INFLATION FORECAST

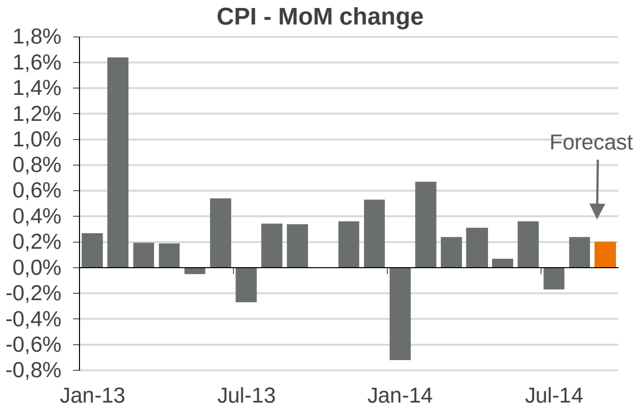
12 September 2014 | Íslandsbanki Research

Summary

- We project a 0.2% rise in the CPI in September
- Headline inflation will fall from 2.2% to 2.1%
- End-of-sale effects and house prices exert upward pressure
- Travel and transport component push the CPI downwards
- We forecast inflation at 1.9% for 2014 as a whole
- We forecast inflation at 2.9% for 2015 as a whole

	1m	3m	6m	12m	24m
Change in the CPI	0.2%	0.6%	1.2%	2.8%	5.9%
Annualised	2.4%	2.4%	2.5%	2.8%	2.9%
			2013	2014	2015
Inflation for the year (Dec-Dec)			4.2%	1.9%	2.9%
Inflation between years			3.9%	2.3%	2.7%
Wage change for the year			6.0%	5.7%	6.0%
Cost of own housing over the year			7.6%	5.8%	5.7%
Trade-weighted exchange rate index (TWI) (yearly average)			218.9	206.9	207.0

CPI to rise 0.2% in September



Source: Statistics Iceland and ISB Research

We project that the consumer price index (CPI) will rise by 0.2% in September, lowering twelve-month inflation from 2.2% to 2.1%.

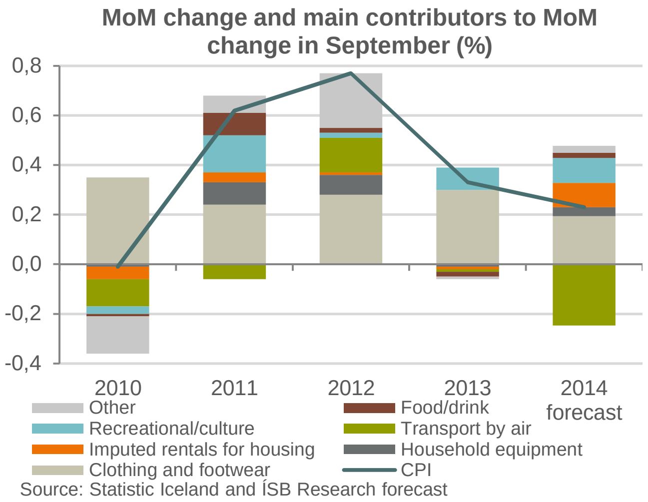
As before, the inflation outlook for this year is good – and actually somewhat improved. We expect inflation to remain below the Central Bank's inflation target through the year-end and then rise thereafter, as the economy gains traction, yet remain modest by Icelandic standards. Statistics Iceland (SI) will publish the CPI for the month at 9:00 hrs. on Thursday 25 September.

End-of-sale effects and house prices push the CPI upwards ...

As usual, end-of-sale effects will exert considerable upward pressure on the CPI in September. Clothing prices rose somewhat more than usual in August, and we expect end-of-sale effects to be less pronounced in September as a result. Overall, we project that end-of-sale effects will raise the CPI by 0.25%, with clothing and footwear accounting for 0.2%.

Furthermore, we estimate that the housing component will raise the index by 0.14% in September. Market indicators imply that the month-on-month rise in imputed rent will be similar to the 0.6% measured in August. We estimate that the annual increases in fees for athletic and recreational activities and entertainment will push the CPI up by 0.07%.

