

# INFLATION FORECAST

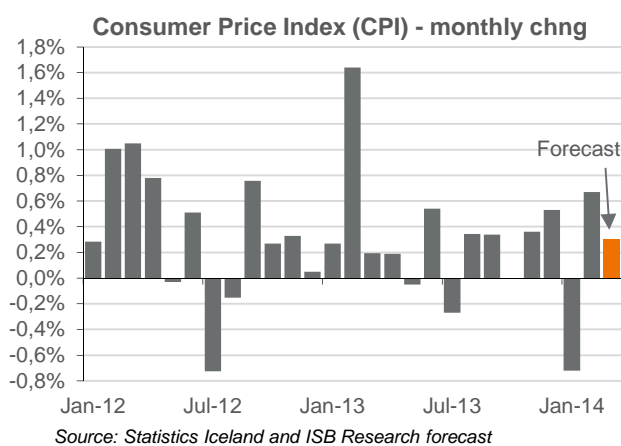
13 March 2014 | Íslandsbanki Research

## Summary

- We forecast a 0.3% rise in the CPI in March
- Inflation will rise from 2.1% to 2.2%
- End-of-sale effects and airfares push inflation upwards
- Housing component rises significantly
- Petrol prices fall
- We forecast 2.5% inflation in Q1/2014
- We forecast inflation at 2.5% at end-2014

	1m	3m	6m	12m	24m
Change in CPI	0.3%	0.8%	1.4%	3.2%	7.0%
Annualised	3.7%	3.2%	2.7%	3.2%	3.5%
	2013	2014	2015		
Inflation for the year (Dec-Dec)	4.2%	2.5%	3.7%		
Inflation between years	3.9%	2.5%	3.5%		
Wage change for the year	6.0%	5.1%	6.0%		
Cost of own housing over the year	7.5%	6.0%	5.6%		
ISK (TWI) (yearly average)	218.9	209.3	216.3		

## OUR FORECAST: CPI to Rise 0.3% in March

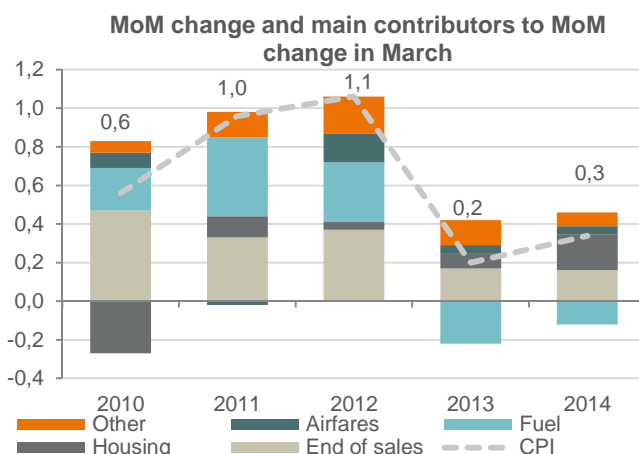


We project that the consumer price index (CPI) will rise by 0.3% month-on-month in March. If the forecast materialises, headline inflation will rise marginally, from 2.1% to 2.2%, as the CPI rose by only 0.2% in March 2013. According to the forecast, inflation will remain just below the Central Bank's (CBI) inflation target.

The prospects for the current year are quite favourable, with inflation set to be near the CBI's 2.5% inflation target at year-end. We

then expect it to begin rising again as economic activity increases, but to settle at a lower level than has prevailed in recent years. Statistics Iceland (SI) is scheduled to publish the March CPI at 9:00 hrs. on 26 March.

## End-of-sale effects and house prices the major contributors to inflation



As is common in March, end-of-sale effects had a considerable upward impact on the CPI. According to our estimate, the conclusion of winter sales will raise the CPI by 0.16%. This is quite modest compared with the same month last year, however, as the ISK has strengthened since end-November and end-of-sale effects were strong in February.

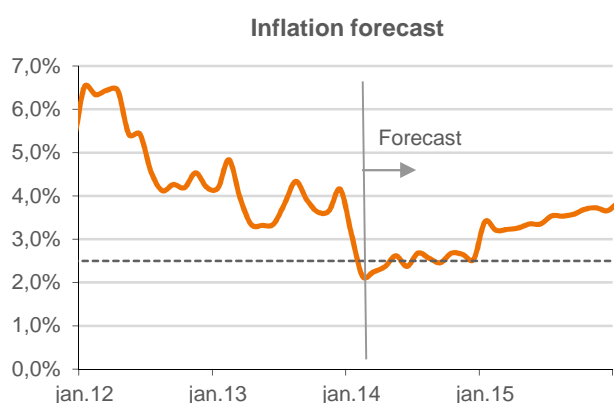
Based on recent market data, we expect the housing component to rise by 0.7% (0.19% CPI effect), driven mainly by a 1.3% increase

in imputed rent, which largely reflects developments in house prices. Furthermore, we expect international airfares to push the CPI upwards by 0.04%.

Offsetting this, however, petrol prices have fallen by over 2% (-0.12% CPI effect) since the last CPI measurement, due to falling global oil prices and the appreciation of the ISK against the US dollar. The appreciation of the ISK has also had a downward effect on a number of other components of the CPI.

### Inflation close to target throughout 2014

The outlook is for modest inflation throughout this year. Most of the private sector wage agreements have been finalised, and the associated cost pressures will be much less pronounced than in recent



Source: Statistics Iceland and ISB Research forecast

years. Furthermore, the recent appreciation of the ISK will make a positive effect on the price of imported goods and inputs for domestic production, although we do not expect the exchange rate to rise above the current level.

We expect the CPI to rise by 0.3% in April, the rise being tempered by the partial rollback of fixed-amount increases in public levies on alcoholic beverages, tobacco and petrol. We expect it to rise by 0.2% in May and 0.3% in June, bringing headline inflation

to 2.6% in June. We forecast that inflation will remain more or less on an even keel for the remainder of the year, measuring 2.5% at the year-end. We expect it to gather pace thereafter, owing to increased economic activity, which will trigger more rapid wage increases and continuing increases in real house prices, and to a slide in the exchange rate later on. We project inflation to average 3.7% over 2015 as a whole and 3.9% in 2016.

The upturn in inflation is not inevitable, however. If we assume that wages will continue to rise roughly at the pace they seem to have set this year, and if the ISK remains stable at the current level, inflation could average 2.9% in 2015 and 3.0% in 2016. Clearly, medium-term developments in inflation will be determined largely by whether efforts to contain steep nominal wage hikes and ISK depreciation are successful.

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