

# The Icelandic Economy

Spring 2006

Macroeconomic forecast  
2006–2010



MINISTRY OF FINANCE

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## MAIN CONCLUSIONS

This report deals with the situation and outlook for the main areas of the Icelandic economy in 2006-2007 on the basis of new macroeconomic projections by the Ministry of Finance. Some changes from the January projections are explained. A projection of developments up to 2010 is also included. The main conclusions are as follows:

- Provisional national accounts for 2005 indicate that real GDP rose by 5.5 per cent due to rapidly increasing national expenditure. In addition to power project investments, unanticipated innovation in the financial markets had a temporary impact to substantially increase private consumption and imports.
- Despite the recent turbulence in financial markets, the profile of the projections is not much changed. This year, real GDP is projected to increase by 4.8 per cent on the basis of a changing composition of growth. The growth in domestic demand and imports decelerates while aluminium exports increase sharply. The departure of the US defence force from Keflavik is expected to have a slight contractionary effect on growth but to offer new opportunities in the future.
- National expenditure is expected to contract in 2007, following tight economic policy in recent years and the completion of the current power project investments. Nevertheless, a strong turnaround in trade is expected to result in GDP growth of 1.8 per cent.
- An unavoidable consequence of the temporary shocks has been a large current account deficit, which amounted to 16.5 per cent of GDP in 2005. The deficit is expected to continue large this year, or 14.4 per cent of GDP, but to decline rapidly in 2007, to 7.7 per cent of GDP. The decline in the exchange rate of the króna accelerates the external adjustment of the economy.
- Unemployment has declined rapidly as is estimated to be 1.6 per cent of the labour force this year but to increase slightly in 2007, to 2.2 per cent, when the pace of activity slows down. The pressure in the economy this year is larger than earlier assumed. The reason is that the revised national accounts for 2004 show that GDP grew by 8.2 per cent, and not 6.2 per cent. The positive output gap is expected to reduce quickly inter alia due to changed conditions in lending markets, the sharp decline in the exchange rate and the completion of the present power project construction projects next year.
- Inflation was around 4 per cent on average for 2005, due to the sharp rise in real property prices. The pace of property price increases has been decelerating rapidly, whereas the sharp decline in the exchange rate in recent weeks will have an inflationary impact on consumer prices. For this year, inflation is expected to average 5.9 per cent, but this situation is expected to be transitory and in 2007 inflation is expected to be 3.5 per cent.
- In the projection for 2008-2010 the economy gradually moves back to equilibrium, with GDP growth and inflation approaching a 2.5 per cent annual rate and the current account deficit down to reach 2 per cent of GDP towards the end of the period.
- The Icelandic economy is a part of the international economy, with all associated opportunities and challenges. In international reports the Icelandic economy has been ranked amongst the most competitive in the world, due to its human resources, technological development and efficient structure. The companies, that enjoy a flexible operating environment, are profitable and resilient in adjusting to changeable

circumstances. The position of the Treasury is strong and the assets of households are many times greater than the debts. It is therefore considered a limited risk that the progress achieved in recent years will be stopped or reversed.

- Main elements of uncertainty in the projections concern the exchange rate and additional large scale investments.



## SUMMARY OF THE FORECAST

### Economic developments in 2004 and 2005

The recently revised national accounts of Statistics Iceland show that GDP growth in 2004 was 8.2 per cent, 2 percentage points higher than earlier estimated. Provisional figures for 2005 indicate a growth rate of 5.5 per cent, 0.2 per cent more than in the Ministry's January forecast. This rapid growth was primarily due to the sharp increase in domestic demand, partly because of power project construction but also because of unforeseen changes in the housing mortgage market in 2004 and the debt market in 2005. Demand therefore exceeded the level in these two years than had been expected at the time when a decision was made to embark upon the present phase of power project construction.

The growth of the past two years can be analysed on the expenditure side of the national accounts as follows. Private consumption increased in real terms by 7.2 per cent in 2004 and 11.9 per cent in 2005. Investment rose still more, by 29.2 per cent in 2004 and 34.5 per cent in 2005, mostly on account of power project construction and related aluminium plant investments. Total national expenditure grew by 10.4 per cent in 2004 and 14.9 per cent in 2005. This growth was accompanied by rising imports and a current account deficit, especially in 2005 when it amounted to 164 billion krónur, 16.5 per cent of GDP. It should be noted in this connection that the exchange rate rose by 10 per cent last year, increasing Iceland's purchasing power abroad. At the same time, the increase in the current account deficit meant that economic growth in 2005 was lower than the year before in spite of a higher growth in national expenditure in that year.

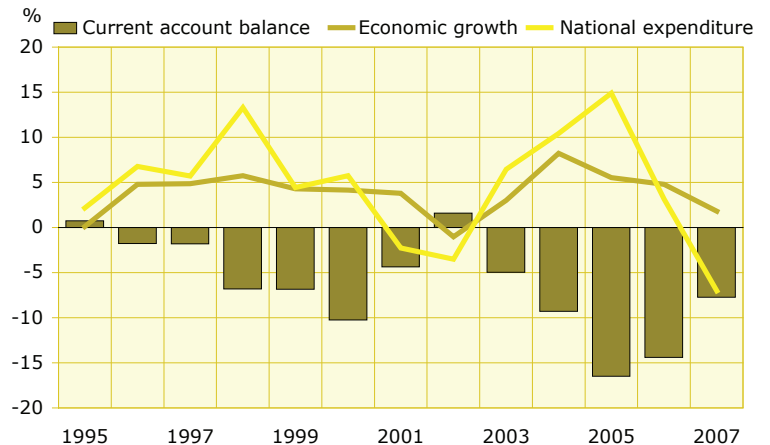
The increase in growth in recent years has also meant that the assessment of the output gap has changed. At present, the output gap in these years is now estimated to have been wider than previously thought.

The activity of the public sector was quite modest in 2005. Public investment declined by 13.5 per cent in real terms and public consumption rose by 3.2 per cent. The public consumption of the central government, including the social security sector, rose by 2.3 per cent, well in line with the medium-term stance for fiscal finances.

The consumer price index rose by 3.2 per cent in 2004 and 4 per cent in 2005. In several instances, inflation exceeded the Central Bank's inflation target in the course of last year. The rise in inflation is mainly due to rising real property prices, as the imputed housing component of the consumer price index rose by 9 per cent in 2004 and more than 22 per cent in 2005. Excluding housing, consumer price inflation came to 2.1 per cent in 2005 and 0.9 per cent in 2005.

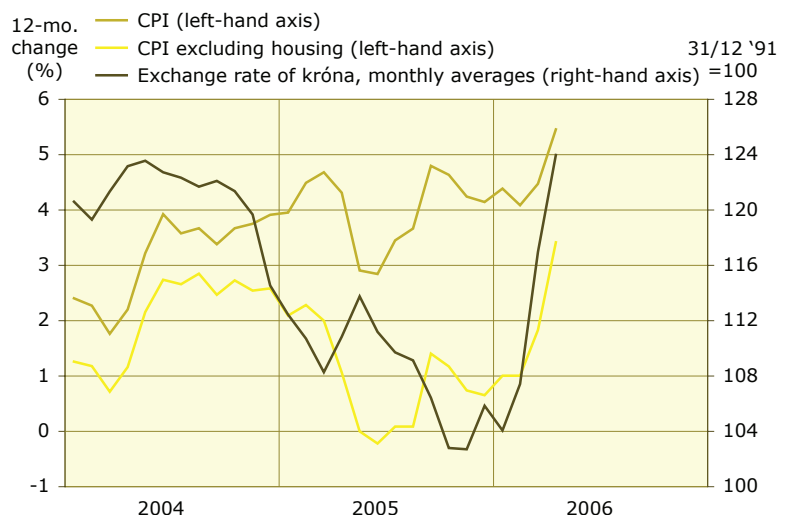
Real wages have increased considerably in recent years. Per capita real wages rose by 3.2 per cent in 2004 and close to 4 per cent in 2005. Real hourly

*Economic growth exceeded expectations*



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

Source: Statistics Iceland and own forecast.



**Chart 2**  
**Inflation and the exchange rate of the króna January 2004 - April 2006**

Sources: Statistics Iceland and Central Bank of Iceland.

wages have risen in recent years in spite of rising inflation. Unemployment had declined rapidly, or from more than 3 per cent of the labour force in 2004 to 2.1 per cent in 2005. In spite of low unemployment, pressures in the labour market have been quite limited in the present expansion. Substantial labour imports have helped in reducing wage drift.

### Economic prospects in 2006 and 2007

In this forecast, it is projected that economic growth will continue to be high in 2006, 4.8 per cent, but slow down rapidly next year, to 1.8 per cent, due to a rapid decline in investment, both of business and households. The increased growth and output gap of recent years have the effect that the output gap will peak this year and be wider than previously estimated. The gap will still exist next year, although it will narrow between years. This situation places the demand upon economic policy that it must be tighter and last longer than previously thought.

The present power project construction is now drawing to a close. This project includes the Reyðarfjörður aluminium plant which will be in full production in 2008 with a capacity of 346 thousand tonnes a year. The Norðurál plant in Hvalfjörður is being expanded by 170 thousand tonnes this year, and a further expansion of 40 thousand tonnes scheduled for completion in the fourth quarter of 2007, will bring the total production capacity of Norðurál to 260 thousand tonnes a year. The total cost of these projects, including hydro- and geothermal power generation, is estimated at close to 260 billion krónur at 2003-prices.

This forecast assumes that the exchange rate index will be close to 120 on average this year, which is equivalent to a 10 per cent decline in the exchange rate. A further decline of 3 per cent in the exchange rate is assumed for 2007, bringing the index to 124.

National expenditure is forecast to increase by 3.2 per cent in 2006. Investment is expected to increase by 4.6 per cent, with business investment increasing by 3.8 per cent, housing construction by 11.6 per cent and public investment declining by more than 15 per cent. Private consumption is forecast to increase by 2.2 per cent and public consumption by 2.5 per cent. The

*Economic growth will continue strong this year and slow down next year ...*

*... when the present power projects will be completed*

*National expenditure expected to slow down this year and decline rapidly in 2007*

**Table 1. Overview of the forecast 2004–2007**

	Bn.kr.	Volume change on prev. year, %			
		Prel.	Estim.	Forecast	
	2005	2004	2005	2006	2007
Private consumption	599.2	7.2	11.9	2.2	0.5
Public consumption	246.3	2.9	3.2	2.5	2.4
Gross fixed capital formation	285.9	29.1	34.5	4.6	-29.2
Change in stocks <sup>1</sup>	-1.3	0.1	0.0	0.1	0.0
National expenditure	1 130.1	10.4	14.9	3.2	-7.0
Exports of goods and services	314.0	8.4	3.5	5.0	11.9
Imports of goods and services	448.6	14.4	28.4	0.3	-11.4
Gross domestic product (GDP)	995.5	8.2	5.5	4.8	1.8
Gross national income (GNI)	967.8	6.3	6.3	4.9	0.5
Effects of changes in terms of trade <sup>2</sup>	-	-0.6	0.3	0.6	-1.4
GNI with effects of ch. in terms of trade	-	5.8	6.7	5.6	-0.9
Current account balance	-164.1	-	-	-	-
% of GDP	-	-9.3	-16.5	-14.4	-7.7

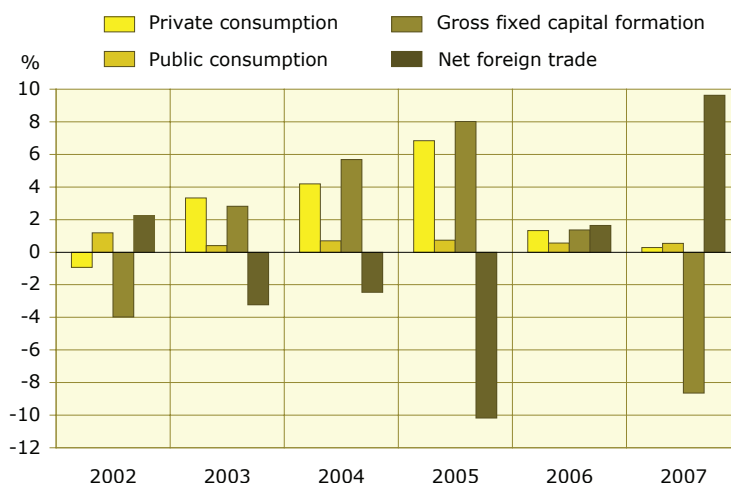
1. Figures show increase in stocks between years as a percentage of GDP for the previous year, at fixed prices.

2. In per cent of national income for the previous year, at fixed prices.

current account deficit is expected to continue high, 14.4 per cent of GDP this year, to a large extent due to power project imports. In spite of high oil prices, the terms of trade are expected to improve this year, thanks to high prices for fish exports and aluminium.

National expenditure is expected to decline in 2007 by 7 per cent in real terms. Investment will contract sharply, by an estimated 44 per cent due to the completion of power project investments.

Business investment was estimated to be about 20 per cent of GDP this year and last, whereas for 2007 it is expected to decline to 11 per cent, which is about the same ratio as in 2003 at the time when power project investments were commencing. Public investment is on the other hand expected to increase by more than 30 per cent next year, as some of the public investment projects that have been postponed in recent years will be begun. Private consumption is forecast to remain almost unchanged in 2007, increasing by a scant 2.5 per cent. At the same time as national expenditure is declining in 2007 as well as the exchange



**Chart 3**  
**Contribution to economic growth 2002-2007**

Source: Statistics Iceland and own forecast.

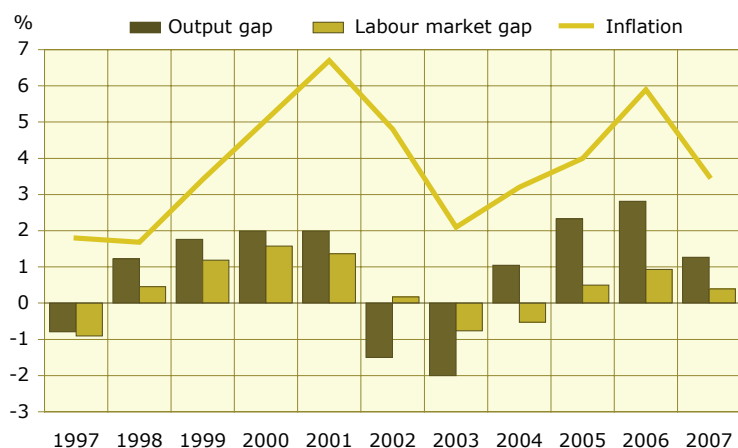
**Table 2. Key economic indicators 2004-2007**

Economic aggregates		2004	2005	2006	2007
GDP growth	%	8.2	5.5	4.8	1.8
National expenditure	Annual growth, %	10.4	14.9	3.2	-7.0
Current account balance	% of GDP	-9.3	-16.5	-14.4	-7.7
Net foreign debt	% of GDP	-79.5	-85.6	-99.6	-106.5
National saving	% of GDP	14.1	12.1	13.8	12.5
<b>Labour market</b>					
Labour force	Thousand man-years	147.7	152.1	158.7	157.2
Unemployment	% of labour force	3.1	2.1	1.6	2.2
Real hourly wage	Annual change, %	1.3	2.7	0.7	0.7
Real disp. income per capita	Annual change, %	3.2	3.9	3.4	3.4
<b>Foreign trade</b>					
Exports of fish products	Annual vol. change, %	6.7	-3.4	2.0	2.0
Aluminium exports	Annual vol. change, %	0.7	-3.1	31.5	58.3
Total merchandise exports	Annual vol. change, %	8.2	1.0	3.0	16.5
Total merchandise imports	Annual vol. change, %	15.8	25.0	6.0	-18.8
<b>Money and prices</b>					
Inflation	%	3.2	4.0	5.9	3.5
Exchange rate index	Dec. 31 1991=100	121.0	108.7	119.7	123.7
Central Bank policy rate	Annual average, %	6.1	9.4	12.0	9.7
<b>External circumstances</b>					
OECD-growth	%	3.3	2.7	2.9	2.9
OECD-inflation	%	1.5	2.0	1.8	1.8
Fish export prices in foreign currencies	Annual change, %	0.3	8.9	3.2	0.0
Import price of oil	Annual change, %	27.6	37.5	0.0	-3.0

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

*Growth will increasingly be export-led*

rate, imports are projected to decline by 11 per cent and exports to increase by 12 per cent, also because of a sharp increase in aluminium production in that year. The reversal on external account will help in reducing the current account deficit by 2 percentage points in 2006 and by half in 2007, bringing it down to 7.7 per cent of GDP.



**Chart 4**  
**The output gap, labour market gap and inflation 1997-2007**

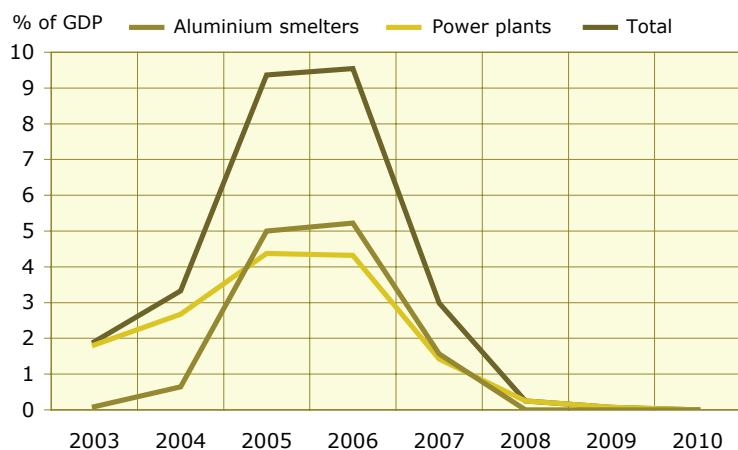
Source: Statistics Iceland and own forecast.

this year but decline gradually next year. The output gap is expected to peak this year. The same applies to the labour market gap, but the decision to open the labour market to the new member countries of the EU as of May 1st of this year will undoubtedly help reduce labour market pressures. The output gap is expected to narrow next year.

### Differences from the previous forecast

In the previous forecast reports of the Ministry, an account has been given of the changes in the latest forecast compared to earlier forecasts in order to increase the transparency and information on forecasting methods. A table in the Appendix compares the main forecast aggregates for the year 2006 and 2007. Part of the discrepancies is attributable to the emergence of new data that were not at hand in earlier forecasts.

In light of most recent economic developments, this year's economic growth is now forecast to be similar to that projected in the Ministry's January forecast. For 2007, growth is thought to be slightly lower than previously assumed. The volume changes in individual items on the expenditure side of the national accounts have also changed for the current year. The growth in private consumption is now projected lower, as well as that of exports and imports. These items have not changed materially for 2007. Real household income is now expected to increase less this year than before, since inflation is thought to be higher. The forecast for unemployment this year and next has been reduced from earlier forecasts.



**Chart 5**  
**Power project construction 2003-2010**

Source: Ministry of Finance.

The present scenario projects a 2.4 per cent annual growth rate for the years 2008-2010. This is a similar result as has been presented earlier. The reason

### Prospects until 2010

The baseline scenario up to 2010 does not assume any further power project developments during this period, although there is at present a considerable likelihood that such projects will continue over the next several years. The Ministry's forecasts are based on the rule that such prospects are not incorporated into forecasts until firm decisions are at hand.



## Special section 1. The impact of the exchange rate on the national economic forecast

In the past several forecasts of the Ministry, attention has been directed at the uncertainty of the exchange rate. Forecasts of the exchange rate have been revised, and it is important to attach a clear caveat to the exchange rate assumption underlying each forecast. This section discusses the impact of the deviation of the actual exchange rate from the assumed rate in the baseline forecast and how it will affect its main aggregates.

The deviation from the baseline forecast show alternatives where the actual exchange rate for 2006 would be 5 per cent higher or lower than the assumed exchange rate. The exercise is then extended for the years 2007 to 2010. The table below shows these two examples, a low and a high alternative scenario derived from the Ministry's forecasting model, which is based on econometrics and historical time series.

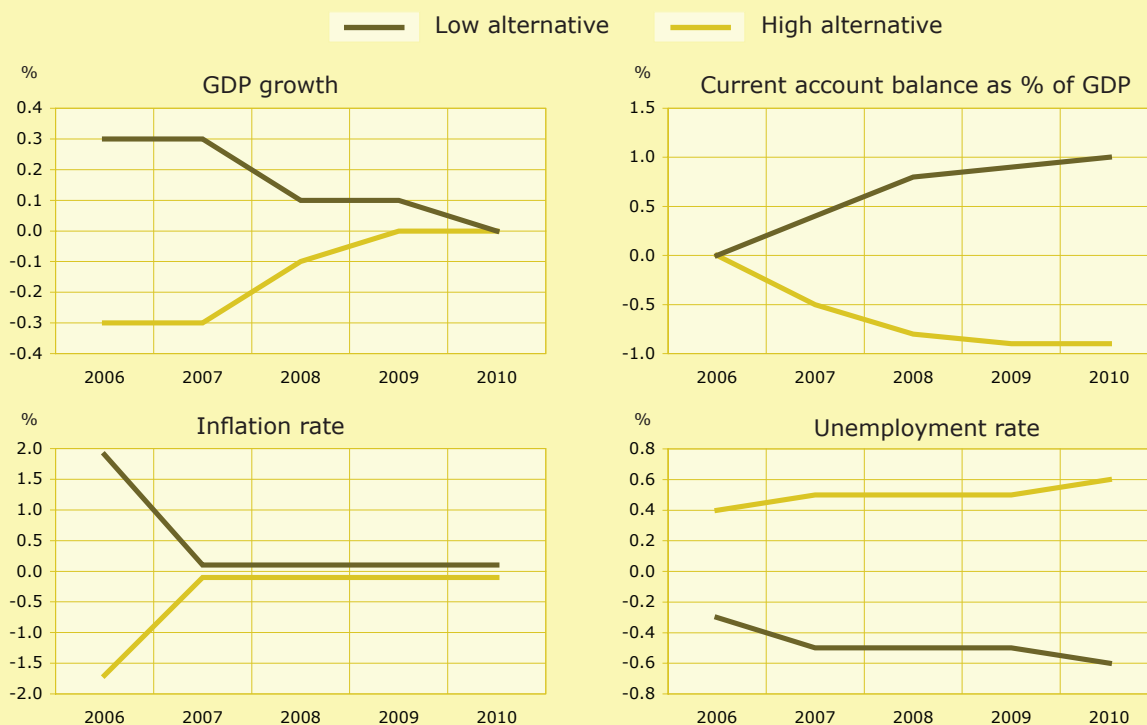
<i>Exchange rate index</i>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Baseline	108.7	119.7	123.7	127.2	128.0	128.0
Low alternative	108.7	125.7	129.8	133.5	134.4	134.4
High alternative	108.7	113.7	117.5	120.8	121.6	121.6
<i>Change in exchange rate index over previous year (%)</i>						
Baseline	-10.2	10.1	3.3	2.8	0.7	0.0
Low alternative	-10.2	15.6	3.3	2.9	0.7	0.0
High alternative	-10.2	4.6	3.3	2.8	0.7	0.0

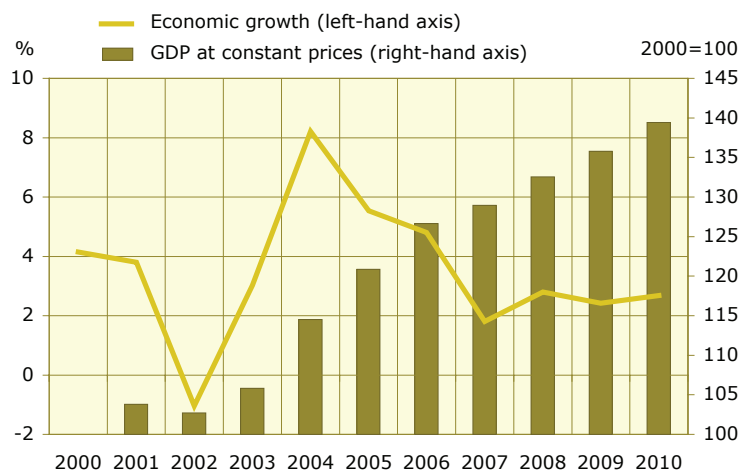
These alternative scenarios have a quite strong initial impact on economic growth. The low alternative indicates that economic growth would be 0.3 per cent higher than in the baseline forecast, both in 2006 and 2007. The deviation declines to 0.1 per cent in 2008 and disappears altogether by 2010. The high alternative is almost symmetrically opposite to the low one, and this applies also to the impact on the current account, inflation and unemployment.

The alternative scenarios convey the impression that the change in the current account balance as a ratio of GDP reacts more slowly than economic growth. According to the extrapolation, about half of the effect emerges in 2007 and the full effect will emerge by 2010 when the current account deficit will be 1 per cent lower in the low alternative than in the baseline scenario.

The inflation impact will be felt immediately and disappears almost fully in the second year. The impact on unemployment increases with time, at least over the period under consideration here.

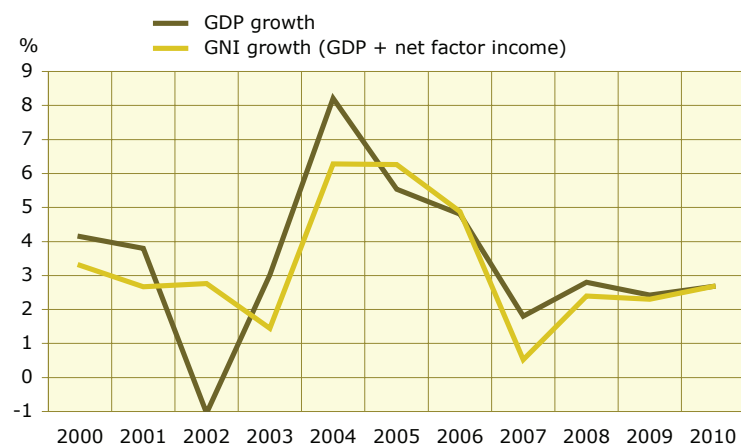
### Impact of alternative scenarios on growth, current account balance, inflation and unemployment





**Chart 6**  
**Economic growth and GDP at constant prices 2000-2010**

Source: Statistics Iceland and own forecast.



**Chart 7**  
**Growth in gross domestic product and gross national income 2000-2010**

Source: Statistics Iceland and own forecast.

why the completion of power projects will not be followed by a contraction is that exports will increase and imports are expected to decrease. In addition, the timing of public investment takes account of the general economic downturn in the wake of the completion of power projects by an increase in public investment in the years 2007 to 2008. The same applies to the last stage of the cut in the personal income tax. The current account deficit is expected to decline and approach 2 per cent of GDP, based on the assumption that no further power project investments will take place before 2010. The projection also indicates that inflation will be close to the Central Bank's inflation target in the 2008-2010 period.

Should further power project investments materialise over the next several years, it will be important that they be distributed over time so as to facilitate the maintenance of economic stability. An increase in aluminium production capacity of 100 thousand tonnes will lead to about a 1 per cent higher economic growth. Such a construction phase does not necessarily need to produce instability in light of the experience presently at hand, especially if other economic circumstances do not increase general economic demand as was the case in 2004 and 2005.

**Table 3. Main economic aggregates 2003-2010**

Annual volume change in % unless otherwise stated	Annual average		Annual change		
	2003-2006	2007-2010	2008	2009	2010
Gross domestic product	5.4	2.4	2.8	2.4	2.7
Private consumption	6.7	1.0	0.8	1.3	1.5
Public consumption	2.5	2.4	2.4	2.4	2.4
Gross fixed capital formation	20.6	-11.3	-16.0	-0.2	4.6
Business sector investment	28.9	-18.2	-29.1	2.9	9.0
Residential construction	9.9	-0.2	-4.3	0.6	2.9
Public sector investment	-2.0	6.6	12.7	-8.8	-4.3
Exports of goods and services	4.6	6.6	10.2	2.8	1.7
Imports of goods and services	13.0	-3.5	-2.6	0.1	0.5
Current account balance, % of GDP	-11.4	-4.0	-3.4	-2.5	-2.1
Unemployment, % of labour force	2.5	2.9	3.3	3.3	2.9
Inflation rate, %	3.9	2.6	2.4	2.1	2.6

## THE INTERNATIONAL ECONOMY

World economic growth amounted to 4.8 per cent in 2005, and the outlook is for a similar growth this year and next. Growth prospects have improved in recent months, in part due to rapid growth in China, India and Russia, along with continued good growth in the United States and improving growth prospects in Japan. The growth pace in the US is still lively in spite of hurricanes and rising oil prices. Growth in the Euro-area has been scant due to weak domestic demand. Growth in the world economy has been much helped by sharply increasing international trade or around 8% in 2005.

