

### **Long-term inflation forecast until the end of 2013**

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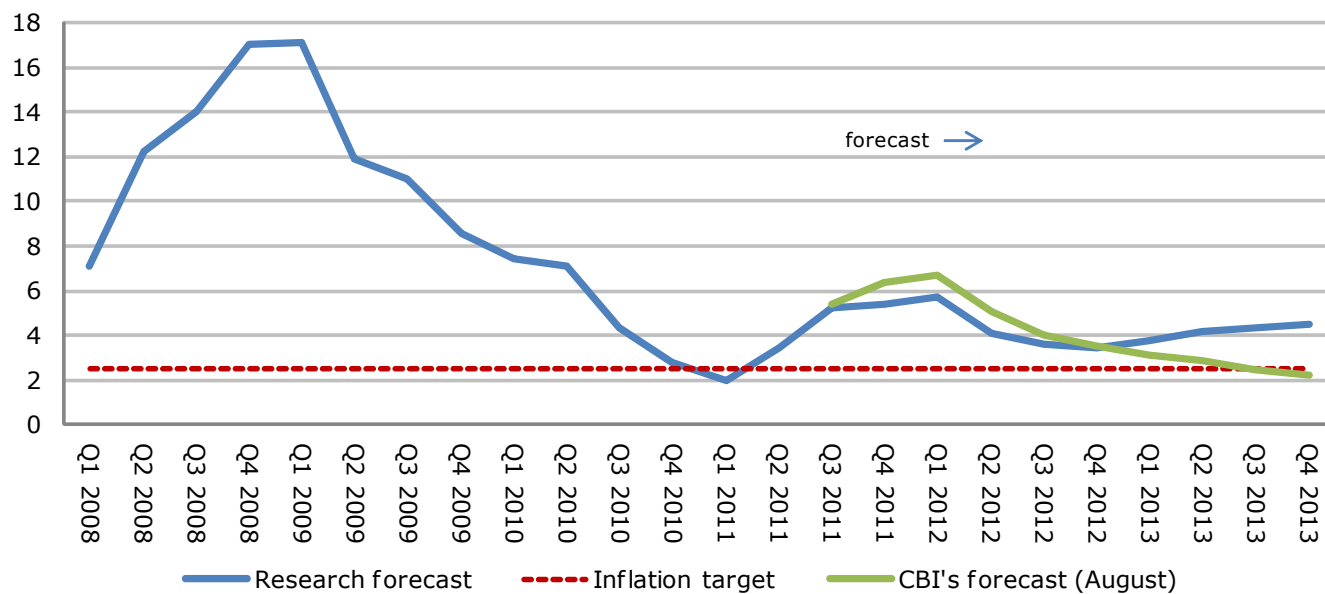
Arion Research expects inflation to remain above the Central Bank of Iceland's inflation targets over the next two years. Arion Research projects that inflation will be 5.4% at the end of this year, 3.4% at the end of 2012 and just over 4% at the end of 2013.

There are several factors behind this persistent inflation, the main one being the increase in the market price of residential property. According to Arion Research's forecast, shortages on the property market in 2013 will fuel further increases in the price of residential property in 2012. As property prices increase and economic activity grows in 2013, a slight rise in inflation can be expected again.

Main assumptions:

- **Underlying slack in the economy remains.** We believe that the growth in demand measured in late summer was temporary. Salary increases this summer and payments relating to the recalculation of indexed loans have undoubtedly had an impact on household consumption patterns. A proposal in the budget bill to reduce employer's contributions to private pensions from 4% to 2% could, however, undermine the incentive for consumers to save and instead encourage increased private consumption, if the bill is passed in its current form.
- **This summer's salary increases resulted in cost push.** Continued salary increases as provided for in union-wage agreements will boost inflation. Salaries are expected to increase 3.5% in 2012 and 3.25% in 2013 which we are certain will be passed through to price levels.
- **ISK stable – capital controls are to remain in place.** It is highly likely that the capital controls are going to remain in place for some time, at least until 2015 as currently authorized. Given the outlook for the underlying current account balance there is very little to suggest that the exchange rate of the króna is going to change significantly during the forecast period.
- **Increases in taxes and public service fees** – will mirror general price increases. The government will raise duties on petrol, alcohol and tobacco; Reykjavík Energy (OR) will raise its tariffs, and local authorities will raise playschool fees, refuse collection fees etc.
- **Housing prices fuelling inflation:** Activity on the property market has increased sharply so far this year. Arion Research believes that housing prices will be one of the main factors fuelling inflation over the next few quarters. Arion Research forecasts an accumulated nominal increase of 18% in the price of housing until the end of 2013.

**Inflation forecast (changes between years)**



Source: Arion Research and Central Bank of Iceland

## Contacts

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