



## Highlights

# Budget Proposal

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## Budget highlights for 2008

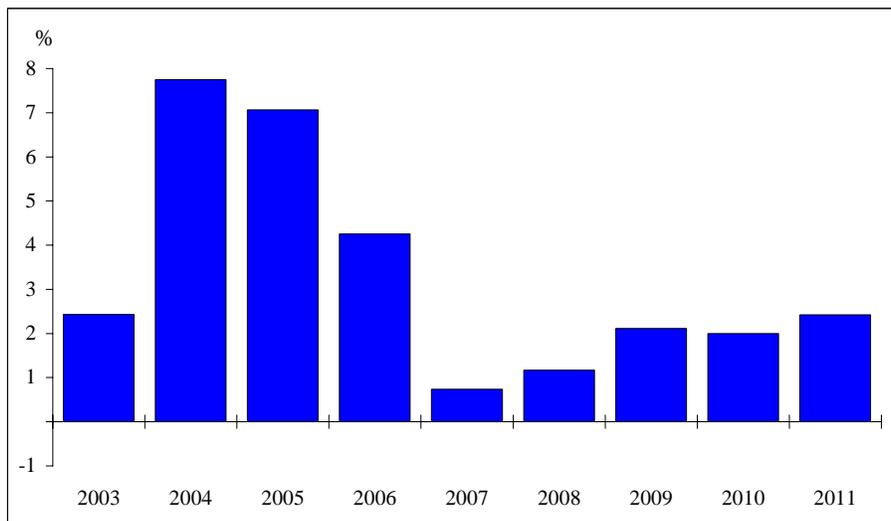
### 1. Economic policy and the objectives of the fiscal budget

#### A responsible economic policy is a precondition for a welfare society

In the Government's [Policy Statement](#), emphasis is placed in the need for a prudent economic policy as a precondition for a vigorous economy and improving welfare. The goal of economic policy is to ensure economic stability with low inflation, a low level of interest rates, a balance on the external account in the long run, a stable and vigorous growth and continued strong Treasury finances. Large-scale investment projects, changes in the tax system and other economic policy measures will be timed in light of these objectives. A competitive environment will be created for Icelandic businesses to assist in their growth and to attract business from abroad.

Iceland's economy is being driven by entrepreneurship and business agility. The change in the economic structure and increased involvement in the international economy have created a phase of strong growth with the emergence of new business sectors and market innovations.

#### Economic growth



The supply of inexpensive foreign credit into the economy has strengthened the exchange rate and contributed to the increase in prices of real property and stocks. The assets of companies and households have increased well in excess of debt, both at home and abroad. This, together with power-based investments, a rise in incomes and a high level of economic activity, has led to a sharp increase in domestic demand.

### **The economy is returning to a better balance**

Although economic policy has been steadily tightened in recent years, the momentum of the economy turned out to be greater than expected with the effect that inflation and the current account deficit have temporarily increased. As the current power-based investments are drawing to a close, a turnaround in demand and the current account balance is expected. Economic growth will revert to a more moderate pace, and the external account is projected to move towards a better balance along with lower inflation.

### **Treasury surplus rose sharply**

The 2006 Treasury surplus turned out to be much higher than projected in the fiscal budget, including the supplementary budget, 7.1 per cent of GDP. For 2007, the surplus is estimated at 5.4 per cent of GDP, also considerably higher than projected in the 2007 budget.

### **The contraction in business investment will be offset**

In order to offset the expected decline in national expenditure, Treasury investment spending will be increased in 2008. In addition, the regional infrastructure must be strengthened. The increase is nevertheless only a fraction of the decline in business investment that will take place at the completion of power-based investments. For 2008, economic policy will take account of the fact that economic growth is slowing down. The fiscal budget calls for a surplus of 31 billion, 2.4 per cent of GDP. The surplus will create room for further debt reduction, thus reducing interest costs and increasing deposits with the Central Bank.

