

# The Icelandic Economy

Winter 2006

Revised macroeconomic forecast  
2005-2007



MINISTRY OF FINANCE

## **EFNISYFIRLIT**

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## Main conclusions

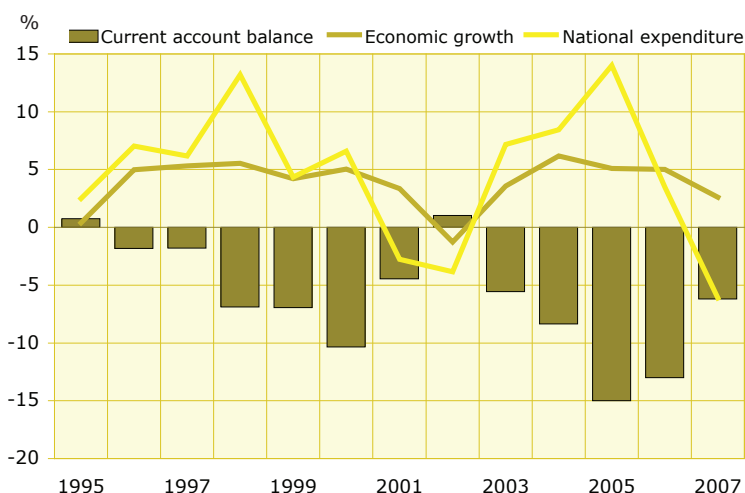
In this report the situation and outlook are discussed for the main elements of the economy in 2005-2007 on the basis of a revised forecast for the Icelandic economy by the Ministry of Finance. Some differences from the October 2005 forecast are explained. The main conclusions are as follows:

- GDP is estimated to have grown 5.1 per cent in 2005 due to a pronounced rise in domestic demand, notably private consumption and fixed investment. However, increased imports, a contraction in the export of marine products and delays in a part of the large scale investment projects had an impact to reduce the growth that year.
- This year GDP growth is expected to continue robust, or 5 per cent, when the growth in domestic demand is expected to slow down but increased exports of aluminum products begin to be felt.
- In 2007, economic activities are projected to slow down and that continuing improvement in foreign trade will drive the growth of GDP, which is expected to be 2.7 per cent.
- The deficit on the current account reach a peak last year when it amounted to 15 per cent of GDP. The current account deficit is expected to decrease this year and be 13 per cent of GDP and then decline sharply in 2007 when it is projected to be about 6 per cent of GDP.
- Unemployment has declined sharply and is expected to be 1.7 per cent of the labour force in 2006, but to increase to 2.6 per cent in 2007, when activity is projected to slow down. Some pressure is expected to be felt in the economy this year but it is expected to unwind quickly next year as major investment projects are completed.
- The rapid rise in housing prices has led to the consumer price index increasing 4% in 2005, which is beyond the 2.5 per cent inflation target of the central bank. According to the projections inflation will be 3.9 per cent this year. It is expected that housing prices have peaked and that the exchange rate of the króna will decline throughout the year. Inflation is expected to reach 4 per cent next year due to continued weakening of the króna.
- The main element of uncertainty in the projections is the exchange rate of the króna.

## A summary of the forecast

The revised forecast for the years 2005-2007 is largely in line with the Ministry's forecast presented last October. However, there are a few differences that suggest GDP growth will be close to 5 per cent instead of 6 per cent in 2005. GDP growth is now expected to be 5 per cent instead of 4.6 per cent in 2006. The forecast for economic growth in 2007 remains unchanged, at 2.6 per cent. The present assessment of power project construction activity is about the same, except that a part of the investment that was to take place in 2005 has been moved to 2006 and 2007.

On the basis of presently available indicators, the Ministry's estimate for private consumption in 2005 is increased from 9.5 per cent to 12 per cent. On the other hand, the estimate for business fixed investment in 2005 has been scaled back slightly, and the decline in public investment appears to be less than previously estimated. The estimate for exports has also been reduced, mostly due



**Chart 1**  
**Real growth in GDP and national expenditure and the current account deficit 1995-2007**

Sources: Statistics Iceland and own forecast.

to a decline in fisheries export production. The same applies to 2005 exports other than from fisheries and energy-intensive production. Although the world price of oil increased by more than 40 per cent last year, the terms of trade improved by about half a percentage point, benefiting national income. This is due to a considerable increase in fish and aluminium prices at the same time as import prices, other than oil, increased only moderately. All told, total national expenditure is estimated to increase by 14 per cent and the current account deficit is expected to have amounted to 15 per cent in 2005.

**Table 1. Key economic indicators 2004–2007**

<b>Economic aggregates</b>		<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
GDP growth	%	6.2	5.1	5.0	2.6
National expenditure	Annual growth, %	8.4	14.0	3.5	-6.1
Current account balance	% of GDP	-8.4	-15.0	-13.0	-6.2
Net foreign debt	% of GDP	-85.3	-84.1	-90.3	-98.1
National saving	% of GDP	14.7	12.8	14.1	13.7
<b>Labour market</b>					
Labour force	Thousand man-years	147.7	152.1	156.7	157.4
Unemployment	% of labour force	3.1	2.1	1.7	2.6
Real hourly wage	Annual change, %	1.4	2.7	1.8	0.5
Real disp. income per capita	Annual change, %	2.6	4.2	3.3	2.2
<b>Foreign trade</b>					
Exports of fish products	Annual vol. change, %	5.4	-3.0	3.0	2.0
Aluminium exports	Annual vol. change, %	2.0	0.2	30.7	55.7
Total merchandise exports	Annual vol. change, %	8.3	-2.9	9.6	15.9
Total merchandise imports	Annual vol. change, %	15.8	24.5	4.5	-15.3
<b>Money and prices</b>					
Inflation	%	3.2	4.0	3.9	4.0
Exchange rate index	Dec. 31 1991=100	121.0	108.7	108.7	117.1
Central Bank policy rate	Annual average, %	6.1	9.4	11.2	9.0
<b>External circumstances</b>					
OECD-growth	%	3.3	2.7	2.9	2.9
OECD-inflation	%	2.0	2.1	1.9	1.9
Fish export prices in foreign currencies	Annual change, %	0.3	8.0	5.0	2.0
World market price of aluminium	Annual change, %	13.0	9.5	0.0	0.0
Import price of oil	Annual change, %	27.6	41.0	-2.5	-7.0

Sources: Central Bank of Iceland, Directorate of Labour, Ministry of Finance, OECD, Statistics Iceland.