The sharp increase in the world price of oil, from about 30 dollars a barrel in 2004 to around 70 dollars in the spring months of 2006, has generally not led to increased world inflation in part due to improved utilisation. Investment in oil productive capacity has been minimal in recent years while oil prices remained lower.

Growth in the US economy came to 3.5 per cent in 2005 in spite of hurricanes and oil price increases. Forecasts indicate that this growth pace will continue both this year and next. The current account deficit is expected to be 7 per cent of GDP this year and goes a long way towards mirroring the combined current account surpluses of all other countries of the world. It appears that this situation will still continue for a while, even if the US current account deficit has persisted for a number of years. The current account deficit amounted to 5.7 per cent of GDP in 2004 and 6.5 per cent in 2005 and all projections indicate that it will not be lower next year. This situation can last as long as investors outside the US are willing to add dollars to their asset portfolios. This applies especially to China, Japan and the oil countries of the Middle East which together have a current account surplus equivalent to 70 per cent of the US current account deficit. One of the main risks to stability in the world economy is that the US will be compelled to sharply adjust its current account deficit, once foreign investors feel saturated with dollar assets. The dollar exchange rate would decline in such circumstances which would disturb the equilibrium in the world economy. Along with the US deficit on current account, the public sector is running at a deficit 5 per cent of GDP. Savings in the private sector are roughly in balance, with households running a deficit that is offset by corporate savings. It appears that the public sector deficit will persist for the near future. Such a persisting twin deficit could eventually dissuade international investors.

*World economic growth was strong last year ...*

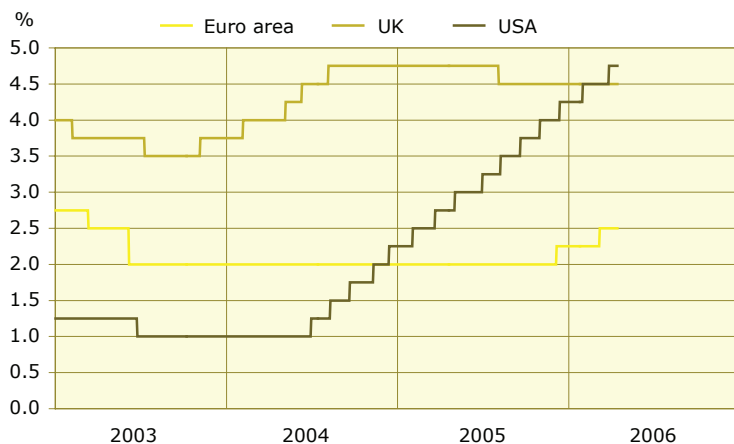
*... in spite of high oil prices*

*The persistent US current account deficit calls for large financing needs in international markets*

**Table 4. Economic growth 2005–2007**

Volume change in GDP, %	2005	2006	2007
World	4.8	4.8	4.7
Euro area	1.3	2.0	1.9
Germany	0.9	1.4	1.0
France	1.5	2.0	2.1
Italy	0.1	1.5	1.5
Spain	3.4	3.2	3.2
The Nordic countries	2.5	3.0	2.3
UK	1.8	2.5	2.7
USA	3.5	3.3	3.6
Japan	2.8	2.8	1.7
Russia	6.4	6.0	5.8
China	9.9	9.5	9.0
India	8.4	7.3	7.1
Africa	5.0	5.7	5.5

Sources: IMF, OECD.

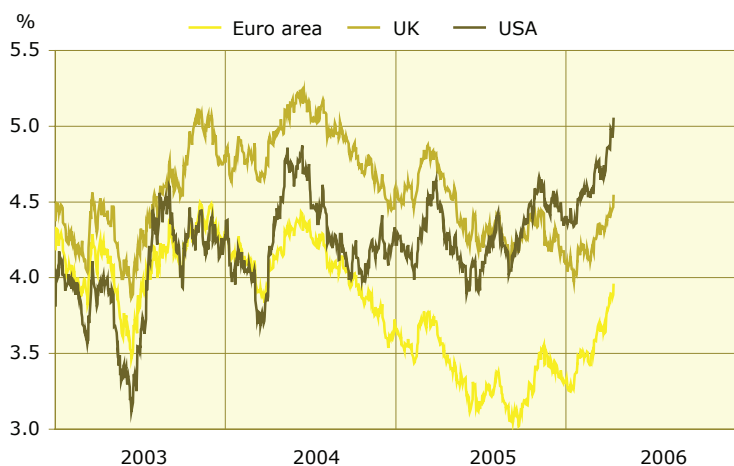


**Chart 8**  
**The policy interest rate in the euro area, the UK and US, daily data 2003–2006**

Source: EcoWin.

for younger people. This intention has been met by much resistance. UK growth slowed down to 1.8 per cent in 2005, but growth prospects appear to be reviving this year and next. The Nordic countries together seem to be able to achieve a slightly higher growth rate this year than their continental neighbours. Taken together, their growth is forecast at about 3 per cent this year, slowing down slightly next year.

Japan's economy is finally recuperating after a long period of stagnation. GDP growth in 2005 appears to have reached 2.8 per cent, 0.8 per cent more than was forecast six months ago. Exports are doing well, mainly because of demand from China and the US. Domestic demand and employment are also reviving. Growth this year appears similar to that achieved in 2005.



**Chart 9**  
**Yield on 10-year Treasury bonds in the euro area, the UK and US, daily data 2003–2006**

Source: EcoWin.

Growth in the Euro-area was scant in 2005, 1.3 per cent, but is forecast to increase slightly this year, to 2 per cent. The Euro-countries are having difficulties in getting out of their low-growth path, mainly Germany and Italy. Labour laws are such that businesses are reluctant to hire additional staff, since reducing staff can be difficult when business slows. This tends to lead to high unemployment, particularly among younger people. Germany is still dealing with high unemployment along with a considerable public sector deficit. Germany has difficulties in reviving domestic demand in spite of low interest rates. France is trying to revise its labour legislation by providing for initial temporary employment

The world economy has benefited from an increasing supply of loanable funds in world financial markets in recent years. Corporate savings in industrial countries have been healthy and the current account surpluses of oil exporting countries have also served to increase world supply of finance. The ample supply of world finance has served to erode the effectiveness of monetary measures by the major central banks of the world. The US Federal Reserve has increased its policy rate from 1 per cent in April 2004 to 4.75 per cent in March of this year. The policy rate in the UK rose earlier and more, and the Euro rate has recently been raised. Ten-year dollar rates have nevertheless continued low and have only edged upwards by about 1 per cent from the

middle of 2005. Bond rates in the Euro-area have behaved similarly since the autumn of 2005 and British interest rates from the beginning of this year. This indicates that inflationary expectations may be on the rise in spite of a tighter monetary policy. It is probably, that expectations of a continued high oil price and a vigorous world growth has such an impact.

Icelandic banks and other domestic borrowers have had good access to foreign financing in recent years. All indications are that the world financial market will continue ample and thus support the Icelandic economy. In spite of the difficulties of recent weeks incurred by the commercial banks, it is difficult to foresee a situation where they will be unable to refinance their debt over the next several years.

*The disquiet in international financial markets is likely to be temporary*



## NATIONAL EXPENDITURE

### Private consumption

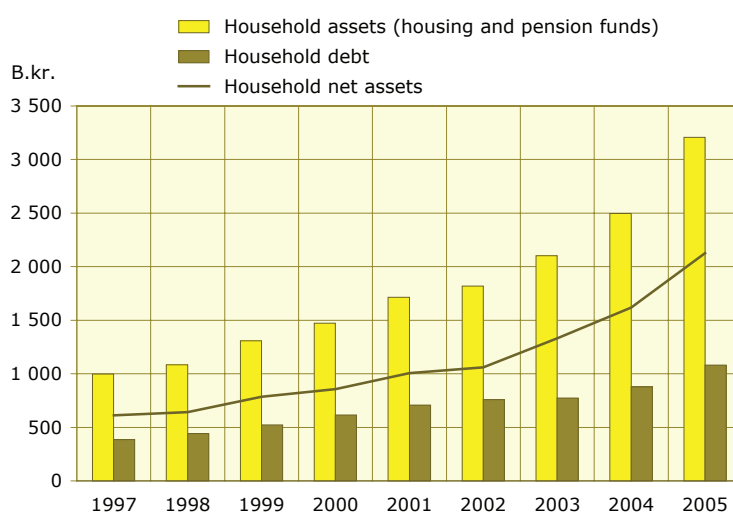
Provisional figures from Statistics Iceland show that private consumption increased by 11.9 per cent in volume terms in 2005 over the previous year, whereas the population increased by 1.1 per cent. Private consumption has been driven by a number of causes that all seem to be working in concert. Real income has been rising fast in recent years at the same time as unemployment has declined. Changes in the housing finance market in the autumn of 2004 increased the financial flexibility of individuals through their access to longer-term financing at favourable interest rates. Many households refinanced their debt in order to invest in more expensive homes and to increase consumption. The strong exchange rate did much to increase household demand for imported consumer goods and private motor vehicles. Auto imports rose by 55 per cent between 2004 and 2005. The rise in housing prices also played a role in increasing private consumption. Average house prices rose by 35 per cent last year. Rising house prices affect the borrowing ability of homeowners, since maximum mortgage amounts are related to market prices for housing. Homeowners can thus take out a mortgage against the increasing market value of their homes to finance their private consumption. Along with rising housing prices, stock prices on the Iceland Stock Exchange rose sharply, by 40 per cent in 2005 over the previous year. All told, last year was a very good year for the household sector.

Household debt has been increasing. At the end of last year, household debt to the credit system amounted to 1,082 billion krónur, having increased by 23 per cent over the previous year. There are no precise figures available for household assets, but an approximation can be made through adding the assessed value of all residential housing in the country together with the net assets of the pension funds, since a large part of household assets consists of these two elements. The total assessed value of residential housing amounted to 2,033 billion krónur at the end of 2005 and assets in pension funds amounted to 1,180 billion krónur. Compared to the end of 2004, household assets in housing and pension funds have increased by 29 per cent. This sum of assets is clearly undervalued, since the assessed value of housing is below the actual market value and household assets in stocks, household furnishings and motor vehicles are not counted. Private motor vehicles were about 187,000 at the end of 2005. Balancing debt against assets shows that the net assets of households have increased by more than 30 per cent in 2005. As can be seen in the chart in the margin, household assets have been increasing faster than debt since 1997 and net debt has thus been growing.

For this year, statistical data indicate that private consumption will not be growing as fast as last year. Credit card turnover rose by 7.5 per cent in the first two months of this year, compared with 16.2 per cent in the first two months of last year. The collection of indirect taxes declined in the first two months of the year, by 2.9 per cent in real terms. Revenue from the value added tax alone declined by 6.8 per cent. Sales of non-durable consumer goods rose by 9.5 per cent in the first two months of the year. The Gallup index of consumer expectations peaked in February and dipped in March, following a series of adverse news such as the decline in the exchange rate

*Increasing private consumption reflects asset price increases*

*In spite of increasing household debt, household assets are three times as large as debt*



**Chart 10**  
**Household assets and debt**  
**1997–2005**

Sources: Central Bank of Iceland and Land Registry of Iceland.

*The rowth in private consumption is expected to slow down*

## Special section 2. Household purchasing power in the housing market

The housing market changed sharply in August 2004 when the banks began to offer home mortgage loans in competition with the Housing Finance Funds and offered lower long-term interest rates and a higher borrowing ratio. The banks also offered refinancing mortgages that many households took advantage of. The combination of a better access to credit, a lower interest rate and a longer repayment period led to a considerably lower repayment burden on housing loans and household purchasing power in the housing market increased.

The purchasing power of households in the housing market can be assessed by tracking the mortgage repayment burden which is dependent upon several variables, i.e. interest rates, housing prices and the length of the repayment period. The trend in wages must also be taken into account since higher wages increase purchasing power. The repayment burden in relation to wages can thus be expressed with the following equation

$$V = \frac{F(r, f, T)}{w \cdot L} \quad (1)$$

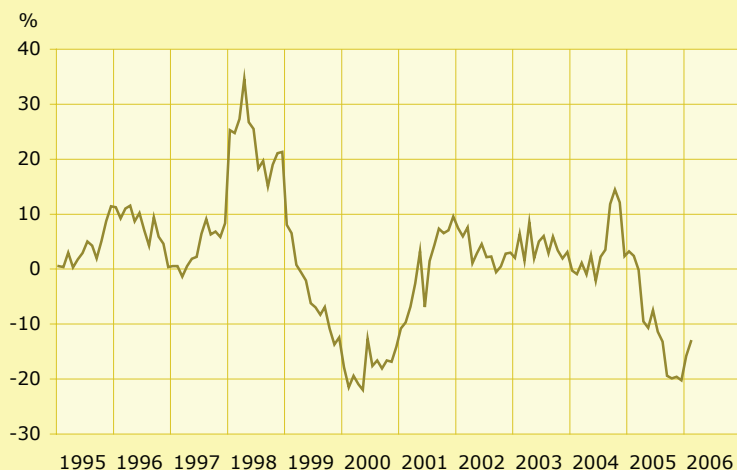
where  $r$  is the interest rate<sup>1</sup>,  $f$  represents housing prices,  $T$  is the repayment period,  $w$  are wage rates, incl. drift, and  $L$  is the number of hours worked.

Households tend to allocate a similar percentage of their total income to housing. If we assume that households will in the long run allocate a certain equilibrium ratio ( $\bar{V}$ ) to housing expenditure and that the number of hours worked ( $L$ ) remains fairly unchanged, equation (1) can be rewritten as

$$\bar{V} = \frac{F(r, f, T)}{w} \quad (2)$$

where  $\bar{V} = V \cdot L$

Equation (2) thus defines the ratio of total wages that is allocated to housing costs at each time. With equation (2) we can assess the trend in household purchasing power in the housing market. The lower the ( $\bar{V}$ ), the higher is the purchasing power of households in the housing market. The reasons for the rise could be lower interest rates, wages increased or repayment periods are lengthened. An increase in purchasing power would tend to increase the demand for housing that would generally increase housing prices which in turn would reduce purchasing power.



**Chart 1**  
**Household purchasing power in the housing market**  
**January 1995 - February 2006**

Sources: Land Registry of Iceland, Statistics Iceland, Housing Financing Fund, Pension Fund of Commerce, Central Bank of Iceland.

The assessed purchasing power of buyers in the housing market has varied in recent years. The Housing Finance Fund began offering a longer repayment period on mortgage loans in 1998 that reduced the repayment burden and increased purchasing power considerably. Purchasing power declined again

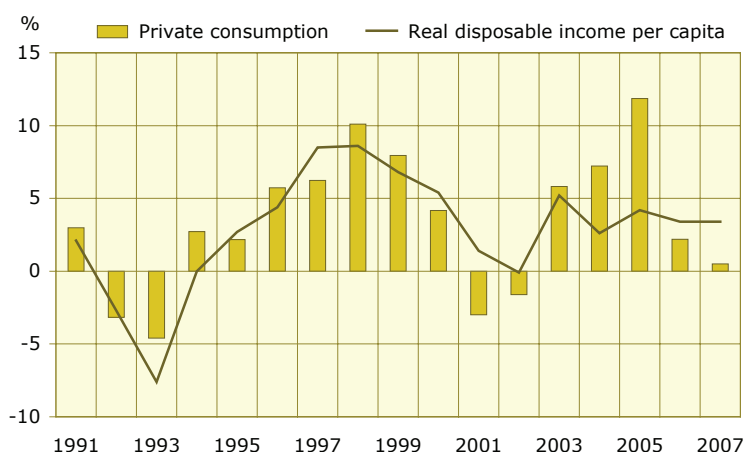
1. The weighted interest cost is assessed on the basis of the market rate of HFF bonds, the real interest rate charged by pension funds and the real interest rate of bonds issued by banks.

from the end of 1999 to the end of 2000 when interest rates on housing credits rose at the same time as housing prices. Purchasing power increased again in the autumn of 2004 and reached a high at the end of 2004, when the increase reached 16 per cent on a 12-month basis. At the same time, households were increasingly refinancing older debt which meant that their repayment burden on housing debt declined. Household purchasing power in the housing market began to decline as of the beginning of 2005, and the gain achieved through a lower repayment burden because of lower interest rates and a longer repayment period is mostly eroded by now through higher housing prices.

Household purchasing power in the housing market has been declining since the autumn of 2005. Mortgage interest rates are edging upwards since the beginning of this year. Turnover in the housing market is declining after a substantial upswing last year. The supply of new housing is increasing along with slower demand is pointing towards a certain equilibrium in the near future. Housing prices are expected to increase far less in the near future than they have done in the recent past. Future household purchasing power will depend upon long-term interest rates in the mortgage market, housing prices and wages.

and of the course of the economy. There are also indications that the access of banks to low-cost foreign financing is becoming less facile. The issue of krónur debt by foreign issuers also declined in March. If these developments continue, it will have an impact upon the ability of the banks to relend foreign funds in the domestic market and thus reduce the scope of households for accessing low-cost loanable funds.

The growth in private consumption is forecast at 2.2 per cent this year as real disposable income is forecast to rise by 3.4 per cent. The exchange rate is expected to decline from last year's average which in turn will erode the purchasing power of Icelanders abroad. One can also expect that after the sharp increase in auto imports and other consumer durables in the past two years, a certain saturation effect will have come into effect. A total of 36 thousand new private motor vehicles have been registered in the past two years. Rising short-term interest rates also have an impact on household spending. Household bank overdrafts amounted to 72 billion krónur at the end of February. The decline in the exchange rate has also increased the repayment burden of households on loans that are linked to the exchange rate. At the end of February, exchange rate-linked debt by households amounted to 31 billion krónur, about 3 per cent of total household debt. The increase in housing prices is also expected to slow down in the course of this year, thus helping to dampen consumer optimism. For 2007, private consumption growth is expected to be slow, about 0.5 per cent.



**Chart 11**  
**Growth in private consumption and real disposable income per capita 1991–2007**

Source: Statistics Iceland and own forecast.

## Public consumption

Public consumption increased by 3.2 per cent in real terms last year, according to provisional national accounts from Statistics Iceland, exceeding the Ministry's January estimate by 0.3 per cent. The public consumption of the central government, including the social security system, increased by 2.3 per cent and that of local governments by 3.8 per cent. Education, communications, the justice system and expenditure by industry ministries were the prime areas of growth in central government consumption.

For this year, public consumption is expected to increase less than last year, by 2.5 per cent in real terms. Central government consumption is projected to rise by 2.3 per cent and local government consumption by 3 per cent. It should be pointed out that a part of the Treasury's transfer payments to the social security sector finances the latter's public consumption expenditure.

*Moderate increase in public consumption in recent years ...*

**Table 5. Public consumption 2002–2007**

	2002	2003	Prel. 2004	Forecast		
				2005	2006	2007
<i>Share of GDP</i>						
Treasury and social security sector	16.7	16.9	16.3	16.2	15.8	16.2
Local governments	8.6	8.9	8.6	8.6	8.6	8.8
Total public sector	25.3	25.8	24.9	24.7	24.4	24.9
<i>Volume change on previous year</i>						
Treasury and social security sector	3.7	1.2	3.1	2.3	2.3	2.4
Local governments	7.6	2.4	2.8	3.8	3.0	2.5
Total public sector	5.0	1.6	2.9	3.2	2.5	2.4

Source: Statistics Iceland and own forecast.

*... and the ratio of public consumption to GDP has declined*

The Treasury's public consumption expenditure is estimated to increase by 1.9 per cent in real terms this year, in accordance with the Government's medium-term programme. This estimate takes account of the Government to hold the growth in overall public consumption expenditure within the limit of 2 per cent in real terms and is based on the fiscal budget and on the budgets of the largest local governments. For next year, central government public consumption is expected to increase by a similar percentage as this year, in line with the Government's medium-term programme. At this stage, no account has been taken of additional expenditure that may be incurred due to changed defence and security circumstances, since these would fall outside the Government's medium-term frame. The growth in the public consumption of local governments is estimated at 2.5 per cent, leaving a growth in total public consumption of 2.4 per cent in 2007.

The share of public consumption in GDP was 24.7 per cent in 2005, compared to 24.9 per cent in 2004 and 25.8 per cent in 2003. This year's share is estimated at 24.4 per cent, increasing to 24.9 per cent next year. Wages and related expenses constitute the bulk of public consumption. They accounted for 64 per cent in 2005 and 63 per cent the year before. This year, the share is expected to rise by a small margin, to 64.5 per cent and increase again next year.

### **Business investment**

*Business investment has surged*

Business investment is estimated to have increased by 57 per cent in 2005, mostly due to power project investment that constitute about half of business investment in that year. Excluding those, business investment increased by 14 per cent over the previous year.

Domestic demand has grown sharply and done much to stimulate business investment, particularly in the construction sector. Imports of investment goods increased by 44 per cent in volume last year, mostly on account of power project investments. The stronger króna undoubtedly did much to encourage imports of investment goods, even if the strength of the exchange last year hurt businesses engaged in international competition. Investment in the fisheries sector is estimated to have decline by 25 per cent last year.

An IMG Gallup poll conducted in February 2006 amongst the 400 largest companies in the country revealed that business investment intentions were similar this year as in the previous year. Fisheries companies are an outstanding exception; 46 per cent of respondents thought that their investment would decline. The poll was commissioned by the Ministry of Finance, the Central Bank and the Confederation of Employers.

*Business investment is expected to decline sharply in 2007*

This forecast assumes that the growth in business investment is slowing down to an increase of 3.8 per cent this year, mostly on account of power project investments that are scheduled to be largely completed this year. It is also

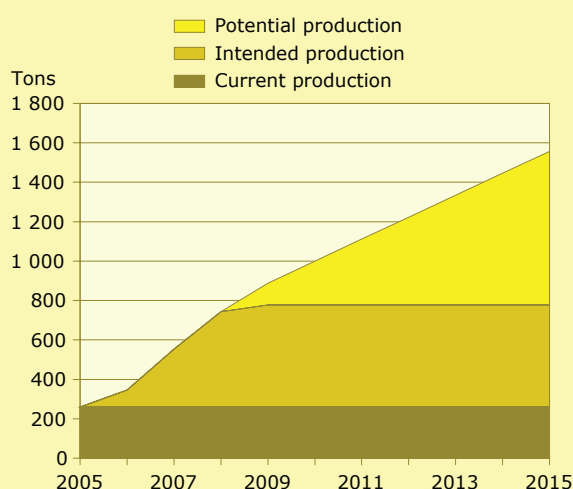


## Special section 3. Prospects for further power project construction

There has been considerable discussion lately whether new power project construction will follow the present projects that are scheduled for completion in the latter half of 2007. There are three alternatives under consideration, calling for a total aluminium production increase of 780 thousand tonnes a year.

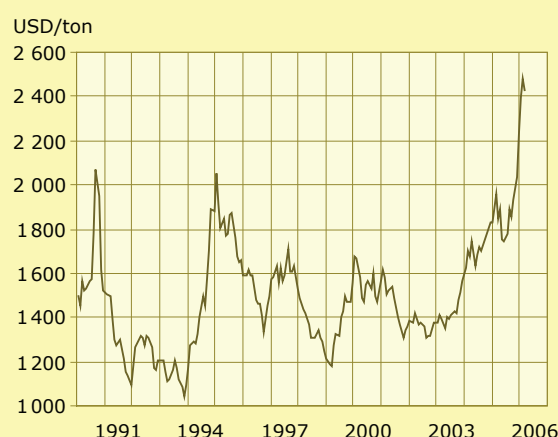
- The expansion of the Alcan smelter in Straumsvík, near Hafnarfjörður, by 280 thousand tonnes in addition to the current annual production capacity of 170 thousand tonnes.
- A new aluminium plant of Norðurál at Helguvík, near the tip of the Reykjanes peninsula, producing 250 thousand tonnes a year.
- A new aluminium plant at Húsavík, on the northern coast, producing 250 thousand tonnes a year.

If all these projects are realised, total aluminium production will reach 1,570 thousand tonnes a year. The chart in the margin shows the increase in aluminium production, assuming a smooth increase in construction activity over the years 2008-2015.



**Chart 1**  
**Aluminium production 2005-2015**

Source: Ministry of Finance.



**Chart 2**  
**The world price for aluminium  
January 1990 - March 2006**

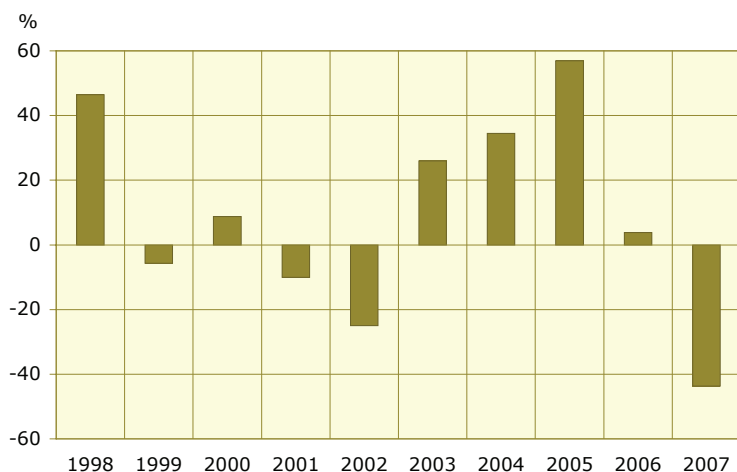
Source: London Metal Exchange (LME).

There are still many issues that must be resolved before these projects can begin, such as assessing the prospects for energy supply, environmental surveys and construction timing. The prospective construction firms are at different stages of preparation and determination with regard to these projects. The main interest of the foreign partners in such ventures is in the supply of environmentally benign energy, a stable economic environment and a well-educated labour force. The high world price for aluminium is encouraging the interest in increasing production.

In light of the experience from the construction cost of the present power projects, these three projects could cost about 420 billion krónur, including plant construction, power generation and power lines. The infrastructure cost, such as roads and harbours, is not included.

Should these projects proceed at an even pace in the years 2008-2015, annual economic growth will be about 1 per cent higher on average than otherwise. By comparison, the present power projects are estimated to have added 1 per cent to growth in 2004, 2 per cent in each year 2005 and 2006 and 0.5 per cent in 2007. Further demand injections were caused by changes in the financial market that increased growth and the imbalance of the economy.

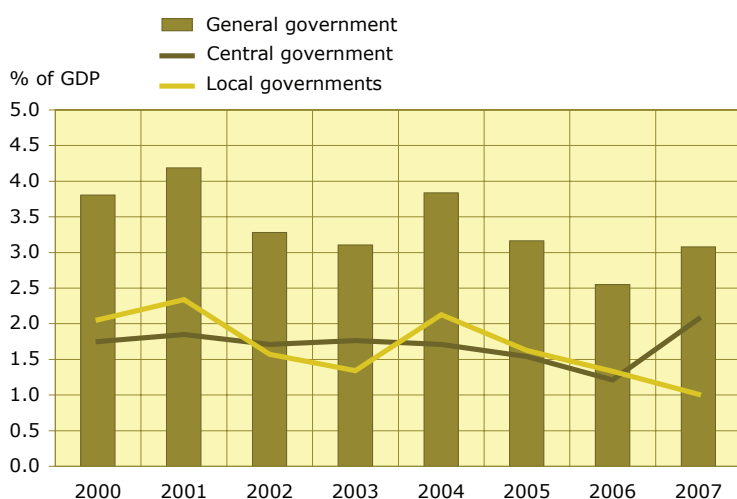
These prospective projects could therefore be better accommodated within the tolerance limits afforded by a small economy such as ours than the already ongoing construction projects. Should no unforeseen external shocks take place during the construction period, such projects could be accommodated in a balanced economic milieu where economic policymakers would apply appropriate measures.



**Chart 12**  
**Business investment, volume change on previous year 1998–2007**

Source: Statistics Iceland and own forecast.

*Public investment has been declining ...*



**Chart 13**  
**Public sector investment 2000–2007**

Source: Statistics Iceland and own forecast.

seen as probable that the more limited access by Icelandic banks to low-cost foreign financing will have an impact on the ability of domestic business to borrow and thus restrain credit financing of business investment. Firm decisions have already been made to invest substantially in aircraft this year, but the net effect of investment in aircraft on GDP are none, since they are offset in imports. Several large investment projects are commencing in the capital area and its vicinity, such as the expansion of the airport terminal at Keflavik Airport. The construction of a convention centre and concert hall in Reykjavík will begin later this year. Investment in other domestic sectors is expected to decline. For 2007, business investment is expected to contract by 43.7 per cent.

Three new power project investments are under consideration. The expansion of the Straumsvík plant is being considered as well as two new aluminium plants, one in the northern part of the country near Húsavík and the other at Helguvík near the tip of the Reykjanes peninsula. No decisions have yet been taken on these projects and they are therefore not included in this forecast. The impact of these projects is further discussed in the special section 3.