### **A responsible fiscal policy**

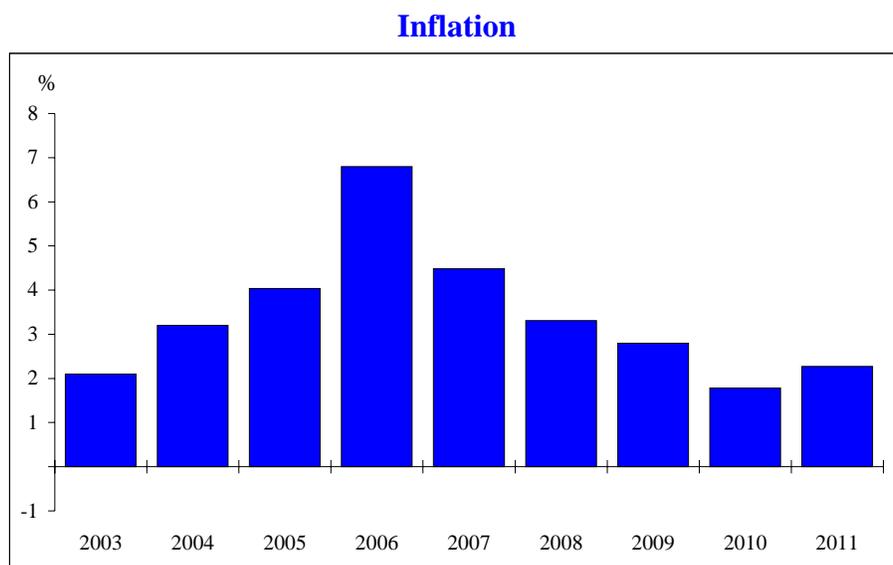
A counter-cyclical fiscal policy is an important prerequisite for economic stability. As in previous years, the Government's medium-term fiscal projection covering the next four years is presented along with the fiscal budget. In accordance with the Government's Policy Statement, a frame budget will be drawn up to prioritise government projects over the next several years, taking account of economic policy objectives and other issues of emphasis by the Government.

### **A more diverse economy**

The Icelandic economy is undergoing rapid change. The economy has become more diverse and robust. The fisheries sector is still the basic export industry, whereas increased power-based production, tourism and high-tech sectors have strengthened the export structure. The ability of the economy to sustain a higher standard of living in an international environment has thereby increased. Icelandic businesses have attracted attention with their foreign ventures and Icelandic assets abroad have been increasing.

The change in the economic structure as well as the impact of globalisation has done much to improve the economic conditions of both households and business. Today, our economic conditions are on par with, if not better, than in our main customer countries. The Government intends to cut personal and business taxes during its period of office. The Government will review the tax and social security regime in order to improve the lot of people with low and

middle incomes. It is important that companies can operate under a stable and encouraging tax environment. The privatisation of public enterprises in finance and communications has strengthened these sectors. The changed business environment has also helped companies and individuals participate in the globalisation of the economy that has been rapidly increasing in the past decade.



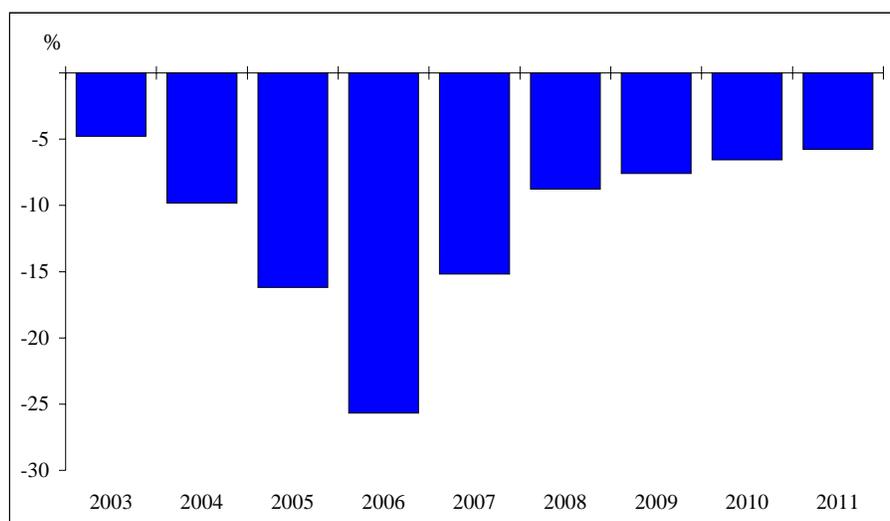
### **Inflation is declining**

In addition to a large fiscal surplus, monetary policy has been tightened with an increase in the policy rate in order to dampen domestic demand and reduce inflation. In spite of considerable fluctuations, the exchange rate has been high in 2006 and 2007. This, along with continuing asset price increases, has contributed to higher household demand than otherwise would have been the case. Due to the restraint of economic policy and the completion of power-based investments, the expansion in demand is declining. Inflation is forecast to decline down to the target level of the Central Bank. The current account deficit will also shrink rapidly and the economy will be in better balance.

