

The Icelandic Economy

Summer 2006

Revised macroeconomic forecast
2006-2008



MINISTRY OF FINANCE

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The Icelandic Economy – Summer 2006

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Main conclusions

In this report, the situation and outlook are discussed for the main elements of the economy in 2005-2008 on the basis of a revised forecast for the Icelandic economy by the Ministry of Finance. Some differences from the April 2006 forecast are explained. The main conclusions are as follows:

- The year 2005 was marked by robust growth of private consumption and investment and thereby domestic demand. GDP is estimated to have grown 5.5 per cent that year. In 2006, the growth of domestic demand is expected to slow down and GDP growth to amount to 4.7 per cent. At the conclusion of the present large scale investment projects in 2007, business fixed investment is expected to contract sharply. Nevertheless, a turnaround in foreign trade is forecast to maintain economic growth, which is predicted to increase by around 1 per cent that year. With the improvement in foreign trade predicted to continue, GDP is forecast to grow 2.3 per cent in 2008.
- The deficit on the current account, which reached a peak of 16.5 per cent of GDP in 2005, is expected to continue substantial this year, or 15.9 per cent of GDP. It is predicted the current account deficit will decrease quickly in the wake of increased exports of aluminum and a contraction in import growth and that it will amount to 7.8 per cent of GDP in 2007 and 3.7 per cent in 2008.
- Unemployment has declined significantly and it is expected to average 1.5 per cent of the labour force this year, but to increase to 2.3 per cent in 2007 and 3.0 per cent in 2008 as activity is scaled down. Substantial output pressure is expected this year but that it will decrease as the present large scale investments end.
- Due to the sharp increase in house prices consumer prices increased by 4 per cent in 2005 from 2004. Despite the significant deceleration of house price increases the recent sharp drop in the exchange rate value of the króna is resulting in inflation will be 7.8 per cent this year, but that it will decline to 4.6 per cent in 2007 and 2.6 per cent in 2008.
- Despite a temporary burst of inflation the per capita real disposable income is estimated to grow by 3.5 per cent this year, 3.3 per cent in 2007 and 1.9 per cent in 2008, due to e.g. changes in income taxes and a conclusion of the present wage negotiations of the social partners.
- The main elements of uncertainty in the projections include the wage agreement of the social partners, further large scale investment projects, the exchange rate of the króna and developments in the international economy.

Summary of the forecast

This revision of the Ministry's forecast presented last April incorporates ongoing developments in the current year along with some revisions for 2007. A draft forecast for 2008 is also presented.

Developments in 2006

For this year, GDP growth is forecast at 4.7 per cent, slightly less than in the last forecast. The main changes in prospects are that fisheries production is expected to decline by 4 per cent and not to increase by 2 per cent as was projected in the previous forecast. The decline is mostly due to a considerable decrease in the capelin catch and smaller

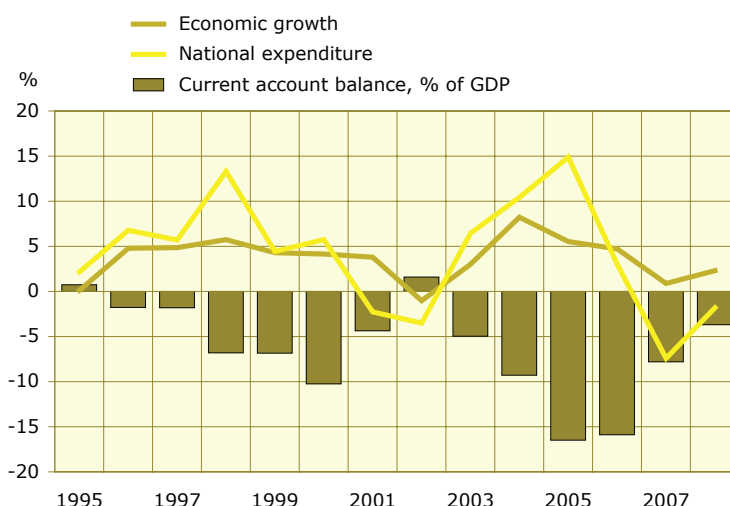


Chart 1

Real growth in GDP and national expenditure and the current account 1995-2008

Source: Statistics Iceland and own forecast.

Table 1. Overview of the forecast 2005–2008

	Bn.kr.	Volume change on prev. year, %			
		Estim.	Forecast		
	2005	2005	2006	2007	2008
Private consumption	599.2	11.9	1.7	0.2	1.8
Public consumption	246.3	3.2	2.5	2.4	2.4
Gross fixed capital formation	285.9	34.5	4.7	-29.9	-16.7
Change in stocks ¹	-1.3	0.0	0.1	0.0	0.0
National expenditure	1 130.1	14.9	3.0	-7.4	-1.8
Exports of goods and services	314.0	3.5	3.4	11.9	9.8
Imports of goods and services	448.6	28.4	-1.1	-10.7	-0.9
Gross domestic product (GDP)	995.5	5.5	4.7	0.9	2.3
Gross national income (GNI)	967.8	6.3	4.4	0.5	2.1
Effects of changes in terms of trade ²	-	0.3	-0.2	-0.8	0.0
GNI with effects of ch. in terms of trade	-	6.7	4.3	-0.2	2.2
Current account balance	-164.1	-	-	-	-
% of GDP	-	-16.5	-15.9	-7.8	-3.7

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.

GDP growth this year is driven by substantial investment

Real disposable income continues to increase

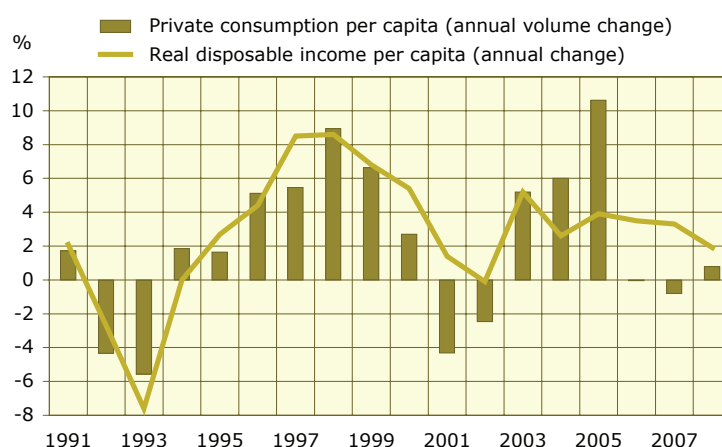
declines in the catches of shrimp. It is assumed that the revision of wage agreements in the general labour market will lead to a 4 per cent increase in average wages as of the beginning of July. This increase will come in addition to agreed wage increases for a total of a 9 per cent increase in wages rates in the general labour market in 2006.

Real disposable income per capita is expected to increase by 3.5 per cent this year, the same rate of increase as was projected in the previous forecast. Inflation will on the other hand be slightly higher, 7.8 per cent instead of 5.9 per cent, based on averages between 2005 and 2006. The higher inflation rate is due to a greater wage increase than was previously assumed and the recent decline in the exchange rate. This forecast assumes that the exchange rate index will average 122.5 for 2006. Registered unemployment, which in recent months has been 1.3 per cent of the labour force, is forecast to average 1.5 per cent this year.

