



INFLATION FORECAST

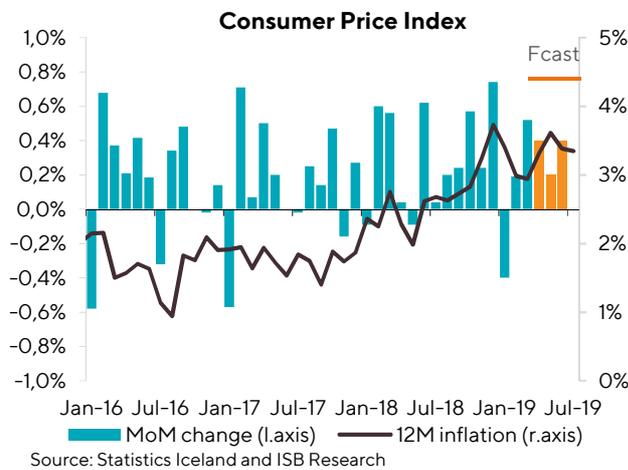
10.4. 2019 | Íslandsbanki Research

Summary

- We forecast a 0.4% rise in the CPI in April
- Headline inflation will rise to 3.3%
- Easter spike in airfares pushes upwards
- Imputed rent pushes downwards
- Inflation outlook has improved somewhat
- Inflation 2.9% in 2019 and 2.8% in 2020

	1m	3m	6m	12m	24m	
Change in the CPI	0.4%	1.0%	1.6%	3.2%	6.2%	
Annualised	4.9	4.1%	3.1%	3.2%	3.0%	
				2018	2019	2020
Inflation at yr-end (Dec-Dec)				3.7%	2.9%	2.8%
Average YoY inflation				2.7%	3.3%	3.1%
Average YoY wage rise				6.0%	5.6%	5.0%
Imputed rent (owner-occupied housing costs), YoY rise				6.5%	2.6%	3.5%
Trade-weighted ISK index (TWI) (yearly average)				166.7	179.6	180.0

We forecast a 0.4% rise in the CPI in April

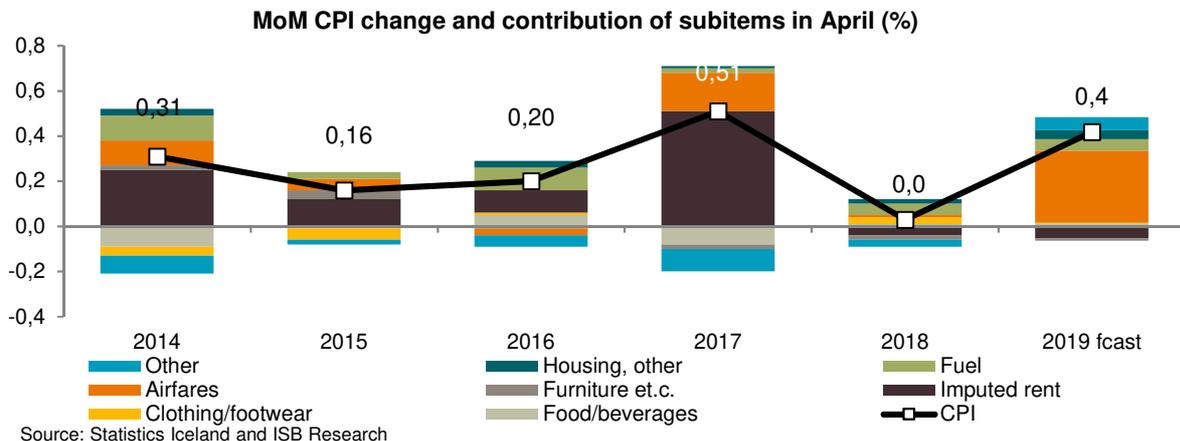


We expect the consumer price index (CPI) to rise by 0.4% month-on-month in April, raising headline inflation to 3.3%, from 2.9% in March. The medium-term inflation outlook has improved somewhat since our last forecast, owing to the prospect of more favourable wage developments in 2019 and a slower rise in house prices than we had previously expected. Inflation looks set to average 3.4% in Q2/2019 and taper off thereafter. We expect it to measure 2.9% at the end of 2019 and 2.8% at the end of 2020. Statistics Iceland (SI) will publish the

April CPI at 9:00 hrs. on 29 April.

Airfares push inflation upwards over Easter

According to our measurements, overseas airfares will be the main driver of the April rise in the CPI. Airfares generally rise in April, owing to the Easter holidays, but in the wake of the collapse of WOW Air, which caused a surge in both demand and ticket prices, airfares can be expected to rise well in excess of the usual seasonal spike. We forecast that the travel and transit component as a whole will raise the CPI by 0.37%. Air travel and transit weigh heaviest, with a

