

INFLATION FORECAST

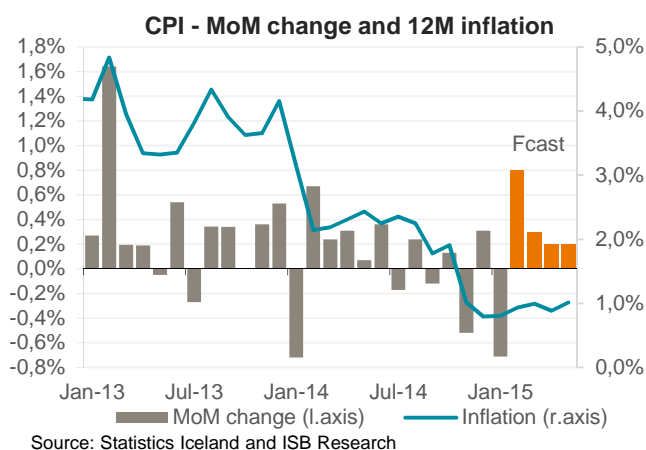
12 February 2015 | Íslandsbanki Research

Summary

- Our forecast: 0.8% rise in CPI in February
- Headline inflation will rise to 0.9%
- End-of-sale effects explain half of the increase
- Housing and travel components contribute to increase
- Inflation forecast at 2.5% for 2015 as a whole
- Inflation forecast at 2.8% for 2016 as a whole

	1m	3m	6m	12m	24m
Change in the CPI	0.8%	1.3%	2.1	2.8%	6.3%
Annualised	10%	5.3%	4.2%	2.8%	3.1%
			2014	2015	2016
Inflation for the year (Dec-Dec)			0.8%	2.5%	2.8%
Inflation between years			2.0%	1.4%	2.7%
Wage change for the year			6.7%	6.6%	6.0%
Cost of own housing over the year			5.9%	6.6%	4.9%
Trade-weighted exchange rate index (TWI) (yearly average)			206.9	207.1	207.0

CPI to rise 0.8% in February



We project that the consumer price index (CPI) will rise by 0.8% month-on-month in February. If this forecast materialises, twelve-month inflation will rise from 0.8%, its nadir this century, to 0.9%. Inflation remains below the lower deviation limit of the Central Bank's (CBI) inflation target, however, for the third month in a row.

For the short term, inflationary pressures are limited. We expect inflation to remain close to the lower deviation threshold of the

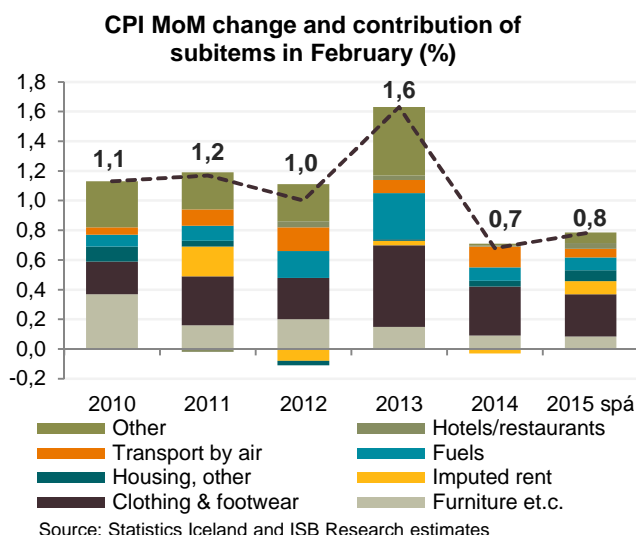
inflation target in the first half of the year and then rise to target by the year-end. We then expect it to rise further as the economy picks up, although it will remain fairly close to target. Statistics Iceland (SI) is scheduled to publish the February CPI at 9:00 hrs. on 26 February.