### Public investment

Public investment, i.e., the investment of the central government and the local governments, primarily covers investment used for public consumption, such as buildings, roads, bridges as well as public-consumption related machinery and equipment. The investments of public corporations, such as in the energy sector, water distribution systems and harbours, belong to the category of business investment.

In accordance with the medium-term programme of the Government to restrain public finances during the peak period of power project construction, a number of public investment projects have been postponed until 2007. Public investment amounted to 31.5 billion krónur in 2005, according to provisional figures. Investment in roads and streets amounted to 14 billion, a similar amount was allocated to public buildings, and 3.5 billion went for other public investment. Public investment amounted to 3.2 per cent of GDP, declining by 13.5 per cent in real terms from the previous year when it amounted to 3.8 per cent of GDP. The investment of the central government declined from the equivalent of 1.7 per cent of GDP in 2004 to 1.5 per cent in 2005, whereas the investment of the local governments rose by 3.3 billion krónur between years, from 2.1 per cent of GDP in 2004 to 1.6 per cent in 2005.

For 2006, public investment is forecast to decline by over 15 per cent in volume terms and amount to 27.6 billion krónur. Central government investment is scheduled to be cut by 2 billion krónur and amount to an estimated 1.2 per cent of GDP. Local government investment, which reached an historical high in nominal terms in 2004, is scheduled to amount to 14.5 billion krónur in 2006, about 1.3 per cent of GDP.

Power project construction is expected to contract sharply next year, economic growth will be slower and unemployment will increase. In contrast, public investment is projected to increase by 31 per cent in real terms, largely on account of a deliberate increase by the central government in its investment outlays to mitigate the impact of the completion of power project investments. Central government investment is expected to increase to 24 billion krónur or by nearly 80 per cent from this year. Local government investment is expected to decline considerably in 2007 or by 3 billion krónur. In spite of the increase between 2006 and 2007, public investment is expected to amount to no more than 3.2 per cent of GDP in 2007, a lower ratio than in many previous years.

*... but is expected to increase by 31 per cent in real terms next year*

#### Special section 4. The economic impact of the departure of the defence force

It proves difficult to assess the economic impact of the change in Iceland's defence arrangement with the United States. Discussions are still underway and it is still uncertain how extensive future defence co-operation will be. At this point, no clear decisions have been reached with regard to the defence of the country. Any assessment of the economic impact must therefore be viewed as sketchy.

The following assessment is based on an econometric calculation, the results of which are shown below. The general assumption is made that most US personnel will have departed at the end of the third quarter, and that the Treasury will assume the cost of those operations that will remain in place. The operation of Keflavik Airport will initially be borne by the Treasury. It is further assumed that the Treasury will take over the operations of radar stations and related communications and that the extent and cost of such operations will remain unchanged. The Treasury will also assume the cost of operating a helicopter service.

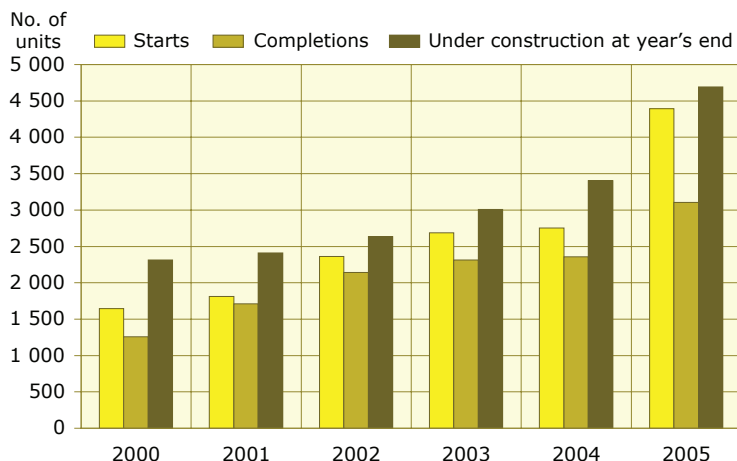
The macro-economic assumptions are that (1) three-fourths of the Icelandic personnel employed by the defence force will leave their jobs later this year and find other similar jobs in the domestic economy; (2) one-fourth of the present personnel will continue being employed in their present jobs on similar pay terms but with a new employer; and (3) half the employees of contractors working for the defence force will find other jobs, the other half continuing in their present work, such as in maintenance of the airport. These assumptions are made in light of the fact that demand for labour is quite strong at present. These changes are thus not expected to lead to increased unemployment.

The calculations based on the econometric model of the Ministry of Finance may be summarised as follows:

- National income will decline by 0.5 to 1 billion krónur in 2006 and 2 to 3 billion in 2007.
- Economic growth will contract slightly or by 0.2 per cent, once the full impact has emerged in 2007.
- The current account is expected to decline by 0.5 per cent of GDP in 2007 or by about 6 billion krónur.
- The Treasury surplus will decline by about 1.5 billion krónur this year and by up to 4 billion next year, mostly because of increased expenditure on projects described above.

It should be kept in mind that the demand for labour has been quite intense in recent months and has been met with labour imports. The employees released from Keflavik Airport should be able to find jobs in consequence of which the need for foreign labour will be reduced. Wage payments to abroad will therefore decline, which will have a positive impact on the current account. Still, it is difficult to assess such an impact at this point. The impact is assessed at up to 0.2 per cent of GDP.

These estimates do not take account of the impact of the departure of defence personnel and their families upon the demand for goods and services in the airport vicinity or for the country as a whole. The effect will be felt at first, but that will depend on the local population in the area. The American experience is that base closures tend to create new opportunities for economic initiatives.



**Chart 14**  
**Housing construction**  
**2000–2005**

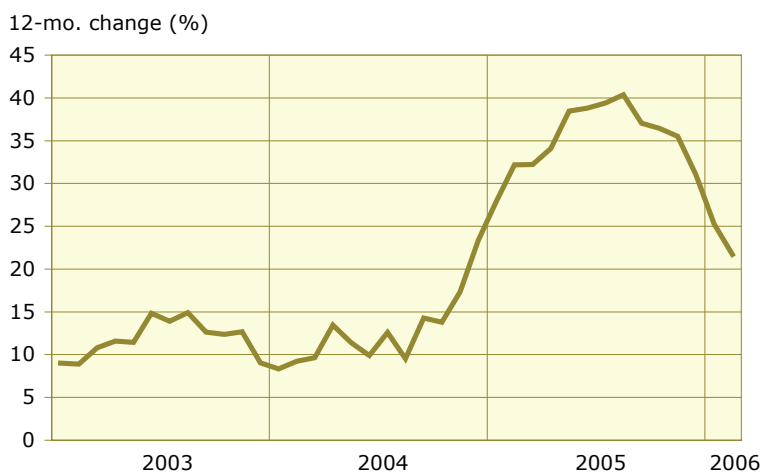
Source: Land Registry of Iceland.



**Chart 15**  
**Turnover in the the housing**  
**market in the capital area<sup>1</sup>**  
**June 2003 – February 2006**

1. Six-week moving average.

Source: Land Registry of Iceland.



**Chart 16**  
**Prices in the housing market**  
**January 2003 – February 2006**

Source: Land Registry of Iceland.

## Housing construction and the housing market

Residential construction expanded rapidly in 2005. Provisional figures from the national accounts show that housing investment rose by 10 per cent at constant prices, amounting to 57.4 billion krónur in nominal terms, 7 billion more than the year before. A total of 3,100 housing units were completed, compared with 2,355 units the year before. The number of housing units in the country now exceeds 120 thousand. Close to 4,700 units were under construction at year's end, 1,300 more than at the end of 2004.

Housing construction is expanding sharply in the capital area. A total of 2,600 units were completed in 2005 of which 782 were in Reykjavík. Figures on housing starts indicate that housing investment is expanding sharply this year. A total of 4,400 units were started in 2005, 1,650 more than the year before. The increase is fully accounted for by housing starts in the regions outside the capital area. There were 2,300 housing starts in the capital area in 2005.

The demand for housing is subject to several factors that all seem to work in concert with each other. As is well known, housing finance was made substantially easier in 2004 and 2005 which led to a marked increase in demand and sharply rising housing prices. Household real incomes have been rising unusually fast in the past two years. Finally, the population increased by 6,300 compared to about 3,000 the year before and by some 7,000 in the years 2000–2003. The 2005 increase is not only due

to imported labour for the construction projects in the East but immigration elsewhere in the country has been unusually lively. Heavy demand has stimulated housebuilding in the entire region from Akranes, the Reykjanes peninsula to the Árborg area.

The main data for the housing market indicate that the sharpest expansion in demand is now a thing of the past. The number of housing sales are declining, and the turnover in the housing market has slowed down in spite of a continuing increase in housing prices, which has slowed down in recent months.

The supply of new housing is increasing in concert with demand. These forces of supply and demand are well in line with the experience from earlier years in this country as well as in neighbouring countries where a sudden swelling of demand is met by increased supply with a one or two-year lag. The latest Gallup poll on consumer intentions indicates that housing demand will continue strong in the remainder

of this year. It appears that buyers are accelerating their purchases because they expect interest rate increases in the course of this year.



Figures on housing under construction at the end of last year indicate that supply is still increasing. In the Ministry's January forecast, an increase of 6 per cent in housing investment was forecast for this year. The latest data indicate that housing construction will be higher, and the forecast has thus been increased to 12 per cent for this year. The supply of new housing is expected to gradually catch up with demand in the course of this year, and only a small increase, 0.7 per cent, in housing investment is expected for 2007.

## Special section 5. Revised national account figures for housing investment

Statistics Iceland has conducted a thorough review of housing investment accounts in cooperation with the Valuation Office, which collects data from all local building inspectorates around the country. The Valuation Office has also reviewed its cost estimates and property assessments, which differ from the building cost index that in earlier years was used as a basis for deflating current price accounts to a constant price basis. The revised figures are compared to earlier data in the following table:

### Housing investment 2000-2005

<i>Million kr. at current prices</i>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Earlier figures	25 886	31 714	35 683	42 774	47 118	.
Revised figures	25 873	31 648	39 262	42 441	50 415	57 420
<i>Volume changes (%)</i>						
Earlier figures	.	15.4	5.0	16.1	5.7	.
Revised figures	.	12.2	12.2	4.0	13.8	10.3

Source: Statistics Iceland.

The new figures differ quite widely from earlier ones. The increase in 2002 is much higher and in 2003 much lower. For 2004, the revised increase is also much higher than in the earlier version. These changes have an impact on total economic growth. For 2004, present national accounts show an 8.2 per cent increase in real GDP, 2 percentage points more than the earlier figure. Since all the forecasting in the Ministry's forecasting model are based on historical data, this revision along with others have a significant impact upon the assessment of the present economic situation as is reflected in this report in many instances.

## FOREIGN TRADE

*The trade deficit has increased ...*

*... due to rising imports*

*The current account deficit is expected to decline this year ...*

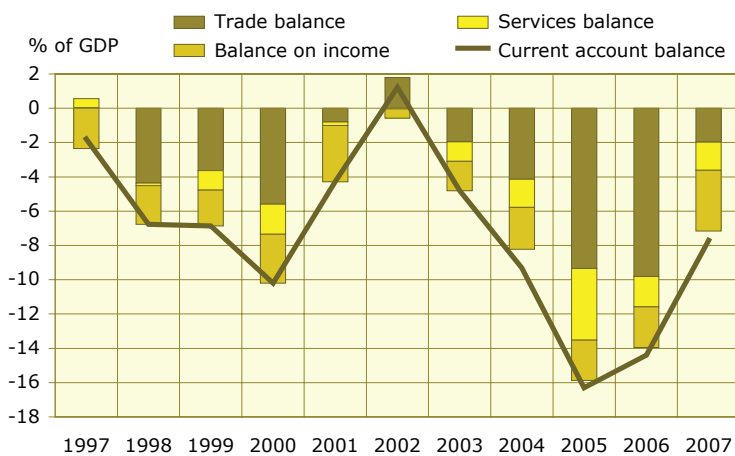
Due to power project construction and increased domestic demand, the current account has gone into considerable deficit. For this year, a deficit of 159 billion krónur is forecast, 14.4 per cent of GDP, compared to 16.5 per cent in 2005 and 9.5 per cent in 2004. The present power project construction will be completed in the course of 2007, and domestic demand is expected to slow down sharply. The current account deficit is thus forecast to decrease to 91 billion krónur or 7.9 per cent of GDP in 2007 and continue declining thereafter, down to 2.5 per cent of GDP in 2010.

The revised national accounts published by Statistics Iceland last March show that the current account deficits in 2004 and 2005 were larger than previously estimated. The deficit on the services account was larger than had been forecast, whereas the trade balance itself was in line with forecasts. Nevertheless, the main reason for the rise in the current account deficit is the growth in imports, on one hand because of power project construction and on the other because of the sharp growth in private consumption. Imports of investment goods rose by more than 40 per cent in volume terms, to a large extent because of power project construction. The strong exchange rate served to encourage imports of consumer goods and motor vehicles; vehicle imports rose by more than 60 per cent in volume.

For this year, the growth in the volume of merchandise imports is expected to be much lower than last year, when it was 25 per cent. For this year it is forecast at 6.2 per cent. The decline in the exchange rate will initially increase import values but gradually reduce the volume of imports, particularly of consumer goods, since the declining exchange rate will increase prices of consumer goods and motor vehicles. Historically, such imports have been quite

sensitive to exchange rate changes. Imports of such goods are therefore expected to increase less this year than last. Imports of investment goods are on the other hand expected to continue to be on a high level, since power project construction is still ongoing.

Imports are expected to contract in 2007 due to the exchange rate impact and the expected slowdown in the economy. The sharpest decline is expected in durable and semi-durable consumer goods, such as motor vehicles and appliances. Imports of investment goods are expected to decline sharply next year because the ongoing construction of power projects will by then be completed.



**Chart 17**  
**Current account balance**  
**1997-2007**

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

*... and continue declining next year when the trade deficit will decline sharply*

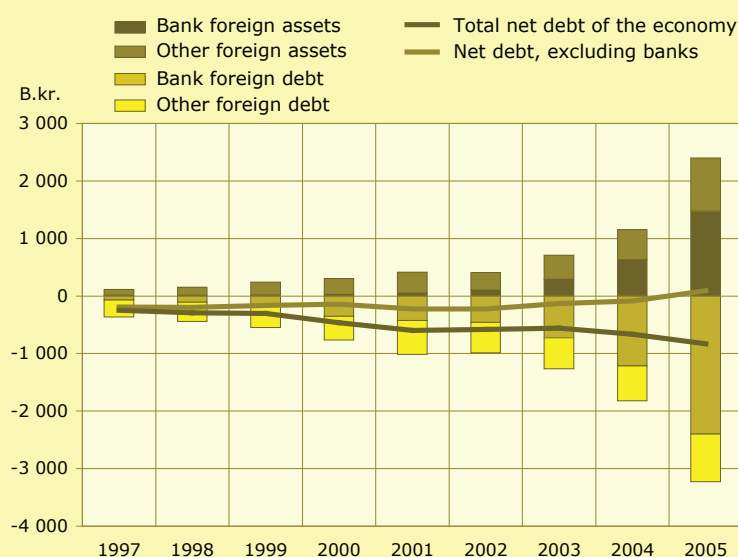
The export sector will benefit from the decline in the exchange rate, and the value of exports is therefore expected to increase this year, although the volume increase will probably not be as large. The main reason is that prospects for the fish catch are considered poor, which is to some extent offset by increased aluminium exports. Exports are on the other hand expected to increase considerably next year, both in volume and value. The increase in aluminium production capacity will lead to an increase in aluminium exports by more than half.

The trade deficit is forecast at 108 billion krónur in 2006, slightly more than last year, when it amounted to 93 billion. Despite a small volume increase, the increased price of imports will be the main cause of a higher trade deficit. Merchandise exports are expected to increase by 10 per cent this year due to increased aluminium export capacity. The trade account is expected to improve sharply in 2007; a deficit of 24 billion krónur is expected for that year.

## Special section 6. Foreign debt of the economy

Total foreign debt amounted to 3,200 billion krónur at the end of 2005, having increased by 77 per cent from the end of 2004. Along with this rapid rate of debt growth, Iceland's foreign assets have also increased sharply. The country's foreign assets amounted to 2,400 billion krónur at the end of 2005, an increase of 108 per cent from the end of the previous year. The statistics show that deposit banks are net debtors abroad whereas excluding the banks the economy as a whole is a net creditor.

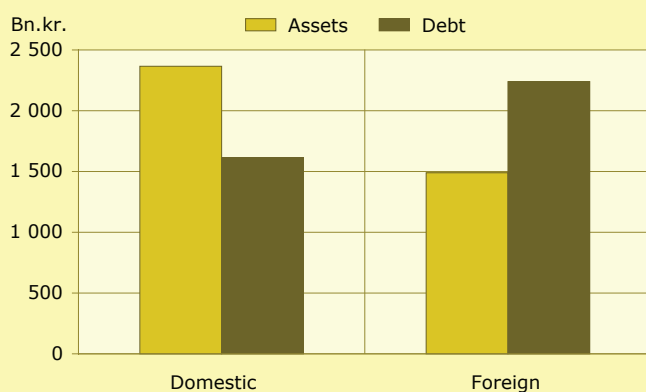
The following chart shows the development of the economy's foreign assets and liabilities in recent years. Both debt and assets have been increasing. The banks have increased their foreign operations, and a large part of their business today takes place abroad. This has led to an increase in their accumulation of foreign assets and debt. Bank debt abroad accounted for 74 per cent of total external debt at the end of 2005 and their foreign assets to 61 per cent. Excluding the deposit banks, assets exceed debt at the end of 2005, which to some extent is explained by the conversion of foreign business debt into Icelandic debt in order to protect themselves against devaluation. The Treasury has also repaid large amounts of foreign debt.



**Chart 1**  
**Foreign assets and liabilities**  
**and net foreign position 1997-2005**

Source: Central Bank of Iceland.

The chart below shows the foreign and domestic assets of the banks at the end of 2005. The net foreign debt of the banks was equivalent to 20 per cent of their total assets, whereas their domestic assets exceeded their domestic debt. In other words, a part of their foreign debt is mirrored in domestic assets, mostly loans to businesses and households with solid surety. It has also been pointed out that about three-fourths of the operations of the three largest commercial banks are presently abroad and denominated in foreign currencies. Only about one-fourth of their financing is lent domestically in Icelandic krónur. The currency risk attached to such credits has been stress-tested and deemed well manageable for the banks in light of their equity position.



**Chart 2**  
**Deposit bank assets**  
**at year-end 2005**

Source: Central Bank of Iceland.

*Large deficit on the services account last year, declining this year*

The services account has proven to be difficult to forecast, since service transactions are not as tangibly measured as merchandise trade. As noted earlier, the 2005 services deficit turned out to be higher than earlier figures had indicated. For 2006, a deficit of 20 billion krónur is expected on services, compared to 42 billion in 2005. The deficit is expected to be similar in 2007.

*Declining exchange rate should stimulate income from tourism ...*

Transport and communications are the most important items on the export side of services, bringing in 52 per cent of total income. Revenue from tourism in Iceland makes up further 22 per cent, and 26 per cent is income from other services, such as banking and income from the defence force. The recent decision to withdraw the defence force from Iceland is incorporated into this forecast to some extent. Income from services to the defence force amounted to nearly 5 billion krónur in 2005. This income item has been declining in recent years and is expected to decline sharply this year and next. At present it is unclear what the impact of the departure of the defence force will be, since the issue is still under discussion.

*... and discourage travel abroad by Icelanders*

The decline in the exchange rate is expected to increase the purchasing power of foreign tourists in Iceland which should in due course help encourage tourism in this country.

Icelandic tourism abroad is the largest item on the payments side of the services account, about 39 per cent of the total. The decline in the exchange rate may be expected to diminish somewhat the appetite for Icelandic travel abroad. The recently released Gallup poll of consumer expectations indicates that Icelandic travels abroad will be substantial this year. Travel expenditure by Icelanders abroad increased by close to 13 billion between 2004 and 2005, amounting to 62 billion for 2005 as a whole. The sudden fall in the exchange rate will probably dampen the enthusiasm for travelling abroad over the next several months.

*Prospects for an increasing deficit on factor income and payments*

The account of factor income and payments was in deficit by close to 28 billion in 2005. The composition of the account has changed significantly over the past several years. The main item has generally been interest on foreign debt, whereas factor income, particularly interest income and income from the appreciation of stocks, has increased considerably. At the end of the year, the stock item was higher than the interest on foreign debt. The stock item was in part offset on the outgoing side by dividend payments etc. Nonetheless, this item was in net surplus. This development in factor income structure reflects the sharp growth in Icelandic business activity abroad in recent years.

Net factor payments abroad are expected to amount to 30 billion krónur in 2006, a similar amount as last year. This item is expected to increase sharply in 2007 and amount to 46.3 billion. Repayments on foreign debt will also be substantial, especially in light of the decline in the exchange rate.

## THE BUSINESS SECTOR

The total turnover of the business sector exceeded 1,750 billion krónur last year, an increase of 13 per cent between years. Turnover in companies engaged in construction, auto sales, financial services and other specialised serviced increased by a third and turnover in the food and beverage sector rose by one-fourth. Turnover in chemicals declined on the other hand by a third and in fisheries by 10 per cent. The latest IMG Gallup poll, covering the 400 largest companies in Iceland based on their total payroll, shows an increased optimism regarding prospects for this year. Some 66 per cent of those questioned expect the turnover in their companies to increase over last year. Another 27 per cent believed turnover would be about the same and 7 per cent thought it would decline. Responses differ little between sectors.

The business sector has undergone profound change in recent years. Business conditions have improved markedly, and the ability of businesses to respond to changed circumstances has significantly improved. Business conditions have improved because of tax cuts and the privatisation of government entities in the financial market and in telecommunications.

Their access to the international market has improved through Iceland's membership in the European Economic Area. A liberalised capital market has led to lower long-term interest rates. The access of business to foreign labour has increased which has relieved some pressures in the labour market. The impact of these changes are also seen in the expansion of Icelandic businesses abroad which has awakened foreign interest in the Icelandic economy. The total profit of companies included in the ICEX index of 15 selected stocks amounted to 152 billion krónur last year, double that of the previous year.

The profit of the three largest firms in the financial sector amounted to 95 billion, some 60 per cent of the stock index total. Total assets of the banks have increased by 270 per cent since 2003, and the combined assets of the three major banks were at the end of 2005 five times the size of the gross domestic product for that year. The average return on equity was 37 per cent in 2005, far in excess of the goal that the banks set themselves.

*The total turnover of the business sector increased last year*

*Business operating conditions are generally favourable and profits have increased*

*Bank profits more than doubled between 2004 and 2005*

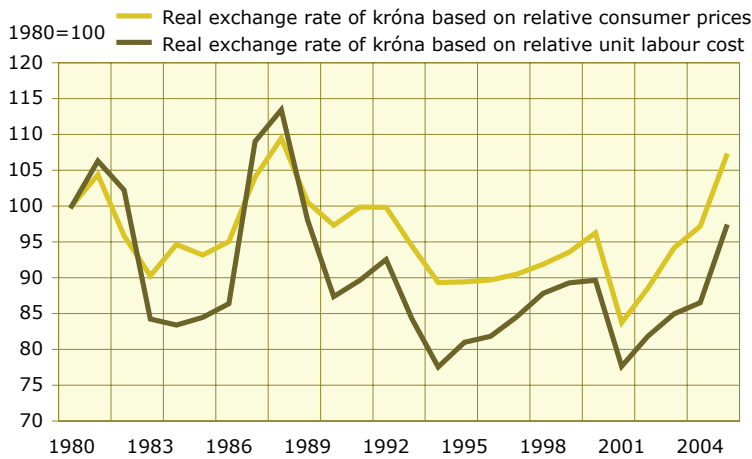
**Table 6. Accounts of commercial banks 2003-2005**

<i>Profits (m.kr.)</i>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Glitnir Banki hf.	5 835	11 958	19 099
Kaupthing Bank hf.	7 520	17 707	49 260
Landsbanki Íslands hf.	3 055	12 723	25 017
<b>Total profits</b>	<b>16 410</b>	<b>42 388</b>	<b>93 376</b>
<i>Assets (m.kr.)</i>			
Glitnir Banki hf.	443 943	677 316	1 472 250
Kaupthing Bank hf.	558 569	1 554 453	2 540 811
Landsbanki Íslands hf.	448 239	737 141	1 405 460
<b>Total assets</b>	<b>1 450 751</b>	<b>2 968 910</b>	<b>5 418 521</b>
<i>Equity capital (m.kr.)</i>			
Glitnir Banki hf.	29 423	48 474	84 750
Kaupthing Bank hf.	45 928	149 370	194 183
Landsbanki Íslands hf.	22 382	37 705	110 059
<b>Total equity capital</b>	<b>97 733</b>	<b>235 549</b>	<b>388 992</b>
<i>Return on equity capital (%)</i>			
Glitnir Banki hf.	30.1	43.8	30.3
Kaupthing Bank hf.	23.0	25.5	34.0
Landsbanki Íslands hf.	17.6	49.5	45.8



*The rise in the exchange rate and the policy rate made the competitive position of businesses more difficult*

The strong exchange rate and a rising policy rate had a significant effect on business conditions in the course of 2005. The exchange rate index averaged 108.6 and declined in the latter half of the year, reaching a low of about 100 towards year's end. The policy interest rate was gradually raised as of May 2004 to an average of 9.9 per cent in 2005. The course of the exchange rate reduces the earnings of companies from foreign currencies whereas their costs are in the domestic currency. Low foreign interest rates along with the strong króna led to lower repayments by businesses on loans in foreign currencies.



**Chart 18**  
**The real exchange rate of Icelandic króna 1980–2005**

Source: Central Bank of Iceland.

*Profits of companies in the fisheries sector have been under pressure*

Icelandic businesses began covering themselves against a devaluation already last year by converting their foreign currency loans into Icelandic krónur, even if the latter carried a higher rate of interest. The króna exchange rate declined in the first several months of this year vis-à-vis foreign currencies. This forecast assumes that the exchange rate of the króna will decline by an average of 10 per cent from last year to this year, reducing the real exchange rate at the same time. It should be noted however that since domestic price and wages are forecast to continue increasing faster in Iceland than abroad, it will have the effect of raising the real exchange rate at the same time as the nominal rate weakens.

*The value of the fish catch has remained unchanged between 2004 and 2005*

Profits in the fisheries sector came under pressure in 2005 because of declining catches, a stronger exchange rate and a rising oil price. These adverse effects were partially offset by rising export prices. The profit outlook is somewhat brighter for this year and next, as the value of the fish catch is thought to increase in light of rising fish prices and a declining exchange rate. The price of oil is assumed to decline by a small margin.

*The export value of fish products declined on the other hand by 10 per cent between years*

The total fish catch declined by 3.5 per cent last year, mostly on account of a smaller blue whiting catch. The catch of demersal species changed little, but the cod catch shrunk by 7 per cent, whereas the catch of other demersal species rose, as did the catch of herring and capelin. The total catch declined in the first two months of this year, compared with the first two months of 2005, mostly on account of a lower capelin catch. In spite of a considerable increase in fish prices last year, the catch value is almost unchanged between years, mostly due to a decline in the catch of blue whiting and cod.

*The decline in the exchange rate this year improves the competitive position considerably*

Last year, fish exports accounted for 60 per cent of total merchandise exports. The export value of fish products declined by 10 per cent in 2005 from the previous year, mostly on account of a lower cod catch, the most valuable species in the total catch, accounting for 40 per cent of the export value in 2005. Export production declined by 3 per cent in volume last year, whereas the Ministry's forecast projects a 2 per cent increase this year and next. Prices of fish products in foreign currency rose by 9 per cent last year, thus offsetting the strengthening of the exchange rate. For this year, a 3 per cent price increase is predicted and that prices next year will be unchanged.

The exchange rate has declined by 11 per cent in the first three months of this year, bringing better prospects to the fishing industry and other export sectors.

Aluminium production declined by 3 per cent in 2005, whereas the world market price of aluminium rose by 11 per cent. For this year, production is expected to commence in the first part of the expansion of the Nordural plant, and production at the Reydaral plant will start next year. Aluminium production is forecast to increase by 32 per cent this year and by 58 per cent next year. This forecast exceeds the earlier forecast made in January, since the expansion of the Nordural plant is being moved forward. The total production capacity of that plant will thus expand from 220 thousand to 260 thousand tonnes a year. The expansion is scheduled to be completed in the fourth quarter of 2007. The Ministry's forecast assumes that the price of aluminium will increase by 22 per cent this year but decline by 11 per cent next year.

