INFLATION FORECAST

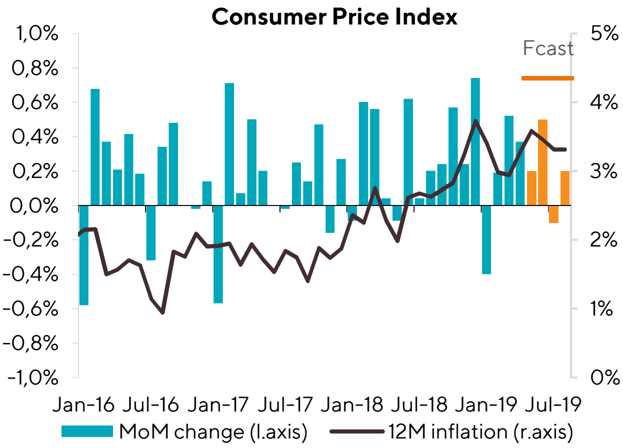
15.5. 2019 | Íslandsbanki Research

Summary

- We forecast a 0.2% rise in the CPI in May
- Headline inflation will rise to 3.6%
- Petrol, food, housewares among upward-pushing items
- Marginal rise in imputed rent
- Airfares fall somewhat
- Slight improvement in inflation outlook
- Inflation 2.8% in 2019 and 2.7% in 2020

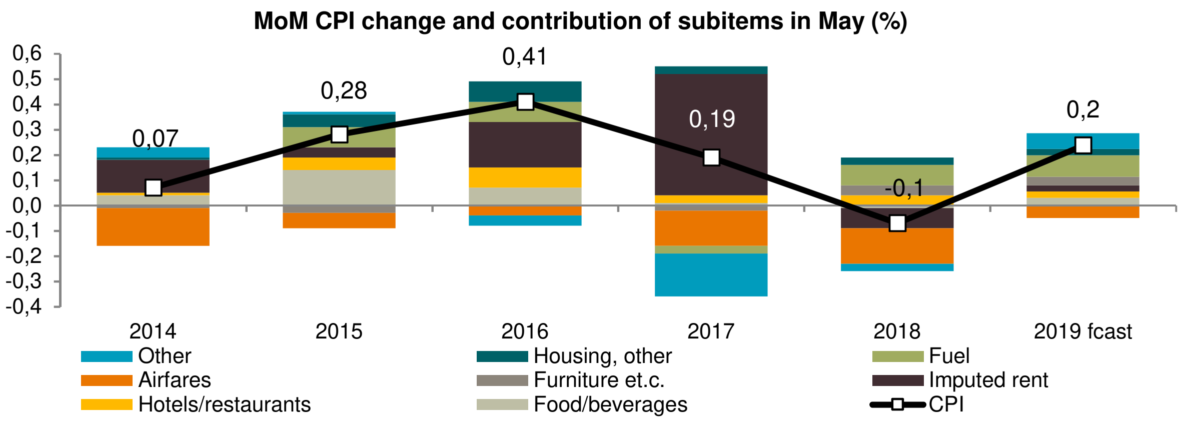
	1m	3m	6m	12m	24m
Change in the CPI	0.2%	0.6%	1.5%	2.8%	5.9%
Annualised	2.4%	2.4%	2.9%	2.8%	2.9%
			2018	2019	2020
Inflation at yr-end (Dec-Dec)			3.7%	2.8%	2.7%
Average YoY inflation			2.7%	3.2%	2.9%
Average YoY wage rise			6.0%	5.2%	5.4%
Imputed rent (owner-occupied housing costs), YoY rise			6.5%	2.6%	3.0%
Trade-weighted ISK index (TWI) (yearly average)			166.7	179.8	180.0

CPI projected to rise 0.2% in May



Source: Statistics Iceland and ISB Research

We expect the consumer price index (CPI) to rise by 0.2% month-on-month in May. Based on this forecast, headline inflation will measure 3.6%, up from 3.3% in April. The medium-term inflation outlook has improved marginally since the last forecast, owing to a more favourable outlook for wage developments in 2019 and the prospect of weaker-than-expected house price inflation in coming quarters. Inflation appears set to average 3.4% in Q2/2019 and taper off thereafter. We expect it to measure 2.8% at year-end 2019 and 2.7% at year-end 2020. Statistics Iceland (SI) will publish the May CPI at 9:00 hrs. on 28 May.



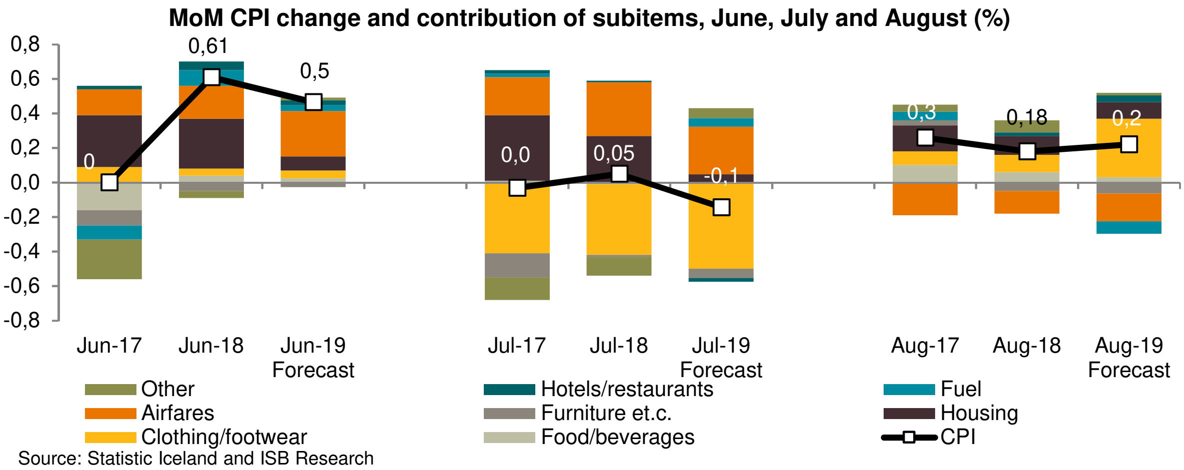
Source: Statistics Iceland and ISB Research