End-of-sale effects explain half of the increase

As is customary in February, end-of-sale effects have a strong upward impact on the CPI measurement. We expect clothing and footwear prices to rise by nearly 7.0% in February (0.29% CPI effect). End-of-sale effects from all goods categories are estimated to raise the CPI by about 0.4%.

Housing and travel components push the CPI upwards

The housing component of the CPI will raise the CPI by 0.16%, according to our forecast. Three factors are at work here. First of all, our price survey indicates that house prices have risen markedly during the measurement period (0.09% CPI effect). Second, the end of the Government-sponsored "Back to Work" initiative, which provided for a full rebate of value-added tax on home maintenance work, raises the index by 0.05%. And third, we estimate the CPI effect of paid rent at 0.03%.



The travel and transport component of the CPI will raise the index by 0.13% in February, according to our forecast. The increase is due primarily to a 2.5% rise in fuel prices (0.09% CPI effect) and increased international airfares (0.06% CPI effect). Presumably, the increase in fuel prices reflects the recent upturn in global oil prices, putting an end to the virtually uninterrupted slide beginning in mid-2014. This last increase is somewhat surprising, however, as competition has grown and petrol prices have fallen steeply in recent quarters, although the last few weeks

have seen prices climbing.

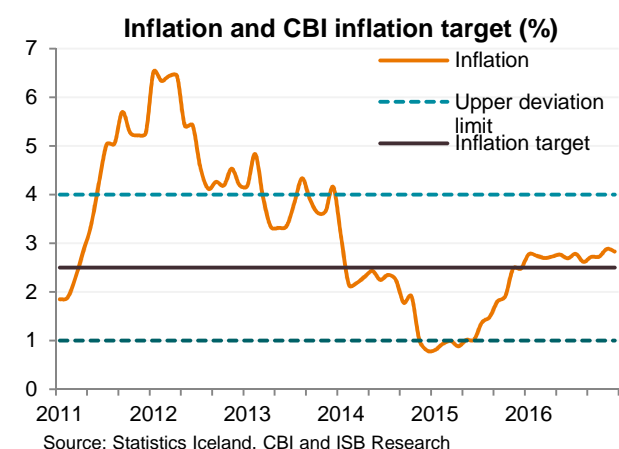
Food and beverage prices stand still

After a 2.6% rise in January, we expect food and beverage prices to remain more or less flat in February. Actually, it is a little surprising that some of the items in this category should be broadly unchanged according to our price survey. One such item is bread: Baked goods producer Myllan announced recently that its prices to retailers had fallen by 1.5-3.2% because of the depreciation of the euro against the ISK. In addition, the cancellation of the sugar tax at the end of 2014 appears to have passed through to prices only partially, although the retail price of sugar itself has fallen dramatically since the beginning of the year.

Inflation to remain low in the near term

We expect the CPI to rise by 0.3% in March, 0.2% in April, and 0.2% in May. According to this, the CPI will rise by 0.4% in Q1, and inflation will average 0.9% for the quarter. End-of-sale effects are usually quite significant in March. In other respects, we anticipate relatively stable prices in coming months — unless domestic costs rise sharply in the wake of forthcoming wage settlements.

Inflation at target by end-2015



We expect inflation to gain pace steadily as 2015 progresses, and align with the CBI's 2.5% inflation target by the year-end. In 2016 we expect the pace to increase yet again, to about 2.8% for the year as a whole. The main drivers of inflation will be relatively rapid wage increases in the near term, continued rises in house prices, and gradually rising imported inflation. Inflation will be close to inflation target at the end of the horizon, however, and if our forecast materialises,

Iceland will see its longest period of low, stable inflation in a decade and a half.

The uncertainty in the forecast is concentrated on the upside, however, for two reasons. First of all, the upcoming wage settlements could generate more rapid rises in nominal wages than we expect, and second, we base our forecast on the assumption that the exchange rate will remain close to its current level, as the ISK has been extremely stable in recent quarters. This could change, however, if steps taken towards lifting the capital controls are accompanied by increased exchange rate volatility and elevated risk of massive foreign exchange outflows, at least temporarily.

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>.