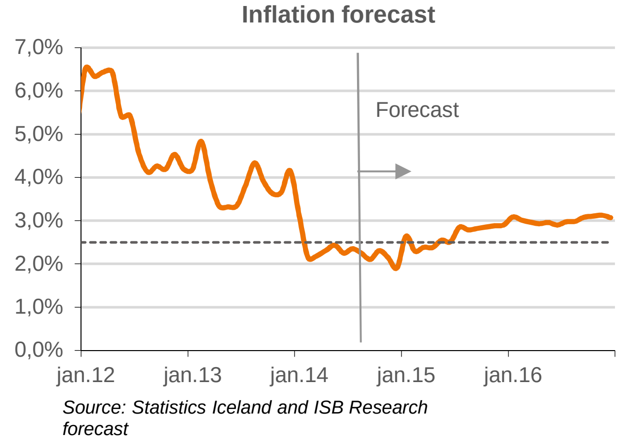
...while travel component pulls it downwards



On the other hand, the travel and transport component of the CPI will decline markedly in September (-0.26% CPI effect) for the second consecutive month. Reduced airfares are the predominant factor here (-0.25% CPI effect), with our survey indicating a significant MoM decline in international airfares. We also expect a decline in the price of petrol, new motor vehicles, and bicycles (combined -0.04% CPI effect). Other components will have a lesser impact, raising the CPI only marginally, according to our forecast.

Inflation below target throughout the year

We expect the CPI to rise by a total of 0.7%% in Q4: 0.2% in October, another 0.2% in November, and 0.3% in December. According to this forecast, inflation will measure 1.9% at the end of the year. This lack of short-term inflationary pressures is due to a number of factors, including extremely low imported inflation, as the ISK is stable and foreign prices of various goods – food and petrol among them – have fallen rather than rising in the recent term. Furthermore, wage pressures remain relatively modest, probably because the moderate nominal pay increases negotiated in the early 2014 wage settlements are generating reduced inflationary pressure.



For next year, we project somewhat higher inflation than in 2014. Presumably, increased economic activity will be reflected in swifter pay rises and continued increases in real house prices. We project inflation to average 2.7% in 2015 and 3.1% in 2016.

Our long-term forecast is based on several assumptions: that house prices will rise by 5-7% per year throughout the forecast horizon, that wage hikes will gain pace in the near future as tension grows in the labour market, and that the ISK exchange rate will remain broadly unchanged.

Authors

Ásta Björk Sigurðardóttir +354 440 4636
Jón Bjarki Bentsson +354 440 4634
Head of Research: Ingólfur Bender +354 440 4635
research@islandsbanki.is
http://www.islandsbanki.is/English/

LEGAL DISCLAIMER

This report is compiled by Islandsbanki Research of Islandsbanki hf.

The information in this report originates in domestic and international information and news networks that are deemed reliable, along with public information, and Islandsbanki Research's own processing and estimates at each time. The information has not been independently verified by Islandsbanki which therefore does not guarantee that the information is comprehensive and accurate. The views of the authors can change without notice and Islandsbanki holds no obligation to update, modify or amend this publication if assumptions change.

This publication is only published for informational purposes and shall therefore not be viewed as recommendation/advice to make or not make a particular investment or an offer to buy, sell or subscribe to specific financial instruments. Islandsbanki and its employees are not responsible for transactions that may be carried out based on information put forth in the report. Before making an investment decision, recipients are urged to seek expert advice and get well acquainted with the investments market and different investment alternatives. There are always financial risks related to investment activities, including risk due to international investments and fluctuations in the exchange rate of currencies. Investors' investment objectives and financial position vary. Past performance does not indicate nor guarantee future performance of an investment.

The research report and other information received from Islandsbanki are meant for private use only. The materials may not be copied, quote or distributed, in part or in whole, without written permission from Islandsbanki.

This report is a short compilation and should not be considered to contain all available information on the subject it discusses.
Supervisory body:
The Financial Supervisory Authority of Iceland (www.fme.is).

UNITED STATES
This report or copies of it must not be distributed in the United States or to recipients who are citizens of the United States against restrictions stated in the United States legislation. Distributing the report in the United States might be seen as a breach of these laws.

CANADA
The information provided in this publication is not intended to be distributed or circulated in any manner in Canada and therefore should not be construed as any kind of financial recommendation or advice provided within the meaning of Canadian securities laws.

OTHER COUNTRIES
Laws and regulations of other countries may also restrict the distribution of this report.
Further information regarding material from Islandsbanki Research can be accessed on the following website: http://www.islandsbanki.is.