Petrol, food, housewares, and accommodation among upward-pushing items in May

Unlike April, no one CPI component stands out as the main driver of inflation in our May forecast. Petrol is the top-ranking inflationary item this month (0.08% CPI effect), as our survey indicates a full 2% rise in petrol prices between the April and May CPI measurements. The main reason for the increase is the rise in global oil prices year-to-date. The price of Brent crude, for instance, is up more than 30% thus far in 2019.

The housing component will raise the CPI by 0.24%, according to our forecast. House price inflation is not a major factor this time, however: our survey indicates a 0.15% increase in imputed rent (0.02% CPI effect), plus an uptick in paid rent and home maintenance costs. We expect food prices to rise (0.3% CPI effect), as well as housewares (0.03%), plus an increase in hotel and restaurant services (0.03%) as the peak tourist season approaches. Many service providers in the tourism sector are facing tightened conditions, however, and must choose between passing wage cost increases through to prices and trying to maximise their share of a declining market.

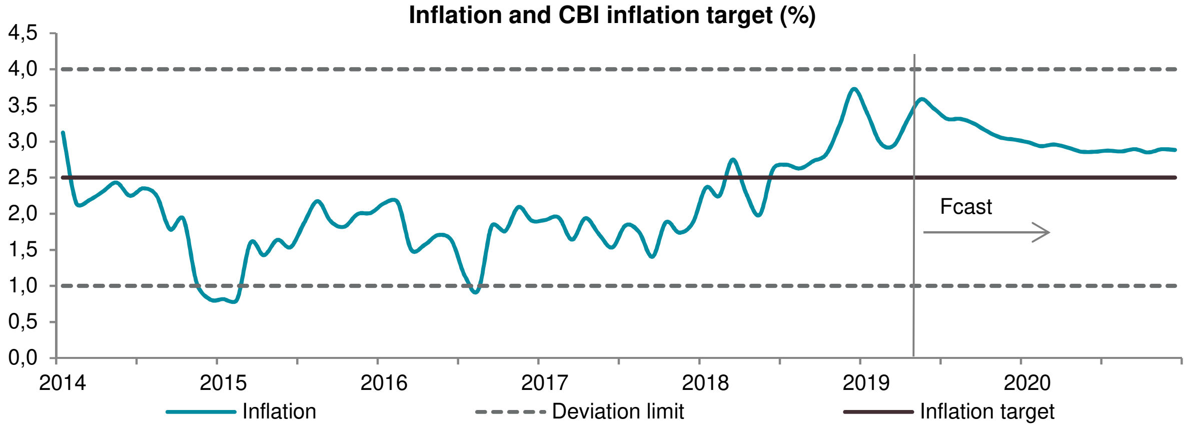
In April, the air transport component drove the rise in CPI, whereas we expect it to push the index up by only 0.05% in May. Airfares often take a breather in May, after the Easter peak and before the summer surge kicks in. But they are difficult to measure at the moment, as SI was forced to revise its methodology at short notice after the collapse of WOW Air.



Inflation target within reach soon?

Inflation looks set to taper off slightly in the next few months. We forecast a 0.5% rise in the CPI in June, a 0.1% decline in July, and a 0.2% increase in August, leaving headline inflation at 3.3% in August. Airfares can be expected to shoot up as summer takes hold, owing to higher fuel prices, peak season demand, and reduced competition with the departure of WOW Air from the scene. Imported inflation due to rising goods prices will continue to taper off in the near term, provided that the ISK does not weaken again. We also expect house prices to continue rising at the current pace in coming months.

We then expect inflation to ease in the second half of the year. The wage agreements reached in early April are more favourable than we had dared hope as regards this year's wage cost pressures. Since then, other wage contracts have been negotiated on similar terms, and uncertainty about private sector wage developments has therefore diminished significantly in the past few weeks. That said, various public sector wage agreements are still pending, but their inflationary impact surfaces more slowly than is the case for private sector agreements.



Source: Statistics Iceland and ISB Research forecast

Furthermore, a number of indicators imply that house price inflation will be at a minimum over the remainder of the year. The economic outlook has darkened substantially, and demand from both tourists seeking short-term rentals and imported workers seeking housing will presumably be weaker than previously assumed. Diminishing demand pressures in the economy will probably cut into wage drift, as well as putting pressure on domestic firms' mark-ups.

We expect inflation to fall to 2.8% by the end of this year and 2.7% by end-2020. The Central Bank's inflation target will therefore be within striking distance as 2019 comes to a close, if our forecast is borne out. Actually, the developments sketched out above are broadly equivalent to target-level inflation. But the outlook is uncertain, as always. A depreciation of the ISK and/or escalating wage demands among the groups that have yet to finalise wage agreements could derail the situation. Even so, the overall inflation outlook for the rest of the decade seems relatively favourable.

Authors

Jon Bentsson, chief economist +354 440 4634
Bergþóra Baldursdóttir +354 440 4637
research@islandsbanki.is
http://www.islandsbanki.is/English/

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