

Flash Comment

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Iceland: Inflation up despite base effect

Statistics Iceland has published inflation numbers for June (actually May/June). While most analysts, ourselves included, expect inflation to generally continue upwards, we were looking for a temporary dip in June due to base effects (we forecast 6.9% y/y). However, inflation actually gathered pace from 7.6% y/y in May to 8.0% y/y in June.

The continuing rise in inflation is primarily being driven by the significant weakening of the Icelandic kronur seen this year. This translates, in particular, into higher oil and car prices, as these are imported goods and, furthermore, they weigh fairly heavily on the consumer price index.

We expect inflation to continue rising in the coming months, as the effects of the weakening ISK carry on passing through to consumer prices. Adding to the inflation equation, sharply increasing wage growth will contribute to the upward pressure, especially on service prices.

As the June figure more than made up for the expected drop due to the base effect, this rise is, in fact, even more dramatic than it appears. Our models undershooting the actual inflation figure by so wide a margin, is probably an indication that the rise was to a quite large extent (maybe as much as a third of the rise in prices month-on-month) driven by rising inflation expectations. This is bad news and an indication that Icelandic consumers and companies probably do not believe the Central Bank of Iceland will be able to bring inflation under control any time soon.

Concluding, inflationary pressures are very strong and today's number serves as yet another reminder that the Central Bank of Iceland (CBI) still has some work to do to bring down inflation towards the CBI's target of 2½%. The question now is whether the CBI will hike by 75bp or 100bp at the next monetary policy meeting.

With significantly higher inflation and strongly rising interest rates it is obvious that the Icelandic consumer is facing much more challenging times, and private consumption growth will likely slow quite considerably in the coming months.

Today's news is clearly negative for the Icelandic equity and fixed income markets - and probably also for the Icelandic kronur.

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