There has been considerable discussion on the state of high-tech and innovative startup companies in Iceland. Some of these firms have announced that they are moving out of the country with part of their operations. In March, the Minister of Finance decided to present tax reforms designed to especially help companies engaged in research, development and innovation. These changes permit entities on the value added tax registry to lengthen the period where entities engaged in development work can extend the postponement of tax payment from six years to twelve. Furthermore, a tax amendment has been proposed that a joint limited company will not be viewed as an independent tax-filing entity unless specifically requested. The Icelandic pension funds are among the largest investors in the domestic financial market. This amendment will enable them to invest in joint limited companies without incurring a tax liability.

In spite of the strong exchange rate, the number of foreign visitors to Iceland increased by 2.5 per cent to a total of 370 thousand. Tourism revenue amounted to 40 billion krónur, an increase of 1.1 per cent, whereas revenue per visitor declined by 1.4 per cent. It appears that the number of visitors will increase this year. During the first two months, the number of visitors coming through Keflavik Airport rose by 3.8 per cent from the corresponding period a year earlier.

*Sharp increase in aluminium production this year and next*

*Tax reforms to encourage high-tech and innovation firms*

*Sharp increase in the number of tourists but declining income from each tourist*

## THE LABOUR MARKET

*The supply of labour has been sufficient to meet increased demand*

The demand for labour rose by 3.9 per cent in 2005 over the previous year. The growth in demand was met with increased labour market participation, imports of labour, a natural increase in the population of working age, a decline in registered unemployment and longer working hours. Unemployment registration declined by a half, although the labour market surveys of Statistics Iceland showed a smaller decline. The demand for labour is expected to increase this year but slow down in 2007 and subsequent years.

*Substantial changes in the economy call for a flexible labour market*

There is no doubt that the labour market is at present quite active. Construction activity is vibrant. Electric power and aluminium plants are under construction, housebuilding is strong as well as other business construction. On the other hand, employment has declined in certain areas, mainly in companies engaged in international competition. The high cost of labour and the strong exchange rate have deterred these companies. Some have moved a part of their operations abroad where labour costs are lower. This shift is a part of the opening of the economy to global competition, where the Icelandic economy gradually specialises in activity that enjoys a comparative advantage. The resilience of the economy has sufficed to make such a shift possible through the creation of new jobs at the same time as others disappear. This resilience will be tested over the next several months when the defence force leaves and several hundred jobs will disappear. This employment shift has already begun, as defence force employees are leaving for other jobs in the general labour market.

*Job increases primarily in the service sector*

In recent years, the labour market has gravitated towards jobs in the service sector. By now, over 70 per cent of all jobs are in various service activities, both in the private as well as the public sector. Only 6 per cent of the jobs are in the primary sector, agriculture and fisheries, and about one-fourth are in the industrial sector. The general services sector, covering computer services and software, research, advertising, real property agents and other general business services, was the largest generator of new jobs in the period from 1998 to 2004, with employment growing by an average of 5 per cent a year over these 6 years. Employment growth in the education sector was slightly lower, averaging 4 per cent a year. The growth in the health and social services sector has been quite even, about 2.5 per cent a year. Due to the size of this sector, its growth in employment has been highest in number terms, averaging 500 new jobs a year. Job growth in the financial sector has averaged 3.5 per cent a year and 3 per cent in the construction sector. Jobs have declined in fisheries and fish processing by an average of 3.7 per cent a year as have jobs in agriculture and other industries. The number of jobs has declined by an average of 700 a year in declining sectors. Except for the health and social services sector, the growth and decline in employment in individual sectors has varied considerably in recent years. New jobs have been about 2,700 in number each year, whereas the net increase has been about 2,000 on average. At this stage, data are not available for 2005, although it is evident that there has been a large increase in the number of jobs in the construction sector. The total number of jobs is thought to have increased by 3.2 per cent and the total volume of labour by 3.9 per cent, taking account of longer working hours.

*The labour force is increasing for a variety of reasons*

The population of working age increased by an average of 1.2 per cent a year in the 1998-2004 period. This is a fairly large increase in comparison with most other nations of Europe. Still, the growth has varied from year to year and consisted of immigration as well as births in excess of deaths. Last year, the population of working age increased by 6,000 or 2.8 per cent, of which net immigration of people of working age was 3,500 or 60 per cent. The imports of labour for the power projects in the East play a major role here. Net immigration to that part of the country was 1,461 persons, double

*Imports of labour have been increasing*

that of the previous year. Net immigration in fact touched all parts of the country last year. About 1,500 persons came to the capital area and more than 900 to regions other than the eastern part of the country. The majority of immigrants were men, but it is a sign of labour demand outside the power construction sector that the number of immigrant women of working age was nearly 900 last year.

Other factors, such as employment participation and unemployment, also have a significant impact upon developments of the labour market. The quarterly labour market data of Statistics Iceland do not extend back for many years and are thus difficult to interpret as to the flexibility of employment participation and working hours. Indications are, however, that the Icelandic labour market is quite flexible. Employment participation has increased significantly in times of expansion, particularly among young people that work along with their studies or even postpone their studies in times of heavy labour demand. Employment of older persons is also variable. The decline in the employment participation of this age group that has been ongoing in recent years has now been arrested and to some extent been reversed. This indicates that older persons are postponing their retirement.

There are indications that labour market participation has not yet reached its peak. During the last expansion, the labour market participation of younger people was higher than at present, and the number of people entering secondary or higher education increased little. Last autumn, such school entries increased by 6 per cent, far in excess of the increase in the total population of this age group. The labour market appears therefore not to be as tempting now as then. Working hours could possibly be still increasing.

The labour market survey of Statistics Iceland for last year shows an increase of 5,200 in the number of jobs from the fourth quarter of 2004 to a year later. Half of the new jobs are occupied by people in the 16-24 age group, 30 per cent were 55 years or older and 20 per cent, about 1,000 new jobs, went to the 25-54 age group. It should be noted that these figures are not quite in accordance with figures on international migration. Net immigration in the 25-54 age group came to 2,700 persons, most of whom must be job-seekers. Their number is far in excess of the total number of job increases in this age group. This points to the conclusion that the actual number of new jobs is well in excess of the already large increase recorded in the labour market survey.

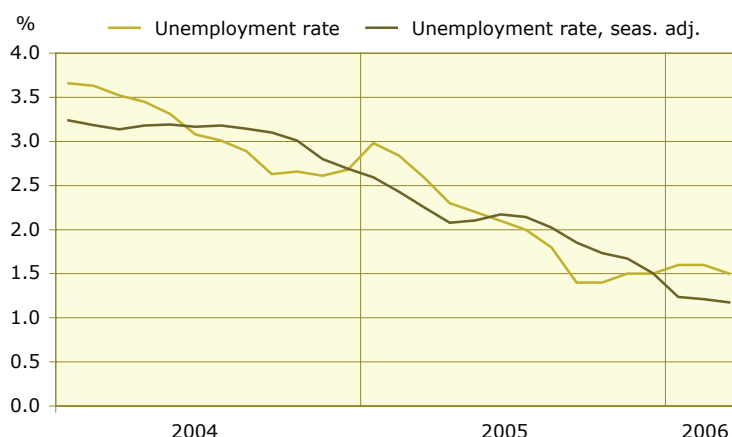
Most nations worry about unemployment. It slows growth down and creates a host of social problems and increases social expenditures and unemployment compensation. The opposite is the case in this country. Low unemployment creates wage pressures because labour demand exceeds supply. About 2,400 persons were registered as unemployed at the end of March, about 40 per cent less than a year earlier. The March unemployment rate was about 1.5 per cent, a low figure by historical standards. Corrected for seasonal fluctuations, the figure is 1.2 per cent. The seasonally adjusted unemployment rate has only been recorded this low for a period of a few months at a time. It must therefore be seen as unlikely that unemployment will decline any further, but it will probably stay at this low level for some time. It also indicates that the average unemployment rate for this year and next will be lower than was projected in previous forecasts.

Recently, the Government decided that it would rescind the limitations placed upon the rights of citizens in the new EU countries to come to this country

*Increased labour market participation helped increase labour supply in 2005*

*Labour market participation will probably increase less this year*

*Large increase in the number of jobs in recent years*



**Chart 19**  
**Unemployment rate**  
**January 2004 – February 2006**

Sources: Directorate of Labour and Ministry of Finance.

*Shortage of labour  
a problem for the labour  
market at present*

to seek work. It is considered likely that people from these countries will come here to an increasing extent. The demand for labour is quite high at present, and a considerable number of people have already entered the country. The experience of other countries is that this influx will facilitate the subsequent attrition of people to come to Iceland and start working. This is offset by the fact that it is difficult to place people in jobs where knowledge of Icelandic and Icelandic culture is a necessity. Nonetheless, it is expected that the opening of the labour market will relieve some of the demand pressure in the market.

*Imports of labour help  
meet heavy labour demand*



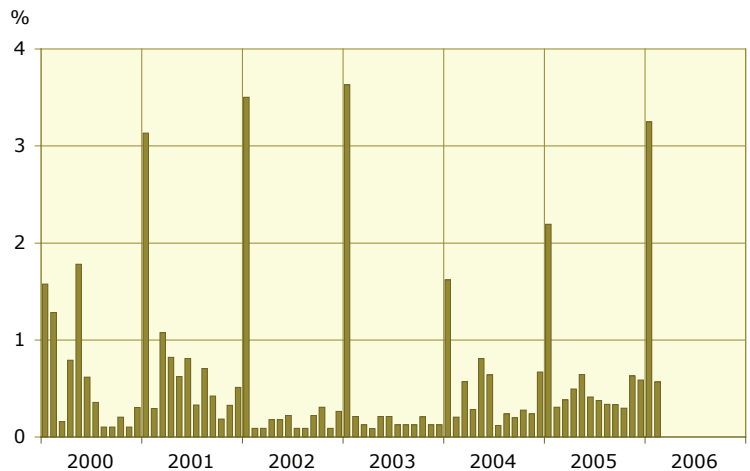
## INCOMES

In recent months, there has been increasing concern that the current economic expansion will lead to wage pressures in excess of wage agreements and productivity. The pressures in the labour market have been somewhat mitigated by greatly increased labour supply, but the labour market is quite segmented, and market conditions vary between sectors. The wage index of Statistics Iceland increased by 3.2 per cent last January, whereas most wage agreements provided for a 2.5-3.5 per cent increase. The index increased by a further 0.6 per cent in February. The wage index has as a rule increased very little in the month following general wage increases, but not in this instance. So far, wage developments have not shown signs of wage drift. The month-to-month development of the wage index – excluding the months when contractual wage increases have come into effect – has been slower than in the previous expansion. The increase in the February index is the highest recorded in the present expansion. The reason for this increase is partially due to a raise given by the City of Reykjavík to its unskilled workforce with consequent effects on other similar labour groups. In spite of a sharp increase in the number of work permits for foreigners at the beginning of the year, there are still a number of sectors that so far have not wanted or been able to meet labour demand with foreign workers. In these cases, it appears that employers have resorted to wage increases in excess of wage agreements in order to hold onto employees.

The majority of central government employees will receive a contractual wage increase on May 1st when new pay scales will come into effect. The total wage increase will be in the range of 2.4 to 3.8 per cent. Unskilled workers in the public sector or in publicly financed workplaces have resorted to informal pressure in order to pressure for higher wages. These pressures emerge because the City of Reykjavík concluded an agreement with its unskilled employees that called for substantially higher wages than those prevailing in other comparable workplaces, even if they are to a large extent staffed with foreign labour. Wage agreements have not been reached with university-educated employees of local governments, and agreements with unskilled labourers may have an impact thereon. Wage agreements have been concluded in most other areas of the labour market. Existing agreements run until 2008. The agreements are based on the premise that inflation will develop in concert with the Central Bank's inflation target, and that other agreements will develop in line with the general wage agreements. These premises will come under review in November of this year, since it is evident that inflation has exceeded previous assumptions.

The year-to-year change in the wage index has been edging upwards in the past two years or since the beginning of 2004. The annual increase has not yet reached the pace at the beginning of this century, when it approached 10 per cent. For this year, a 6.6 per cent wage increase is estimated and 4.2 per cent next year.

*Indications that wage drift is increasing*



**Chart 20**  
The wage index, one-month changes  
January 2000 – February 2006

Source: Statistics Iceland.



**Chart 21**  
The wage index, twelve-month changes  
December 2000 – February 2006

Source: Statistics Iceland.

*Wage increases still below those of the previous cyclical peak*

*Wage increases in excess of price increases call for increased productivity*

The wage index reflects the flexibility of the labour market. The increase in the index slowed down as soon as the previous expansion, at the turn of the century, expired. This was reversed as soon as the present expansion began to accelerate.

It is evident that wage increases this year and next will be somewhat in excess of inflation. If the rise in the real wage is to be sustainable, productivity must progress similarly. Real disposable incomes are expected to continue increasing, in part because the personal income tax rate was cut by 1 per cent at the beginning of this year and will be cut by another two percentage points at the beginning of next year. This may be seen in chart 11 on p. 15. Real disposable incomes are discussed further in special section 7.

## Special section 7. Tax cuts and disposable income

The general definition of disposable income is the income remaining after direct tax. Disposable income in the national accounting sense is somewhat different. It includes for example imputed rent from owner-occupied housing so as to create a certain correspondence between income and consumption expenditures of households. This section only discusses disposable income in generally understood terms.

Income changes from year to year, covering income from work, transfer income from the public sector or income from capital. In calculating income per capita, account is taken of labour market participation, working hours and population. Taxes also change due to a change in tax ratios, the standard income tax credit and other tax-related credits to taxpayers. The changes in disposable income represent the net balance of these two, and real disposable income takes account of the prices for goods and services.

Real disposable income has in recent years increased on the basis of all these factors. Wages have also increase in excess of prices. This year, real wages per capita are estimated to increase by 0.7 per cent and by the same percentage next year. Capital income has also increased rapidly in recent years. They increased by 17 per cent in 2004 and also increased substantially in 2005, to judge by the collection of the capital income tax. The capital income of individuals will not be fully accounted until next August, at the time of the final income tax assessment for 2005.

The tax cuts this year and next increase both nominal and real disposable income. The personal income tax rate is scheduled to be cut by 2 percentage points in 2007 and play a major role in the increase in disposable income in that year. Such a cut of 2 percentage points will technically speaking increase disposable income by 3.2 per cent per capita. However, after taking account of the standard income tax credit, income distribution and wage changes, it is estimated that real wages will increase by 2.7 per cent per capita of which 0.7 per cent will be due to higher child allowances. The abolishment of the personal income surtax adds another 0.3 per cent to per capita disposable income. This calculation is in line with the estimates derived from the Ministry's forecasting model, which takes account of several other influences.

### Household disposable income 2004

(Bn.kr.)

#### Wages (+)

Wages and sundry income	445.3
Transfer payments from central and local government	42.1
Income from pension funds	30.4
Capital income	74.5
Total income	592.3

#### Taxes (-)

Personal taxes	147.5
Less: Child benefits and interest credits (+)	10.0
Taxes, net	137.5

Disposable income (=) 454.8

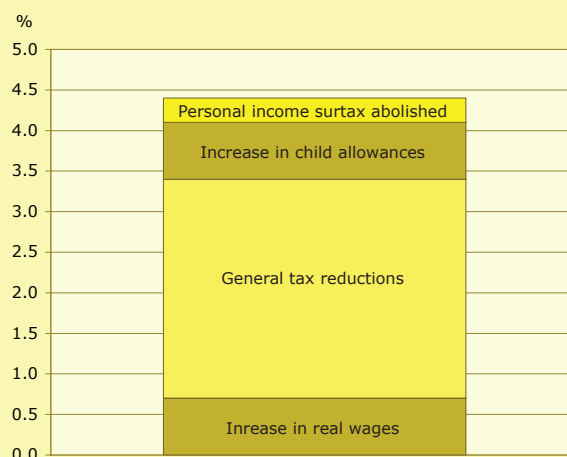


Chart 1

### Components of the change in real disposable income 2007

Source: Directorate of Internal Revenue and own calculations.

## PRICES AND THE EXCHANGE RATE

Inflation has exceeded the 2.5 per cent target of the Central Bank for some time. Rapidly rising housing prices have driven the increase in the consumer price index, whereas the strong exchange rate has held down the increase in the prices of imports of goods and services. Inflation was 4.0 per cent on average in 2005. April of this year proved to be a turning point when the impact of a declining exchange rate began to show up in merchandise imports. This, together with continuing housing price increases, brought inflation up to a 5.5 per cent rate in April. At present, the outlook is for a slowdown in housing price increases, whereas other prices are expected to be affected by the decline in the exchange rate.

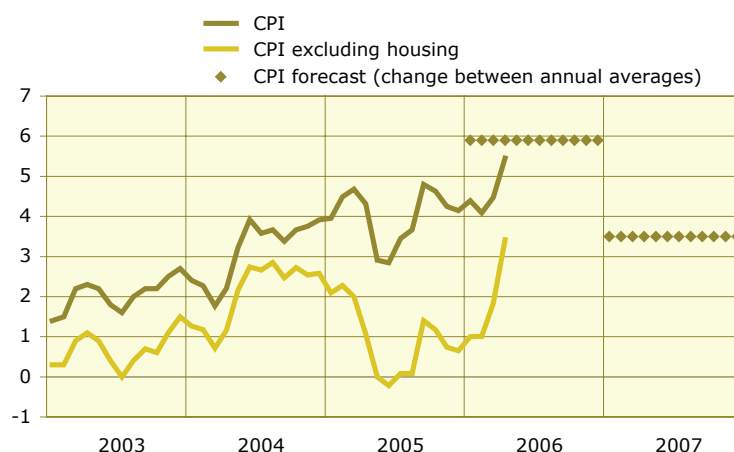
Most of the inflation can be attributed to rising housing prices. When the commercial banks entered the housing mortgage market in competition with the Housing Finance Fund in the autumn of 2004, the demand for housing increased due to favourable interest rates, increasing access to financing, higher loan amounts and more flexible credit terms. The housing component of the consumer price index rose by 12.3 per cent from April 2005 to April 2006. The weight of housing in the consumer price market basket increased from 19.6 per cent at the beginning of last year to 23.0 per cent in April of this year. For the past twelve months, the housing component accounts for 3.25 per cent out of a 4 per cent average increase in the consumer price index, more than 77 per cent of the increase. Excluding housing, inflation was minimal in spite of heavy demand in the economy. The exchange rate effect of monetary policy has proven to be quite effective, as the exchange rate strengthened by more than 10 per cent in the twelve-month period up to March of this year, in turn holding down import prices. This contrasts with an inflation in the international economy of about 2 per cent in spite of rapidly rising oil prices. For the above period, import prices increased by an average of 2.8 per cent of which 0.2 per cent occurred in March, before the exchange rate began to decline. At the same time, domestic prices, other than farm products and vegetables, increased by 4.4 per cent.

Housing prices aside, inflation has been well within the goal of the Central Bank. In 2005, inflation excluding housing averaged less than 1 per cent and 0.7 per cent in the first two months of 2006. In April it shot up to a rate of 3.4 per cent when the exchange rate decline of the previous several weeks began to show up in rising prices in addition to increasing oil prices in world markets. The Harmonised Index of Consumer Prices, calculated by Eurostat for all the EEA-countries, gives a similar picture. According to this index, the annual inflation rate was lower than in the EEA-countries since April 2005, at 1.2 per cent up to February of this year against a 2.2 per cent rate in the EEA-countries. This index does not include owner-occupied housing costs but includes housing rent.

The exchange rate has rarely been stronger than in 2005; the exchange rate index declined by 10 per cent between the averages of 2004 and 2005 and by more than 7 per cent from the beginning to the end of the year. The Ministry's forecasts assumed that the exchange rate would decline last year, but the issue of krónur bonds by foreign entities as of last autumn kept the exchange rate strong.

The projected decline in the exchange rate turned out to take place in the beginning of 2006 and at a faster pace than had been anticipated. The adverse commentary on Icelandic banks and the economy that began in November

*Rising housing prices have pushed inflation above the Central Bank's upper tolerance limit*

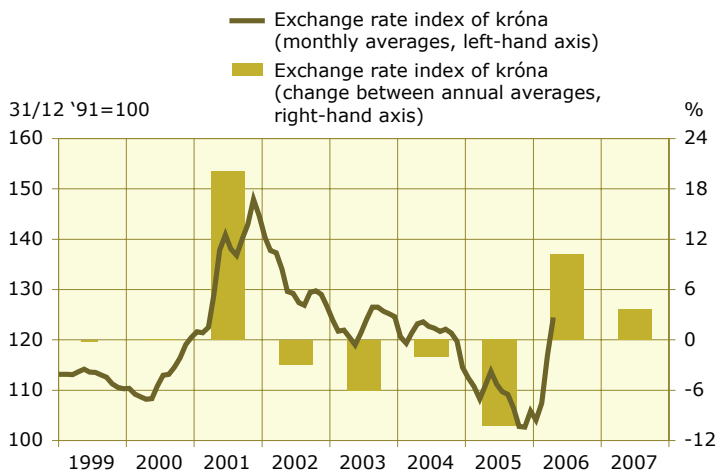


**Chart 22**  
**Inflation 2003–2007**

Source: Statistics Iceland and own forecast.

*Excluding housing, inflation has been low*

*The declining exchange rate is expected to push up inflation this year*



**Chart 23**  
**Exchange rate of Icelandic króna 1999–2007**

Source: Central Bank of Iceland and own forecast.

*Inflation is expected to recede in 2007 when the exchange rate has recovered its equilibrium and the real property market has calmed down*

of 2005 and erupted in February and March of 2006 served to upset the foreign exchange markets. The króna began to decline rapidly and is at present about 19 per cent weaker than at the beginning of the year. It is possible that the decline has overshoot, although it can not be assumed that the exchange rate will regain its strength of last year. This forecast is based on the assumption that the króna will be 10.1 per cent lower this year on average than last year.

The transmission mechanism of monetary policy has been quite effective through the exchange rate in recent months. In light of the fact that the exchange rate has begun its descent, the Central Bank is faced with the problem that the declining exchange rate will soon be translated into domestic

inflation. In addition, the increase in housing prices has not decelerated as fast in recent weeks as had been hoped. Indications of wage drift in several sectors are signalling that demand pressures are still substantial in the economy. For these reasons, it is forecast that the consumer price index will increase by an average of 5.9 per cent this year. This forecast is based on the assumption that the influences underlying inflation trends will change in the course of this year and next. The housing market is expected to calm down over the next several months. The rising housing prices as well as higher indexed interest rates on long-term loans are likely to reduce demand in the housing market. Decelerating increases in housing prices will help reduce inflation, whereas the declining exchange rate is likely to increase other prices over the next several months, since the exchange rate will have a domestic price impact with some lag. The exchange rate impact is therefore likely to be the dominant influence on prices over the medium term. Inflation is expected to slow down in 2007 to an average of 3.5 per cent for the year, by which time most of the exchange rate impact should have emerged. The pace of economic growth is also expected to slow down in that year.

## PUBLIC FINANCES

### The Treasury

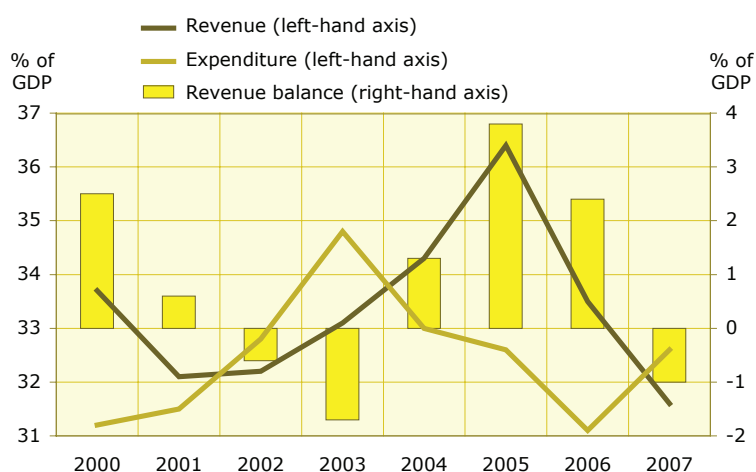
The Treasury revenue surplus amounted to 38 billion krónur or 3.8 per cent of GDP in 2005 according to provisional data. This represents a major turnaround from 2003 when there was a revenue deficit of 1.7 per cent of GDP. The surplus in 2005 is primarily due to increased revenue, both from direct and indirect taxes, at the same time as expenditure was subject to restraint. From 2003 to 2005, Treasury revenue has increased by 88 billion krónur, equivalent to 33.1 per cent of GDP in 2003 to 36.4 per cent in 2005, excluding the privatisation profits from the sale of Iceland Telecom and capital income tax therefrom. Expenditure increased by only 36 billion krónur at the same time, thus contracting their ratio to GDP by two percentage points, from 34.8 per cent in 2003 to 32.6 per cent in 2005.

In order to generate fiscal restraint during the peak period of power project construction, the Government has implemented its medium-term fiscal programme since 2003 by setting goals for the volume growth of public consumption and transfer payments. The goal is to limit central government public consumption growth to 2 per cent a year in real terms and the growth of transfer payments to 2.5 per cent a year. The annual growth of public consumption averaged 2.6 per cent over these two years and the growth of transfer payments was similar. Furthermore, several public investment projects have been postponed. Treasury investment amounted to 15.7 billion krónur or 1.5 per cent of GDP in 2004, whereas in 2005 a total of 14 billion was allocated to investment, 1.4 per cent of GDP. Seen in an international context, Treasury investment as a ration of GDP is quite low at present. Treasury expenditure increased by a total of 12.4 per cent over this period, 4.7 per cent in excess of price increases.

As seen above, Treasury revenue has increased much faster than expenditure during the economic upswing. This is partly explained by the fact that indirect taxes increased by 48 per cent from 2003 to 2005 or by 27 per cent in excess of price increases. Revenue from the value added tax weighs most heavily here. Direct taxes on income and net wealth rose at the same time by 33.5 per cent, with the increase in the corporate income tax and the capital income tax being the highest. Together, these taxes yielded 33 billion in 2005 compared with 20 billion in 2003.

In this year's fiscal budget total revenue is projected to increase by 8.4 billion and expenditure by 19.9 billion or by 6.1 per cent. The revenue surplus will

*Treasury expenditure has increased far less than revenue ...*



**Chart 24**  
**Central government revenue balance 2000–2007**

Source: Statistics Iceland and own forecast.

*... in order to increase fiscal restraint*

### Special section 8. Estimation of the corporate income tax

Each year, the Ministry goes through the exercise of estimating revenue and expenditure for the coming fiscal year. This is a complicated process where many details must be scrutinised, since the operations of the Treasury are far-flung. Once the fiscal budget has been passed into law, the fiscal estimates become law thereby. Nevertheless, there are always bound to be changes in expenditure and revenue from the time that the estimates were made. On the revenue side, tax revenues make up the largest part of the total. They are based on existing tax laws and estimated on the basis of business and personal income. In order to generate new revenue or abolish revenue, the tax legislation must be amended. The Treasury's tax revenue changes, without tax laws being amended, in line with changing economic



conditions from the time that revenue was estimated for budget purposes. When the budget is being drafted for the coming year, the revenue estimates are continually revised in light of the latest revenue data and ongoing developments in the national economy.

In this section, the estimation of the corporate income tax is further explained. For the current year, it is based on the profit of the previous year. This poses problems, since information is gathered with a considerable time lag. The revenue from the corporate tax for the coming year must be estimated before the final tax assessment for the current year, on the basis of previous year's income, has been completed by the Directorate of Internal Revenue in October of each year. This assessment is done on the basis of corporate tax returns or, in their absence, an estimated tax is assessed. Figures on revenue from the corporate income tax are presented in the fiscal budget proposal, at the beginning of October, with the caveat that they must be revised in light of the actual tax assessment that it published at the end of that month. It should also be taken into account that a tax assessment can be appealed and the appellate assessment may differ from the original one. In order to strengthen the estimates of revenue in the fiscal budget proposal and the national economic forecast, the profit figures for the largest companies paying the most in income tax are especially reviewed.

### Assessed corporate tax by sector

	Number of companies		Income tax			
	2004	2005	M.kr.		Share (%)	
			2004	2005	2004	2005
Manufacturing	2 439	2 568	1 615	2 359	11.86	9.92
Construction	2 636	3 040	1 185	2 151	8.70	9.05
Commerce and repair services	4 041	4 418	2 559	3 985	18.79	16.76
Financial services, pension funds and insurance	520	551	2 079	5 571	15.26	23.43
Real property transactions, rental services and other specialised services	8 750	9 856	2 820	5 253	20.71	22.10
Other sectors	13 392	13 935	3 363	4 453	24.69	18.73
<b>Total</b>	<b>31 778</b>	<b>34 369</b>	<b>13 622</b>	<b>23 770</b>	<b>100.0</b>	<b>100.0</b>

In the next table it is shown that 40 per cent of the total proceeds from the corporate income tax in 2004 came from 133 taxpayers, 1.2 per cent of the total.

