English translation of the Weekly Web Release

MINISTRY OF FINANCE IN ICELAND

February 23d 2006

Economic stability in Iceland

In a report released Wednesday by the ratings agency, Fitch Ratings, the *long-term outlook* for Icelandic Treasury was changed from *stable* to *negative*. The favourable rating (AA-) remained unchanged in light of the Treasury´s strong fiscal position. The main reasons given for the change in the outlook were that i) the current account deficit last year exceeded forecasts; ii) the significant increase in the debt of households (in part due to housing investment) and businesses (partly because of foreign investments) and iii) the rating agency´s opinion that fiscal policy restraint has been insufficient. The report raises doubts about the sustainability of economic developments in Iceland and in this respect recalls the financial crisis in Asia in the last decade. Following the release of the report, share prices on the stock exchange and the exchange rate declined by about 9 per cent, but both had risen sharply in recent months. A short while later, half of the decline had been reversed.

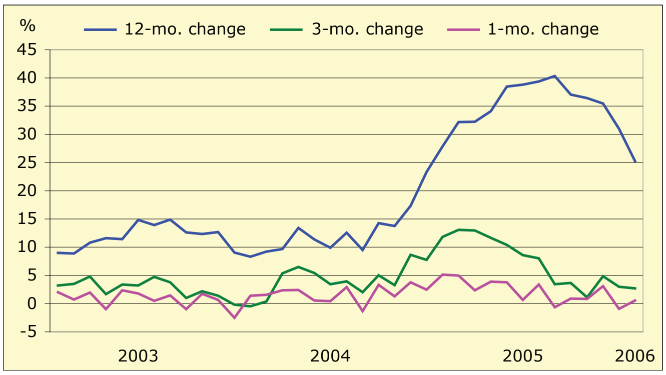
The increase in the current account deficit last year is to a large extent explained by two major innovations in the financial market. First, the banks entered into competition with the Housing Finance Fund in August 2004 with a reduction in the interest rate on mortgage credits as well as raising the lending limit. The improvement in household liquidity, along with the stronger exchange rate, led to a sharp rise of imports of consumer goods and motor vehicles. The innovation also fuelled housing demand and a surge in housing prices which contributed to higher inflation. Second, foreign institutions began to issue bonds denominated in Icelandic krónur in August 2005. This contributed to a further strengthening of the exchange rate and the purchasing power of Icelandic households abroad. The strong króna also stimulated Icelandic investments abroad. It was difficult for economic policymakers to react to these developments beyond the decisions of the Central Bank to raise the policy interest rate further still. These developments now appear to have largely been absorbed and the outlook is for slower growth this year in private consumption and imports. For next year, a decline in investment and imports is expected along with a further slowing down of the growth in private consumption. At the same time, increased aluminium production capacity is coming on line which is increasing merchandise exports sharply. The current account deficit will thus contract quickly. The outlook is thus quite positive concerning the temporary external imbalance. Should the exchange rate decline more, the turnaround in foreign trade would be accelerated. Most indications therefore suggest the current account deficit in coming years will be sustainable.

As regards the criticism of fiscal policy, the Ministry of Finance has pointed out that the general government balance improved by 5.4 per cent of GDP from 2003 to 2005, one of the sharpest improvements in the OECD-area during that time. In addition, the long-term target of Treasury finances is still in effect, to restrain public expenditure and allow revenues to generate a surplus in the upswing. This policy has markedly improved Treasury finances. There is therefore little doubt that fiscal policy has been tight. It has also been pointed out that discretionary measures on the revenue or income side to a greater extent than has been done is not likely to improve the economic management. As estimated fiscal multipliers are fairly small, the required large discretionary measures to significantly alter economic growth could themselves become a source of instability. Moreover, it would prove difficult to reach a consensus on where to cut expenditures, since they are mostly in education, health and social welfare. In addition to the systematic restraint on fiscal policy, the government has placed an emphasis on increasing the flexibility of the economy by privatising state enterprises and introducing structural reforms that enable market participants to react to developments and participate effectively in globalisation. This policy framework has turned out to be a success by generating ample employment and rapidly rising real incomes. Despite the temporary imbalances, most indications are that economic development will remain stable.

Housing price increases are slowing down

There are now clear indications that the housing price increases that characterised the housing market at the beginning of last year are slowing down. Housing prices have mostly been stagnant in recent months resulting in rapidly declining monthly price increases. Data on turnover in the housing market also indicate that the market is calming down, following the lively period last year. Housing price developments show up in the consumer price index with a lag as the index incorporates housing prices on a three-month moving average basis. If present prospects of little or no housing price increases are realised, it will lead to a further reduction in consumer price inflation. The twelve-month increase in the consumer price index to February 2006 was 4.1 per cent, with two-thirds being due to rising housing prices. Excluding house prices, the index rose 1.5 per cent. As shown in the accompanying graph, the twelve-month increase in housing prices has declined from 40 per cent in August 2005 to 25 per cent in January 2006. The three-month increase has declined from 13 per cent in March of last year to 3 per cent and the monthly change from 6 per cent in January 2005 to 0.5 per cent in the same month this year.

Changes in housing prices in the capital area



A quiet revolution?

The Ministry's November forecasts on the migration of Icelandic citizens proved to be right on target, whereas the emigration of foreign citizens slightly exceeded the figure forecast. A total of 4,680 foreign citizens immigrated of which 2,300 were registered in the last three months of the year. The main point is that the increase in the population due to net immigration came to 3,860, nearly double what was expected last October. The focus in this respect has been on the power project investment in the East in 2005. Net migration to the eastern part of the country totalled 1,461 in 2005, twice the number of the previous year. Migration from abroad increased the population of all regions last year. Net immigration amounted to nearly 1,500 in the capital area and more than 900 in the regions other than the eastern part of the country. Excluding the East, the western part benefited most relatively.

Last year's migration added considerably individual age groups. The number of men increased by as much as 4 per cent in certain cohorts and by more than 2 per cent in all age groups between 20 and 54 years. This indicates that Icelandic society is permanently changing in view of the fact that the number of women increased by as much as 2 per cent in individual age groups and more than 1 per cent in all age groups between 15 and 40 years. The immigration of women last year can only be marginally attributed to power project investments, and the same applies to men that have immigrated to regions other than the East.

Treasury revenue, January-December		
12 month changes (%)	*2003-2004*	*2004-2005*
Total tax revenue	13.1	20.7
Income taxes	10.7	22.7
Social security taxes	11.1	16.2
Asset taxes	38.8	23.7
Indirect taxes	13.4	20.3
Total revenue	8.1	42.2

Treasury expenditure, January-December		
12 month changes (%)	*2003-2004*	*2004-2005*
Administration	3.7	7.9
Social affairs	6.4	6.9
Economic affairs	2.6	4.7
Interest	-12.5	35.2
Other	3.2	49.3
Total expenditure	4.3	10.0

Treasury finances, January-December		
Million krónur	*2004*	*2005*
Cash from operations	-292	32,014
Net financial balance	22,408	81,888
Debt redemption	-32,477	-62,305
Gross borr. requirement	-17,569	14,101
Net borrowing	25,867	10,234
Overall cash balance	8,298	24,335

Economic indicators		
12 month changes (%)	*2004-2005*	*2005-2006*
Inflation (Feb. '06)	4.5	4.1
Core inflation (Feb. '06)	4.5	3.8
Wage index (Jan. '06)	6.6	8.3
Total turnover (Jan. - Oct. '05)	10.0	9.5
Retail turnover (Jan. - Oct. '05)	4.5	5.2
Unemployment rate (Jan. '06)	2.6	1.2

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