A continued divergence is expected between national expenditure and GDP which is reflected in a current account deficit equivalent to almost 16 per cent of GDP this year. A large part of the deficit is due to imports for power projects and aluminium plant construction, both of which peak this year. Private consumption will continue strong, although its pace in real terms is expected to slow down significantly over the course of the year. Prospects for public consumption and gross fixed investment for this year are unchanged from the previous forecast. Public consumption is expected to increase by 2.5 per cent and investment by 4.7 per cent in real terms, including an increase in housing construction by 11 per cent.

The revenue surplus of the general government is expected to be slightly larger this year than in the earlier forecast, or 21 billion króna or 1.9 per cent of GDP. The main change is that local income tax and personal income tax are expected to produce more revenue due to wage increases being

Pressure in the economy peaks this year

**Chart 2**

Private consumption and real disposable income per capita 1991–2008

Source: Statistics Iceland and own forecast.

greater than earlier assumed. On the other hand, expenditure on income transfers is now estimated to increase.

It is estimated that pressure in the economy will increase this year due to increased domestic demand, low unemployment, increasing inflation and a sizeable current account deficit. A calculation of the output gap shows the gap is slightly greater at present than in the previous upswing. The labour market gap seems smaller this time which is linked to the substantial imports of foreign labour. As has been noted in previous forecasts of the Ministry, the above measurements of the output and labour market gaps should be viewed as indicative, since they are subject to uncertainty. In this forecast, it is assumed that the Central Bank policy rate will average 12.4 per cent this year, but may reach as high as 14 per cent in the latter half of 2006.

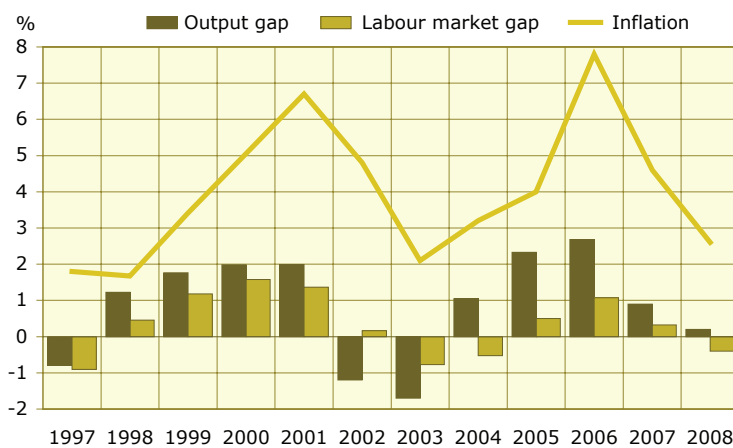


Chart 3
The output gap, labour market gap and inflation 1997-2008

Source: Statistics Iceland and own forecast.

Economic prospects for 2007

In 2007, it is forecast that GDP at current prices will amount to 1,160 billion krónur and that GDP will grow by close to 1 per cent. This is lower than the 1.8 per cent growth forecast earlier. The lowering of the forecast is due to reduced prospects for the growth in private consumption and investment.

Table 2. Key economic indicators 2005-2008

Economic aggregates		2005	2006	2007	2008
GDP growth	%	5.5	4.7	0.9	2.3
National expenditure	Annual growth, %	14.9	3.0	-7.4	-1.8
Current account balance	% of GDP	-16.5	-15.9	-7.8	-3.7
Net foreign debt	% of GDP	-85.5	-99.8	-107.3	-107.5
National saving	% of GDP	12.1	13.0	12.7	13.0
Labour market					
Labour force	Thousand man-years	152.1	158.9	157.3	157.2
Unemployment	% of labour force	2.1	1.5	2.3	3.0
Real hourly wage	Annual change, %	2.7	1.1	0.9	0.9
Real disposable income per capita	Annual change, %	3.9	3.5	3.3	1.9
Foreign trade					
Exports of fish products	Annual vol. change, %	-3.4	-4.0	2.0	2.0
Aluminium exports	Annual vol. change, %	-3.1	31.5	58.3	35.5
Total merchandise exports	Annual vol. change, %	1.0	0.4	16.9	14.0
Total merchandise imports	Annual vol. change, %	25.0	1.3	-16.1	-5.6
Money and prices					
Inflation	%	4.0	7.8	4.6	2.6
Exchange rate index	Dec. 31 1991=100	108.7	122.4	126.6	127.0
Central Bank policy rate	Annual average, %	9.4	12.4	11.3	6.9
External circumstances					
OECD-growth	%	2.8	3.1	2.9	2.9
OECD-inflation	%	2.0	2.2	2.0	1.8
Fish export prices in foreign currencies	Annual change, %	8.9	2.5	1.0	2.0
Import price of oil	Annual change, %	37.5	12.5	-3.0	-5.0

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

GDP growth slows down in 2007 due to a contraction in large scale investment

GDP and national expenditure will move more closely in line, and the current account deficit is expected to decline by half to around 8 per cent of GDP. National expenditure is forecast to decline by over 7 per cent in 2007.

Unemployment is projected to gradually increase, averaging 2.3 per cent in 2007, a similar percentage as in the previous forecast. The inflation rate is expected to come down to an average 4.5 per cent for the year. The policy interest rate is expected to be reduced as inflation decelerates and to average 11 per cent for the year. In 2007, a further weakening of the exchange rate is expected and that the exchange rate index will average around 127 and be 3.5 per cent higher than in 2006. It should be noted that substantial uncertainty is attached to the course of the exchange rate in the medium term.

Next year it is expected that the revenue balance of the general government will turn into a deficit of 1.4 per cent of GDP. In accordance with the Government's medium-term programme, Treasury investment is scheduled to increase in order to partly offset the expected slowdown in the economy. It is also assumed that the tax cuts of the Treasury already legislated will be fully implemented in 2007.

In 2007, investments in power projects and aluminium plant construction are expected to decrease substantially. As has been noted earlier, only those projects already decided upon are incorporated into the projections. The departure of the US defence force from Keflavik Airport in 2006 will release Icelandic employees into the labour market and reduce foreign factor incomes. In mid-June 2006, a decision had not been taken

on the maximum fish catch for the fisheries in the following year. The total fish catch is assumed to remain unchanged between 2006 and 2007, except a slightly higher capelin catch is expected next year. The capelin catch is subject to great uncertainty next year. The export production of aluminium is expected to increase by 58 per cent next year. Merchandise exports are expected to increase by 17 per cent and merchandise imports to decline by 16 per cent. Such a large positive turn-around in merchandise trade has not been registered before.

Prospects for 2008

GDP growth is expected to revive in 2008 to just over 2 per cent. National expenditure will continue to decline, although not by as much as in 2007. Continued improvement in the current account deficit will be the driver of the growth in GDP, but it is expected that the current account deficit will move under 4 per cent of GDP in that year.

Unemployment is expected to continue slowly increasing, to 3 per cent of the labour force that year. Domestic inflation is forecast to decelerate and approach the Central Bank's policy target. Reflecting more balance in the economy, it is assumed the Central Bank's policy rate will have been reduced below 7 per cent on average in 2008.