In 2006, national expenditure is forecast to rise by 3.5 per cent in 2006, and the deficit on the current account to be 12 per cent of GDP. The forecast is for a reduction in the growth of imports of goods and services and that it is 3 per cent but for exports to increase by about 7 per cent, explained largely by increased production capacity of aluminium plants. Aluminium exports are expected to increase by 31 per cent and the exports of marine products to increase by 3 per cent. The main change in the forecast is greater business fixed investment and production of marine products than earlier forecast.

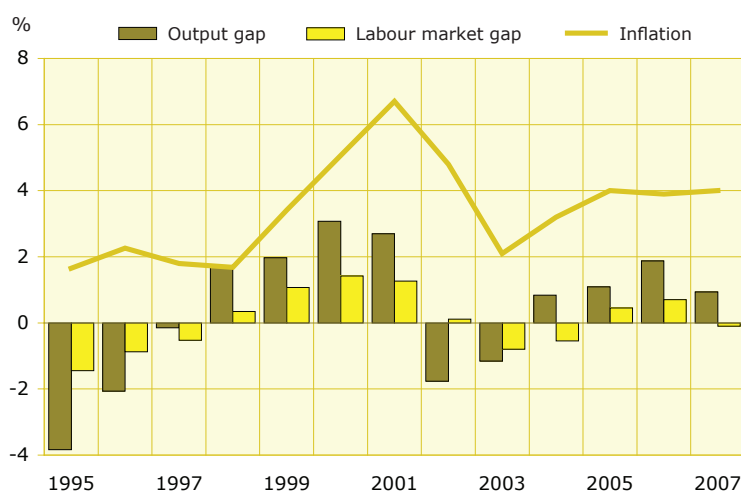
In the revised forecast for 2007, national expenditure is expected to decline by 6.1 per cent and the current account deficit is forecast at 6.2 per cent of GDP. Imports of goods and services are forecast to decline by 12 per cent in relation to the stagnation of the growth in private consumption expenditure

and a 40 per cent contraction in business fixed investment. The main changes from the earlier forecast is that the contraction of business fixed investment is expected to increase more than thought earlier, whereas the decline in housing investment is seen to be slightly smaller.

The forecast for wage developments in the years 2005-2007 has been revised upwards. Wage drift has gradually been increasing in recent months and is expected to continue along with declining unemployment. Registered unemployment is estimated to have been 2.1 per cent of the labour force last year. Unemployment is expected to continue declining, averaging 1.7 per cent in 2006. However, the unemployment rate is expected to be 2.6 per cent in 2007. The inflation forecast is almost the same as last autumn. Inflation is expected to hover around the upper tolerance limit of the Central Bank at a 4 per cent annual rate. This forecast implies that the rise in housing prices will slow down considerably over the next several months as well as in the medium term.

The exchange rate rose by 11 per cent between the averages of 2004 and 2005 and by 7.5 per cent during the course of 2005. It is assumed that the exchange rate index will remain unchanged between the averages of 2005 and 2006, whereas the exchange rate is expected to decline during the course of 2006. Compared with the October forecast, the decline in the exchange rate is expected to be less in 2006. The innovation in the bond market that took place in the Autumn of 2005, when the issue of krónur denominated bonds by foreign issuers in significant amounts is estimated to have strengthened the currency. Furthermore, in the forecast it is assumed that the Central Bank's policy rate is assumed to be higher and that it will average more than 11 per cent in 2006. However, in view of the large current account deficit a weakening of the currency may be expected in the medium term. It is assumed the exchange rate will decline by 6 per cent during 2007. As has been emphasised in previous reports of the Ministry, assumptions about the exchange rate are always subject to considerable uncertainty.

According to the above, price stability is under threat. That said, it should be pointed out that last year's inflation stems mostly from the rise in the price for housing. Excluding housing, inflation was scant last year. The strategy of monetary and fiscal policy has been to restrain inflation through the increase in the policy interest rate and a systematic reduction in the growth of central government expenditure. The present forecast indicates that the implicit output gap will peak this year and gradually recede thereafter. The same applies to the labour market gap. It should be kept in mind in this connection, that the Icelandic economy has become quite open. Foreign labour is more readily available to meet the labour demand. The access of Icelanders to foreign investment goods, intermediate goods and consumer goods has also greatly increased. Combined, these factors have the effect of mitigating pressures in the domestic labour and goods markets. In 2007, the policy interest rate is expected to decline and fiscal policy to become more stimulative to mitigate the expected slowdown in economic activity and increase of unemployment.



**Chart 2**  
**The output gap, labour market gap and inflation 1995-2007**

Sources: Statistics Iceland and the Ministry of Finance.

## The international economy

World economic growth was close to 4 per cent last year. GDP growth in the OECD-countries was slightly less, or 2.7 per cent. Growth in the US economy was relatively robust, or 3.5 per cent, despite extensive property damage

due to hurricanes. In Japan, the economy grew 2.4 per cent, whereas in the Euro-area GDP grew only 1.4 per cent. World economic growth is expected to accelerate in 2006 to 4.5 per cent, driven by a 6-7 per cent growth in world trade. For the OECD-countries as a whole, around 3 per cent GDP growth is forecast in both 2006 and 2007. Growth in the US and Japan is expected to slow down slightly whereas it may increase in the Euro-area.

**Table 2. Economic growth**

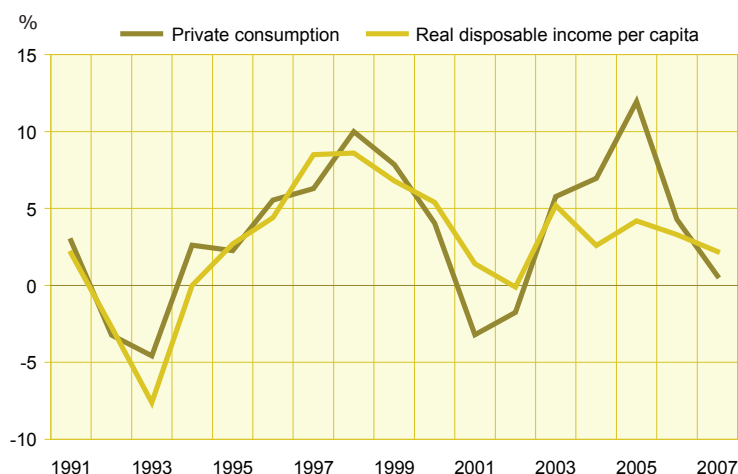
Volume change on previous year. %	2005	2006	2007
Euro area	1.4	2.1	2.2
Germany	1.1	1.8	1.7
France	1.6	2.1	2.2
Italy	0.2	1.1	1.5
Spain	3.4	3.2	3.3
United Kingdom	1.7	2.4	2.7
United States	3.6	3.5	3.3
Japan	2.4	2.0	2.0

Source: OECD Economic Outlook. December 2005.