### Corporate taxpayers classified by tax amount

Amounts are in million kr.

Income tax	Number of companies	Tax base	Income tax	% of companies	% of income tax
0-2	10 322	25 834	4 767	90.60	34.99
2-10	938	17 556	3 231	8.23	23.72
10+	133	30 857	5 624	1.17	41.29
<b>Total</b>	<b>11 393</b>	<b>74 247</b>	<b>13 622</b>	<b>100.0</b>	<b>100.0</b>

The assessed corporate income tax on financial services amounted to 5.6 billion krónur in 2005, about one-fourth of the corporate income tax. An estimate of the corporate income tax of the four largest financial service companies for 2005 shows that their 2006 assessment will amount to an estimated 26.7 billion krónur, compared with 9.3 billion the year before. A part of this amount will not become due for payment, since gains from the sale of shares can be postponed for tax purposes over the end of two years from the date of sale. In addition, a part of the above estimated tax is payable abroad to foreign countries. The corporate income tax is estimated at 17.5 billion krónur in the 2006 fiscal budget, compared with a provisional estimate of 19 billion for 2005. In light of the information available at present on the 2005 accounts of the largest companies in the country, it is evident that revenue from the corporate income tax will be higher than had been estimated in the fiscal budget.

therefore not be as large as last year, an estimated 2.4 per cent of GDP or 26 billion in 2006. The main reason for the scant increase in Treasury revenue is that substantial tax cuts took effect this year. The net wealth tax and the personal income surtax were abolished and the personal income tax was cut. Indirect taxes are also expected to yield less revenue due to lower growth in private consumption and imports. Dividend income of the Treasury will also be lower because Iceland Telecom has been privatised. Revenue from the corporate income tax is expected to increase considerably and income from the value added tax is forecast to increase by 8 per cent in nominal terms from this year. Treasury expenditure is expected to decline by 1.5 percentage points relative to GDP, to 31.1 per cent in 2006. The contribution of the Treasury to public consumption is forecast at 2 per cent in real terms and the growth in transfer payments will be higher by a small margin. Treasury investment expenditure is expected to contract by 18 per cent to 11 billion krónur, or by the equivalent of 1 per cent of GDP.

*Fiscal restraint continuing in 2006 ...*

**Table 7. Public finances 2003–2007**

<i>Bn.kr.</i>	2003	Prelim.	Forecast		
		2004	2005	2006	2007
Total revenue	274.4	314.4	362.0	370.4	365.0
Total expenditure	288.4	302.9	324.2	344.1	377.0
Financial balance	-14.0	11.5	37.8	26.3	-12.0
<i>In % of GDP</i>					
Total revenue	33.1	34.3	36.4	33.5	31.6
Total expenditure	34.8	33.0	32.6	31.1	32.6
Financial balance	-1.7	1.3	3.8	2.4	-1.0

Source: Statistics Iceland and own forecast.

The Treasury revenue balance is expected to turn into a deficit in 2007, of 12 billion krónur or 1 per cent of GDP. Treasury revenue is expected to decline in real terms to 31.6 per cent of GDP compared with 33.5 per cent in 2006. The revenue decline is due to a slower growth of the economy, a lower import turnover along with a cut in the personal income tax. At the same time, Treasury expenditure is forecast to increase by 33 billion, equivalent to 1.5 per cent of GDP. Treasury investment is projected to increase by 10.5 billion, an 80 per cent increase in real terms from this year. The increase in public consumption of the Treasury in real terms is projected to be within the 2 per cent goal of the Government for 2007. The growth in transfer payments is expected to exceed the Government's goal due to the decision of appropriating funds in order to equalise the disability payments burden of the pension funds, increase the income linkage of unemployment compensation and increasing child allowances. Discussions are also underway with the Association of Senior Citizens with regard to their circumstances and the services rendered to them.

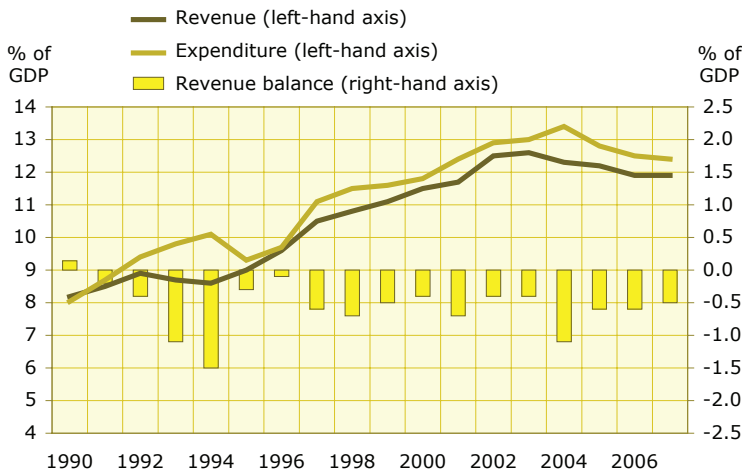
*... but will be relaxed next year when the economy slows down*

## Local governments

The finances of local governments have been in deficit for a number of years. In fact, one must go all the way back to 1990 to find a surplus in their finances, as may be seen in chart 25 on p. 38. Provisional figures indicate that the local government deficit has declined significantly in 2005. A similar deficit is expected for this year and next year a small decline in the deficit is projected.

*Persistent deficits of local government finances*

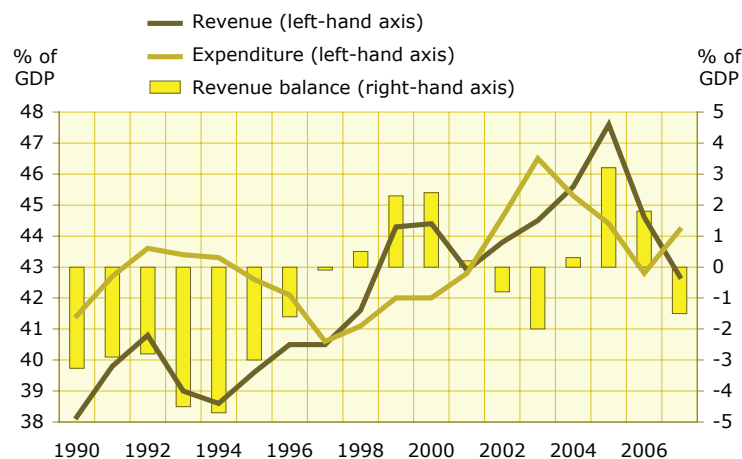
The local governments went into substantial deficits in the first half of the last decade. In 1997 the local governments took over the operation of elementary schools from the central government and a part of the personal



**Chart 25**  
**Local government revenue balance 1990–2007**

Source: Statistics Iceland and own forecast.

*Local government public consumption increasing considerably this year but expected to slow down next year*



**Chart 26**  
**General government revenue balance 1990–2007**

Source: Statistics Iceland and own forecast.

income tax was at the same time shifted from the central government to the local governments. The change in the division of tasks between the central government and the local governments also meant that the composition of local government expenditure changed. The share of consumption in their total expenditure increased and that of investment shrank. At the beginning of the last decade, consumption took up just over a half of total expenditure and investment about one-fourth. Last year, consumption took up about two-thirds of expenditure and investment one-eighth.

Provisional data, compiled by Statistics Iceland on the basis of local government budgets and provisional results from the largest local gov-

ernments, indicate that the revenue deficit of local governments amounted to 6.2 billion krónur or 0.6 per cent of GDP in 2005. This deficit is far less than the year before, one of 10 billion krónur or 1.1 per cent of GDP. Local government revenue is estimated to have increased by 8 per cent or 9 billion krónur between years, whereas expenditure is thought to have risen by 4 per cent or 5 billion. Provisional estimates indicate that public consumption of local governments increased by 3.7 per cent in real terms and investment contracted by up to 20 per cent in real terms, following a peak in 2004 when it amounted to 19.5 billion.

For this year, a revenue deficit is expected to be similar as this year, 6.6 billion or about 0.6 per cent of GDP. This is a slightly higher deficit than was estimated in the Ministry's previous forecast, since account is now taken of wage increases towards the end of last year. Local government revenue is estimated to increase by 8.3 per cent from 2005 or by close to 4 per cent

in excess of general price increases, whereas expenditure is expected to increase by 9 per cent, 4.5 per cent in excess of general price increases. Public consumption is expected to increase by about 2.5 per cent in real terms whereas investment is expected to decline from the previous year. In 2007, when the economy is expected to slow down, a further decline in local government investment in streets and related projects is expected. Their revenue balance is thought to improve by a small margin, to 5.8 billion, 0.5 per cent of GDP. Revenue is estimated to increase by 5 per cent and expenditure by just over 4 per cent.

## The public sector

The revenue balance of the public sector, i.e., the central and local governments combined, amounted to 32 billion krónur in 2005, 3.2 per cent of GDP. This compares with a surplus of 0.3 per cent of GDP in 2004 and a deficit of 2.0 per cent in 2003, as can be seen in the chart here in the margin. This considerable turnaround is primarily due to a sharp increase in revenue at the same time as expenditure has not increased as fast. From 2003 to 2005, revenue increased by 107 billion or 44.5 per cent of 2003-GDP to 47.6 per cent of GDP in 2005. Expenditure

increased at the same time by 58 billion, shrinking in GDP-ratio terms from 46.5 per cent in 2003 to 44.4 per cent in 2005.

For this year, the public sector revenue surplus is expected to decline to 20 billion, 1.8 per cent of GDP. Revenue is expected to increase by 19 billion in

nominal terms but decline by about 1 per cent in real terms. More than half of the revenue increase is projected to come from the local governments. Public sector expenditure is on the other hand expected to increase by 2 per cent in real terms or by 32 billion. Public sector consumption is estimated to increase by 2.5 per cent and investment to decline by 15 per cent, both in real terms. The investment decline is mostly due to the postponement of investment projects by the central government and also to declining investment activity by local governments.

The public sector revenue balance is expected to turn into deficit in 2007, one of 17 billion or 1.5 per cent of GDP. Revenue is expected to shrink to 42.7 per cent of GDP compared to 44.6 per cent in 2006 and 47.6 per cent in 2005. The decline in revenue will take place because of slower economic growth and imports and the cut in the personal income tax rate. Public sector expenditure is projected to increase by 1.4 per cent of GDP to 44.2 per cent in 2007. Investment by the public sector is expected to increase by 23 per cent in real terms and income transfers by 6 per cent.

### Public debt

As can be seen in the chart 27, the net debt of the public sector, aside from pension commitments, has improved significantly in recent years, particularly the debt of the Treasury. The large deficits of the public sector from the mid-eighties to the mid-nineties inevitably led to large borrowing. Since then, the balance of the public sector has improved, particularly that of the Treasury. Debt has declined commensurably.

For this year, net public debt is expected to decline to 9.7 per cent of GDP, compared to a peak of nearly 40 per cent in 1995. The net debt of the Treasury itself is lower still; it is estimated at 5.5 per cent of GDP this year, down from 35 per cent in 1995. Taking the pension fund commitments of the Treasury into account, chart 27 shows that they amounted to 14 per cent of GDP at the beginning of the 'nineties, but have increased to 21 per cent of GDP in 2004. The commitments of the local governments, mostly pension fund commitments, amounted to 5.2 per cent of GDP in 2004 or 48 billion krónur.

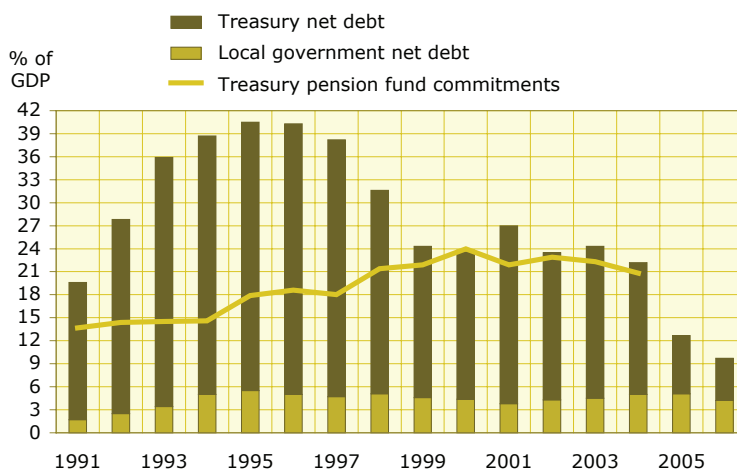
### Structural fiscal balance

As was discussed above, the Treasury revenue surplus amounted to 3.8 per cent of GDP in 2005, as measured by traditional national accounting standards. Such a measurement has its limits when one seeks to assess the impact of the business cycle on fiscal finances, i.e. the revenue and expenditure of the Treasury. It is evident that a substantial economic upswing has a direct positive impact on Treasury revenue, especially when reflected in increased private consumption.

Expenditure is generally not as cyclically sensitive as revenue. Nonetheless, there are certain transfer payments to households, such as unemployment compensation, that increase as the economy slows down. The fiscal structure thus has an automatic impact upon the business cycle through the revenue balance that improves in an upswing but deteriorates in a downswing. In addition, certain tax rates have been cut that have tended to cut the revenue stream. The case is not that simple, however, since tax cuts can have a stimulating impact in the economy and thereby increase tax revenue.

In order to assess the impact of fiscal finances upon the business cycle, it is seen as important to separate the cyclical effect from fiscal finances from

*Fiscal restraint of the total public sector tight this year but will relax next year*



**Chart 27**  
**Public sector net debt 1991-2006**

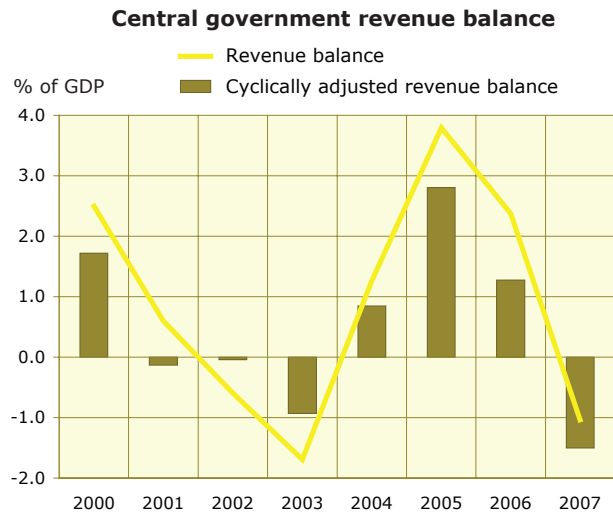
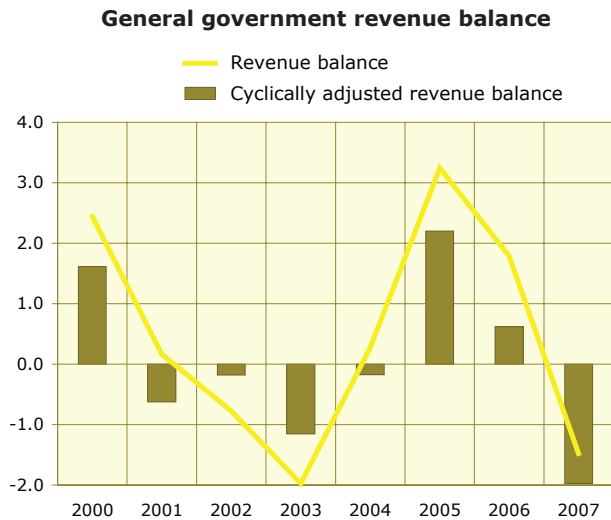
Source: Statistics Iceland and own forecast.

*Public debt has declined sharply and is low by international standards*

*Adjusting for cyclical impact shows that fiscal restraint was high in 2005*

*The cyclically adapted surplus will continue high this year but turn into deficit next year*

its longer-term structural balance. Such an adjustment is made through the measurement of the output gap, i.e. the difference between actual output and potential output, and its effect on the Treasury balance (i.e. revenue and expenditure items). In times of equilibrium – when actual output equals potential output – there is no cyclical impact on Treasury finances. Such a Treasury balance is often called a structural balance or a cyclically adjusted balance. It shows a better measurement of the economic impact of fiscal finances upon the economy.



**Chart 28**  
**General government and central government cyclically adjusted revenue balance 2000–2007**

Sources: Statistics Iceland and Ministry of Finance.

Last year, the structural surplus was 2.8 per cent of GDP compared with 0.8 per cent the year before. It indicates that fiscal restraint increased significantly in that year. The positive output gap is assessed at having been 2 per cent of GDP that year. Potential output is also thought to have increased rapidly last year. Treasury revenue increased sharply due to unusually high demand along with high imports. Due to the restraint in fiscal expenditure, the revenue increase was rapidly reflected in an increasing revenue balance. For 2006, the nominal revenue balance of the Treasury is estimated at 2.4 per cent of GDP. Since the positive output gap is expected to increase this year, the structural balance is assessed at about half of the nominal balance, about 1.3 per cent of GDP.



## MONETARY DEVELOPMENTS

Iceland's monetary developments have undergone profound change in recent years. The power project investments, and largely unforeseen systemic changes in the financial market have led to substantial increases in property prices as well as an increase in private consumption and an exacerbation in the imbalance of the economy. In recent months, the international press has been quite critical of the Icelandic financial system and questioned its stability, which in turn has caused stock prices and the exchange rate to decline rapidly, as well as increasing the foreign financing cost of domestic banks. The positive aspect of such discussion has been to elicit the fact that the Icelandic economy is robust and based on a solid foundation. In the short run, however, the adverse commentary may raise the financing cost of domestic banks internationally, which in turn could reduce domestic activity. At the same time such a development would be appropriate given the present overexpansion of the economy.

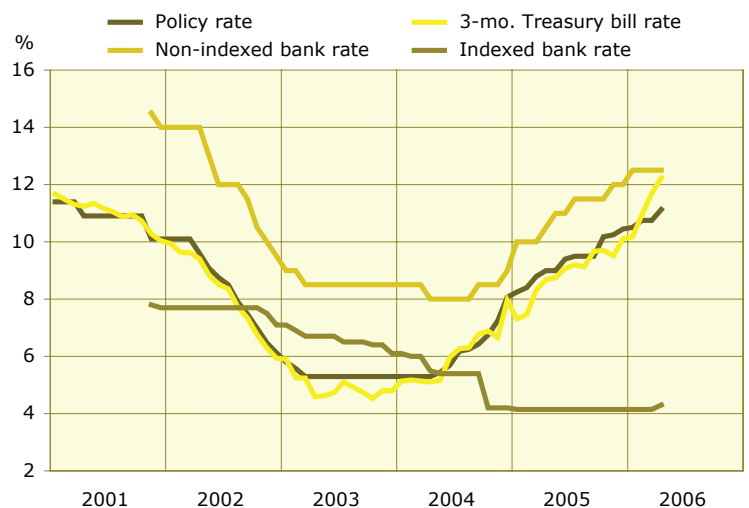
Inflation stayed close to the Central Bank's goal of a 2.5 per cent annual rate from the beginning of 2003 until the spring of the following year. The Bank's policy rate was kept fairly low during this period. As the economy gathered pace, inflation began to creep upwards in May of 2004, and the Bank began to raise its policy rate, bringing it up to 8.25 per cent by the end of that year. The change in the system of mortgage financing that took place in August of 2004 was followed by a sharp increase in real property prices and a rising consumer price index. This development was largely unforeseen. Inflation exceeded 4 per cent at the beginning of 2005, the upper limit of the inflation range and stayed above that limit for the rest of the year. The Bank continued to increase its policy rate, bringing it to 10.5 per cent at the end of the year. The exchange rate strengthened sharply towards the end of 2005, partly because foreign issuers began to issue krónur-denominated bonds. The stronger exchange rate helped quell inflation, but made life difficult for businesses engaged in international competition. Inflation continued to be high, and the policy rate was raised again in January 2006, this time to 10.75 per cent.

The exchange rate and stock prices fell sharply over a short period, following the disturbances in the financial market in the latter half of February 2006 caused by the adverse commentary of foreign analysts on Icelandic banks and the economy. In the middle of March, Statistics Iceland released data that indicated that economic growth and the external imbalance had been greater than previous figures had indicated. The new figures also pointed to the conclusion that the pressures in the economy had been much greater than previously thought, which indicated that inflation pressures were also greater. Since the summer of 2005 inflation on the housing market has been receding, which is positive for the inflation outlook. The further drop in the exchange rate has in turn exacerbated the inflation outlook. The Central Bank reacted to these developments with its 75 point increase in the policy rate on March 30th, bringing the rate to 11.5 per cent. At the same time it strongly indicated that the rate would be increased until inflation prospects were back to a satisfactory level.

In recent years, the transmission mechanism of monetary policy has emerged through the exchange rate, but only to a lesser extent through the interest rate structure. The increase in the exchange rate has helped quell inflation

*Monetary management tackles difficult circumstances*

*Unforeseen innovations in the financial market*



**Chart 29**  
**Central Bank policy interest rate, 3-month Treasury bill rate and average bank lending rate January 2001 – April 2006**

Source: Central Bank of Iceland.

*The policy rate has increased sharply*

*Rising interest rates indicate that monetary policy is working*

but stimulated demand at the same time. The strong exchange rate has encouraged imports and thus contributed to the external imbalance of the economy. The changes in the financial system in 2005 probably had the effect that the rising policy rate had less of an impact through the interest rate structure than expected. Home mortgage rates stayed very low at the beginning but crept up gradually towards the end of last year and into this year. The issue of non-indexed international krónur bonds has also subdued interest rates on certain types of such bonds but has had less of an impact on indexed bonds.

The decline in the exchange rate, a reduced pace of international krónur bond issues along with the more limited access of domestic entities to foreign financing are together likely to strengthen the transmission mechanism of monetary policy via the interest rate structure for the near future. The disquiet in domestic markets and the lack of confidence caused by adverse foreign commentary will undoubtedly limit somewhat the access of Icelandic banks to foreign financing.

It is also likely that those business firms that have no income in foreign currencies will become more conscious of their exchange risk and will seek to convert their foreign low-interest debt into higher-interest domestic debt. There are also signs that interest rates in foreign markets may be on the rise, partly through rising interest rates in neighbouring countries, thus restricting the inflow of liquid capital from abroad. Iceland has until recently been a popular destination in the so-called carry-trade financial market, where investors have taken advantage of the large interest rate differential between Iceland and other countries. The instability of the exchange rate and a possible declining interest rate differential (the differential has been rather stable recently) could reduce still further the flow of funds to the country. In fact, there are signs already that the issue of international krónur bonds is receding quite fast, following the drop in the exchange rate. All these trends, taken together, could mean that the Icelandic banks would become more dependent upon the Central Bank, for example for their liquidity. This would mean that the transmission mechanism of monetary policy through the interest rate structure would strengthen.

*The policy rate is expected to decline once inflation recedes*

In this forecast, the assumption is made that the Central Bank will continue to tighten monetary policy by raising the policy rate to 13 per cent in 2006, bringing the 2006-average to 12 per cent. It is assumed that the policy rate will start declining in 2007 as the economy cools down and inflation slows.

## FINANCIAL MARKETS

International financial markets have been going through a period of disquiet in recent weeks, as long-term interest rates have been increasing. The domestic financial market is increasingly intertwined with the international market and has therefore been considerably affected. The present imbalance in the Icelandic economy, together with the aggressive foray of Icelandic companies into international markets has led to increasing attention paid by foreign analysts to the Icelandic economy, its general economic and financial stability. This discussion has disturbed the financial market, followed by a declining exchange rate and share prices on the Stock Exchange. As a result, investors will probably reassess their view of growth prospects of Icelandic companies and consolidate their position. This will probably strengthen future financial stability.

Bank credit has continued to expand in recent months in spite of an increasingly tighter monetary policy. Domestic bank credit amounted to 1,816 billion krónur at the end of February 2006 and foreign credit to 577 billion. Total bank credit had increased by 952 billion since February 2005, or by 58 per cent. The main reason for this sharp increase has been the increased penetration of the banks into foreign markets, made possible through their unusually good access to low-cost foreign financing.

Bank credit to households has expanded quite rapidly in recent years. Total credits (including market securities) to households amounted to 202 billion in August 2004. By February of this year they had reached 577 billion. Most of the increase can be traced to the change in mortgage financing that began in August 2004 when the banks entered into mortgage financing and captured a large part of the mortgage financing business. Households seized the opportunity to repay their debt to the Housing Finance Fund with new bank financing. The increase in the twelve months up to February of this year was 67 per cent. The twelve-month rate of increase is slowing down, after having reached a peak of 127 per cent in August 2005. The increase in bank credit to households is also slower but still quite pronounced.

Credit to business has also expanded vigorously. It increased by 382 billion in the year up to February 2006, amounting to 1,202 billion at the end of that month, an increase of 47 per cent for the year.

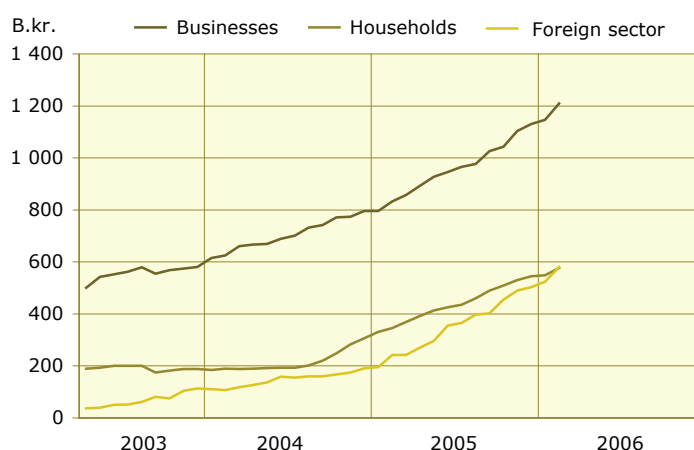
Credit to public entities has on the other hand declined. The Treasury has deliberately drawn down its debt with banks; it declined by 13.8 per cent in the twelve month to the end of February of this year. Debt declined by 24.3 per cent for the same period, the year before. The local governments also repaid debt, reducing it by 10.7 per cent from February 2005 to February 2006.

Credit to foreign borrowers has increased rapidly in recent years. Such credit amounted to 638 billion at the end of February of this year as against only 251 billion a year earlier. This increase reflects the penetration of Icelandic banks into foreign markets in recent months.

The banks have mostly financed their credit increase through borrowing, mostly abroad. The main part of the banks' financing now takes place abroad. This reflects in part their increasing activity abroad. The foreign debt of the banks increased by 113 per cent in the twelve months up to February of this year, whereas foreign assets increased by 160 per cent. Most of the foreign debt is in the form of securities issues; it amounted to 1,952 billion

*The disquiet in international financial markets touches Iceland*

*Bank credit has increased rapidly*



**Chart 30**  
**Bank credit by sector**  
**April 2003 – February 2006**

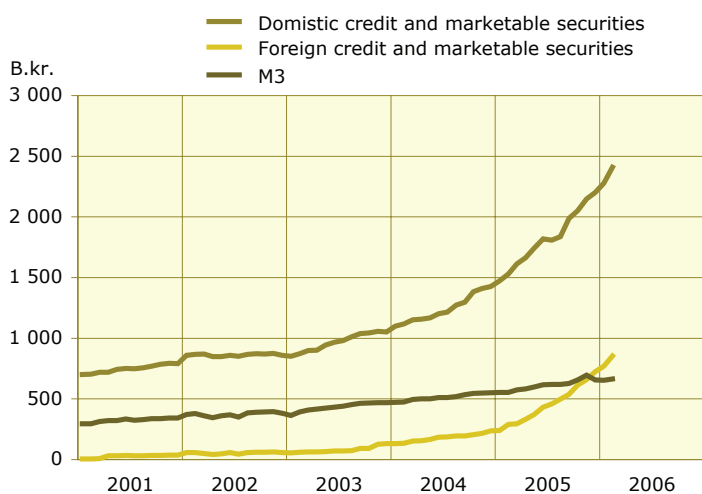
Source: Central Bank of Iceland.

*Domestic credit is increasingly financed through foreign borrowing*

*Limited exchange risk of the banks*

last February compared with 215 billion in February 2003 (not adjusted for price changes). Domestic financing, on the other hand, relies primarily on deposits rather than securities issues. Domestic deposits amounted to 654 billion at the end of February of this year, an increase of 21 per cent over the past twelve months. The issue of domestic securities amounted to 134 billion at the same time.