The international economy

The latest forecasts of the OECD and the IMF indicate that world economic growth is on the rise and could reach 5 per cent this year and next. This growth is to an increasing extent fuelled by demand in developing countries such as India and China. Many other countries in Asia and elsewhere are growing quickly and increasing their participation in international trade, which

Inflation begins to decelerate in 2007

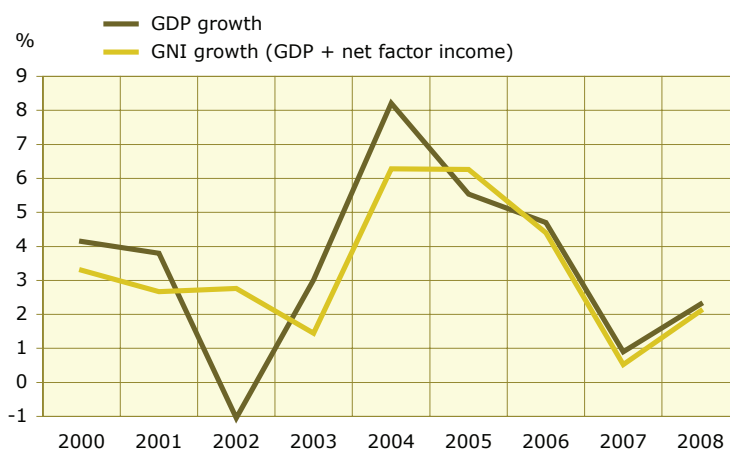


Chart 4
Growth in gross domestic product and gross national income 2000–2008

Source: Statistics Iceland and own forecast.

Economic growth picks up in 2008, based on increased exports and private consumption

Table 3. Economic growth

Annual GDP growth, per cent	2005	2006	2007
Euro area	1,4	2,1	2,2
United States	3,5	3,5	3,0
United Kingdom	1,8	2,4	2,9
Nordic countries	2,7	3,3	2,8
Japan	2,7	3,0	3,3

Source: OECD, April 2006.

is expected to grow 8 per cent this year. Economic growth in the developed countries is expected to be less. In the OECD countries GDP is expected to grow 3 per cent this year and next. Growth is slowest in the Euro-area, as domestic demand in Germany, France and Italy is basically stagnant, in part because of structural problems in labour markets. Interest rates, however, have remained low, and since demand elsewhere in the world has been on the increase, growth in the Euro-area is forecast to reach 2 per cent this year and next. Growth in the UK and the Nordic countries is expected to be marginally higher, or around 3 per cent this year and next. Growth in the United States has been about 3.5 per cent a year, slightly above its long-term trend. US growth is being propelled by strong consumer demand and a significant deficit of the public sector. This has been reflected in a sizeable deficit on the current account, 6-7 per cent of GDP. For next year, growth is expected to slow down to around 3 per cent, in part because of a rising policy interest rate and a tightening of fiscal policy. Japan's economy is reviving after years of stagnation. GDP growth is forecast to reach 3 per cent this year and increase slightly next year. International forecasts are based on the assumption that oil prices will remain high. Still, high oil prices are not expected to have a significant impact on inflation in the OECD-area; it is forecast to remain in the vicinity of 2 per cent this year and next.

Robust world economic growth

Close to 3 percent growth in Iceland's main trading partners

Private consumption growth slowing down

Private consumption

According to provisional data from Statistics Iceland for the first quarter of 2006, private consumption increased by 12.6 per cent of the corresponding quarter of last year. The exchange rate began to decline at the end of February, and the exchange rate index presently stands at 129 which indicates that the decline in the exchange rate has reduced the purchasing power of individuals abroad. There are indications that the growth in private consumption is shrinking. The credit card turnover increased by 5.8 per cent in real terms in the first four months of this year, compared with a 12 per cent growth in the corresponding period a year ago. On a month-to-month basis, turnover in April was 4.3 per cent lower in real terms than in April last year. In the first five months of this year new auto registrations rose by 7.5 per cent over the first five months of 2005. In May 2006, new auto registrations declined by 17.3 per cent compared to May in the previous year. Household expectations appear to have declined in the wake of the decline in the exchange rate and turbulence on the financial market. The Gallup index of consumer expectations stood at 96.5 in May. A level below 100 indicates that more consumers are pessimistic for the economy than those optimistic. Real wages per capita are forecast to increase by 3.5 per cent this year and 3.3 per cent next year. The growth in private consumption is forecast at 1.7 per cent this year and 0.2 per cent next year, both in real

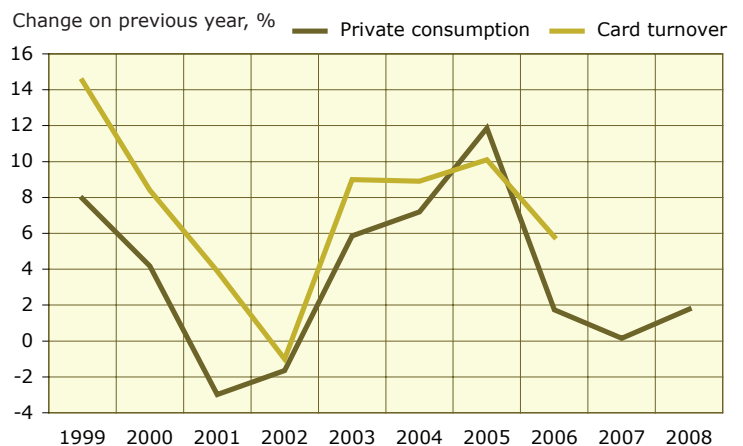


Chart 5
Private consumption and payment card turnover 1999–2008¹

1. Credit and debit card turnover is in real terms. Domestic turnover is deflated by the CPI excluding housing and turnover abroad is deflated by the exchange rate. Data on turnover in 2006 are based on January–April 2006. Figures on private consumption in 2006–2008 are Ministry forecast.

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

terms. In 2008, private consumption is expected to increase again and reach 1.8 per cent in real terms, when per capita real disposable income is expected to increase by 1.9 per cent.

Public consumption

In 2005, public consumption increased by 3.2 per cent according to provisional national accounts data from Statistics Iceland. No major changes are expected in the growth of public consumption since the Ministry issued its April forecast. The growth of public consumption is expected to be 2.5 per cent in real terms in 2006. Thereof, the growth of public consumption of the Treasury is expected to be 2 per cent, in accordance with the medium-term target of the Government, and 3 per cent growth of public consumption at the local government level. In 2007 and 2008, the public consumption of the general government is projected to increase by 2.4 per cent each year. It is assumed the growth of public consumption at the central government level will be in line with the medium term target of the government. At this stage, possible additional expenditure associated with changes in Iceland's defence arrangements have not been taken into account. As for the local governments, it is assumed that their public consumption growth will be 2.5 per cent per year in 2007 and 2008.