The increase in the US policy interest rate last year is expected to slow down the US economy in the near future. In the forecast there is some uncertainty related to the large current account and fiscal deficits. These are being financed through long-term bond issues and the sale of shares. Should international demand for such financial assets decline, it could weaken the dollar and increase bond yields which in turn would further hamper US growth. In the Euro-area, a rise in the policy interest rate is expected. The rate has been below 2.25 per cent for a long time, partly because of weak demand in the larger continental economies. The combination of weak growth and high unemployment has increased calls for structural change in labour markets and downsizing of the government sector, especially in Germany. Consumer confidence has improved in Japan and domestic demand has revived. The policy interest rate is still quite low, close to zero. The effort to reduce government debt may be expected to deter economic growth in coming years.

### Private consumption

Private consumption has increased very much in recent years. All indications are that private consumption grew in 2005 at the fastest rate since 1987. According to Statistics Iceland, private consumption rose by 12.5 per cent in real terms in the first three quarters of 2005, at the same time as the population increased by 1.1 per cent. Last year has been very good for Icelandic households for a number of reasons. Real per capita income rose by 4.2 per cent and unemployment was minimal. The changes that took place in the home mortgage market in the autumn of 2004 made it possible for households to reduce their mortgage payments, thus leaving a larger part of their income for consumption. The strong exchange rate has also led to increased household demand for imported consumer goods, automobiles and travel abroad. For the first eleven months of last year, credit card turnover rose by 8.5 per cent at home and by 40.9 per cent abroad, both in real terms. This reflects increased purchases by



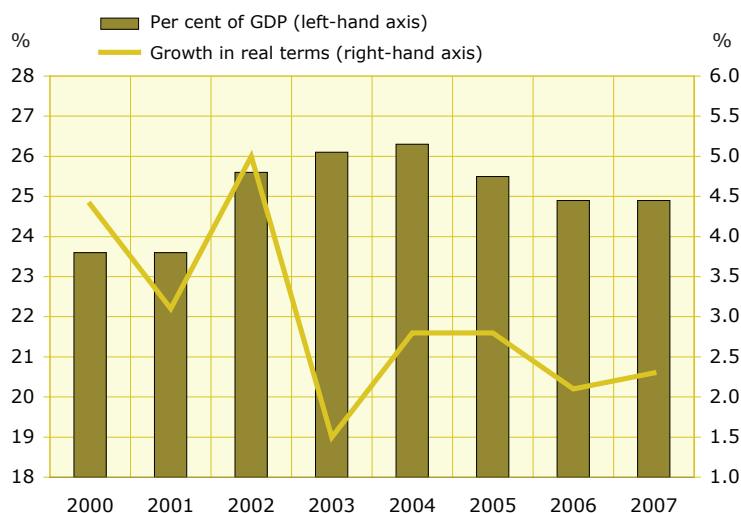
**Chart 3**  
**Growth in private consumption and real disposable income per capita 1991-2007**

Sources: Statistics Iceland and own forecast.

households of goods, both at home and abroad. At the same time, proceeds from indirect taxes rose by 14.9 per cent in real terms over a year earlier, of which value added taxes grew by 16.5 per cent in real terms. Turnover of non-durable consumer goods rose by 9.6 per cent in the first eleven months of 2005. In the latter half of 2005, the mortgage interest rate of the Housing Finance Fund rose, as did the rates of most other financial agencies in concert with a rising policy rate. These increases are expected to reduce the growth in private consumption. Real disposable incomes are expected to rise by 3.3 per cent in 2006. It is also assumed that the exchange rate will decline in the course of this year which will reduce the purchasing power of the public abroad. A saturation effect in import demand for automobiles is also expected to set in, and the same will apply to other consumer durables. A growth rate of 4.3 per cent in private consumption is therefore forecast for 2006, and for 2007 private consumption growth is forecast to slow down further, and reach 0.6 per cent.

### Public consumption

The growth in public consumption of the total public sector is now estimated to have been slightly higher than had been forecast earlier, 2.9 per cent instead of 2.5 per cent. This increase is mostly attributable to a greater increase in central government expenditure as reflected in the supplementary fiscal budget for 2005. Most of the extra increase is attributable to higher hospital costs, education and the privatisation of Iceland Telecom. For 2006 and 2007 it is forecast that the real increase in the public consumption of the central government and the social security sector will be in concert with the fiscal budget and the Government's medium-term fiscal projection of 2 per cent growth. As regards the municipalities, a 2.5 per cent real growth in their outlays is assumed for 2005, with a similar growth in 2006 and 2007.



**Chart 4**  
**Public consumption 2000-2007**

Sources: Statistics Iceland and own forecast.

### Business fixed investment

In the revised forecast, the growth in business fixed investment for 2005 has been revised to 45 per cent. Most of the increase is attributable to power project investments and the construction of aluminium plants. At the same time, increased domestic demand and the strong exchange rate of have stimulated business fixed investment in other sectors. The strong exchange rate has had an adverse effect on the earnings of companies that receive their income from abroad or compete with imports but with their expenditures denominated in the króna. The Gallup survey of last November of the 400 largest companies in Iceland indicates that companies in other sectors are scaling back their investment plans in 2006. Total business investment is forecast to increase by 7 per cent in 2006. Part of the increase is due to power project construction intended for last year having been delayed to this year. Power project investments and aluminium plant construction will mostly be completed in 2007. Business investment is forecast to decline by 40 per cent in that year.