The criticism of foreign analysts has primarily been directed at the sensitivity



**Chart 31**  
**M3 and bank credit 2001-2006**

Source: Central Bank of Iceland.

of the banks with respect to their access to credit, income from shares and the weakening of the króna. The criticism has not been entirely justified in all instances, for example it has been pointed out that the largest share of the banks' assets and revenue is in foreign currencies. The exchange rate risk is therefore less than the critics have indicated. Bank profits have been quite healthy in an international context, even if income from rising stock prices are excluded. It has also been pointed out that the financing structure of the Icelandic banks has been too dependent on borrowed funds (direct loans and security issues) but it is considered a sign of strength to base financing by banks on deposits, that generally cost less and are more stable than debt financing. The Icelandic banks have reacted to this criticism by attracting customers through

favourable mortgage financing terms in the domestic market. They have also attracted foreign customers since deposits by foreigners in Icelandic banks have increased rapidly in recent months. Such deposits amounted to only 15 billion at the beginning of last year but had reached 135 billion at the end of February of this year. This is not a large amount relative to the total debt of the banks, but it indicates an increased emphasis on the deposit side of the banks' balance sheets. The state of the banks may therefore be deemed to be better than foreign discussion would indicate.

*Stock prices have fluctuated widely*

Much optimism reigned in the stock market in 2005. The ICEX-15 stock index rose by as much as 65 per cent and the turnover on the stock exchange reached a new record, 2,527 billion of which 1,158 billion was in stocks, a turnover increase of 67 per cent. New stock issues on the Iceland Stock Exchange amounted to 123 billion. Most analysts agreed that the rise in stock prices would slow down in 2006. These predictions seemed to be exceeded in the first months of the year as the stock index continued to rise. By the middle of February the index had increased by 23 per cent from the beginning of this year. Adverse reports on the Icelandic economy began to appear thereafter, and stock prices began a rapid decline which still is ongoing. In spite of considerable declines in stock prices, the stock index is still slightly above its level at the turn of the year. Due to the turbulence in the domestic market, some investors have left the domestic market and invested in foreign stocks, partly to profit from the declining exchange rate, whereas others have reinvested in domestic debt.

*Increasing turnover in the bond market*

The bond market has also been quite lively. Turnover amounted to 1,322 billion in 2005, 12 per cent less than in 2004. Still, this is the second year in terms of turnover from the beginning. The bond market was rather quiet in the early months of the year but turnover accelerated towards the end and has reached a record for one quarter in the first quarter of this year, a development that must be seen against events in the stock market.

*Activity in the domestic financial market expected to slow down*

The disquiet of recent weeks in the financial market is expected to peter out over the next several months. It is expected to result in a slower turnover in the domestic financial market.

## APPENDIX: THE IMPACT OF STRUCTURAL REFORM ON ECONOMIC GROWTH

A number of international reports that list countries by their competitiveness have had Iceland climbing towards the top of the charts in recent years. A country's competitiveness is assessed on the basis of its ability to increase national income per capita. The Icelandic economic environment has undergone a significant transformation in recent years, following the privatisation of public enterprises, increased liberalisation and better business operating conditions. For example, the efficiency of public services in Iceland is considered among the best in the world. The organisation and operation of economic policy have also been improved. The tax system has been simplified and designed to stimulate participation in the economy. The results have been quite positive. Economic enterprise has been buoyant, the number of students in higher education has been increasing and technological innovation is increasing, all of which contributes to higher per capita income.

The OECD has for a number of years conducted research into the structural policy of its member countries for the purpose of offering advice as to their longer-term emphasis in matters of economic structure and the conduct of economic policy. The objective is to increase welfare, for which output per capita is an important measurement. The OECD has also monitored the results in its recent report "Economic Policy Review: Going for Growth 2006".

The report emphasises the role of labour in economic growth. It is seen as twofold, labour productivity and labour utilisation. Labour productivity measures how much each worker produces, as measured by the average income of all workers, by the gross domestic product and by how much production increases between years. The utilisation of the workforce is also considered important, i.e., how many take part in productive activity and how many hours they work on average each year. This latter measurement is also an indicator of the share of the population of working age that is dependent upon others for their economic support, a factor that is important for productivity. For example, there is a large difference between labour force participation in the US and continental Europe, partly because of differing emphasis in labour legislation, wage distribution and the structure of transfer incomes. A large part of the population of working age in Europe is welfare-dependent, and public expenditure for this purpose is therefore quite large, calling for increased taxation on the working population and businesses. As a result, there is a tendency in Europe to use labour-saving capital in order to increase per capita productivity. By contrast, the US uses a large share of the population of working age, with a wider distribution of income than is seen in Europe. The increased use of the labour force does not lower per capita productivity, since wages reflect the distribution of human resources. The growth in GDP per capita has therefore been considerably higher in the US than in Europe. Other factors also influence productivity, such as the extent of the public sector and the regulatory burden, both of which have been greater in many countries of Europe than in the US.

Most OECD countries see a need for improving the utilisation of the labour force. This does not apply to Iceland since the utilisation of the labour force has always been high in this country. Unemployment has been minimal and hours worked per worker about the highest. There are several reasons for this. The Icelandic labour market has for many years been more flexible than in many other countries in continental Europe, closer to the pattern in the US, the UK and Ireland. Furthermore, social support payments have been modest. Such payments are in many countries fairly high in relation to wage levels, and therefore there is less incentive to work in order to augment disposable income. Iceland is in the lowest third of the countries where such social support payments are lowest in relation to wage levels. Experience

*The Icelandic economy is one of the most competitive in the world today*

*Growing income is the basis for increased welfare*

*Productivity and the use of labour is the key to success*

*The emphasis has been on high labour utilisation but productivity has also increased*



*The tax and transfer payment system encourages participation in the labour market*

*Number of university graduates increasing rapidly*

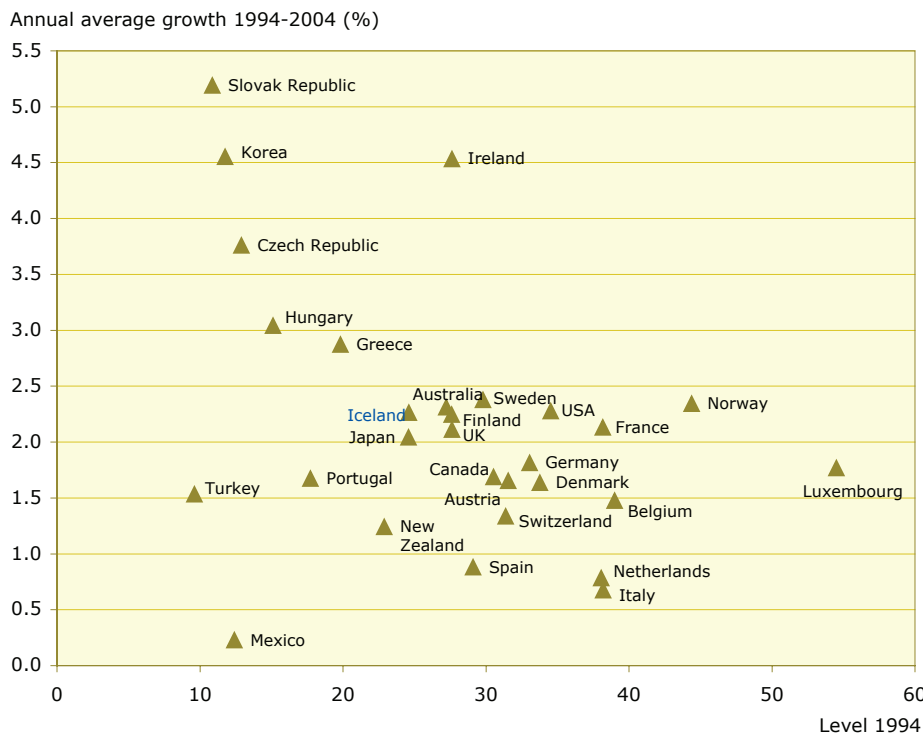
*The Icelandic economy has done well*

shows that low social support and a high rate of economic growth generally go together. Unemployment compensation in Iceland has until recently been made independent of wages. The present arrangement is that unemployment compensation related to income has recently been adopted, and the level of compensation has been raised. The encouragement to work rather than stay unemployed should therefore still be in place. In spite of increased, the wage-related cost of employers is lower in this country than in most OECD countries. By the same token, Iceland does the least amongst OECD countries to encourage people to retire early, which is related to the marginal tax rate on the difference between working wages and retirement income. In many other countries, people of upper middle age retire, whereas in Iceland the retirement age is much higher. For these reasons the entry and exit of the labour market is quite open. Although it is easier to lose a job it is at the same time easier to find a new one. Such flexibility improves the specialisation of the economy and its achievements in a globalised environment

Iceland's wage distribution is narrower than in the US and is more closely in line with that found in the other Nordic countries. In such circumstances, it is important to improve human resources and introduce new technology. Since the education of the labour force constitutes a valuable social asset and can be crucial in economic development, emphasis has been placed on making education more accessible at all levels. When it comes to the share of graduates with higher education, Iceland was in 2003 well above the OECD average in the 45-54 year age group; 25.7 per cent in that group had a university degree at that time. Iceland is close to the average in the 25-34 year group with 29 per cent having a university degree. It is instructive to review how education has been developing and how the financial resources of the public have been used to achieve success. From 1998 to 2004, the public expenditure on education at the university level increased by more than a third in real terms, whereas the number of graduates increased by 80 per cent.

This is an indication that the use of public funds at the university level has improved in recent years. Since then, expenditure at the university level has continued to increase in real terms, and an increase in the number of university graduates may be expected. Iceland's position in relation to other OECD countries should thereby improve in relation to GDP.

An international comparison of productivity has generally used the US as a basis for comparison, since the US has for many years excelled in per capita GDP. In 2004, Norway was the only country in the OECD that had a higher GDP per capita than the US. Ireland, which several decades ago was one of the poorest countries in Western Europe, is now in second place. Iceland was



**Chart 1**  
**Labour productivity<sup>1</sup>**

1. GDP per hour worked, PPP-adjusted, in USD.  
Source: National Accounts of OECD Countries, OECD 2005.

in fifth place. The difference can be explained by labour productivity as well as the use of the labour force. The use of the labour force was 12 per cent higher here than in the US in 2004, and only Korea, Japan and the Czech Republic have a higher use ratio. Labour productivity was on the other hand 27 per cent lower here than in the US in 2004. As a result, the PPP-adjusted GDP per capita was 18 per cent lower here than in the US in that year. Only



France, Belgium, Ireland and Norway have a higher PPP-adjusted GDP per capita than the US in 2004. These results are based on the latest available information from the OECD . In 1994, the PPP-adjusted GDP per capita was 19 per cent lower than in the US. This improvement is notable because per capita growth has been higher in Iceland than in the US during this period. As noted before, this difference can on one hand be explained by labour productivity and by the increased utilisation of the labour force. The utilisation of the labour force was 12 per cent higher in Iceland than in the US in 2004, and only Korea, Japan and the Czech Republic had a higher utilisation of the labour force in that year. Labour productivity was on the other hand 27 per cent lower here than in the US in 2004. As can be seen in Chart 1, productivity has increased at a similar pace as there, or by 2.3 per cent in real terms on average per year since 1999. Since 1994, the total number of hours worked in relation to population has increased by 1.5 per cent, which has helped Iceland close the gap vis-à-vis the US. The economic measurements show that much has been achieved in economic developments in recent years.

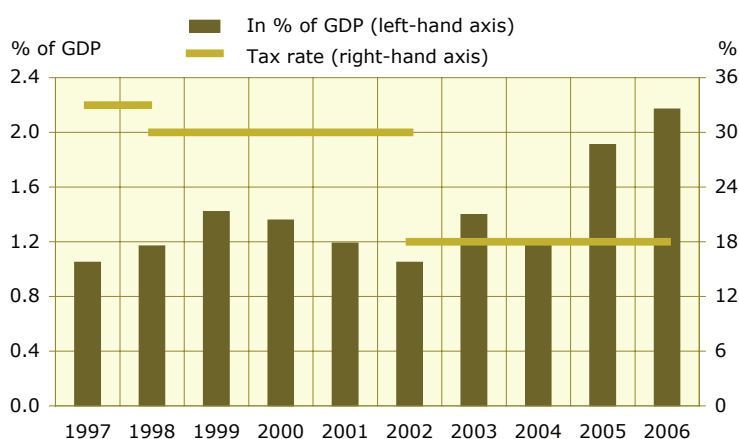
A number of other factors contributed to this development. It is important for the conditions of economic activity that the prevailing rules are clear and transparent, and that the public regulatory mechanism does not unnecessarily encumber individuals and businesses. Iceland rates generally well in such a comparison, and its position has improved in recent years. The directives of the European Union regarding the free flow of labour, goods, services and finance were adopted by Iceland when it became a member of the EEA in 1994. Market operations are therefore liberalised and flexible, and competition has increased in the wake of these changes.

Iceland places first among OECD countries in a five-year period up to 2003 as regards price control and “command and control” regulations. Iceland is in second place in respect of simplifying regulations that limit the production of goods. The grade for the role of the public sector in enterprises was in the lowest third amongst OECD countries in 1998 and had not changed much by 2003. The participation of the public sector in business activity has generally been declining in the OECD countries. This result calls for attention, since the Treasury has in recent years sold its share in a total of 33 companies and public agencies, including Iceland Telecom. Iceland’s position in this respect may be expected to have improved considerably. The privatisation of the banks and the financial savings in the pension system have also vastly increased activity in the financial sector and greatly contributed to the development of the economy.

Finally, it should be noted that wide-ranging tax reforms have been brought about in recent years which also have served to stimulate economic growth. A determined effort has been made to simplify the tax system and design it to stimulate individuals to participate successfully in the economy. The corporate income tax has been cut in stages from 50 per cent in 1989 to 18 per cent in 2001. In spite of this cut, the tax has not yielded less revenue, measured in relation to GDP. As can Chart 2, the ratio has in fact increased, due to rising economic activity in recent years. The tax on personal income (the sum of the central and local government tax) has also been cut from 42 per cent in 1997 to below 35 per cent in 2007. A surtax on higher incomes of 7 per cent was levied from 1998 to 2003, but has since been cut in steps and will be totally this year in order to reduce marginal taxation and stimulate worker incentive.

*Regulations are not a burden for business ...*

*... and the tax system is simple and designed to increase productivity*



**Chart 2**  
**The corporate income tax 1997-2006**

Source: Ministry of Finance.

*Sensible structural reform  
creates scope for higher  
economic growth*

The Treasury has for many years appropriated funds to enterprise innovation in order to support the development of high-tech activities. The activity of high-tech firms was negligible a decade ago but now they account for 4 per cent of GDP.

Economic governance, both concerning monetary and fiscal policy, has been improved. Fiscal management and the privatisation of government assets since the middle of the last decade has results in a ratio of Treasury debt to GDP that is now lower than in most other OECD countries. The monetary policy target was amended from an exchange rate target to an inflation target in 2001 in a setting of a floating exchange rate. The success of these changes will become more visible, once the imbalances in the economy associated with the present power project construction and the innovation in the financial market have passed through.

The above section has briefly discussed the main structural reforms of the economy in recent years, where an emphasis has been placed on a market economy, stability and economic achievements. The above changes have contributed to a higher standard of living and are likely to do so in coming years.

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

	Billion krónur at current prices				Volume change on previous year (%) <sup>1</sup>			
	Prel. 2004	Estim. 2005	Forecast		Prel. 2004	Estim. 2005	Forecast	
			2006	2007			2006	2007
1. Private consumption	525.8	599.2	652.4	675.7	7.2	11.9	2.2	0.5
2. Public consumption	228.3	246.3	269.8	288.4	2.9	3.2	2.5	2.4
i.e. central government	149.6	160.8	175.0	186.8	3.1	2.3	2.3	2.4
i.e. local government	78.6	85.5	94.8	101.6	2.8	3.8	3.0	2.5
3. Gross fixed investment	215.6	285.9	312.2	234.6	29.1	34.5	4.6	-29.2
Business sector investment	130.1	197.0	218.1	129.7	34.5	56.9	3.8	-43.7
Residential construction	50.4	57.4	66.4	67.9	13.8	10.3	11.6	0.2
Public investment	35.2	31.5	27.6	36.9	32.2	-13.5	-15.4	31.0
4. Final domestic demand	969.7	1 131.5	1 234.3	1 198.7	10.3	15.0	2.9	-7.0
5. Stock changes <sup>2</sup>	-1.0	-1.3	0.0	0.0	0.1	0.0	0.1	0.0
<b>6. Total national expenditure</b>	<b>968.8</b>	<b>1 130.1</b>	<b>1 234.3</b>	<b>1 198.7</b>	<b>10.4</b>	<b>14.9</b>	<b>3.2</b>	<b>-7.0</b>
7. Export of goods and services	316.9	314.0	376.4	429.1	8.4	3.5	5.0	11.9
8. Import of goods and services	369.0	448.6	504.5	471.0	14.4	28.4	0.3	-11.4
<b>9. Gross domestic product</b>	<b>916.7</b>	<b>995.5</b>	<b>1 106.2</b>	<b>1 156.7</b>	<b>8.2</b>	<b>5.5</b>	<b>4.8</b>	<b>1.8</b>
10. Net factor income from abroad	-32.1	-27.7	-30.0	-46.3	-	-	-	-
11. Net current transfers	-1.2	-1.7	-1.3	-1.4	-	-	-	-
12. Current account balance (7.-8.+10.+11.)	-85.3	-164.1	-159.4	-89.6	-	-	-	-
<b>13. Gross national income (9.+10.)</b>	<b>884.7</b>	<b>967.8</b>	<b>1 076.2</b>	<b>1 110.4</b>	<b>6.3</b>	<b>6.3</b>	<b>4.9</b>	<b>0.5</b>
14. Effects of changes in terms of trade <sup>3</sup>	-	-	-	-	-0.6	0.3	0.6	-1.4
15. Real gross national income	-	-	-	-	5.8	6.7	5.6	-0.9
16. Current account balance (% of GDP)	-	-	-	-	-9.3	-16.5	-14.4	-7.7

### 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. 2004	Estim. 2005	Forecast		Prel. 2004	Estim. 2005	Forecast	
			2006	2007			2006	2007
<b>Export production</b>								
Marine products	120.7	112.1	129.9	136.8	6.7	-3.4	2.0	2.0
Aluminium	35.9	34.9	61.6	89.6	0.7	-3.1	31.5	58.3
Other products	44.4	36.5	36.7	39.4	29.2	-6.7	-2.4	5.1
<b>Total</b>	<b>201.0</b>	<b>183.4</b>	<b>228.1</b>	<b>265.8</b>	<b>9.0</b>	<b>-4.0</b>	<b>7.3</b>	<b>16.7</b>
Export of old ships and aircraft	0.4	9.6	3.5	3.8	-	-	-	-
Stock changes in export production	-1.0	-1.3	0.0	0.0	-	-	-	-
<b>Merchandise exports, total</b>	<b>202.4</b>	<b>194.4</b>	<b>231.6</b>	<b>269.6</b>	<b>9.2</b>	<b>-0.4</b>	<b>3.0</b>	<b>16.5</b>
<b>Merchandise imports, total</b>	<b>238.9</b>	<b>287.4</b>	<b>340.1</b>	<b>292.4</b>	<b>15.8</b>	<b>25.0</b>	<b>6.0</b>	<b>-18.8</b>
General merchandise imports	197.8	213.7	240.4	232.1	11.5	10.3	0.3	-7.9
of which: Oil imports	20.7	25.8	29.0	29.6	13.5	1.1	1.1	1.9
of which: Other imports	177.1	187.9	211.4	202.5	11.3	11.4	0.2	-9.0
Special imports	41.2	73.7	99.7	60.3	38.3	87.0	20.3	-41.5
<b>Balance of trade</b>	<b>-36.5</b>	<b>-93.0</b>	<b>-108.5</b>	<b>-22.8</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Export of services (excl. factor income)	114.5	119.6	144.7	159.5	7.0	10.5	8.2	4.5
Import of services (excl. factor income)	130.0	161.2	164.4	178.6	12.1	34.7	-9.2	3.1
<b>Balance of services (excl. factor income)</b>	<b>-15.5</b>	<b>-41.6</b>	<b>-19.7</b>	<b>-19.1</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Net factor income from abroad	<b>-32.1</b>	<b>-27.7</b>	<b>-30.0</b>	<b>-46.3</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Net current transfers <sup>2</sup>	-1.2	-1.7	-1.3	-1.4	-	-	-	-
<b>Current balance</b>	<b>-85.3</b>	<b>-164.1</b>	<b>-159.4</b>	<b>-89.6</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 2006 and 2007

	Forecast for 2006						Forecast for 2007			
	Oct. 2004	Jan. 2005	April 2005	Oct. 2005	Jan. 2006	April 2006	April 2005	Oct. 2005	Jan. 2006	April 2006
<b>Volume changes (%)</b>										
Private consumption	5.0	5.6	6.1	4.3	4.3	2.2	0.6	0.6	0.6	0.5
Public consumption	2.0	2.0	2.7	2.2	2.2	2.5	2.5	2.2	2.1	2.4
Gross fixed capital formation	9¼	7.1	-0.8	0.8	3.6	4.6	-24.9	-23.8	-27.2	-29.2
National expenditure	5½	5.3	3.8	2.9	3.5	3.2	-5.1	-5.2	-6.1	-7.0
Exports of goods and services	5¾	7.1	7.5	6.2	6.9	5.0	12.5	11.6	11.8	11.9
Imports of goods and services	8½	8.0	2.9	1.9	3.0	0.3	-6.2	-8.8	-10.9	-11.4
Gross domestic product (GDP)	4½	4.7	5.7	4.6	5.0	4.8	2.4	2.5	2.6	1.8
Current account balance (% of GDP)	-13½	-12.8	-11.4	-12.2	-13.0	-14.4	-6.2	-6.4	-6.2	-7.7
General government balance (% of GDP)	1½	1.6	1.1	1.0	1.1	1.8	-1.2	-0.8	-0.9	-1.5
<b>Income and price changes (%)</b>										
Disposable income per capita	7¼	7.2	5.0	6.6	7.3	9.5	4.6	6.2	6.3	7.0
Wages <sup>1</sup>	4.4	4.4	5.0	5.0	5.8	6.6	4.6	4.5	4.5	4.2
Real disposable income per capita	4.0	3.7	3.3	2.7	3.3	3.4	2.5	2.1	2.2	3.4
Inflation	3¼	3.5	3.8	3.8	3.9	5.9	3.4	4.0	4.0	3.5
Exchange rate index (Dec. 31, 1991=100)	128.0	124.2	116.8	113.8	108.7	119.7	122.8	119.3	117.1	123.7
Unemployment, % of labour force	2¼	2.2	2.2	1.8	1.7	1.6	3.5	2.7	2.6	2.2

1. Wages in the private sector only from April 2006.



### Appendix table 4. Gross domestic product (continued on next page)<sup>1</sup>

	Prel. Estim. Forecast													
	2004	2005	2006	2007	2003	2002	2001	2000	1999	1998	1997	1996	1995	1994
<b>Billion krónur at current prices</b>														
1. Private consumption	525.8	599.2	652.4	675.7	476.9	445.6	432.2	413.5	378.1	340.9	305.4	285.1	263.0	251.9
2. Public consumption	228.3	246.3	269.8	288.4	213.5	202.1	178.2	159.3	143.8	129.1	114.1	106.9	100.1	94.9
3. Gross fixed capital formation	215.6	285.9	312.2	234.6	164.7	139.3	164.7	152.8	136.3	139.2	103.5	92.4	71.1	70.2
4. Stock changes	- 1.0	- 1.3	0.0	0.0	- 1.5	- 0.2	- 2.1	2.5	0.1	0.9	0.1	0.0	3.1	0.3
5. Total national expenditure	968.8	1 130.6	1 234.3	1 198.7	853.6	786.9	773.0	728.1	658.3	610.2	523.1	484.3	437.3	417.3
6. Exports of goods and services	316.9	314.0	376.4	429.1	288.6	305.6	299.5	229.6	212.2	204.3	190.7	176.9	161.3	157.5
6.1 Goods, f.o.b.	202.4	194.4	231.6	269.6	182.6	204.3	196.6	149.3	144.9	136.6	131.2	125.7	116.6	112.7
6.2 Services	114.5	119.6	144.7	159.5	106.0	101.3	102.9	80.3	67.3	67.7	59.5	51.2	44.7	44.8
7. Imports of goods and services	369.0	448.6	504.5	471.0	314.3	292.9	307.6	279.3	242.0	230.4	187.9	173.9	144.9	134.8
7.1 Goods, f.o.b.	238.9	287.4	340.1	292.4	198.5	190.2	202.5	186.8	167.3	161.6	131.0	124.5	103.3	93.0
7.2 Services	130.0	161.2	164.4	178.6	115.8	102.7	105.1	92.6	74.7	68.8	57.0	49.4	41.6	41.8
8. Gross domestic product	916.7	995.5	1 106.2	1 156.7	827.9	799.6	764.9	678.3	628.5	584.1	525.9	487.3	453.7	440.0
9. Net factor income from abroad	- 32.1	- 27.7	- 30.0	- 46.3	- 14.1	- 1.2	- 24.3	- 18.9	- 12.4	- 12.7	- 12.0	- 11.2	- 12.7	- 13.5
10. Gross national income (8.+9.)	884.7	967.8	1 076.2	1 110.4	813.8	798.3	740.6	659.4	616.1	571.4	513.9	476.1	441.0	426.4
11. Current account balance	- 85.3	- 164.1	- 159.4	- 89.6	- 41.0	12.6	- 33.4	- 69.4	- 42.9	- 39.8	- 9.5	- 8.7	3.4	8.5
11.1 Balance on goods f.o.b.	- 36.5	- 93.0	- 108.5	- 22.8	- 15.9	14.1	- 5.9	- 37.5	- 22.4	- 25.0	0.3	1.2	13.4	19.7
11.2 Balance on services	- 15.5	- 41.6	- 19.7	- 19.1	- 9.9	- 1.4	- 2.2	- 12.3	- 7.4	- 1.1	2.5	1.8	3.1	3.0
11.3 Balance on income	- 32.1	- 27.7	- 30.0	- 46.3	- 14.1	- 1.2	- 24.3	- 18.9	- 12.4	- 12.7	- 12.0	- 11.2	- 12.7	- 13.5
11.4 Net current transfer	- 1.2	- 1.7	- 1.3	- 1.4	- 1.2	1.2	- 1.0	- 0.8	- 0.7	- 1.0	- 0.2	- 0.5	- 0.3	- 0.6
12. Current account balance, % of GDP	- 9.3	- 16.5	- 14.4	- 7.7	- 5.0	1.6	- 4.4	- 10.2	- 6.8	- 6.8	- 1.8	- 1.8	0.7	1.9
<b>Volume indices, 2000=100</b>														
1. Private consumption	108.3	121.1	123.8	124.4	101.0	95.4	97.0	100.0	96.0	88.9	80.8	76.1	71.9	70.4
2. Public consumption	113.2	116.8	119.7	122.6	110.1	108.3	103.1	100.0	95.9	91.4	88.3	86.1	85.2	83.8
3. Gross fixed capital formation	118.1	158.9	166.2	117.7	91.4	78.6	97.0	100.0	90.5	94.2	71.1	65.1	52.0	52.9
4. Total national expenditure	110.8	127.3	131.4	122.1	100.4	94.3	97.7	100.0	94.6	90.6	79.9	75.6	70.8	69.3
5. Exports of goods and services	122.8	127.2	133.5	149.5	113.3	111.4	107.4	100.0	95.9	92.3	90.0	85.2	77.6	79.4
5.1 Goods	123.4	123.0	126.7	147.6	113.0	114.3	107.2	100.0	101.3	94.6	97.2	95.8	87.8	89.7
5.2 Services	121.6	134.3	145.3	151.9	113.6	105.9	107.7	100.0	86.0	88.2	77.5	66.9	59.8	61.3
6. Imports of goods and services	112.3	144.2	144.6	128.1	98.1	88.6	90.9	100.0	92.1	88.2	71.5	66.2	56.8	54.8
6.1 Goods	108.0	135.0	143.1	116.1	93.3	87.0	90.0	100.0	97.3	94.3	75.9	72.2	61.9	58.1
6.2 Services	120.6	162.5	147.5	152.1	107.6	91.8	92.7	100.0	82.3	76.7	63.2	54.8	47.2	48.6
7. Gross domestic product	114.5	120.9	126.7	128.9	105.8	102.7	103.8	100.0	96.0	92.1	87.1	83.0	79.2	79.1
8. Gross national income	111.8	119.3	125.9	124.7	105.7	105.9	102.8	100.0	97.6	93.6	86.9	82.2	79.0	78.4