Business investment

In this revised forecast, business investment is expected to increase by 4 per cent this year, an increase similar to the previous projections. The increase is mainly attributable to power project investments which are continuing at a very high level this year. The turbulence in financial markets in recent months may be expected to have an impact on the investment decisions of business. Icelandic financial institutions are in most cases intermediaries for foreign funds to domestic firms. Possible limits upon access to foreign financing may have an impact on the credit terms of businesses in this country. Since no decisions have been made regarding additional large scale investment projects, they are not included in Ministry's forecast assumptions. It is assumed that the bulk of the present power project investments will have been completed next year. The revised projections are unchanged from April that business investment declines by 44 per cent in real terms that year. Business investment is forecast to decline further in 2008, by 31 per cent. The forecast for a decline in domestic demand in these years may largely be attributed to business investment returning to its level prior to the current power project investments.

Public investment

Public investment amounted to 31.5 billion krónur in 2005, or 3.2 per cent of GDP. Public investment is estimated to decline by 15 per cent in real terms this year and to amount to 28 billion krónur or 2.5 per cent of GDP. For this year, Treasury investment is expected to decline by over 2 billion and that of the local governments by a slightly lesser amount. On the basis of the medium term programme for Treasury expenditure ap-

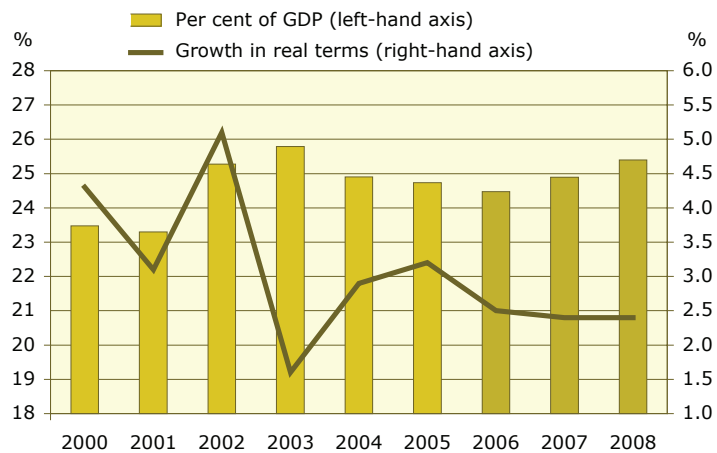


Chart 6
Public consumption 2000-2008

Sources: Statistics Iceland and own forecast.

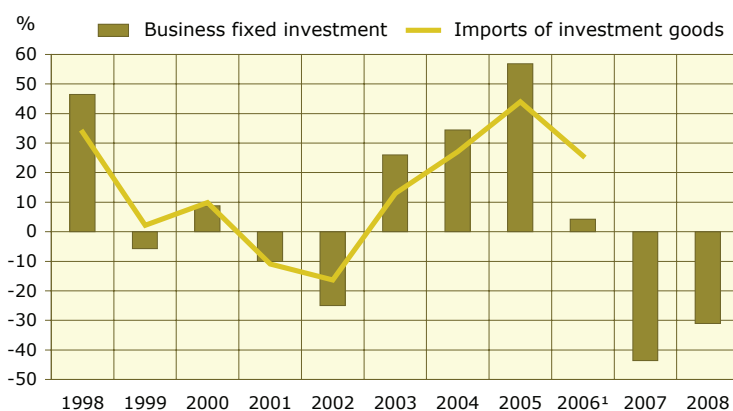


Chart 7
Business sector fixed investment and imports of investment goods (volume changes) 1998-2008

1. Imports of investment goods in the first four months of 2006.

Sources: Statistics Iceland and own forecast.

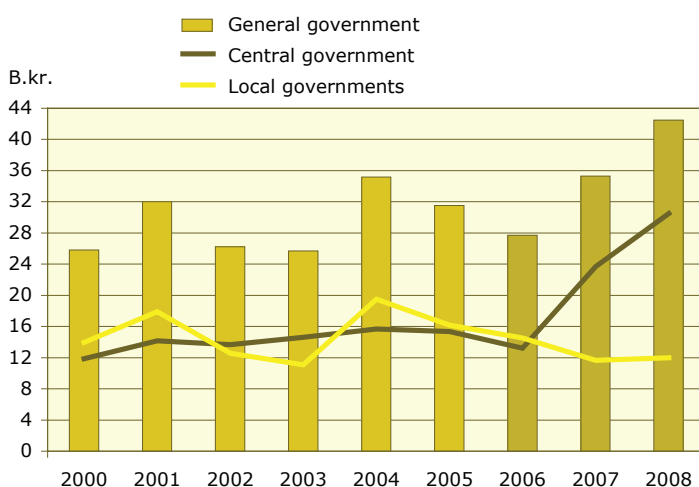


Chart 8
Marine product prices 2003-2005

Source: Statistics Iceland.

proved by the Government in the autumn of 2005, it is expected that public investment will increase 28 per cent in real terms, bringing it to 37 billion krónur or 3.2 per cent of GDP. A 13 per cent increase in public investment is forecast for 2008, bringing it to 43 billion krónur, 3.5 per cent of GDP.

Housing and the real property market

The demand pressure in the real property market seems to be slowing down and property price increases have been slower so far this year. Housing prices in the capital area increased by 13 per cent in the twelve months up to May, far less than when price increases were at their peak in August last year when they were close to 40 per cent. The slower growth in home mortgage bank credit indicates that housing demand is slower. Mortgage financing is getting tighter, since mortgage rates have increased from 4.15 per cent to 4.7-4.9 per cent at present, and maximum mortgage financing in relation to the purchase price has been cut. Figures on housing construction at the beginning of this year show that the supply of new housing has increased. The supply of building land in the capital area and in other major communities around the country is also on the increase, an important determinant of new housing supply. The increased supply of new housing at a time when demand is slowing down has meant that building contractors are phasing their construction plans over a longer period. In the Ministry's April forecast, housing investment was forecast to increase by 11.6 per cent this year and remain about unchanged next year. The forecast for this year is slightly lower, 10.7 per cent, but next year's housing investment is now expected to decline by 2.5 per cent and further in 2008 by 1 per cent.

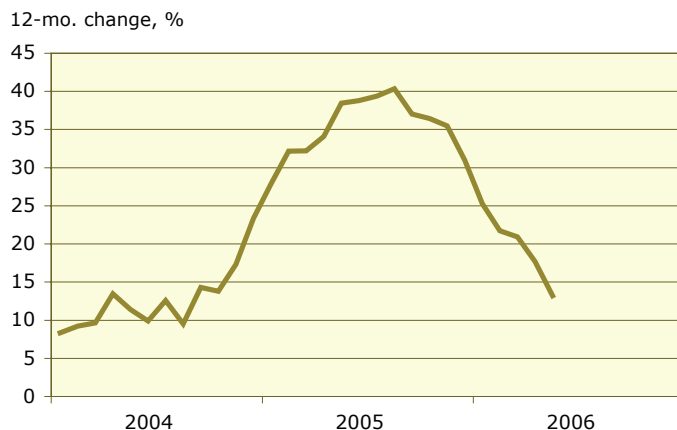


Chart 9
Residential housing prices in the capital area January 1994 – May 2006

Source: Land Registry of Iceland.