**Chart 5**  
**Business sector fixed investment and imports of investment goods (volume changes) 1998-2007**

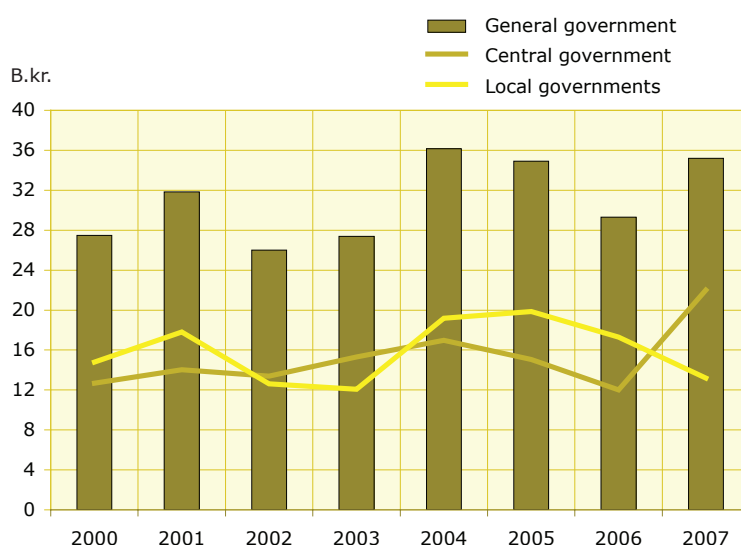
Sources: Statistics Iceland and own forecast.

## Residential construction and the property market

Demand pressures in the property market have declined in recent months and are expected to continue doing so. Demand is still buoyant and property prices are still increasing, although not at the same pace as earlier last year. Demand for single homes in the capital area has declined, although sales of smaller housing units are still considerable. The turnover in the housing markets in the capital suburbs is still strong, as is home construction in those areas. The largest increase in housing construction is in Fjarðarbyggð, in the eastern part of the country, in the vicinity of the Alcoa aluminium plant now under construction. Housing construction plans in the south-western part of the country are still substantial, both amongst building firms and municipalities developing new building land. The four largest municipalities in the capital area are opening new building land this year, which will have an impact on the pace of home construction this year and next. The slower pace of new home sales in recent months indicates that present construction plans may stretch over a longer period. The rise on mortgage financing rates will also deter home buyers. Housing investment, which is estimated to have increased by 12 per cent in 2005, is forecast to rise by 6.5 per cent this year, whereas next year it is thought to decline by a small margin, 1.5 per cent.

## General government investment

Total investment of the general government is estimated to have amounted to 37 billion krónur last year, a decline of close to 7 per cent in real terms from the previous year. This decline is slightly lower than had been expected in earlier forecasts, due to increased appropriations as reflected in the supplementary 2005 fiscal budget. Public investment is estimated at 31 billion krónur in 2006 which indicates a decline of 20 per cent in real terms from the previous year. In 2007, when power project investments will decline sharply and GDP growth slow down, public investment will be increased by 15 per cent. Municipal investment is expected to decline by up to 30 per cent in 2006 and 2007.



**Chart 6**  
**General government investment**  
**2000-2007**

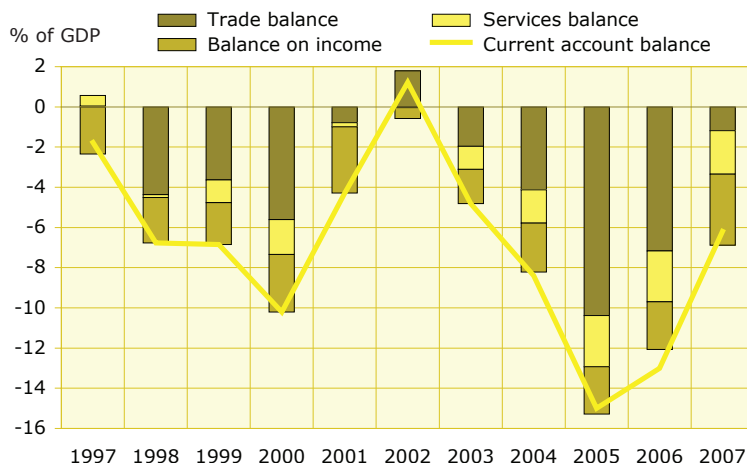
Sources: Statistics Iceland and own forecast.

## Foreign trade

The current account deficit is estimated to have amounted to 146 billion krónur in 2005, equivalent to 15 per cent of GDP, compared with 8.4 per cent in 2004. The increase can be attributed to the merchandise trade deficit, with imports of goods amounting to 283 billion in 2005 and exports to 188 billion. Merchandise exports are estimated to have declined by 2.9 per cent in 2005. The high exchange rate has hampered the export sector, but the exchange rate impact has in part been offset by rising prices of major export items in foreign currencies. Merchandise imports, on the other hand, increased by 24.5 per cent in 2005. Rising power project construction activity helped increase imports of investment goods by 40 per cent. The rise in private consumption was reflected in demand for imports of consumer goods and automobiles. Rising fuel prices also contributed to the increase in the import bill. This year, the growth in merchandise imports is expected to slow down considerably, to 4.5 per cent, followed by a 15.3 per cent decline in 2007 when power project construction activity draws to a close and private consumption slows down. Merchandise exports, on the other hand, are expected to increase by close to 10 per cent this year on account of increasing aluminium production and further by 16 per cent in 2007 when production in the Reyðarfjörður plant will commence. The deficit on the ser-



vices account is estimated at 27 billion krónur in 2005. Service expenditures rose far more than service income that year. The growth in service expenditures is expected to slow down this year and next, whereas the income from services is expected to increase, and the services deficit thus decline. Net factor payments are expected to increase from 22 billion krónur in 2005 to 24 billion in 2006 and further to 36 billion in 2007, in part because of expected interest rate increases abroad and a decline in the exchange rate. Due to an improving trade balance, the current account deficit is expected to decline sharply over the next two years, to 13 per cent of GDP in 2006 and 6.2 per cent in 2007.

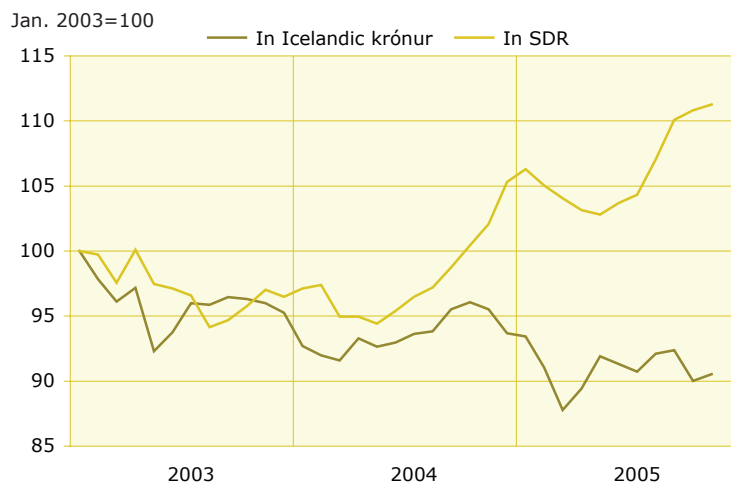


**Chart 7**  
**The current account balance 1997-2007**

Sources: Statistics Iceland, Central Bank of Iceland and own forecast.