## Appendix table 4. Gross domestic product (continued)<sup>1</sup>

	Price indices, 2000=100								Prelim. Estim.				Forecast	
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
1. Private consumption	86.5	88.4	90.7	91.4	92.7	95.3	100.0	107.7	112.9	114.2	117.4	119.6	127.5	131.4
2. Public consumption	71.1	73.8	77.9	81.2	88.7	94.2	100.0	108.6	117.2	121.8	126.6	132.4	141.5	147.7
3. Gross fixed capital formation	86.8	89.5	92.9	95.2	96.7	98.5	100.0	111.2	115.9	117.9	119.5	117.8	122.9	130.5
4. Total national expenditure	82.7	84.8	88.0	89.9	92.6	95.6	100.0	108.6	114.6	116.8	120.1	122.0	129.1	134.8
5. Exports of goods and services	86.4	90.6	90.4	92.3	96.4	96.4	100.0	121.5	119.5	111.0	112.4	107.6	122.8	125.1
5.1 Goods, f.o.b.	89.7	87.8	95.8	97.2	94.6	101.3	100.0	107.2	114.3	113.0	123.4	123.0	142.2	142.1
5.2 Services	61.3	59.8	66.9	77.5	88.2	86.0	100.0	107.7	105.9	113.6	121.6	134.3	150.3	158.4
6. Imports of goods and services	88.0	91.3	94.1	94.1	93.5	94.1	100.0	121.1	118.4	114.7	117.6	111.4	124.9	131.7
6.1 Goods, f.o.b.	58.1	61.9	72.2	75.9	94.3	97.3	100.0	90.0	87.0	93.3	108.0	135.0	150.8	159.7
6.2 Services	48.6	47.2	54.8	63.2	76.7	82.3	100.0	92.7	91.8	107.6	120.6	162.5	182.4	192.2
7. Gross domestic product	82.0	84.4	86.5	89.1	93.5	96.5	100.0	108.6	114.8	115.3	118.0	121.5	128.8	132.3
8. Gross national income	82.5	84.7	87.8	89.7	92.6	95.7	100.0	109.3	114.3	116.7	120.0	123.1	129.7	135.1
<b>Volume changes on previous year (%)</b>														
1. Private consumption	2.7	2.2	5.7	6.2	10.1	7.9	4.2	-3.0	-1.6	5.9	7.2	11.9	2.2	0.5
2. Public consumption	4.0	1.7	1.0	2.6	3.6	4.9	4.3	3.1	5.1	1.6	2.9	3.2	2.5	2.4
3. Gross fixed capital formation	-0.2	-1.7	25.0	9.3	32.5	-3.9	10.4	-3.0	-18.9	16.3	29.2	34.5	4.6	-29.2
4. Total national expenditure	1.7	2.2	6.8	5.7	13.3	4.4	5.7	-2.3	-3.5	6.4	10.4	14.9	3.2	-7.0
5. Exports of goods and services	9.3	-2.3	9.9	5.6	2.5	3.9	4.3	7.4	3.8	1.6	8.4	3.5	5.0	11.9
5.1 Goods, f.o.b.	12.2	-2.2	9.1	1.5	-2.6	7.1	-1.3	7.2	6.6	-1.2	9.2	-0.4	3.0	16.5
5.2 Services	2.6	-2.5	12.0	15.8	13.8	-2.4	16.2	7.7	-1.7	7.3	7.0	10.5	8.2	4.5
6. Imports of goods and services	3.8	3.6	16.5	8.0	23.4	4.4	8.6	-9.1	-2.6	10.8	14.4	28.4	0.3	-11.4
6.1 Goods, f.o.b.	7.5	6.5	16.6	5.1	24.3	3.2	2.8	-10.0	-3.4	7.3	15.8	25.0	6.0	-18.8
6.2 Services	-3.7	-2.7	16.1	15.3	21.3	7.2	21.6	-7.3	-1.0	17.2	12.1	34.7	-9.2	3.1
7. Gross domestic income	3.5	0.1	4.8	4.9	5.8	4.3	4.1	3.8	-1.0	3.0	8.2	5.5	4.8	1.8
8. Gross national income	2.9	0.8	4.1	5.7	7.8	4.3	2.4	2.8	3.0	-0.2	5.8	6.7	5.6	-0.9
<b>Price changes on previous year (%)</b>														
1. Private consumption	1.6	2.2	2.5	0.9	1.4	2.8	5.0	7.7	4.8	1.1	2.9	1.9	6.5	3.1
2. Public consumption	1.6	3.7	5.7	4.1	9.3	6.2	6.2	8.6	7.9	3.9	4.0	4.6	6.9	4.4
3. Gross fixed capital formation	3.9	3.1	3.8	2.5	1.5	1.9	1.5	11.2	4.3	1.6	1.4	-1.4	4.4	6.2
4. Total national expenditure	2.3	2.6	3.7	2.2	3.0	3.3	4.6	8.6	5.5	1.9	2.8	1.6	5.8	4.4
5. Exports of goods and services	6.2	4.8	-0.2	2.1	4.5	0.0	3.8	21.5	-1.7	-7.1	1.3	-4.3	14.2	1.8
5.1 Goods, f.o.b.	12.2	-2.2	9.1	1.5	-2.6	7.1	-1.3	7.2	6.6	-1.2	9.2	-0.4	15.7	-0.1
5.2 Services	2.6	-2.5	12.0	15.8	13.8	-2.4	16.2	7.7	-1.7	7.3	7.0	10.5	11.9	5.4
6. Imports of goods and services	5.9	3.7	3.1	0.0	-0.7	0.6	6.3	21.1	-2.3	-3.1	2.6	-5.3	12.2	5.4
6.1 Goods, f.o.b.	7.5	6.5	16.6	5.1	24.3	3.2	2.8	-10.0	-3.4	7.3	15.8	25.0	11.7	5.9
6.2 Services	-3.7	-2.7	16.1	15.3	21.3	7.2	21.6	-7.3	-1.0	17.2	12.1	34.7	12.3	5.4
7. Gross domestic product	2.6	3.0	2.5	2.9	5.0	3.2	3.6	8.6	5.6	0.5	2.3	2.9	6.0	2.7
8. Gross national income	2.5	2.6	3.7	2.2	3.1	3.4	4.5	9.3	4.6	2.1	2.8	2.6	5.3	4.1

### Appendix table 4. Gross domestic product (continued)<sup>1</sup>

	Prelim. Estim. Forecast													
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	
<b>Per capita volume indices, 2000=100</b>														
1. Private consumption	74.4	75.6	79.5	83.8	91.3	97.4	100.0	100.0	95.7	93.3	98.2	104.0	115.1	116.2
2. Public consumption	88.6	89.6	90.0	91.6	93.9	97.2	100.0	100.0	101.7	105.9	107.0	108.8	111.0	114.5
3. Gross fixed capital formation	56.0	54.7	68.0	73.8	96.8	91.8	100.0	100.0	95.6	76.9	88.9	113.5	151.0	109.9
4. Total national expenditure	73.2	74.4	79.0	83.0	93.0	95.9	100.0	100.0	96.4	92.2	97.5	106.5	121.0	114.1
5. Exports of goods and services	83.9	81.6	89.1	93.4	94.8	97.3	100.0	100.0	105.9	109.0	110.1	118.0	120.8	139.6
5.1 Goods, f.o.b.	94.9	92.3	100.1	100.8	97.1	102.8	100.0	100.0	105.8	111.8	109.8	118.6	116.8	137.8
5.2 Services	64.8	62.8	70.0	80.4	90.6	87.3	100.0	100.0	106.2	103.6	110.4	116.9	127.7	141.9
6. Imports of goods and services	58.0	59.8	69.2	74.2	90.6	93.4	100.0	100.0	89.7	86.6	95.4	107.9	137.0	119.6
6.1 Goods, f.o.b.	61.4	65.1	75.4	78.7	96.8	98.7	100.0	100.0	88.8	85.1	90.7	103.8	128.3	108.5
6.2 Services	51.3	49.7	57.3	65.6	78.8	83.4	100.0	100.0	91.5	89.7	104.6	115.9	154.4	142.1
7. Gross domestic product	83.6	83.3	86.8	90.4	94.5	97.4	100.0	100.0	102.4	100.4	102.9	110.0	114.8	120.4
8. Gross national income	82.8	83.0	85.9	90.1	96.1	99.0	100.0	100.0	101.4	103.5	102.8	107.5	113.3	116.5

#### Gross domestic product per capita, US dollars

1. GDP per capita, current exchange rate	23 652	26 191	27 172	27 347	29 994	31 311	30 588	27 447	30 402	37 285	44 682	53 530	...	...
2. GDP per capita, current PPPs	22 154	22 586	24 102	25 374	26 944	27 955	28 967	30 201	30 164	30 774	33 695	35 749	...	...

#### Notes:

1. Corrections have been made due to change in base year of time series.

Source: Statistics Iceland and own forecast.

## Appendix table 5. Income, prices and exchange rate

Indices, 1990=100	Estim.											Forecast					
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
<b>Income</b>																	
Disposable income per capita	108.9	109.9	106.6	108.2	113.1	120.8	133.4	147.3	162.6	179.9	194.7	204.0	219.0	231.9	251.3	275.2	294.5
Wages <sup>1</sup>	108.2	110.9	111.9	112.9	117.7	123.9	131.1	140.4	147.9	156.4	169.5	178.7	188.6	197.0	210.6	224.5	233.9
<b>Prices</b>																	
Consumer price index	106.8	110.8	115.3	117.0	119.0	121.7	123.9	126.0	130.3	136.8	146.0	153.0	156.2	161.3	167.8	177.7	183.9
Purchasing power <sup>2</sup>																	
Disposable income per capita	102.1	99.3	92.5	92.5	96.0	100.3	108.7	118.1	126.1	132.9	134.8	134.7	141.6	145.3	151.4	156.6	161.9
Wages <sup>1</sup>	101.3	100.1	97.0	96.5	98.9	101.8	105.8	111.4	113.5	114.3	116.1	116.8	120.7	122.2	125.5	126.3	127.2
<b>Exchange rate</b>																	
Effective price of foreign currency <sup>3</sup>		100.0	110.6	116.0	116.1	116.2	114.7	112.8	112.6	112.7	135.4	131.4	123.5	121.0	108.6	119.7	123.7
Real exchange rate relative to prices	99.9	99.8	94.4	89.3	89.4	89.7	90.5	91.9	93.6	96.3	83.7	88.5	94.2	97.2	107.0	101.6	99.9
Real exchange rate relative to wages	89.6	92.5	84.3	77.6	81.0	81.9	84.5	89.0	90.5	91.3	79.1	85.2	89.2	90.8	101.9	95.1	92.5
<b>Changes on previous year, %</b>																	
<b>Income</b>																	
Disposable income per capita	8.9	0.9	-3.0	1.5	4.4	6.8	10.4	10.5	10.4	10.6	8.2	4.7	7.4	5.9	8.4	9.5	7.0
Wages <sup>1</sup>	8.2	2.5	0.9	0.9	4.3	5.3	5.8	7.1	5.4	5.7	8.4	5.4	5.6	4.5	6.9	6.6	4.2
<b>Prices</b>																	
Consumer price index	6.8	3.7	4.1	1.5	1.7	2.3	1.8	1.7	3.4	5.0	6.7	4.8	2.1	3.2	4.0	5.9	3.5
Purchasing power <sup>2</sup>																	
Disposable income per capita	2.1	-2.7	-7.6	0.0	2.7	4.4	8.5	8.6	6.8	5.4	1.4	-0.1	5.2	2.6	4.2	3.4	3.4
Wages <sup>1</sup>	1.3	-1.1	-3.1	-0.6	2.5	2.9	3.9	5.3	1.9	0.7	1.6	0.6	3.4	1.2	2.7	0.7	0.7
<b>Exchange rate</b>																	
Effective price of foreign currency <sup>3</sup>			10.6	4.9	0.1	0.1	-1.3	-1.6	-0.2	0.1	20.1	-3.0	-6.0	-2.0	-10.3	10.3	3.3
Real exchange rate relative to prices	2.6	0.0	-5.4	-5.4	0.1	0.3	0.9	1.6	1.8	2.9	-13.0	5.7	6.3	3.2	10.1	-5.1	-1.6
Real exchange rate relative to wages	2.6	3.2	-9.0	-7.9	4.4	1.1	3.3	5.3	1.7	0.8	-13.3	7.7	4.7	1.8	12.2	-6.7	-2.7

### Notes:

1. Wages in the private sector only from April 2006.
2. Deflated by the consumer price index.
3. Official exchange rate of the króna vis-à-vis foreign currencies, December 31, 1991 = 100.

## Appendix table 6. Fish catch

Thousand tonnes	2001	2002	2003	2004	Prelim. 2005	Forecast 2006
Cod	240	213	206	227	212	215
Haddock	40	50	60	85	96	109
Saithe	32	42	52	63	68	82
Redfish	50	66	63	48	61	58
Catfish	18	14	16	13	15	14
Greenland halibut	17	19	20	15	13	17
Herring	101	97	132	122	108	108
Shrimp	31	35	29	20	9	13
Capelin	924	1 079	681	524	605	400
Blue whiting	365	286	502	419	266	350
Atlantic-Scandian herring	78	127	118	103	156	150
Oceanic redfish	42	45	48	37	16	15
Other marine products	49	60	53	49	42	30
<b>Total marine product</b>	<b>1 987</b>	<b>2 133</b>	<b>1 980</b>	<b>1 725</b>	<b>1 667</b>	<b>1 560</b>
<b>Percentage change in total catch value from previous year, constant prices<sup>1</sup></b>	.	<b>3.8</b>	<b>-2.0</b>	<b>-2.7</b>	<b>-4.3</b>	<b>1.9</b>

### Notes:

1. Calculated by using fish prices from the Freshfish Price Directorate.

Source: Statistics Iceland and own forecast.

## Appendix table 7. Gross fixed capital formation

Million krónur at current prices	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Brb.
Agriculture and forestry	1 884	1 805	1 606	2 543	3 184	4 979	5 280	6 185	2 990	3 906	5 358	4 728	4 820	
Fishing	2 348	3 680	1 803	5 523	590	6 610	3 608	5 688	11 165	1 636	1 189	5 318	2 982	
Fish processing	1 420	2 040	2 749	4 044	7 809	3 682	1 050	1 315	- 459	4 504	4 791	681	2 038	
Food industry, other	635	521	571	664	915	1 954	2 779	3 550	2 950	1 360	1 615	2 494	3 184	
Manufacture of metal prod. except machinery and equipment	625	380	501	6 288	10 541	11 049	3 610	5 508	4 488	1 241	1 011	7 682	46 708	
Manufacturing, other	3 657	3 985	4 763	6 519	3 735	5 821	4 902	6 079	5 262	5 560	5 278	1 811	3 498	
Electricity and water supply	3 559	3 088	3 552	5 213	9 521	17 559	15 708	12 491	16 409	16 219	27 887	34 425	49 625	
Construction	1 857	1 656	2 295	3 337	5 337	7 826	5 399	5 031	4 398	4 735	8 549	10 014	13 127	
Retail and wholesale	1 084	1 202	1 474	1 850	5 511	5 725	6 512	5 779	5 297	-1 812	1 931	7 725	6 393	
Hotels and restaurants	1 196	1 170	1 344	1 650	1 521	1 072	3 507	2 017	1 692	1 049	2 686	2 331	2 694	
Transport and supporting activities; travel agencies	2 459	1 385	2 755	2 782	5 906	11 603	4 305	10 848	9 538	14 332	8 903	14 123	14 982	
Post and telecommunications	3 464	4 556	4 553	5 003	2 402	4 507	5 227	8 614	5 995	2 708	3 126	4 477	4 976	
Financial intermediation and insurance	1 046	1 168	1 356	1 623	1 218	2 424	3 910	967	2 103	1 648	2 103	3 947	5 763	
Real estate activities	749	728	821	995	- 398	1 437	6 310	6 288	11 777	8 182	13 052	15 720	19 160	
Renting of machinery; computer & related activ.	395	419	506	634	830	776	2 780	1 916	1 228	1 054	1 695	2 241	2 738	
Research and development	131	118	161	226	- 17	1 301	2 224	3 702	1 336	389	-1 010	617	721	
Other business activities	1 067	1 071	1 260	1 567	605	3 464	5 957	7 705	8 151	2 607	856	3 478	4 460	
Education	11	12	16	20	82	36	277	5	41	17	81	53	97	
Health and social work	164	169	222	298	249	409	864	1 337	666	1 731	816	727	1 106	
Sewage, refuse disposal; activities of membership organization sn.e.c.	61	58	77	105	265	407	133	312	301	3 016	2 275	1 976	2 267	
Recreational, cultural and sporting activities	211	234	290	369	1 388	584	1 107	1 345	2 665	- 566	680	2 585	1 735	
Other activities	1 180	1 383	1 576	1 950	2 923	1 351	5 258	2 779	3 277	3 133	4 136	2 910	3 925	
<b>Business sector, total</b>	<b>29 200</b>	<b>30 829</b>	<b>34 251</b>	<b>53 204</b>	<b>64 117</b>	<b>94 577</b>	<b>90 709</b>	<b>99 464</b>	<b>101 269</b>	<b>76 650</b>	<b>97 009</b>	<b>130 063</b>	<b>196 999</b>	
<b>Residential construction</b>	<b>19 541</b>	<b>20 858</b>	<b>19 619</b>	<b>22 060</b>	<b>20 678</b>	<b>21 573</b>	<b>22 217</b>	<b>25 873</b>	<b>31 648</b>	<b>39 262</b>	<b>42 441</b>	<b>50 415</b>	<b>57 420</b>	
<b>Government services</b>	<b>18 994</b>	<b>18 523</b>	<b>17 272</b>	<b>17 094</b>	<b>18 706</b>	<b>23 070</b>	<b>23 337</b>	<b>27 487</b>	<b>31 830</b>	<b>23 383</b>	<b>25 248</b>	<b>35 169</b>	<b>31 513</b>	
Roads and bridges	4 442	3 982	3 546	3 268	3 485	3 547	4 196	4 595	6 248	5 359	8 509	9 198	7 924	
Streets and sewers	3 291	3 548	2 690	2 887	3 586	4 122	4 378	5 333	7 188	4 393	4 035	7 450	6 145	
Public buildings	9 300	9 100	8 800	8 735	9 291	12 799	11 486	14 286	15 255	11 025	9 950	15 383	14 018	
Other public assets n.e.c.	1 961	1 893	2 236	2 204	2 345	2 602	3 277	3 273	3 139	2 606	2 755	3 138	3 426	
<b>Gross fixed capital formation, total</b>	<b>67 735</b>	<b>70 210</b>	<b>71 143</b>	<b>92 358</b>	<b>103 501</b>	<b>139 220</b>	<b>136 263</b>	<b>152 825</b>	<b>164 746</b>	<b>139 295</b>	<b>164 698</b>	<b>215 647</b>	<b>285 933</b>	

Source: Statistics Iceland.



## Appendix table 8. Private consumption indicators

	Change on previous year (%)										Changes from the same period the previous year (%) <sup>2</sup>												
											Month												
	2000	2001	2002	2003	2004	2005	J	F	M	A	M	J	J	A	S	O	N	D	2002	2003	2004	2005	2006
CPI	5.0	6.7	4.8	2.1	3.2	4.0	J	F	M										9.0	1.7	2.1	4.4	4.3
CPI, excluding housing	3.6	6.8	4.6	0.7	2.1	0.9	J	F	M										9.6	0.5	1.1	2.1	1.3
Wage index	6.6	8.9	7.2	5.6	4.7	6.8	J	F											9.9	5.6	3.3	6.7	8.5
Real wages	1.5	2.1	2.2	3.4	1.4	2.6	J	F											0.6	4.0	1.0	2.3	4.0
Changes in average unemployment	-0.5	0.1	1.1	0.9	-0.3	-1.0	J	F											0.9	1.5	-0.3	-0.7	-1.3
Number of unemployment days	-28.3	7.7	80.6	34.6	-6.3	-32.4	J	F											59.3	59.5	-8.9	-18.4	-42.5
Taxes on turnover, volume change	2.0	-6.9	-1.3	6.9	9.9	15.6	J	F											-9.6	11.4	7.4	17.5	-2.9
Of which VAT	3.7	-4.8	0.1	6.8	10.0	17.4	J	F											-8.8	10.3	10.4	18.3	-6.8
Personal income tax	8.9	7.3	-0.7	0.5	7.0	3.3	J	F											5.8	-2.6	5.8	7.2	2.3
Social Security taxes	-17.0	26.6	-0.2	5.5	5.4	8.8	J	F											0.4	-4.2	7.9	15.3	6.5
Debit and credit card turnover, constant prices	8.4	3.9	-1.0	9.0	8.9	10.1	J	F											-6.5	9.1	4.6	16.2	7.5
Domestic, constant prices	8.2	5.1	-0.8	7.9	7.8	7.9	J	F											-6.2	8.2	3.6	15.3	5.4
Abroad, constant prices	12.0	-16.3	-4.0	32.9	26.9	41.5	J	F											-14.5	35.1	26.1	34.1	42.5
Imports of consumer goods, volume change	0.3	-15.8	-1.0	13.3	15.7	27.1	J	F	M	J	J	A	S	O	N	D			-1.0	13.3	15.7	27.1	...
Automobiles	-10.2	-44.8	-2.2	43.7	35.0	54.9	J	F	M	J	J	A	S	O	N	D			-2.2	43.7	35.0	54.9	...
Durable goods (e.g. home appliances)	3.1	-14.6	-4.8	17.2	17.1	35.7	J	F	M	J	J	A	S	O	N	D			-4.8	17.2	17.1	35.7	...
Semi-durables (e.g. clothes)	13.5	-12.2	-5.3	8.8	7.5	20.6	J	F	M	J	J	A	S	O	N	D			-5.3	8.8	7.5	20.6	...
Food and drink	1.5	1.2	4.0	3.7	10.2	12.4	J	F	M	J	J	A	S	O	N	D			4.0	3.7	10.2	12.4	...
Imports less ships, aircraft and fuel, constant prices	9.0	-12.1	-4.8	12.2	18.2	31.1	J	F	M										-15.9	-7.8	44.2	10.0	50.0
Turnover VAT returns, constant prices	3.1	5.2	-2.4	1.4	12.2	8.9	J	F	M	J	J	A	S	O	N	D			-2.4	1.4	12.2	8.9	...
Commission and wholesale trade, constant prices	53.2	-4.4	-3.5	7.9	18.5	5.7	J	F	M	J	J	A	S	O	N	D			-3.5	7.9	18.5	5.7	...
Retail trade, constant prices	-1.3	-0.3	-0.9	1.1	5.1	5.5	J	F	M	J	J	A	S	O	N	D			-0.9	1.1	5.1	5.5	...
Gallup index of consumer confidence	.	.	25.8	12.7	1.6	5.0	J	F	M										-10.8	12.3	18.0	-1.7	3.7
Turnover in grocery stores	.	.	.	4.3	3.7	9.7	J	F											.	5.8	3.8	4.5	9.5
Turnover in liquor stores	.	.	.	1.3	3.4	8.5	J	F											.	5.6	2.5	3.2	8.6
Turnover in pharmacies	.	.	.	1.4	4.2	...	J	F	M	J	J	A	S						.	2.5	5.2	2.1	...
Registration of new vehicles	-9.9	-47.3	-53.5	200.8	30.8	57.2	J	F	M										-34.8	56.8	35.8	61.4	37.4
Registration of all passenger vehicles	-66.1	-44.7	12.9	200.3	28.6	58.9	J	F	M										-33.5	62.9	29.6	61.4	39.3
Registration of new passenger vehicles	-32.2	-21.8	3.9	16.7	21.1	50.9	J	F	M										-31.7	58.6	22.3	47.3	49.2

### Skýringar:

1. Table 8 is based on data available on April 7, 2006.

2. All changes between years are based on cumulated data (sum or average) from the beginning of the year to the month indicated.

Sources: Central Bank of Iceland, Directorate of Labour, Federation of Trade and Services, IMG Gallup in Iceland, Ministry of Finance, Motor Dealers' and Services Federation and Statistics Iceland.

## Appendix table 9. Balance of payments (continued on next page)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>1 Million krónur at current prices</b>	<b>-3 074</b>	<b>- 77</b>	<b>12 271</b>	<b>19 662</b>	<b>13 355</b>	<b>1 200</b>	<b>254</b>	<b>-25 019</b>	<b>-22 382</b>	<b>-37 479</b>	<b>-6 124</b>	<b>14 082</b>	<b>-15 900</b>	<b>-37 787</b>	<b>-94 539</b>
1.1 Balance on goods	91 560	87 833	94 657	112 654	116 606	125 689	131 213	136 592	144 928	149 273	196 394	204 303	182 580	202 373	194 355
1.1.1 Merchandise exports, f.o.b.	73 236	69 880	74 572	84 838	83 872	92 580	93 648	99 233	97 683	94 498	121 844	128 592	113 693	121 746	110 130
Marine products	8 076	8 053	8 259	10 833	12 305	12 105	15 197	18 416	22 538	27 691	39 361	38 583	34 252	36 487	35 997
Aluminium	158	523	1 248	3 368	4 109	4 146	5 201	2 246	6 391	3 136	3 311	2 330	1 382	787	9 645
Ships and aircraft	10 092	9 376	10 583	13 615	16 324	16 857	17 168	16 698	18 316	23 948	31 877	34 799	33 253	43 353	38 583
Other goods	94 634	87 910	82 386	92 992	103 251	124 489	130 959	161 611	167 310	186 752	202 518	190 221	198 480	240 160	288 895
1.1.2 Merchandise imports, f.o.b.	18 739	16 786	16 332	19 143	22 072	28 239	32 794	42 343	41 472	44 330	44 357	38 597	46 067	52 824	67 199
Investment goods	16 290	14 629	8 940	11 734	12 883	18 204	18 065	26 018	29 370	31 914	28 258	25 943	27 034	40 013	58 205
Transport equipment	7 799	7 334	7 520	7 597	7 317	9 632	9 897	8 049	8 924	17 300	17 725	15 984	15 362	21 859	27 028
Fuels and lubricants	25 042	22 881	22 400	24 766	28 852	32 929	33 557	41 237	39 078	43 355	55 584	54 116	53 036	61 086	69 104
Industrial supplies	19 694	19 265	18 991	20 549	21 869	24 200	25 452	29 895	33 092	35 139	39 101	37 570	39 736	43 318	47 335
Consumer goods	7 070	7 015	8 203	9 203	10 258	11 285	11 194	14 069	15 374	14 714	17 493	18 012	17 245	21 061	20 024
Other goods	<b>-1 746</b>	<b>- 110</b>	<b>956</b>	<b>3 143</b>	<b>3 169</b>	<b>1 880</b>	<b>2 682</b>	<b>- 822</b>	<b>-6 934</b>	<b>-11 637</b>	<b>-1 549</b>	<b>- 718</b>	<b>-9 150</b>	<b>-14 427</b>	<b>-40 202</b>
<b>2 Balance on services</b>	34 111	33 764	41 036	44 782	44 643	51 146	59 440	67 622	67 238	80 248	102 830	101 171	105 647	113 918	118 860
2.1 Exports of services	13 468	12 035	16 011	18 139	17 340	22 452	25 735	31 109	30 819	38 721	46 986	48 477	50 195	63 232	62 354
Transportation	7 945	7 390	9 428	10 642	10 847	14 963	17 380	22 692	23 097	30 194	36 959	38 658	41 118	54 148	50 642
Air transport	5 523	4 645	6 583	7 497	6 493	7 489	8 355	8 417	7 722	8 527	10 027	9 819	9 077	9 084	11 712
Sea transport	8 684	8 124	9 764	10 595	12 004	11 722	12 021	14 633	16 070	17 967	22 881	22 835	24 531	26 079	25 752
Travel	11 959	13 605	15 261	16 048	15 299	16 972	21 684	21 880	20 349	23 560	32 963	29 859	30 921	24 607	30 754
Other receipts	931	918	1 192	1 461	1 476	1 549	1 673	1 336	696	820	2 337	704	640	717	563
Communication services	411	697	788	405	338	366	377	402	414	435	577	606	543	605	525
Insurance services	7 030	7 552	6 675	6 342	6 657	7 635	8 344	7 557	7 531	8 457	8 091	7 666	7 429	6 730	5 376
Government services	3 587	4 438	6 606	7 840	6 828	7 422	11 290	12 585	11 708	13 848	21 958	20 883	22 309	16 555	24 290
Other services	35 857	33 874	40 080	41 639	41 474	49 266	56 758	68 444	74 172	91 885	104 379	101 889	114 797	128 345	159 062
2.2 Exports of services	10 710	9 421	10 794	12 077	13 371	16 614	17 916	22 766	25 622	32 697	36 721	38 610	39 685	48 799	56 244
Transportation	4 899	4 509	5 151	5 696	6 596	9 034	10 623	15 466	15 426	21 287	27 258	27 167	29 407	37 478	39 155
Air transport	5 811	4 912	5 643	6 381	6 775	7 580	7 293	7 300	10 196	11 410	9 463	11 443	10 278	11 321	17 089
Sea transport	17 685	16 886	18 261	17 892	18 194	20 472	22 893	28 049	31 487	37 082	36 401	33 406	39 818	48 501	61 232
Travel	7 462	7 567	11 025	11 670	9 909	12 180	15 949	17 629	17 063	22 106	31 257	29 873	35 294	31 045	41 586
Other receipts	773	725	1 001	1 210	1 192	1 576	1 738	1 451	529	155	2 742	3 429	3 480	1 464	2 242
Communication services	1 297	989	1 172	1 770	1 304	1 304	927	931	740	432	714	1 748	1 865	1 352	1 825
Insurance services	572	504	454	716	746	799	845	1 202	1 077	1 205	1 560	1 645	1 692	1 464	1 405
Government services	4 820	5 349	8 398	7 974	6 667	8 501	12 439	14 045	14 717	20 314	26 241	23 051	28 257	26 765	36 114
Other services															