Foreign trade

The present forecast of the current account deficit is slightly higher than in the Ministry's spring forecast, amounting to 176 billion krónur in 2006, 15.9 per cent of GDP. The deficit is forecast to decline in 2007 to 90 billion or 7.8 per cent of GDP, with the decline continuing in 2008 to 47 billion or 3.7 per cent of GDP. On the export side, fish production for export is currently forecast to decline by 4 per cent, instead of an earlier forecast of a 2 per cent increase. The main reason for a lower export production forecast is a slow fish catch, especially of capelin and shrimp. This is in part offset by the lower exchange rate which increases the krónur value of fish exports.

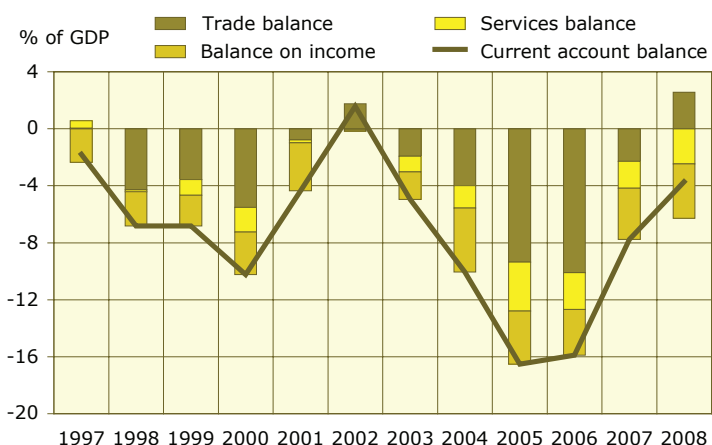


Chart 10
The current account balance 1997–2008

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

The decline in the exchange rate will have a marginal effect upon merchandise imports in value terms, compared to the previous forecast. The lower exchange rate is expected to raise the value of merchandise imports this year but cause a considerable reduction next year. It is certain that imports of investment and intermediate goods will decline sharply next year as power project investment draw to a close. Auto imports are also beginning to slow down, following a record pace in recent years. An increase in the price of consumer imports may also be expected over the next several months.

The services account is expected to be in deficit by 28 billion krónur this year and by 22 billion next year. This represents a substantial increase from previous years, partly due to the cessation of service income from the departing defence force. The deficit on services is expected to rise to 30 billion in

Large turnaround in foreign trade balance ahead

2008. Net factor payments to abroad are expected to amount to 34 billion this year, increase to 40 billion in 2007 and further to 45 billion in 2008. Wage payments by the defence force to its Icelandic staff will cease this year, and the lowered exchange rate along with higher international interest rates will together raise debt service payments to abroad.

The business sector

The Icelandic economy has been subject to some turbulence in recent months. The exchange rate has declined from the beginning of the year, as had been expected for some time. Companies in the fisheries sector and other export sector had been experiencing difficulties due to the strong exchange rate are feeling easier now that the exchange rate has declined. According to the latest IMG Gallup poll of business conditions amongst Iceland's largest enterprises, 50 per cent of respondents thought that the exchange rate developments of recent months would tend to have an adverse effect upon business profits, whereas 32 per cent thought the impact would be beneficial and 18 per cent said the exchange rate changes would have no effect. Enterprises in construction and commerce were predominant among those who thought that the decline in the exchange rate would have an adverse effect.

For the first five months of this year the total fish catch of Icelandic vessels has declined by 36 per cent compared to the same period last year. At constant prices, the decline has amounted to 10 per cent. Most of the decline was in the capelin catch. The production of fish products is expected to decline by 4 per cent this year, mainly because of a decline in catches of capelin and shrimp, whereas the earlier forecast had assumed a 2 per cent increase. The Marine Research Institute recently issued its recommendation for a maximum fish catch for the next fisheries year, beginning on September 1st 2006. If the recommendation of the Institute is implemented, the catch value at constant prices may be expected to decline by 2-3 billion krónur. The Institute recommends that the cod quota be reduced from 198 thous. tonnes to 187 thous. tonnes and the haddock quota from 105 thous. tonnes to 95 thous. tonnes. No decision has yet been taken on the catch quota for the next fisheries year.

As in the Ministry's spring forecast, it is assumed that aluminium production will increase by 32 per cent this year and by 58 per cent next year. Aluminium production is forecast to increase by 38 per cent in 2008. During the first four months, the number of foreign travellers coming through Keflavik Airport to Iceland increased by 5 per cent from the corresponding periods a year earlier. It is expected that travel to Iceland will continue to increase.

Increased labour market participation and hours worked

The labour market survey of Statistics Iceland for the first quarter of this year shows that the labour market participation rate is higher than it has ever been recorded since such continuous labour market surveys began in 2003. It currently stands at 81.1 per cent and has increased more among older persons than younger ones. The survey shows an increase in the labour force by 7,700 in 2005, 4.9 per cent. The increase comes from a variety of sources. About 800 unemployed went back to work,

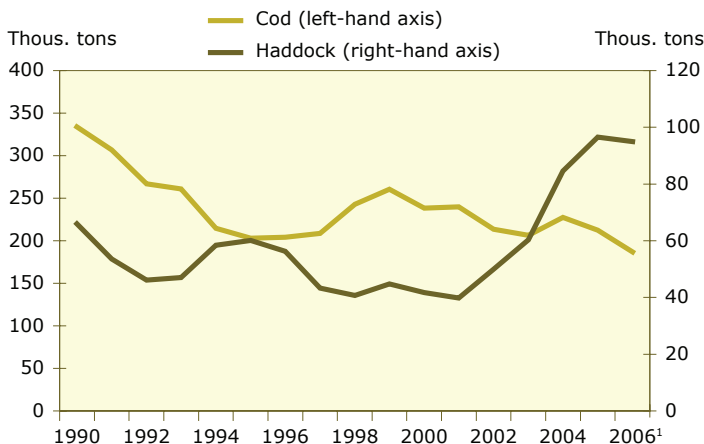


Chart 11
Catches of cod and haddock of Icelandic vessels, 1990–2007¹

1. 2006-figures are based on recommendation by Marine Research Institute for the 2006/2007 fisheries year.

Sources: Statistics Iceland, The Marine Research Institute.

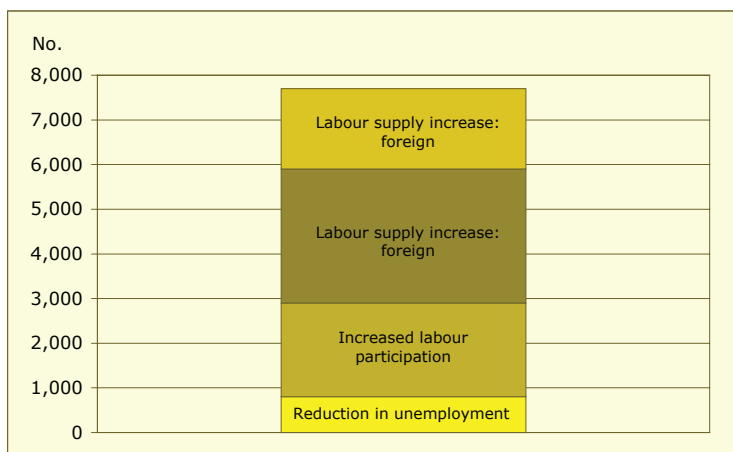


Chart 12
Labour market developments in 2006

Sources: Statistics Iceland and Ministry of Finance calculations.

