

English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

June 8th 2006

The probability of a hard landing

In recent months, there has been a lively discussion on the probability of hard landing of the Icelandic economy. [Standard & Poor's](#) recently revised its rating of Treasury debt from stable to negative, leaving the otherwise good rating of the Treasury unchanged. The agency argues that inflation is increasing in the wake of a declining exchange rate which in turn increases the likelihood that the Central Bank will raise its policy rate further in order to restrain inflation. This could in turn produce a hard landing.

But what exactly is meant by a hard landing? A hard landing indicates a deep downturn in the economy with rapidly increasing unemployment and loan defaults by households and businesses. This would in turn reduce the lending capacity of the financial sector and could even severely constrain the financial system. Experience shows that governments of countries that have experienced such a situation have tended to assume the obligations of lending institutions to the extent necessary to safeguard the operational viability of the financial system.

In a recent macroeconomic forecast of the Ministry of Finance, the possibility of a hard landing is seen as remote. There are numerous reasons for that judgement. Even if imbalances in the economy are considerable at the present time, the situation is temporary. When the present power project construction activity is completed next year, imports will decline and exports increase sharply due to the tripling of capacity in aluminum production. The lower exchange rate will help in reducing imports of consumer goods and autos. This trend is confirmed by the latest import figures (see article below on May imports). The current account deficit is expected to be sizeable this year due to imports for power projects, but is forecast to decline by half in 2007. As for inflation, it has been pushed up by rising housing prices. Housing price inflation peaked last August. It has since then receded rapidly and is expected to continue on a downward path. Still, inflation is expected to increase this year due to the decline in the exchange rate and rising imports prices. Inflation is expected to decline in the spring of 2007 and fall below the upper tolerance limit of the inflation target. GDP growth is forecast at close to 5 per cent this year and nearly 2 per cent next year. The forecast assumes that unemployment will increase by a small margin.

The Ministry's report emphasises that the Icelandic economy is very flexible, due to e.g. extensive structural changes in the past fifteen years. History shows that households and businesses react sensibly to changes in the exchange rate. When the exchange rate declined in 2000 and 2001, imports declined sharply and the substantial current account deficit turned into a surplus in 2002. A difference is that the exchange rate has declined far less this year than it did then. It is also emphasised that the foundations of the economy are strong with household assets three times as large as the debt. Treasury finances are also strong. A large part of business income, including the banks, is in foreign currency, which reduces their exchange rate risk. The capital ratio of the banks is also quite high. In spite of the recent turmoil in financial markets, the banks have been able to finance their short-term debt without undue difficulty. Independent stress tests reveal that the banks can tolerate substantial changes in the exchange rate and loan defaults. It is also important to note the favourable conditions in the international economy and that financial markets are quite liquid. Finally, it should be noted that there is a good possibility that additional power project investments may materialise in the near future. Certainly, there is a possibility that the Icelandic economy will suffer a hard landing, just like the international economy. In the view of the Ministry of Finance, however, this possibility is judged to be remote.

Substantial immigration in the first quarter of 2006

Statistics Iceland has collected provisional data on migration in the first quarter for the Ministry of Finance. A total of 2,574 persons mi-

grated to Iceland in the first quarter, whereas 798 persons emigrated. Net migration was therefore close to 1,800. The wave of immigration already evident in the latter half of 2005 has continued at the same vigorous pace this year. The largest share of immigrants has settled in the capital area, whereas close to 700 have gone to the eastern part of the country.

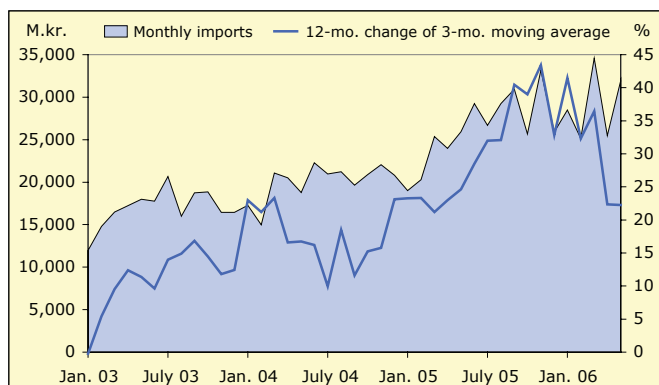
Figures on internal migration show that the capital area is again experiencing a net influx, reversing the small outflow of last year. The southern region and the Reykjanes peninsula are also receiving more people, whereas other parts of the country are losing population because of internal migration. In the South, only Árborg and Hveragerði are adding population. Internal migration from the East is also continuing from last year from most communities except Fljótsdalshérað. The aluminium developments have therefore not begun to have a significant impact upon population trends.

The demand for labour in the East has peaked, and a continuing influx of labour is therefore not expected. Immigration to the South-West is expected to continue, at least under present economic conditions. Restrictions on labour immigration from the new member states of the EU were lifted on May 1st of this year. The impact of this change will emerge in second quarter migration figures.

Imports in May

Merchandise imports in May amounted to 35.7 billion krónur, according to VAT data, bringing the twelve-month increase, excluding ships and aircraft, to 23.2 per cent.

Merchandise imports in volume, January 2003 - May 2006



The largest monthly increase is in intermediate and investment goods, mostly due to the power project investments. Fuel imports also play a large role, but it should be kept in mind that they fluctuate considerably. Such imports were small in April. Imports of consumer goods increase slightly between months, especially of semi-durable goods (e.g. appliances).

Imports of motor vehicles are slowing down. They were strong at the beginning of the year, especially in March, but declined in April and remained almost constant in May, which is an unusual situation since vehicle imports usually increase at the beginning of summer, peaking in June each year. Figures on new auto registrations in May do not indicate that consumer purchases of autos have increased from the same period a year ago (based on a three-month moving average). This development is probably due to the decline in the exchange rate which was quite steep in March. Since imports in that month are cleared through customs based on the exchange rate of the previous month, importers and consumers have taken advantage before the customs exchange rate declined. Auto imports in that month increased, which in turn had the impact of reducing imports in April and May, opposite to the usual.

Treasury revenue January-April		
12 month changes (%)	2004-2005	2005-2006
Total tax revenue	21.0	15.0
Taxes on income & profit	18.0	34.0
Taxes on property	64.4	-29.1
Taxes on goods & services	19.7	6.5
Social contributions	23.1	14.3
Total revenue	25.4	9.0

Treasury expenditure January-April		
12 month changes (%)	2004-2005	2005-2006
General public services	122.5	-30.7
Health	52.4	6.9
Social security & welfare	47.8	6.6
Economic affairs	46.0	-6.7
Education	41.0	10.4
Total expenditure	58.7	-2.7

Treasury finances January-April		
Million krónur	2005	2006
Cash from operations	13,092	24,347
Net financial balance	19,356	21,869
Debt redemption	-29,826	-31,685
Gross borr. requirement	-11,670	-11,136
Net borrowing	13,949	6,456
Overall cash balance	2,279	-4,680

Economic indicators		
12 month changes (%)	2004-2005	2005-2006
Inflation (May)	2.9	7.6
Core inflation (May)	3.4	6.4
Wage index (April)	6.7	8.4
Total turnover (Jan. - Feb.)	5.9	9.2
Retail turnover (Jan. - Feb.)	1.8	6.5
Unemployment rate (April)	2.1	1.1