uncertainties about these drivers. As regards the ISK exchange rate, we consider the short-term uncertainty to be concentrated on the upside. Offsetting this, uncertainty relating to wage costs and house prices is also on the upside, as we think it likely that both will rise more rather than less in the coming term.

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