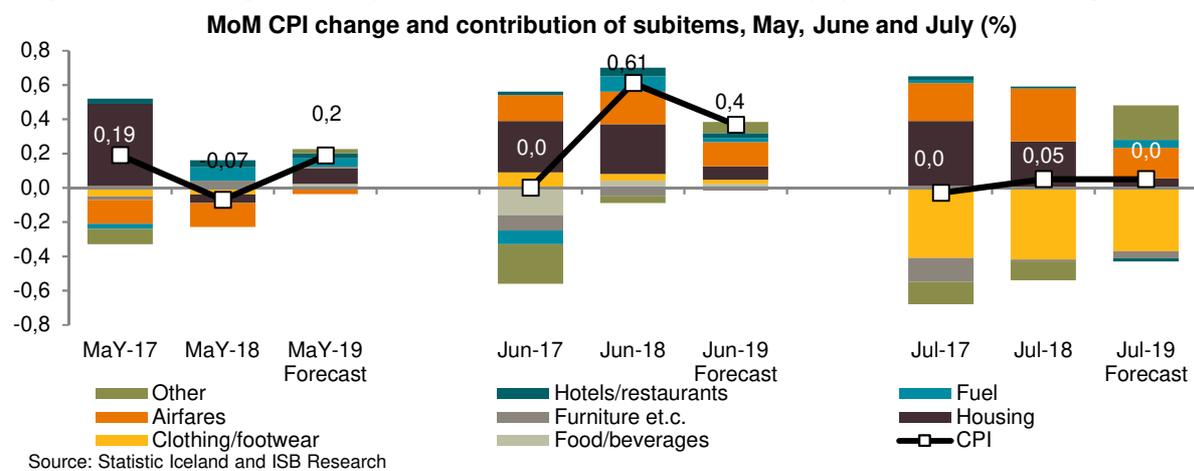




price increase of 25% (0.32% CPI effect), although the MoM rise in fuel prices is a factor as well (0.05% CPI effect).

Apart from airfares, though, price increases overall appear relatively moderate at present. We expect the housing component to remain virtually flat between months. Imputed rent, which is mainly a reflection of house prices, declines by 0.25% (-0.05% CPI effect), while paid rent rises by 0.50% (0.02%). House price inflation has been more modest in 2019 to date than in recent years. The supply of available housing has increased steadily, while demand has eased. This suggests that the residential housing market is reaching some sort of balance – a situation we expect to continue in the coming months.

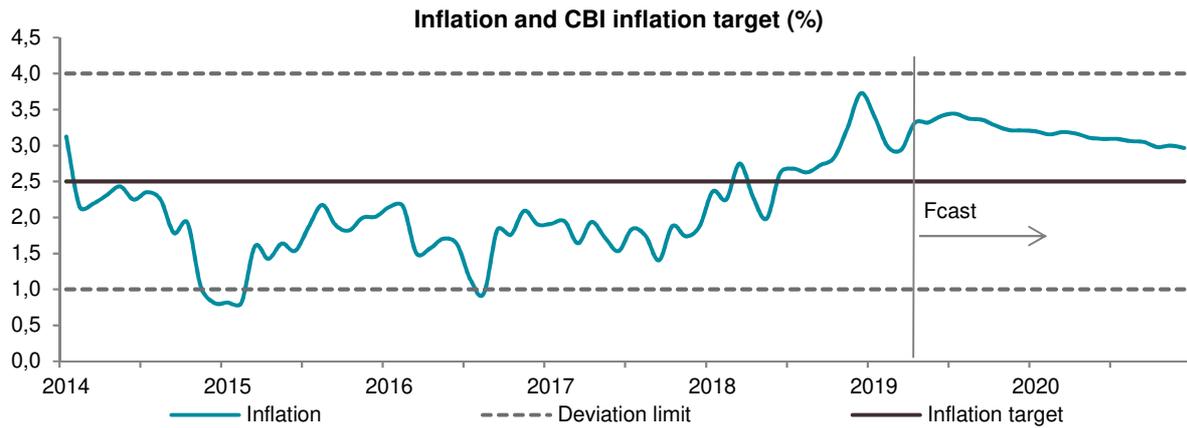
The pass-through from last autumn’s ISK depreciation to imported goods prices appears to be tapering off as well. For instance, we expect relatively little change in food prices in April, and only modest changes in the price of housewares, electronic equipment, and clothing.



Inflation target within reach again?

The outlook is for inflation to remain roughly at the current level in the next few months. We expect the CPI to rise by 0.2% in May and 0.4% in June, and to remain virtually unchanged in July, leaving headline inflation at 3.3% in July. Airfares can be expected to rise strongly as summer takes hold, owing to rising fuel prices, peak season demand, and reduced competition after the fall of WOW. Imported inflation due to rising goods prices should continue to taper off as the summer approaches, assuming that the ISK holds its ground. We also expect house prices to rise at roughly the current pace in coming months.

Thereafter, we expect inflation to ease somewhat in the second half of the year. The wage settlements announced in early April are somewhat more favourable than we had dared hope, as regards year-2019 wage pressures. Although all of the uncertainty in the labour market has not yet been put to rest, we think it appropriate to revise our wage increase assumptions downwards from our last forecast.



In addition, a number of factors suggest that house price inflation will be more modest over the remainder of the year. The economic outlook has clouded over, and both tourist demand for short-term rentals and imported workers' demand for housing will probably be weaker than previously assumed.

We expect inflation to fall to 2.9% by the end of this year and measure 2.8% by end-2020. The Central Bank's inflation target will therefore be within striking distance later this year if our forecast materialises. Actually, the values above can be interpreted as target-level inflation. That said, it is not a given that inflation will develop as we have projected. A drop in the exchange rate and/or an escalation of wage demands in the labour market negotiations that are still pending could complicate matters, and there is still much that is unknown about the housing measures and other provisions agreed upon in connection with the early April wage settlements.

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