2,100 persons previously outside the labour force entered into it, another 3,000 are due to an increase in the number of people of working age and another 1,800 is due to net immigration. Figures on immigration indicate that net immigration was twice as large; the labour market surveys may therefore underestimate the increase in labour market activity. Figures on migration for the first quarter of this year show a continued net inflow of immigrants, one of 1,800 persons in excess of emigration. About half of the immigrants settle in the capital area and on the East coast, reflecting the heavy demand for labour at present. Hours worked were 1.2 per cent longer in the first quarter of this year than a year ago, a record for this time of the year. Hours worked tend to be longer by the middle of the year than at other times. For 2006, the number of hours worked is expected to increase by 5 per cent, even if economic activity is thought to slow down in the course of the year. Hours worked are expected to decline by 2 per cent in 2007 due to declining investment activity, and further by 1 per cent in 2008. Unemployment is expected to be 1.5 per cent of the labour force this year, rising to 2.3 per cent in 2007 and further to 3 per cent in 2008.

Wages

Heavy demand for labour has in part been met by labour imports that in turn helped in bringing down labour market pressures. Labour imports have not been able to solve demand pressures in all areas of the market. A Gallup survey among the largest firms in May 2006 indicates that labour market shortages have increased since February. About half of survey respondents indicated they needed labour, mostly in the service sectors other than in financial services. The wage index has continued its rise in the course of the year. New pay tables were adopted by the central government in May. The Employers' Confederation has recently made an offer to organised labour of a 12,000 krónur wage increase for all who have not received any other wage increases, so that all will receive not less than a 4.5 per cent wage increase this year. This offer is subject to the condition that wages will not be renegotiated because of inflation trends. The unions have this offer under consideration. Should this offer be accepted, it is estimated to lead to a 4 per cent increase in wage levels in the general labour market over and above what was implemented at the beginning of this year. On the whole, nominal wage increases are expected to amount to 9 per cent this year and prospects are for a 5 per cent increase in 2007. In 2008, when the pressure in the labour market is expected to have subsided, wages are forecast to increase by 3.5 per cent in nominal terms. Taking the forecast for prices into account, real hourly wages are expected to increase by 1 per cent a year over the forecast period. Total real wages are expected increase more, partly because of tax cuts, or by 3.5 per cent in 2006, 3.3 per cent in 2007 and 1.9 per cent in 2008.

Prices

Inflation has increased rapidly so far this year and reached 8 per cent in June. This is due to an increase in prices for housing and the decline in the exchange rate. The twelve-month increase in housing prices shows that they are still increasing but at a slower pace, down to 17 per cent in April from more than 40 per cent in August of last year. The recent increase in inflation is mostly attributable to a rise in prices

High labour market participation and longer work hours

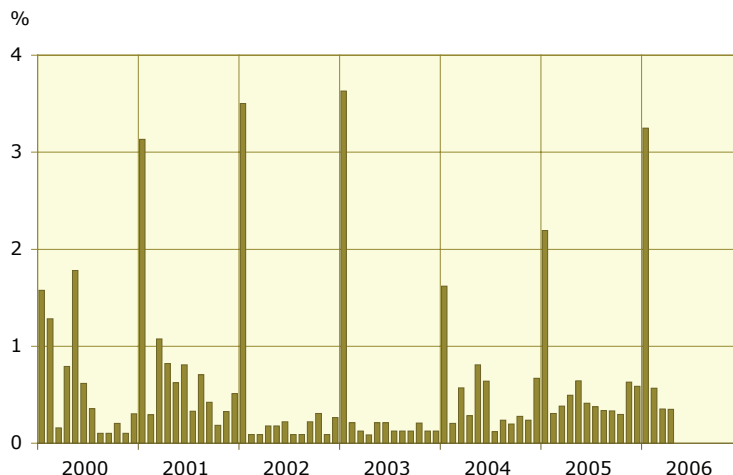


Chart 13
The wage index, one-month changes January 2000 – April 2006

Source: Statistics Iceland.

Declining exchange rate causes temporary rise in inflation

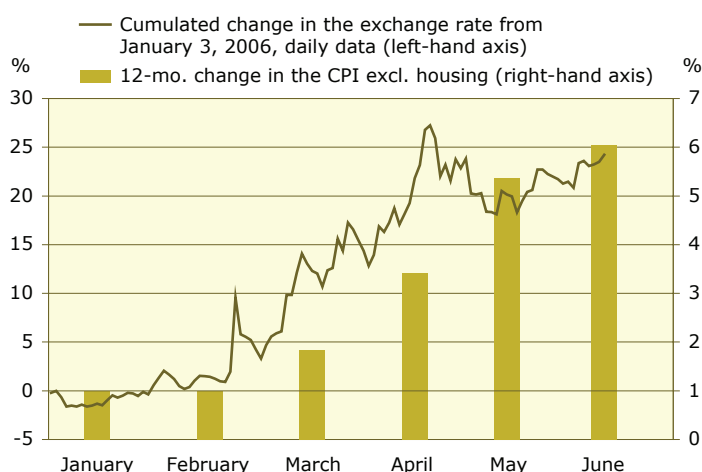


Chart 14
Inflation and exchange rate developments January - June 2006

Sources: Central Bank of Iceland and Statistics Iceland.

for imported goods, following a decline of more than 20 per cent in the exchange rate since the beginning of this year. As a result, the consumer price index excluding housing rose by 6.0 per cent in June on a twelve-month basis, after having increased little last year and early this year. This is mostly explained by the strengthening of the exchange rate in the course of 2005 and into the early part of this year.

Amongst imported goods, auto prices have increased fastest in line with the exchange rate; auto prices rose by 5.3 per cent in May and 1.26 per cent in June. Other imported consumer goods, such as appliances and apparel, have not increased as much, but their prices are expected to rise in coming months in line with the exchange rate changes, since it generally takes a few months for prices of imported goods to fully reflect the change in the exchange rate. The price of imported food has increased as well but the same applies to domestic food products according to the last inflation report. In this revised forecast, inflation is expected to reach 7.8 per cent this year, considerably higher than the 5.9 per cent forecast in April. On one hand, the main reason is that the decline in the exchange rate is greater than assumed earlier, even if the assumption is that the bulk of the devaluation is over by now. On the other hand, wage drift is expected to be greater. The real property market is expected to slow down in coming months in line with increased supply of new housing, an already high level of housing prices. Indexed mortgage interest rates have begun to increase and the banks are becoming more restrictive in the mortgage lending. Next year, when power project investments will draw to a close, demand pressures on prices will be significantly reduced and property price inflation will be negligible. The exchange rate effect is expected to have fully materialised by the spring of 2007. Inflation is therefore expected to decelerate rapidly in the spring and approach the inflation limit of the Central Bank. For 2007 on average, inflation is forecast at 4.6 per cent, declining to 2.6 per cent in 2008.