### Appendix table 9. Balance of payments (continued)

Million krónur at current prices	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
<b>3 Balance on income, net</b>	<b>-10 659</b>	<b>-9 086</b>	<b>-10 108</b>	<b>-13 659</b>	<b>-12 829</b>	<b>-11 317</b>	<b>-12 157</b>	<b>-12 956</b>	<b>-12 880</b>	<b>-19 560</b>	<b>-24 921</b>	<b>-1 907</b>	<b>-14 823</b>	<b>-33 159</b>	<b>-29 100</b>
3.1 Receipts	4 930	5 612	5 715	5 228	5 277	6 923	7 132	8 509	9 288	11 414	16 634	27 158	28 548	32 515	93 485
Compensation of employees	2 994	3 037	3 175	2 993	3 260	4 242	4 128	4 742	4 901	5 516	5 772	5 417	6 236	5 624	4 639
Interest and investment income received	1 936	2 575	2 540	2 235	2 017	2 681	3 004	3 767	4 387	5 898	10 862	21 741	22 312	26 891	88 846
3.2 Expenditure	15 589	14 698	15 823	18 887	18 106	18 240	19 289	21 465	22 168	30 974	41 555	29 065	43 371	65 674	122 585
Compensation of employees	883	723	702	532	365	306	391	293	341	844	533	702	465	817	1 533
Interest and investment income received	14 706	13 975	15 121	18 355	17 741	17 934	18 898	21 172	21 827	30 130	41 022	28 363	42 906	64 857	121 052
4 Current transfer	- 510	- 269	- 211	- 626	- 306	- 464	- 238	- 1 003	- 725	- 762	- 959	1 170	- 1 166	- 1 180	- 1 719

## Appendix table 10. General government finances

	Estimate																
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 <sup>2</sup>	2004 <sup>2</sup>	2005	2006	2007
Billion krónur at current prices <sup>1</sup>																	
<b>Total revenue</b>	<b>159.8</b>	<b>163.9</b>	<b>161.4</b>	<b>169.7</b>	<b>179.7</b>	<b>197.2</b>	<b>213.2</b>	<b>242.9</b>	<b>278.6</b>	<b>301.1</b>	<b>328.5</b>	<b>350.6</b>	<b>368.4</b>	<b>418.0</b>	<b>473.9</b>	<b>493.3</b>	<b>494.4</b>
1. Direct taxes	53.2	55.1	59.6	62.7	68.0	76.3	86.0	98.6	115.6	128.8	149.3	157.5	168.7	188.6	216.9	224.6	215.7
2. Indirect taxes	84.5	84.3	77.5	79.7	83.1	90.7	96.1	109.3	124.5	131.0	129.7	133.1	144.3	167.0	194.1	200.1	205.8
3. Interest income	7.3	6.8	6.8	7.0	6.8	6.8	6.6	7.5	8.7	10.2	14.6	19.5	13.6	14.2	13.6	17.7	18.9
4. Other income	3.6	4.7	4.2	5.1	5.6	5.3	6.2	5.5	6.0	5.8	6.8	7.6	5.1	9.2	8.3	7.8	8.6
5. Sales of goods and services	11.2	13.0	13.4	15.3	16.2	18.1	18.4	22.0	23.8	25.4	28.0	32.9	36.7	39.0	40.9	43.0	45.4
<b>Total expenditure</b>	<b>171.4</b>	<b>175.1</b>	<b>179.9</b>	<b>190.4</b>	<b>193.1</b>	<b>204.9</b>	<b>213.3</b>	<b>240.0</b>	<b>264.0</b>	<b>284.6</b>	<b>327.2</b>	<b>356.8</b>	<b>384.8</b>	<b>415.5</b>	<b>441.6</b>	<b>473.6</b>	<b>511.4</b>
1. Operational costs	93.8	98.0	103.2	110.2	116.3	125.0	132.5	151.2	167.7	184.6	206.2	235.0	250.2	267.3	287.2	312.9	333.7
of which: public consumption	82.6	85.0	89.8	94.9	100.1	106.9	114.1	129.1	143.8	159.3	178.2	202.1	213.5	228.3	246.3	269.8	288.4
2. Interest expenditure	14.6	14.5	15.3	16.9	18.8	18.2	18.2	19.8	21.2	21.3	26.9	23.4	23.7	23.7	24.6	25.7	24.5
3. Subsidies	11.6	12.5	9.7	8.8	8.7	9.2	9.2	9.2	10.1	10.8	12.9	12.8	12.5	12.8	14.8	15.4	14.5
4. Income transfers	29.0	30.6	33.0	33.9	36.2	37.2	38.8	40.1	42.7	47.2	53.8	63.9	77.6	81.7	90.1	99.7	109.8
5. Gross investment	18.0	17.8	19.7	19.5	16.0	17.6	18.4	23.6	26.1	25.8	32.0	26.2	25.7	35.2	31.5	27.7	35.3
6. Depreciation (-)	7.4	7.9	8.6	9.3	9.9	10.5	11.1	11.9	12.6	13.5	14.5	15.2	16.0	17.2	18.6	20.0	21.3
7. Capital transfers	11.7	9.7	7.5	10.3	7.1	8.2	7.3	8.1	8.8	8.4	9.9	10.7	11.1	12.0	12.0	12.2	14.8
<b>Financial balance</b>	<b>-11.6</b>	<b>-11.2</b>	<b>-18.4</b>	<b>-20.6</b>	<b>-13.4</b>	<b>-7.7</b>	<b>-0.1</b>	<b>2.8</b>	<b>14.6</b>	<b>16.6</b>	<b>1.3</b>	<b>-6.2</b>	<b>-16.3</b>	<b>2.5</b>	<b>32.3</b>	<b>19.7</b>	<b>-17.0</b>
<b>Percentage of GDP</b>																	
Revenue	39.8	40.8	39.0	38.6	39.6	40.5	40.5	41.6	44.3	44.4	42.9	43.8	44.5	45.6	47.6	44.6	42.7
Expenditure	42.7	43.6	43.4	43.3	42.6	42.1	40.6	41.1	42.0	42.0	42.8	44.6	46.5	45.3	44.4	42.8	44.2
Financial balance	-2.9	-2.8	-4.5	-4.7	-3.0	-1.6	0.0	0.5	2.3	2.4	0.2	-0.8	-2.0	0.3	3.2	1.8	-1.5
Taxes	34.3	34.7	33.1	32.4	33.3	34.3	34.6	35.6	38.2	38.3	36.5	36.3	37.8	38.8	41.3	38.4	36.4
Public consumption	20.6	21.2	21.7	21.6	22.1	21.9	21.7	22.1	22.9	23.5	23.3	25.3	25.8	24.9	24.7	24.4	24.9

1. This table is accordance with the national accounts standards of the EU, ESA 95.

2. Provisional.

Source: Statistics Iceland and own forecast.

## Appendix table 11. Central government finances

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 <sup>2</sup>	2004 <sup>2</sup>	Estimate	
															2005	2007
Billion krónur at current prices <sup>1</sup>																
<b>Total revenue</b>	<b>127.0</b>	<b>130.2</b>	<b>127.3</b>	<b>134.5</b>	<b>141.3</b>	<b>155.7</b>	<b>162.4</b>	<b>183.9</b>	<b>213.8</b>	<b>228.7</b>	<b>245.4</b>	<b>257.3</b>	<b>274.4</b>	<b>314.4</b>	<b>362.0</b>	<b>370.4</b>
1. Direct taxes	38.2	39.3	39.8	42.8	46.9	53.2	54.3	61.7	74.2	82.8	95.2	99.2	107.6	122.5	143.6	146.1
2. Indirect taxes	73.1	72.7	70.6	72.5	74.8	82.1	87.3	98.9	113.5	117.5	116.2	120.9	131.6	153.3	179.5	182.6
3. Interest income	6.2	5.9	5.9	6.4	6.2	6.2	5.9	6.7	7.6	8.7	12.4	12.9	9.0	9.2	9.3	13.6
4. Other income	2.4	3.7	2.8	3.4	3.3	3.1	3.8	3.2	3.6	3.5	3.3	3.9	4.4	6.6	5.9	3.7
5. Sales of goods and services	7.1	8.5	8.3	9.4	10.1	11.1	11.1	13.5	14.9	16.1	18.3	20.3	21.8	22.8	23.7	24.4
<b>Total expenditure</b>	<b>138.2</b>	<b>139.7</b>	<b>141.1</b>	<b>147.9</b>	<b>152.9</b>	<b>163.0</b>	<b>159.6</b>	<b>177.8</b>	<b>198.2</b>	<b>211.7</b>	<b>240.9</b>	<b>262.0</b>	<b>288.4</b>	<b>302.9</b>	<b>324.2</b>	<b>344.1</b>
1. Operational costs	59.9	62.0	65.2	68.5	73.1	75.8	76.3	88.5	98.4	107.9	121.2	135.3	141.8	150.9	161.6	174.2
of which: public consumption	52.8	53.4	56.9	59.1	63.0	64.7	65.1	75.0	83.5	91.8	102.9	115.0	120.0	128.1	137.9	149.8
2. Interest expenditure	13.0	13.0	13.8	15.1	16.8	16.4	16.3	17.7	18.9	18.4	21.8	20.5	21.5	21.4	22.1	21.8
3. Subsidies	10.9	11.8	9.0	8.1	8.0	8.2	8.3	7.9	8.8	9.0	10.9	11.6	11.2	11.4	13.3	13.8
4. Income transfers	40.0	41.2	42.5	43.8	47.1	52.1	51.9	54.3	60.2	66.2	73.5	81.9	99.8	103.7	113.3	123.2
5. Gross investment	8.3	7.6	9.4	9.5	8.9	9.9	8.0	10.1	12.4	11.9	14.1	13.7	14.6	15.7	15.4	13.2
6. Depreciation (-)	5.5	5.9	6.3	6.8	7.3	7.7	8.1	8.7	9.2	9.8	10.4	11.1	11.7	12.6	13.6	14.6
7. Capital transfers	11.5	10.0	7.5	9.7	6.2	8.4	7.0	7.9	8.7	8.1	9.7	10.2	11.2	12.3	12.3	12.5
<b>Financial balance</b>	<b>-11.2</b>	<b>-9.6</b>	<b>-13.8</b>	<b>-13.4</b>	<b>-11.6</b>	<b>-7.3</b>	<b>2.7</b>	<b>6.2</b>	<b>15.6</b>	<b>16.9</b>	<b>4.6</b>	<b>-4.7</b>	<b>-14.0</b>	<b>11.6</b>	<b>37.8</b>	<b>26.2</b>
<b>Percentage of GDP</b>																
Revenue	31.6	32.4	30.7	30.6	31.1	31.9	30.9	31.5	34.0	33.7	32.1	32.2	33.1	34.3	36.4	33.5
Expenditure	34.4	34.8	34.1	33.6	33.7	33.5	30.4	30.4	31.5	31.2	31.5	32.8	34.8	33.0	32.6	31.1
Financial balance	-2.8	-2.4	-3.3	-3.1	-2.5	-1.5	0.5	1.1	2.5	2.5	0.6	-0.6	-1.7	1.3	3.8	2.4
Taxes	27.7	27.9	26.6	26.2	26.8	27.8	26.9	27.5	29.9	29.5	27.6	27.5	28.9	30.1	32.5	29.7
Public consumption	13.2	13.3	13.7	13.4	13.9	13.3	12.4	12.8	13.3	13.5	13.5	14.4	14.5	14.0	13.9	13.5

1. This table is accordance with the national accounts standards of the EU, ESA 95.

2. Provisional.

Source: Statistics Iceland and own forecast.

## Appendix table 12. Local government finances

	Estimate																
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 <sup>2</sup>	2004 <sup>2</sup>	2005	2006	2007
Billion krónur at current prices <sup>1</sup>																	
<b>Total revenue</b>	<b>34.2</b>	<b>35.9</b>	<b>36.0</b>	<b>37.7</b>	<b>40.9</b>	<b>46.9</b>	<b>55.5</b>	<b>62.9</b>	<b>69.9</b>	<b>77.7</b>	<b>89.5</b>	<b>99.8</b>	<b>104.3</b>	<b>112.7</b>	<b>121.6</b>	<b>131.7</b>	<b>138.1</b>
1. Direct taxes	15.0	15.8	19.8	19.9	21.2	23.1	31.7	36.9	41.5	46.0	54.1	58.2	61.1	66.1	73.3	78.5	81.6
2. Indirect taxes	11.3	11.6	6.9	7.2	8.3	8.7	8.8	10.4	11.0	13.5	13.5	12.2	12.7	13.7	14.7	17.6	18.8
3. Interest income	1.1	0.8	0.8	0.5	0.5	0.5	0.6	0.7	0.9	1.2	1.6	6.1	4.1	4.4	3.7	3.5	3.6
4. Other income	2.8	3.3	3.4	4.3	5.0	7.8	7.2	6.5	7.6	7.8	10.6	10.8	11.6	12.5	13.0	13.7	14.4
5. Sales of goods and services	4.1	4.4	5.0	5.8	6.0	6.9	7.2	8.5	8.9	9.2	9.6	12.5	14.8	16.0	17.0	18.4	19.7
<b>Total expenditure</b>	<b>34.8</b>	<b>37.6</b>	<b>40.7</b>	<b>44.5</b>	<b>42.3</b>	<b>47.4</b>	<b>58.5</b>	<b>67.2</b>	<b>72.8</b>	<b>80.3</b>	<b>94.8</b>	<b>102.8</b>	<b>107.6</b>	<b>122.7</b>	<b>127.9</b>	<b>138.3</b>	<b>143.9</b>
1. Operational costs	22.9	25.4	27.8	30.9	31.7	36.7	44.8	50.1	55.3	61.0	68.7	81.5	88.5	94.6	102.5	113.3	121.3
of which: public consumption	18.8	21.0	22.8	25.2	25.8	29.8	37.5	41.5	46.4	51.7	59.1	69.0	73.6	78.6	85.5	94.9	101.6
2. Interest expenditure	1.6	1.5	1.5	1.8	2.0	1.9	2.0	2.1	2.3	2.8	5.1	2.9	2.1	2.3	2.6	3.9	4.0
3. Subsidies	0.7	0.7	0.7	0.7	0.7	1.0	1.0	1.2	1.4	1.8	2.1	1.2	1.3	1.4	1.5	1.6	1.7
4. Income transfers	1.7	2.3	2.6	3.0	2.7	3.0	3.1	3.3	3.6	4.2	5.0	8.3	9.1	9.7	10.5	10.6	11.3
5. Gross investment	9.6	10.1	10.3	10.0	7.1	7.7	10.4	13.5	13.7	13.9	17.9	12.6	11.1	19.5	16.2	14.5	11.6
6. Depreciation (-)	1.9	2.1	2.2	2.5	2.6	2.7	3.0	3.2	3.4	3.7	4.1	4.1	4.3	4.6	5.0	5.3	5.7
7. Capital transfers	0.2	-0.4	0.0	0.6	0.8	-0.2	0.3	0.2	0.2	0.3	0.2	0.5	-0.2	-0.3	-0.3	-0.3	-0.3
<b>Financial balance</b>	<b>-0.6</b>	<b>-1.7</b>	<b>-4.7</b>	<b>-6.8</b>	<b>-1.4</b>	<b>-0.4</b>	<b>-3.0</b>	<b>-4.3</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-5.3</b>	<b>-3.0</b>	<b>-3.4</b>	<b>-9.9</b>	<b>-6.2</b>	<b>-6.6</b>	<b>-5.8</b>
<b>Percentage of GDP</b>																	
Revenue	8.5	8.9	8.7	8.6	9.0	9.6	10.5	10.8	11.1	11.5	11.7	12.5	12.6	12.3	12.2	11.9	11.9
Expenditure	8.7	9.4	9.8	10.1	9.3	9.7	11.1	11.5	11.6	11.8	12.4	12.9	13.0	13.4	12.8	12.5	12.4
Financial balance	-0.2	-0.4	-1.1	-1.5	-0.3	-0.1	-0.6	-0.7	-0.5	-0.4	-0.7	-0.4	-0.4	-1.1	-0.6	-0.6	-0.5
Taxes	6.5	6.8	6.5	6.2	6.5	6.5	7.7	8.1	8.3	8.8	8.8	8.8	8.9	8.7	8.8	8.7	8.7
Public consumption	4.7	5.2	5.5	5.7	5.7	6.1	7.1	7.1	7.4	7.6	7.7	8.6	8.9	8.6	8.6	8.6	8.8

1. This table is accordance with the national accounts standards of the EU, ESA 95.

2. Provisional.

Source: Statistics Iceland and own forecast.



**Appendix table 13. Central government debt, claims and cash at hand<sup>1</sup>**

Million krónur, year-end values	Forecast														
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
<b>Gross debt</b>	<b>166 116</b>	<b>195 569</b>	<b>213 924</b>	<b>232 585</b>	<b>239 246</b>	<b>241 566</b>	<b>237 793</b>	<b>225 968</b>	<b>228 530</b>	<b>298 314</b>	<b>281 108</b>	<b>277 187</b>	<b>252 990</b>	<b>196 500</b>	<b>190 500</b>
Central Bank	13	6	-	-	-	-	-	-	-	-	-	-	-	-	-
Treasury bonds	51 793	60 796	69 008	74 140	73 889	84 424	82 865	82 618	68 898	64 243	50 818	47 402	37 910	26 200	28 100
Treasury notes	2 487	6 012	5 563	5 768	8 366	11 258	15 846	11 018	11 430	19 588	32 482	41 075	55 400	67 100	78 000
Treasury bills	12 545	13 742	14 630	16 406	15 811	12 296	15 209	9 899	5 970	12 003	12 004	20 504	14 504	14 000	4 000
Other domestic liabilities	12 005	12 709	11 090	9 010	8 962	6 960	6 555	4 297	2 907	4 191	3 799	3 977	3 888	3 700	3 600
Foreign debt	87 273	102 304	113 633	127 261	132 218	126 628	117 318	118 136	139 325	198 289	182 005	164 229	141 288	85 500	76 800
<b>Total claims</b>	<b>67 700</b>	<b>64 968</b>	<b>69 066</b>	<b>77 196</b>	<b>71 021</b>	<b>69 309</b>	<b>86 496</b>	<b>107 159</b>	<b>101 172</b>	<b>129 542</b>	<b>131 600</b>	<b>118 023</b>	<b>97 019</b>	<b>123 300</b>	<b>133 400</b>
Long term credit	41 654	46 875	55 469	64 065	63 661	65 278	64 739	69 347	70 919	93 049	80 874	76 381	51 633	71 800	73 700
Indexed to domestic prices	22 774	26 405	37 016	45 357	50 565	52 885	53 215	57 699	59 262	79 517	73 799	70 909	47 698	70 300	72 100
In foreign currency	18 880	20 470	18 453	18 708	13 096	12 393	11 524	11 648	11 657	13 532	7 075	5 472	3 935	1 500	1 600
Short-term claims	26 046	18 093	13 597	13 131	7 360	4 031	21 757	37 812	30 253	36 493	50 726	41 642	45 386	51 500	59 700
<b>Cash at hand, net</b>	<b>4 116</b>	<b>5 821</b>	<b>5 901</b>	<b>4 677</b>	<b>4 309</b>	<b>4 553</b>	<b>13 044</b>	<b>15 354</b>	<b>16 830</b>	<b>18 046</b>	<b>16 468</b>	<b>16 848</b>	<b>24 384</b>	<b>47 000</b>	<b>42 000</b>
<b>Net debt</b>	<b>98 416</b>	<b>130 601</b>	<b>144 858</b>	<b>155 389</b>	<b>168 225</b>	<b>172 257</b>	<b>151 297</b>	<b>118 809</b>	<b>127 358</b>	<b>168 772</b>	<b>149 508</b>	<b>159 164</b>	<b>155 971</b>	<b>73 200</b>	<b>57 100</b>
Claims as a percentage of debt	40.8	33.2	32.3	33.2	29.7	28.7	36.4	47.4	44.3	43.4	46.8	42.6	38.3	62.7	70.0
<b>Net financial position<sup>4</sup></b>	<b>-94 300</b>	<b>-124 780</b>	<b>-138 957</b>	<b>-150 712</b>	<b>-163 916</b>	<b>-167 704</b>	<b>-138 253</b>	<b>-103 455</b>	<b>-110 528</b>	<b>-150 726</b>	<b>-133 040</b>	<b>-142 316</b>	<b>-131 587</b>	<b>-26 200</b>	<b>-15 100</b>
<b>Percentage of GDP</b>															
<b>Gross debt</b>	<b>41.4</b>	<b>47.2</b>	<b>48.6</b>	<b>51.3</b>	<b>49.1</b>	<b>45.9</b>	<b>40.7</b>	<b>36.0</b>	<b>33.7</b>	<b>39.0</b>	<b>35.2</b>	<b>33.5</b>	<b>27.6</b>	<b>19.7</b>	<b>17.2</b>
of which: foreign debt	21.7	24.7	25.8	28.0	27.1	24.1	20.1	18.8	20.5	25.9	22.8	19.8	15.4	8.6	6.9
<b>Total claims</b>	<b>10.1</b>	<b>11.1</b>	<b>12.5</b>	<b>14.0</b>	<b>13.0</b>	<b>12.3</b>	<b>11.0</b>	<b>10.8</b>	<b>10.2</b>	<b>11.7</b>	<b>10.1</b>	<b>9.1</b>	<b>5.6</b>	<b>7.1</b>	<b>6.5</b>
of which: In foreign currency	4.5	4.8	4.2	4.1	2.7	2.3	2.0	1.9	1.6	1.7	0.9	0.7	0.5	0.2	0.1
<b>Short term credit, net</b>	<b>6.4</b>	<b>4.3</b>	<b>3.1</b>	<b>2.9</b>	<b>1.5</b>	<b>0.8</b>	<b>3.7</b>	<b>5.9</b>	<b>4.4</b>	<b>4.6</b>	<b>6.3</b>	<b>5.0</b>	<b>4.9</b>	<b>5.1</b>	<b>5.3</b>
<b>Net debt</b>	<b>24.8</b>	<b>31.9</b>	<b>33.0</b>	<b>34.4</b>	<b>34.6</b>	<b>32.9</b>	<b>26.0</b>	<b>19.3</b>	<b>19.1</b>	<b>22.7</b>	<b>18.8</b>	<b>19.4</b>	<b>17.2</b>	<b>7.6</b>	<b>5.5</b>
<b>Net financial position</b>	<b>-22.7</b>	<b>-29.3</b>	<b>-31.4</b>	<b>-33.2</b>	<b>-33.6</b>	<b>-31.7</b>	<b>-23.5</b>	<b>-16.9</b>	<b>-15.1</b>	<b>-18.8</b>	<b>-17.6</b>	<b>-17.2</b>	<b>-15.3</b>	<b>-3.0</b>	<b>-1.3</b>

1. Including accrued interest liabilities.

## Appendix table 14. General government debt and claims<sup>1</sup>

														Forecast	
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Million krónur, year-end values															
<b>General government gross debt</b>	<b>185 639</b>	<b>220 084</b>	<b>245 071</b>	<b>267 611</b>	<b>274 447</b>	<b>279 351</b>	<b>280 460</b>	<b>271 455</b>	<b>277 950</b>	<b>354 610</b>	<b>340 712</b>	<b>336 008</b>	<b>320 693</b>	<b>269 273</b>	<b>266 994</b>
Domestic debt	95 466	113 296	126 467	135 881	138 088	145 149	153 144	141 472	125 047	138 274	146 107	159 778	168 170	172 847	179 694
Foreign debt	90 173	106 788	118 604	131 730	136 359	134 202	127 316	129 983	152 903	216 336	194 605	176 230	152 523	96 426	87 300
<b>General government total claims</b>	<b>79 127</b>	<b>76 905</b>	<b>79 577</b>	<b>88 313</b>	<b>82 925</b>	<b>82 820</b>	<b>99 746</b>	<b>124 477</b>	<b>119 287</b>	<b>155 328</b>	<b>158 558</b>	<b>139 692</b>	<b>120 705</b>	<b>147 300</b>	<b>156 600</b>
Long-term claims	48 346	54 091	61 559	70 760	71 249	74 449	74 482	80 429	81 007	113 424	101 832	92 050	69 900	89 800	90 900
Taxes outstanding and other short-term claims	30 781	22 814	18 018	17 553	11 676	8 371	25 264	44 048	38 280	41 904	56 726	47 642	50 805	57 500	65 700
<b>General government net debt</b>	<b>106 512</b>	<b>143 179</b>	<b>165 494</b>	<b>179 298</b>	<b>191 522</b>	<b>196 531</b>	<b>180 714</b>	<b>146 978</b>	<b>158 663</b>	<b>199 282</b>	<b>182 154</b>	<b>196 316</b>	<b>199 988</b>	<b>121 973</b>	<b>110 394</b>
Central government	98 416	130 601	144 858	155 389	168 225	172 257	151 297	118 809	127 358	168 772	149 508	159 164	155 971	73 200	57 100
Local governments	10 195	14 552	22 185	25 131	24 189	25 037	30 089	28 663	31 654	30 712	32 790	37 289	44 147	48 896	53 414
Social security system	-2 099	-1 974	-1 549	-1 222	- 892	- 763	- 672	- 494	- 349	- 202	- 144	- 137	- 130	- 123	- 120
<b>Gross debt at 1998-prices</b>															
General government gross debt	203 802	227 796	250 494	270 731	274 588	278 889	280 460	268 189	258 622	291 641	296 548	288 482	280 055	230 743	203 334
General government net debt	115 536	146 593	166 943	179 232	189 773	195 389	180 714	149 322	149 740	161 968	165 840	176 286	186 354	121 398	95 728
<b>Percentage of GDP</b>															
<b>General government gross debt</b>	<b>45.1</b>	<b>51.9</b>	<b>55.5</b>	<b>58.8</b>	<b>56.3</b>	<b>52.8</b>	<b>47.8</b>	<b>43.2</b>	<b>39.2</b>	<b>44.6</b>	<b>43.5</b>	<b>40.3</b>	<b>35.6</b>	<b>27.0</b>	<b>23.3</b>
<b>Domestic debt</b>	<b>23.6</b>	<b>27.0</b>	<b>28.7</b>	<b>29.8</b>	<b>28.2</b>	<b>27.4</b>	<b>26.2</b>	<b>22.0</b>	<b>18.2</b>	<b>17.5</b>	<b>18.2</b>	<b>19.1</b>	<b>18.0</b>	<b>17.0</b>	<b>15.6</b>
Foreign debt	21.5	24.9	26.8	29.1	28.1	25.4	21.7	21.2	21.1	27.1	25.4	21.2	17.6	10.0	7.7
General government total claims	19.4	18.2	18.0	19.4	17.0	15.7	17.0	19.4	17.2	19.6	19.8	16.7	13.0	14.5	13.6
<b>General government net debt</b>	<b>25.7</b>	<b>33.7</b>	<b>37.5</b>	<b>39.5</b>	<b>39.3</b>	<b>37.2</b>	<b>30.8</b>	<b>23.7</b>	<b>22.0</b>	<b>24.9</b>	<b>23.8</b>	<b>23.6</b>	<b>22.7</b>	<b>12.5</b>	<b>9.7</b>

1. The general government is defined according to the ESA-definition. Government enterprises and financial institutions are excluded.