## The business sector

The operating conditions of the business sector have changed considerably in the past year. The real exchange rate in terms of prices rose by an average of 13 per cent from the previous years. It is therefore evident that the competitive position of export and import-competing firms has deteriorated. Foreign interest rates have stayed low, however, which has benefited firms with foreign debt. Conventional manufacturers, as well as high-tech and innovation enterprises, have announced that they are transferring a part of their operations abroad. Although this departure is partially brought about to reduce production costs, it is also done to strengthen product development and marketing through being closer to customers and suppliers in large international markets. Fish export production is estimated to have declined by 3 per cent in 2005, in part because of declining catches of cod and blue whiting, which was to some extent offset by increase in the catch of other demersal species as well as of herring and capelin. The considerable increase in export fish prices in the course of the year did much to offset the strengthening of the exchange rate. It is nevertheless evident that the operating conditions of the fishing industry deteriorated during the year in light of declining output and the higher price of oil. For 2006, a 3 per cent increase in the value of fish export production is forecast and a further 2 per cent increase in 2007. Aluminium production is estimated to have been unchanged in 2005 from the previous year. World aluminium prices rose by more than 9 per cent in 2005, which is partially offset by the weaker dollar in terms of Icelandic krónur. Aluminium production is forecast to increase by 31 per cent in 2006, when the first phase of the expansion of the Norðurál plant will come into production. Production in the Fjarðarál plant will commence in 2007, and aluminium production is forecast to increase by 56 per cent in that year. The number of foreign tourists coming to Iceland is estimated to have increased by 1 per cent in 2005 and income from tourism increased by 1 per cent in real terms.



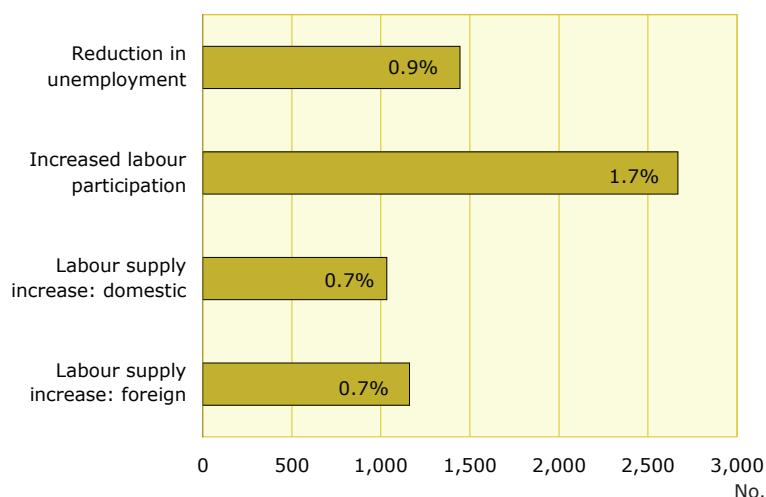
**Chart 8**  
**Marine product prices 2003-2005**

Source: Statistics Iceland.

## The labour market

Labour market activity increased more in 2005 than previously estimated. The demand for labour intensified, the work-week lengthened by about half a per cent, and the number of labour market participants rose by about 6,300 or 4 per cent from the previous year. The number of workers far exceeded the 1.4

per cent increase in the population of working age, which can be explained by increased labour market participation, a decline in unemployment and imports of labour. Increased labour market participation contributed 1.7 per cent, the reduction in registered unemployment 0.9 per cent and labour imports 0.7 per cent. For 2005 as a whole, net immigration amounted to 3,700 persons, considerably more than expected. Work permits were nearly 4,000 in number, 2,900 of which were issued in the second half of the year. Labour market activity is expected to peak this year as the labour force is forecast to increase by 3.5 per cent. The slowdown in economic activity in 2007 may be expected to increase unemployment and reduce employment, as foreign construction labour departs.



**Chart 9**  
**Labour market developments in 2005**

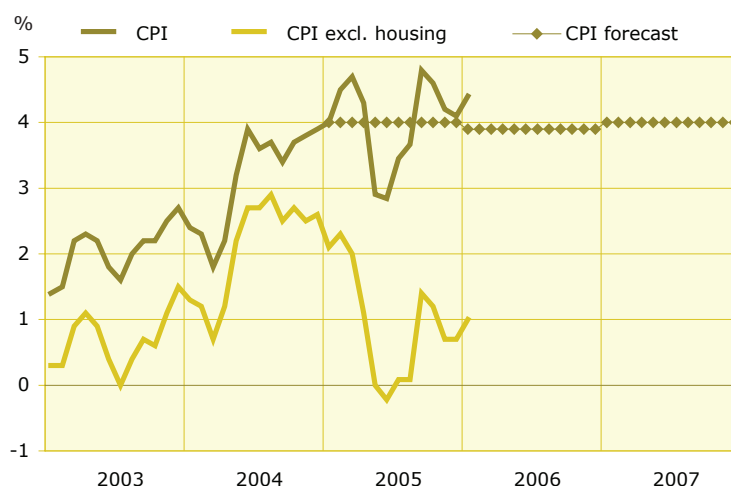
Sources: Statistics Iceland, Directorate of Labour and the Ministry of Finance.

## Wages

The wage index appears to have increased faster in 2005 than had been anticipated in the Ministry's October forecast. The wage agreements concluded towards the end of the year play a role here. Under the present circumstances in the labour market, wage pressures will probably be in evidence in the course of this year, both due to wage agreements and wage drift. Unemployment is forecast to average 1.7 per cent, which is below the unemployment rate consistent with economic stability, 2.5 to 3 per cent. Wage increases are nevertheless no greater than can be expected in the current state of the labour market. Substantial labour imports during the year have helped in containing wage drift. The month by month rise in the wage index has thus been less in the current expansion than in the one at the turn of the century. Wage agreements in the general labour markets have now been concluded and will be in effect until the end of 2007, following the tri-partite agreement between labour, employers and the Government last November. A 5.6 per cent wage increase is forecast for 2006 and a further 4.5 per cent in 2007. It is assumed that the recent wage agreement between the City of Reykjavík and nursery school helpers will not lead to a chain reaction impacting the wage demands to those unions that are still negotiating, such as university-educated employees. Nor is it expected that this agreement will lead to increased wage drift for those who already have concluded wage agreements.