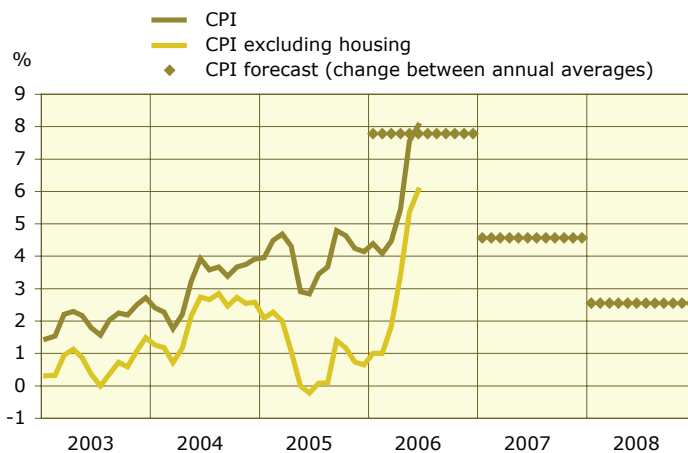


Chart 15
Inflation 2003-2008

Source: Statistics Iceland and own forecast.

After years of large Treasury surpluses a deficit is projected

Public finances

The public sector revenue surplus amounted to 32 billion krónur in 2005, 3.2 per cent of GDP. The Treasury surplus amounted to 38 billion, 3.8 per cent of GDP, whereas the local government were in deficit by 6 billion, 0.6 per cent of GDP. Prospects for public finances in 2006 have changed little since the Ministry issued its April forecast. The public sector surplus for this year is currently expected to be slightly higher, 21 billion instead of 20 billion, mostly on account of higher revenue from personal income taxes due to higher wage increases than estimated earlier. The Treasury surplus is expected to reach 25 billion, 2.3 per cent of GDP, whereas the revenue deficit of the local governments is estimated to amount to 4 billion, 0.4 per cent of GDP. Last year, the public sector surplus amounted to 32 billion or 3.2 per cent of GDP. The Treasury yielded a surplus of 38 billion or 3.8 per cent of GDP whereas the local governments had a 6 billion deficit, 0.6 per cent of GDP. This shows that the Treasury operations, based on longer-term goals that limit the increase in expenditure, is having a counter-cyclical influence and thus helps prevent the overheating of the economy. It is also evident that the local governments have not applied restraint to the same extent, as can be seen from chart 16. The local governments have run a revenue deficit

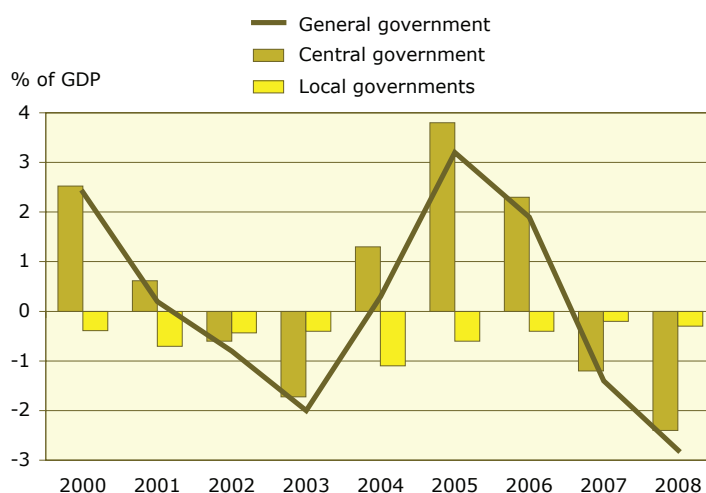


Chart 16
General government revenue balance 2000-2008

Sources: Statistics Iceland and own forecast.

throughout this decade. Their deficit peaked in 2004 at 20 billion krónur, at the same time as their investment spending was also at a record.

For next year, the economy is expected to slow down upon completion of ongoing power projects. On the basis of the Government's medium term programme, the public sector deficit is forecast to amount to 1.4 per cent of GDP. According to the programme, the Treasury increases its investment expenditure in order to mitigate the slowdown of the economy. The cuts in the personal income tax will also be fully implemented in 2007, and transfer payments to households will increase. In this forecast, it is assumed that the growth in Treasury public consumption will stay within the 2 per cent goal of the Government, but that the real growth in transfer payments will exceed the 2.5 per cent goal due to decisions by the Government to increase spending on welfare and for older persons. Local government investment is expected to decline in 2007, and their deficits should be slightly lower than in the previous three years, about 2.5 billion krónur or 0.2 per cent of GDP. For 2008, the public sector deficit is expected to amount to 2.7 per cent of GDP. The Treasury deficit is expected to amount to 2.3 per cent of GDP, and that of the local governments to 0.4 per cent of GDP. The finances of the public sector are expected to begin to stimulate activity in 2007 and 2008, when the economy begins to move back towards a state of equilibrium.

Treasury finances provide a counter-cyclical influence

Monetary developments

Increasing inflation prospects and the decline in the exchange rate, following disquiet in the financial markets, have led to a sharp tightening in Central Bank monetary policy. The decline in the exchange rate was quickly translated into general prices and came on top of housing price increases in recent months. The revisions of the national accounts for 2004 showed that pressures in the economy were substantially greater than estimated earlier. The policy interest rate was therefore increased by 75 basis points in April and again in May to the present level of 12.25 per cent. Inflation is substantially exceeding the inflation rate goal of the Central Bank and currently stands at 8 per cent. The Central Bank has indicated strongly that the policy rate will be increased further until inflation recedes. The impact of the declining exchange rate will be felt in the inflation figures for several more months, and inflation will not get back within the Central Bank's inflation limits until next year. The increases in the policy rate are gradually showing up in indexed interest rates. Mortgage rates were earlier down to 4.15 per cent but have now increased to 4.6-4.9 per cent. The policy interest rate is expected to peak at 14 per cent this year and average 12,4 per cent for the year. For next year, when inflation is expected to decline rapidly, it is assumed that the policy rate will decline to an average of 11,3 per cent and further to 6.9 per cent in 2008.

A higher policy rate expected

The domestic financial market

Despite increases in the Central Bank's policy rate, there are limited signs that the growth in bank credit is abating, to judge by April banking data. The domestic credit of deposit banks increased by 2,064 billion krónur or 57.8 per cent in the twelve months up to April of this year. Credit to abroad expanded rapidly or by 454 billion in the same period and currently amounts to 725 billion. The credit expansion should slow down in the course of this year in light of steep policy rate increases and the disquiet that has emerged in financial markets earlier this year. Housing credits have slowed down of late due to rising mortgage rates, increased inflation, stricter lending terms by banks and a decrease in refinancing. The stock market has been lively in recent months but seems to have quietened in the past several weeks. The stock index rose slightly in May, by 2.4 per cent. Iceland has not been alone in experiencing stock market fluctuations. Similar developments have taken place in all the major financial markets of the world that may be due to economic uncertainty and expected interest rate increases in the US.

