English translation of the Weekly Web Release

MINISTRY OF FINANCE IN ICELAND

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The report of Danske Bank on the Icelandic economy

A new report by Danske Bank, the second largest bank in the Nordic countries, on the Icelandic economy and its financial system has produced a strong reaction on both domestic and foreign financial markets. The reaction is based on two things. First, the report served to raise concerns about economic stability in Iceland. Second, it has been found to treat Icelandic economic data and behaviour liberally and draw stark conclusions on the basis of that.

As regards the coverage of Danske Bank about the economy, it should be pointed out that the authors of the report have no special expertise on the Icelandic economy, which may possibly explain their errors of fact and analysis. In the report, it is pointed out that the current account deficit in the fourth quarter of last year amounts to 20 per cent of GDP, but according to the latest figures it is 16.5 per cent for the year as a whole. The report does not consider that the current imbalance in the economy is temporary. According to the forecasts of the Ministry of Finance, power project investments and the construction of aluminium plants will peak this year and be completed next year. It has been expected that the exchange rate will decline, as it now has, and that private consumption and associated imports will contract. With increasing aluminium production and exports the merchandise trade deficit is expected to disappear next year. The current account deficit should therefore decline quickly this year and next.

The report discusses a hard landing of the economy in 1999 and again in 2002 and predicts another hard landing ahead. It should be pointed out that there was no recession in 1999, when real GDP grew by 4.3 per cent and the recession in 2002 was relatively modest and brief with GDP growth contracting by 1 per cent. Most forecasts indicate economic growth will remain vigorous this year and moderate next year. The report ignores the fact that Icelandic households adjust their private consumption expenditures and related imports to the prevailing exchange rate. When the currency is strong on the foreign exchange market, as it has been, private consumption and imports increase. When the currency weakens the situation is reversed. Such consumer behaviour is more reflective of flexibility and rationality in household decision-making than irrational expectations. The report asserts that a decline in the exchange rate will erode financial stability. In this connection, it should be noted that 73 per cent of the funds lent out by the banks are to foreign entities and the associated income stream is mostly unaffected by the króna exchange rate. It should also be pointed out that households and enterprises generally do not carry much exchange rate risk on their debt. A large part of household debt is in the form of mortgages which generally are regarded as sound debt. Icelandic households also enjoy the special position of having fully funded pension funds that will finance their future pensions. Household and Treasury finances are therefore more sound than the report suggests.

In the report, it is asserted that the current inflation rate is being driven by rapid wage increases. This is wrong. Inflation last year is largely explained by the change in home mortgage financing that began in 2004, which contributed heavily to the rise in house prices. This price increase began to slow down in the middle of last year and that trend is expected to continue this year. Real wages have increased in step with rising productivity which indicates the development is sustainable. It is right, however, that some pressures have emerged in the labour market. In relation to that, the figures mentioned by Danske Bank on unemployment as share of the labour force are wrong, but the unemployment rate was 1.6 per cent in February and not 1 per cent. Furthermore, the inflow of foreign labour has increased rapidly which has eased conditions on the labour market. The figures quoted in the report on Treasury finances are not comparable. The report quotes OECD figures on cyclically adjusted public balance on one hand and unadjusted primary balance on the other hand. These figures are not comparable since the OECD figures are based on earlier data. It is also important to observe the output gap (the gap between potential output and actual output) when assessing the impact of the business cycle on government finances. According to estimate by the Ministry, the impact of the business cycle on public finances was limited this past year. Other comments can be made, but let this suffice on the shortcomings of the report.

New opinion survey on business confidence

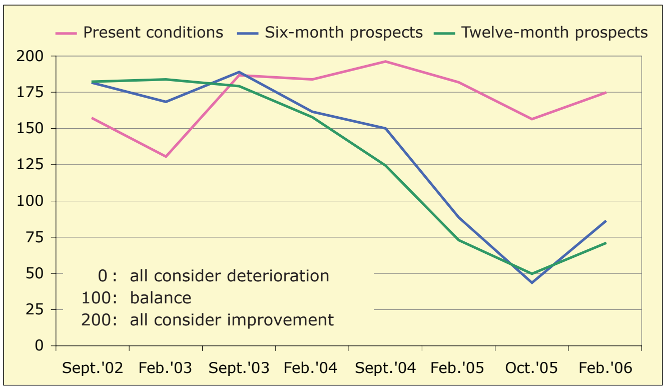
IMG Gallup has recently conducted its regular survey among Iceland's largest companies concerning their situation and outlook. The companies in the survey are selected on the basis of total payrolls. The survey is conducted on behalf of the Ministry of Finance, the Central Bank and the Confederation of Icelandic Employers. The survey was conducted over the period from February 9th to March 3rd of this year and covered a total of 388 companies in the final sample, with a response rate of 68.3 per cent.

Some 75 per cent of respondents thought that economic conditions were favourable and 11 per cent thought they were poor. The confidence index currently stands at 174.5 compared to 156.4 in the previous survey, conducted last October. The proportion of those that see prospects as favourable is therefore growing since the previous survey. Businessmen in the regions are generally more optimistic since the previous survey; 62 per cent of respondents in the regions deem present economic conditions to be favourable compared with 44 per cent in the previous survey. About 80 per cent in the capital area see economic conditions as favourable, a similar percentage as in the last survey.

Looking six months ahead, 17 per cent see conditions improving as against 8 per cent in the previous survey. Some 60 per cent believe that conditions will be about the same six months hence, and 23 per cent believe that conditions will deteriorate.

Looking twelve months ahead, 20 per cent see conditions as improving and 36 per cent see them as deteriorating. The confidence index for looking twelve months ahead currently stands at 71 compared with 49 in the previous survey. The ratio of those who think the economy will deteriorate is therefore shrinking relatively. Looking at individual sectors, companies in fisheries and fish processing are generally more optimistic for the next twelve months, compared to other sectors.

The confidence index



Only 10 per cent of respondents said that their companies were at present operating in excess of normal capacity, 45 per cent thought they were running at or close to capacity and a similar percentage said they were running below capacity. There is not much difference between responses in the capital area and the regions. As to individual sectors, the construction industry and various specialised services are close to or above normal capacity. The survey also asked whether the capacity situation was expected to remain unchanged over the next six months and 90 per cent thought it would.

Treasury revenue in January

12 month changes (%)	*2004-2005*	*2005-2006*
Total tax revenue	28.8	37.6
Income taxes	35.2	54.3
Social security taxes	60.7	11.2
Asset taxes	15.6	14.2
Indirect taxes	34.4	15.0
Total revenue	27.0	37.6

Treasury expenditure in January

12 month changes (%)	*2004-2005*	*2005-2006*
Administration	8.9	6.5
Social affairs	-1.6	10.1
Economic affairs	-19.8	-2.5
Interest	141.0	-76.6
Other	1.7	4.3
Total expenditure	2.4	0.7

Treasury finances in January

Million krónur	*2005*	*2006*
Cash from operations	2,655	13,926
Net financial balance	5,874	12,849
Debt redemption	-11,135	-4,049
Gross borr. requirement	-5,261	8,470
Net borrowing	5,563	1,532
Overall cash balance	302	10,002

Economic indicators

12 month changes (%)	*2004-2005*	*2005-2006*
Inflation (March '06)	4.7	4.5
Core inflation (March '06)	4.7	4.2
Wage index (Feb. '06)	6.7	8.6
Total turnover (Jan. - Dec. '05)	12.2	8.9
Retail turnover (Jan. - Dec. '05)	5.1	5.5
Unemployment rate (Feb. '06)	2.4	1.2

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