## Prices

The consumer price index rose by 4 per cent in 2005 from the previous year, although the year-on-year increase was higher in some months. Inflation was largely influenced by rising housing prices, following increased competition in the mortgage market since the autumn of 2004. This was mitigated by the strengthening of the exchange rate. Excluding housing, the consumer price index rose by only 0.9 per cent. According to the EU Harmonised Index of Consumer Prices, which includes rent but not the price of housing, Iceland's inflation averaged 1.4 per cent in the first eleven months of 2005, compared to 2.2 per cent in the EEA-area. Prices for domestic goods declined by 1 per cent in 2005. A price war in the non-durable consumer goods market helped reduce inflation during the spring and summer months, but



**Chart 10**  
**Inflation 2003-2007**

Sources: Statistics Iceland and own forecast.

these price increases were partially reversed later. Prices of imported goods declined by 2.2 per cent on a twelve-month basis, whereas fuel prices rose considerably. For 2006, a 3.9 per cent rise in the consumer price index is forecast, and 4.0 per cent for 2007. The rise in housing prices is expected to slow down rapidly over the next several months, whereas the exchange rate is expected to decline in the course of this year and next. Prices of imported goods are therefore expected to rise, although with a lag. The output gap is expected to peak this year and narrow in 2007. The price forecast should be viewed with the caveat that exchange rate assumptions are subject to much uncertainty.

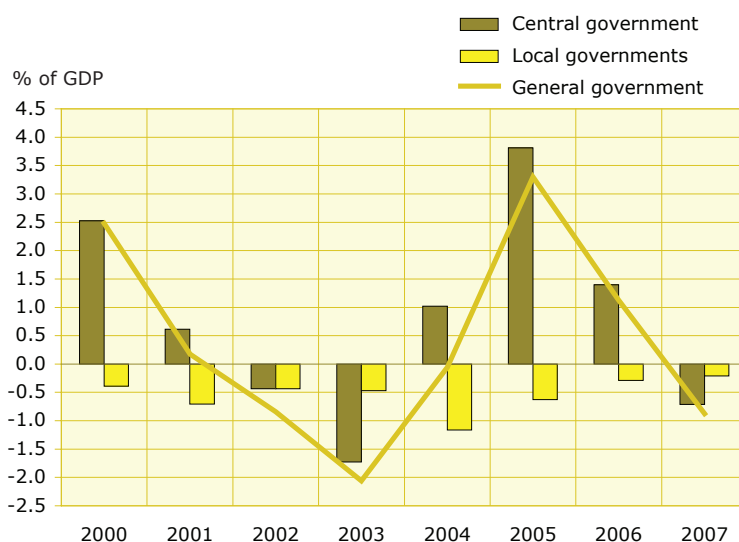
## Monetary policy

The Central Bank continued increasing its policy rate in the course of 2005. It started to raise the rate in the spring of 2004 when it stood at 5.3 per cent. The bank raised the rate six times in 2005, from 8.4 per cent to 10.5 per cent last December. In spite of the sharp increase in the policy rate, the Bank has found it difficult to dampen the inflation rate down to its goal of 2.5 per cent, due to a sharp rise in housing prices. Inflation exceeded the upper tolerance limit of 4 per cent from February to April and again in September and has stayed above the limit since then. The problem is partly attributable to the fact that interest rates for indexed mortgage credits have increased little, and the access of the domestic financial market to low-cost foreign financing has rapidly increased in recent years. The large interest rate differential between Iceland and other countries has led to substantial foreign bond issues in Icelandic krónur which began in the autumn of 2005. The congruent inflow of capital has served to considerably strengthen the exchange rate and thus helped the efficacy of monetary policy by reducing prices for imported goods and services. The policy rate is expected to increase further in the first half of this year and remain high in the near future until the inflation rate has been brought down to its goal. For this reason, it is expected that the exchange rate will decline less this year than had been expected earlier. The decline is in turn expected to be greater next year.

## General government finances

The revenue balance of the general government measures the difference between revenue and expenditure. The change in the revenue balance between years tells us whether general government finances (the central and local governments together) have the impact of stimulating or restraining economic activity. Provisional data for 2005 indicate that the general government revenue surplus amounted to 32 billion krónur or 3.5 per cent of GDP. The increase in the general government surplus indicates that general government finances restrained economic activity and contributed to prevent an overheating of the economy. The Treasury and the social security sector are estimated to have yielded a 38 billion krónur surplus, more than 4.1 per cent of GDP, compared to 3 per cent in the October forecast. The large Treasury surplus is primarily due to increased revenue from income and indirect taxes as well as from increased restraint on the expenditure side. The local governments appear to have turned in a 6 billion krónur revenue balance deficit, equivalent to 0.7 per cent of GDP.

For this year, a 14 billion krónur general government surplus is forecast, 1.3 per cent of GDP, of which 16 billion is expected from the Treasury and



**Chart 11**  
**General government revenue balance 2000-2007**

Sources: Statistics Iceland and own forecast.

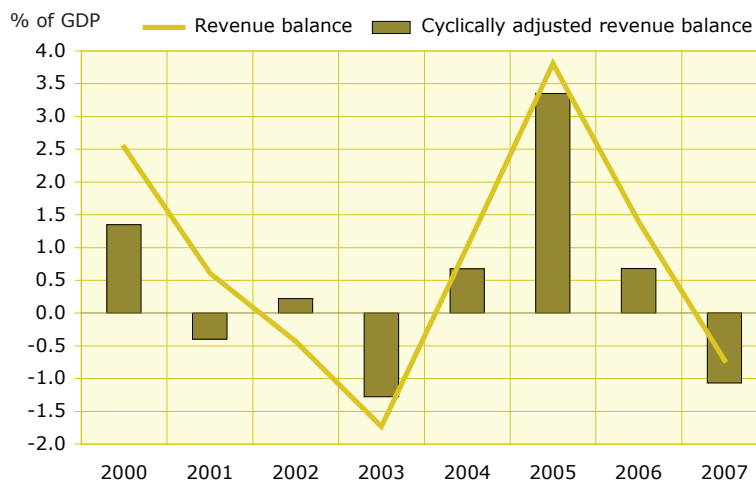
a 2 billion local government deficit. As may be seen from the chart 11, it is evident that the local governments have been run at a revenue balance deficit for a decade. One must go all the way back to 1990 to find them in surplus. Investment outlays play a large role in their financial results in the year 2004-2006 (see chart 6 on page 8). The economy is expected to slow down considerably next year, and the general government balance is forecast to revert to a 10 billion krónur deficit or 0.9 per cent of GDP. A large part of the reversal is due to the scheduled Treasury tax cuts. Revenue from indirect taxes is expected to decline, and the central government plans to increase its investment sharply in order to offset the slowdown in the economy. Taken together, it is evident that Treasury finances have done much to prevent overheating of the economy over the last three years. The 1.7 per cent deficit of 2003 has been turned into a 4 per cent surplus last year. The Treasury surplus is expected to turn in at 1.5 per cent of GDP in 2006. The reduced surplus is in part due to tax cuts and a decline in revenue from indirect taxes. As noted above, Treasury finances are expected to mitigate the slowdown in the economy in 2007 with further tax cuts and increased investment spending.