Indications of slower credit growth

Appendix table 1. Output and expenditure 2005-2008

	Billion krónur at current prices				Volume change on previous year (%) ¹			
	Estim.	Forecast			Estim.	Forecast		
	2005	2006	2007	2008	2005	2006	2007	2008
1. Private consumption	599.2	655.1	681.9	708.9	11.9	1.7	0.2	1.8
2. Public consumption	246.3	270.3	288.8	311.6	3.2	2.5	2.4	2.4
i.e. central government	160.8	175.0	186.8	202.5	2.9	2.3	2.4	2.4
i.e. local government	85.5	95.3	102.0	109.1	3.8	3.0	2.5	2.5
3. Gross fixed investment	285.9	319.0	237.9	205.3	34.5	4.7	-29.9	-16.7
Business sector investment	197.0	224.3	133.8	95.1	56.9	4.2	-43.6	-31.1
Excl. power-intensive projects, ships & aircraft	112.6	124.4	94.3	81.3	22.8	0.2	-27.0	-15.5
Residential construction	57.4	66.7	67.1	67.7	10.3	10.7	-2.5	-1.1
Public investment	31.5	28.0	37.0	42.5	-13.5	-15.4	28.1	12.6
4. Final domestic demand	1 131.5	1 244.4	1 208.6	1 225.8	15.0	2.7	-7.4	-1.8
5. Stock changes ²	- 1.3	0.0	0.0	0.0	-0.0	0.1	0.0	0.0
6. Total national expenditure	1 130.1	1 244.4	1 208.6	1 225.8	14.9	3.0	-7.4	-1.8
7. Export of goods and services	314.0	377.4	435.4	487.8	3.5	3.4	11.9	9.8
8. Import of goods and services	448.6	517.4	483.9	486.7	28.4	-1.1	-10.7	-0.9
9. Gross domestic product	995.5	1 104.3	1 160.1	1 226.9	5.5	4.7	0.9	2.3
10. Net factor income from abroad	- 27.7	- 34.3	- 40.4	- 45.3	-	-	-	-
11. Net current transfers	- 1.7	- 1.3	- 1.4	- 1.4	-	-	-	-
12. Current account balance (7.-8.+10.+11.)	- 164.1	- 175.6	- 90.2	- 45.6	-	-	-	-
13. Gross national income (9.+10.)	967.8	1 070.0	1 119.7	1 181.6	6.3	4.4	0.5	2.1
14. Effects of changes in terms of trade ³	-	-	-	-	0.3	-0.2	-0.8	0.0
15. Real gross national income	-	-	-	-	6.7	4.3	-0.2	2.2
16. Current account balance (% of GDP)	-	-	-	-	-16.5	-15.9	-7.8	-3.7

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 2005-2008

	Billion krónur at current prices				Volume change on previous year (%) ¹			
	Estim.	Forecast			Estim.	Forecast		
	2005	2006	2007	2008	2005	2006	2007	2008
Export production								
Marine products	112.1	124.2	132.4	138.2	-3.4	-4.0	2.0	2.0
Aluminium	34.9	63.0	94.9	130.9	-3.1	31.5	58.3	35.5
Other products	36.5	38.5	41.7	44.7	-6.7	1.1	5.2	5.2
Total	183.4	225.6	269.1	313.7	-4.0	4.3	17.2	14.3
Export of old ships and aircraft	9.6	4.2	4.5	4.7	-	-	-	-
Stock changes in export production	-1.3	0.0	0.0	0.0	-	-	-	-
Merchandise exports, total	194.4	229.8	273.6	318.4	1.0	0.4	16.9	14.0
Merchandise imports, total	287.4	341.5	300.0	287.0	25.0	1.3	-16.1	-5.6
General merchandise imports	213.7	251.6	236.4	232.4	10.3	1.3	-10.7	-3.2
of which: Oil imports	25.8	32.4	32.8	32.3	1.1	-1.9	0.7	3.4
of which: Other imports	187.9	219.2	203.6	200.2	11.4	1.6	-11.9	-4.0
Special imports	73.7	89.9	63.6	54.6	87.0	1.3	-29.6	-13.0
Balance of trade	-93.0	-111.6	-26.4	31.4	-	-	-	-
Export of services (excl. factor income)	119.6	147.5	161.8	169.4	10.5	8.3	3.9	2.2
Import of services (excl. factor income)	161.2	175.9	183.8	199.7	34.7	-5.0	-1.0	6.2
Balance of services (excl. factor income)	-41.6	-28.4	-22.0	-30.3	-	-	-	-
Net factor income from abroad	-27.7	-34.3	-40.4	-45.3	-	-	-	-
Net current transfers ²	-1.7	-1.3	-1.4	-1.4	-	-	-	-
Current balance	-164.1	-175.6	-90.2	-45.6	-	-	-	-

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 2006–2008

	Forecast for 2006						Forecast for 2007				Forecast for 2008		
	Oct. 2004	Jan. 2005	April 2005	Oct. 2005	Jan. 2006	April 2006	June 2006	April 2005	Oct. 2005	Jan. 2006	April 2006	June 2006	June 2006
Volume changes (%)													
Private consumption	5.0	5.6	6.1	4.3	4.3	2.2	1.7	0.6	0.6	0.6	0.5	0.2	1.8
Public consumption	2.0	2.0	2.7	2.2	2.2	2.5	2.5	2.5	2.2	2.1	2.4	2.4	2.4
Gross fixed capital formation	9¼	7.1	-0.8	0.8	3.6	4.6	4.7	-24.9	-23.8	-27.2	-29.2	-29.9	-16.7
National expenditure	5½	5.3	3.8	2.9	3.5	3.2	3.0	-5.1	-5.2	-6.1	-7.0	-7.4	-1.8
Exports of goods and services	5¾	7.1	7.5	6.2	6.9	5.0	3.4	12.5	11.6	11.8	11.9	11.9	9.8
Imports of goods and services	8½	8.0	2.9	1.9	3.0	0.3	-1.1	-6.2	-8.8	-10.9	-11.4	-10.7	-0.9
Gross domestic product (GDP)	4½	4.7	5.7	4.6	5.0	4.8	4.7	2.4	2.5	2.6	1.8	0.9	2.3
Current account balance (% of GDP)	-13½	-12.8	-11.4	-12.2	-13.0	-14.4	-15.9	-6.2	-6.4	-6.2	-7.7	-7.8	-3.7
General government balance (% of GDP)	1½	1.6	1.1	1.0	1.1	1.8	1.9	-1.2	-0.8	-0.9	-1.5	-1.4	-2.7
Income and price changes (%)													
Disposable income per capita	7¼	7.2	5.0	6.6	7.3	9.5	11.6	4.6	6.2	6.3	7.0	8.1	4.6
Wages ¹	4.4	4.4	5.0	5.0	5.8	6.6	9.0	4.6	4.5	4.5	4.2	5.5	3.5
Real disposable income per capita	4.0	3.7	3.3	2.7	3.3	3.4	3.5	2.5	2.1	2.2	3.4	3.3	1.9
Inflation	3¼	3.5	3.8	3.8	3.9	5.9	7.8	3.4	4.0	4.0	3.5	4.6	2.6
Exchange rate index (Dec. 31, 1991=100)	128.0	124.2	116.8	113.8	108.7	119.7	122.4	122.8	119.3	117.1	123.7	126.6	127.0
Unemployment, % of labour force	2¼	2.2	2.2	1.8	1.7	1.6	1.5	2.2	2.7	2.6	2.2	2.3	3.0

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