### Treasury finances

As noted earlier, the Treasury surplus amounted to a 3.8 per cent of GDP in 2005. Cyclically adjusted, however, the surplus amounted to 3.4% per cent of GDP that year, which means that the central government finances had a considerable impact on restraining activity in the economy. The cyclically adjusted balance is estimated on the basis of the output gap measure, which is estimated to have been just over 1 per cent of GDP in 2005. It should be noted that along with the fast growth of GDP last year potential output is also estimated to have grown quickly. The sharp increase in Treasury revenue was related to the unusually high growth of national expenditure and the corresponding rise in imports. Due to the restraint on expenditure at the central government level the increase in Treasury revenue quickly fed into a revenue surplus. In 2006, the revenue surplus is estimated to reach 1.4 per cent of GDP, but as the output gap is estimated to increase this year, the cyclically adjusted surplus is estimated to be about half of the revenue balance or about 0.7 per cent of GDP.

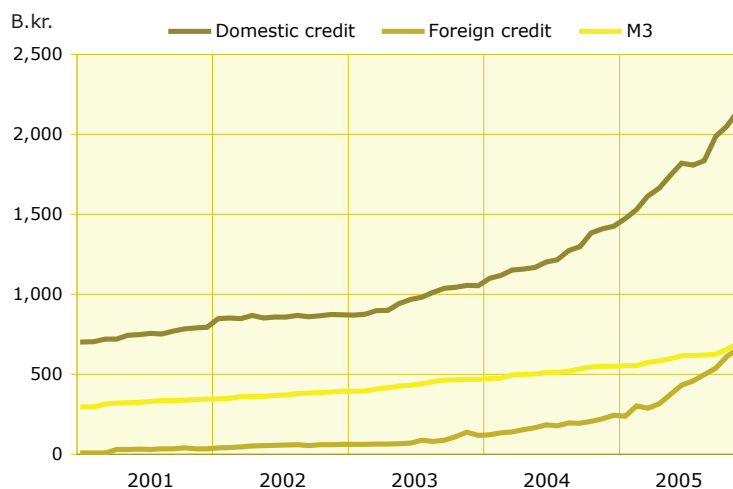
### The domestic financial market

The increases in the policy rate of the Central Bank, which have an impact on economic activity with a time lag, have not yet dampened credit demand in the financial market. Total bank credit rose by more than 1,000 billion krónur or 51 per cent in the first eleven months of 2005. Of this amount, 590 billion krónur was domestic credit and 420 billion was foreign credit. Part of the expansion in domestic credits is attributable to mortgage re-financing, where bank loans were used to repay loans from the Housing Finance Fund. The twelve-month average of the broad money supply (M3) rose by 18 per cent. Although the increase in the policy rate has not yet dampened credit expansion, the intermediation of monetary policy has been most effective through the exchange rate. The increases have kept the exchange



**Chart 12**  
**Central government revenue balance 2000-2007**

Sources: Statistics Iceland and the Ministry of Finance.



**Chart 13**  
**Money and credit 2001-2005**

Source: Central Bank of Iceland.

rate high which in turn has contributed to lower import prices. The interest rate differential between Iceland and other countries has prompted the issue of krónur bonds by foreign issuers to the tune of 160 billion krónur from August 2005 to January 2006. These issues have helped to keep the exchange rate strong which in turn has served to hold down inflation but also served to create downward pressure on non-indexed interest rates.

## Appendix table 1. Output and expenditure 2004-2007

	Billion krónur at current prices				Volume change on previous year (%) <sup>1</sup>			
	Prel.	Forecast			Prel.	Forecast		
	2004	2005	2006	2007	2004	2005	2006	2007
1. Private consumption	506.1	581.4	626.2	658.8	6.9	12.0	4.3	0.6
2. Public consumption	226.3	244.7	264.1	282.1	2.8	2.9	2.2	2.1
i.e. central government	148.1	160.9	170.8	183.1	2.9	3.1	2.0	1.9
i.e. local government	78.2	83.8	93.3	99.0	2.5	2.5	2.5	2.5
3. Gross fixed investment	207.2	268.7	288.2	226.7	21.0	27.7	3.6	-27.2
Business sector investment	123.9	170.2	190.1	121.7	23.3	45.0	7.0	-40.5
Residential construction	47.1	63.6	69.4	70.2	5.7	12.0	6.5	-1.5
Public investment	37.3	36.7	30.8	37.9	37.6	-6.6	-19.5	17.9
4. Final domestic demand	939.5	1,094.8	1,178.6	1,167.5	8.7	13.4	3.7	-6.1
5. Stock changes <sup>2</sup>	-3.3	1.5	0	0	-0.2	0.5	-0.2	0.0
<b>6. Total national expenditure</b>	<b>936.2</b>	<b>1,096.3</b>	<b>1,178.6</b>	<b>1,167.5</b>	<b>8.4</b>	<b>14.0</b>	<b>3.5</b>	<b>-6.1</b>
7. Export of goods and services	316.1	299.6	329.3	395.9	8.3	-1.3	6.9	11.8
8. Import of goods and services	367.3	422.1	442.2	429.4	14.2	21.6	3.0	-10.9
<b>9. Gross domestic product</b>	<b>885.0</b>	<b>973.7</b>	<b>1,065.7</b>	<b>1,134.0</b>	<b>6.2</b>	<b>5.1</b>	<b>5.0</b>	<b>2.6</b>
10. Net factor income from abroad	-21.6	-21.8	-24.0	-36.0	-	-	-	-
11. Net current transfers	-1.2	-1.3	-1.3	-1.4	-	-	-	-
12. Current account balance (7.-8.+10.+11.)	-73.9	-145.6	-138.2	-70.8	-	-	-	-
<b>13. Gross national income (9.+10.)</b>	<b>863.4</b>	<b>951.9</b>	<b>1,041.7</b>	<b>1,098.0</b>	<b>5.5</b>	<b>5.3</b>	<b>5.0</b>	<b>1.7</b>
14. Effects of changes in terms of trade <sup>3</sup>	-	-	-	-	-0.6	0.6	0.3	-0.7
15. Real gross national income	-	-	-	-	4.9	5.9	5.3	1.0
16. Current account balance (% of GDP)	-	-	-	-	-8.4	-15.0	-13.0	-6.2

### Notes:

1. Volume changes are based on 2000-prices.
2. As a percentage of GDP of the previous year, at constant prices.
3. As a percentage of GNI of the previous year, at constant prices.

## Appendix table 2. Export production and foreign trade 2004-2007

	Billion krónur at current prices				Volume change on previous year (%) <sup>1</sup>			
	Prel.	Forecast			Prel.	Forecast		
	2004	2005	2006	2007	2004	2005	2006	2007
<b>Export production</b>	<b>198.2</b>	<b>185.8</b>	<b>208.5</b>	<b>258.8</b>	<b>8.3</b>	<b>-3.2</b>	<b>9.2</b>	<b>16.1</b>
Marine products	118.7	111.7	120.8	135.3	5.4	-3.0	3.0	2.0
Aluminium	36.5	36.0	47.0	78.8	2.0	0.2	30.7	55.7
Other products	43.0	38.1	40.7	44.7	27.7	-7.2	5.2	5.2
Export of old ships and aircraft	0.8	3.7	3.2	3.6	-	-	-	-
Stock changes in export production	-3.3	1.5	0	0	-	-	-	-
<b>Merchandise exports, total</b>	<b>202.4</b>	<b>187.9</b>	<b>211.7</b>	<b>262.4</b>	<b>8.3</b>	<b>-2.9</b>	<b>9.6</b>	<b>15.9</b>
<b>Merchandise imports, total</b>	<b>238.9</b>	<b>283.4</b>	<b>300.7</b>	<b>277.4</b>	<b>15.8</b>	<b>24.5</b>	<b>4.5</b>	<b>-15.3</b>
General merchandise imports	194.4	208.9	219.1	217.0	9.9	11.7	3.1	-9.0
of which: Oil imports	20.7	27.3	27.3	27.6	13.5	3.3	2.4	0.8
of which: Other imports	173.7	181.6	191.8	189.4	9.5	12.7	3.2	-10.0
Special imports	44.5	74.5	81.6	60.4	46.0	74.1	8.0	-30.1
<b>Balance of trade</b>	<b>-36.5</b>	<b>-95.5</b>	<b>-89.0</b>	<b>-15.0</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Export of services (excl. factor income)	113.7	111.6	117.7	133.6	6.7	5.7	2.4	4.4
Import of services (excl. factor income)	128.3	138.7	141.5	152.1	11.5	16.5	0.0	-2.1
<b>Balance of services (excl. factor income)</b>	<b>-14.6</b>	<b>-27.1</b>	<b>-23.8</b>	<b>-18.5</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Net factor income from abroad	-21.6	-21.8	-24.0	-36.0	-	-	-	-
Net current transfers <sup>2</sup>	-1.2	-1.3	-1.3	-1.4	-	-	-	-
<b>Current balance</b>	<b>-73.9</b>	<b>-145.6</b>	<b>-138.2</b>	<b>-70.8</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>

### Notes:

1. Volume changes are based on 2000-prices.
2. Net transfers from abroad other than factor income.

**Appendix table 3. Evolution of the macroeconomic forecast for 2005-2007**

	Forecast for 2005					Forecast for 2006				Forecast for 2007						
	Oct. 2003	Jan. 2004	May 2004	Oct. 2004	Jan. 2005	April 2005	Oct. 2005	Jan. 2006	April 2005	Oct. 2005	Jan. 2006	April 2005	Oct. 2005	Jan. 2006		
<b>Volume change (%)</b>																
Private consumption	5	3½	3½	5	6.8	7.6	9.5	12.0	5	5.6	6.1	4.3	4.3	0.6	0.6	0.6
Public consumption	2	2	2	2	2.0	2.6	2.4	2.9	2	2.0	2.7	2.2	2.2	2.5	2.2	2.1
Investment	16½	7¼	15½	18	22.5	30.3	28.5	27.7	9¼	7.1	-0.8	0.8	3.6	-24.9	-23.8	-27.2
Total national expenditure	7	4¼	6	7½	9.5	11.6	12.8	14.0	5½	5.3	3.8	2.9	3.5	-5.1	-5.2	-6.1
Total exports	3	1½	4	4	3.8	4.3	1.4	-1.3	5¾	7.1	7.5	6.2	6.9	12.5	11.6	11.8
Total imports	6¼	3¼	6½	10½	13.7	18.0	18.3	21.6	8½	8.0	2.9	1.9	3.0	-6.2	-8.8	-10.9
Gross domestic product (GDP)	5½	3½	5	5	5.5	5.9	6.0	5.1	4½	4.7	5.7	4.6	5.0	2.4	2.5	2.6
Current account balance (% of GDP)	-4¾	-6¼	-9	-11	-10.7	-12.1	-13.3	-15.0	-13½	-12.8	-11.4	-12.2	-13.0	-6.2	-6.4	-6.2
General government balance (% of GDP)	1	1	1	1½	1.5	0.9	2.4	3.3	1½	1.6	1.1	1.0	1.1	-1.2	-0.8	-0.9
<b>Income and price changes (%)</b>																
Disposable income per capita	7	6½	6	6¾	7.1	5.7	7.7	8.4	7¼	7.2	5.0	6.6	7.3	4.6	6.2	6.3
Wages	7	5½	4½	5¼	5.7	5.8	6.3	6.8	4.4	4.4	5.0	5.0	5.8	4.6	4.5	4.5
Real disposable income per capita	4	3¾	2¾	3¼	3.9	1.8	3.7	4.2	4	3.7	3.3	2.7	3.3	2.5	2.1	2.2
Inflation	3	2¾	3	3½	3.2	3.9	3.9	4.0	3¼	3.5	3.8	3.8	3.9	3.4	4.0	4.0
Exchange rate, index	127.0	127.0	125.0	125.0	119.4	111.3	109.8	108.7	128.0	124.2	116.8	113.8	108.7	122.8	119.3	117.1
Unemployment, % of labour force	2	2¾	2¾	2¾	2.8	2.4	2.2	2.1	2¼	2.2	2.2	1.8	1.7	3.5	2.7	2.6