### **The Icelandic economy is strong**

Most economic measurements show that Iceland rates high by international comparison. Economic growth has been strong and per capita income is amongst the highest in the OECD-countries. Unemployment is far below the level prevailing in neighbouring countries. Icelandic companies are characterised by their agility and entrepreneurship. Looking at the longer term, it emerges that the state of our economy is better than in most other countries. Our pension system is stronger, since it is largely fund-based rather than on the basis of current financing. Treasury finances are in very good shape, both as regards the fiscal surplus and Treasury debt.

### Current account balance



### Economic stability

The main thrust of the fiscal budget and the medium-term fiscal projection is to maintain economic stability at a time when power-based investments are completing and domestic demand is declining. In these circumstances, fiscal policy is being eased in 2008 in line with the Government's policy objective of maintaining economic stability.

## 2. Main elements of fiscal finances

### 2.1 Fiscal finances in 2007

#### Fiscal surplus exceeds the budget by far

The finances of the Treasury have been reassessed in light of economic and fiscal developments in the course of this year. The table below shows the 2006 Treasury accounts along with the estimate for the 2007. The 2006 surplus was higher than assumed in the budget plus the supplementary budget, amounting to 82 billion krónur. The same may be said for the 2007 surplus that is estimated to be far higher than in the budget. The 2007 revenue surplus is estimated at 66 billion, compared to a figure of 9 billion in the 2007 budget. The surplus amounted to 7 per cent of GDP in 2006 and is estimated at 5.4 per cent this year. Fiscal finances have thus done more to dampen demand than earlier estimated.

### Treasury finances

Billion krónur, current prices	Accounts 2006	Budget 2007	Estimate 2007	Budget proposal 2008
Revenue.....	422.0	376.4	448.2	461.2
Expenditure.....	340.2	367.3	382.2	430.4
<b>Revenue surplus .....</b>	<b>81.8</b>	<b>9.1</b>	<b>66.0</b>	<b>30.8</b>
Non-financial current items.....	5.9	-2.4	-13.4	-6.4
<b>Cash from operations .....</b>	<b>87.7</b>	<b>6.7</b>	<b>52.6</b>	<b>24.4</b>
Financial transactions.....	-104.9	3.0	-65.5	7.5
<b>Net financial balance.....</b>	<b>-17.2</b>	<b>9.7</b>	<b>-12.9</b>	<b>31.9</b>

Treasury revenue was estimated to amount to 376.4 billion in the 2007 budget. This estimate has now been increased to 448.2 billion, 72 billion higher than the budget figure. There are a number of reasons for this increase. Income from the capital income tax has increased due to increasing asset prices.

#### Revenue increases faster than expenditure

Furthermore, revenue from the personal income tax, social security contributions, import duties and the value added tax have all increased more than expected. Private consumption, money wages and the population have all increased more than was assumed in the drafting of the budget last autumn. In addition, the increased surplus has helped increase Treasury interest income.

Total Treasury expenditure in 2007 is estimated at 382.2 billion, compared with 367.3 billion in the budget, an increase of close to 15 billion. On a cash basis, the excess of expenditure over the budget amounted to 8.7 billion. The main reasons for the excess is that the write-off of tax claims exceeded the budget by 4 billion and a special non-recurrent charge of 1.1 billion was expensed due to the discounted difference between interest income and financing costs of social housing. Contributions to the Municipal Equalisation Fund increased by 1.8 billion, mostly due to the linkage to Treasury revenue and the decision to provide a special temporary appropriation of 700 million krónur to the Fund. Interest expenditures increase by more than 1 billion and the capital income tax paid by the Treasury by 0.6 billion. The Government's measures to mitigate the impact of the cut in the cod catch and in line with the proposals of the Westfjord Committee call for another 1.3 billion. Furthermore, a 1.2 billion capital contribution will go to the Regional Development Institute, a total of 2.5 billion. Pension expenditures of the Social Security Institute increase by more than half a billion krónur, due to the decision of the Government to ease the income-linkage of pensions. Finally, the cost to the health insurance scheme of drugs exceeded estimates by half a billion. Other changes are minor and are detailed in the notes to the 2007 supplementary budget.

The 2007 surplus is estimated to amount to 66 billion and cash at hand from operations to 55 billion. The net deficit from financial transactions is estimated at close to 66 billion, leaving a

borrowing requirement of 13 billion. One of the reasons for the deficit is the 30 billion purchase by the Treasury of the share of local governments in Landsvirkjun and the decision to increase the capital of the Central Bank by 44 billion. Furthermore, the capital of the Regional Development Institute will be strengthened with a 1.2 billion contribution, which is a part of the Government's measures to mitigate the impact of the cut in the cod catch, as noted earlier. Finally, the Communications Fund will be receiving 500 million for its initial capital. These appropriations are offset by the 7.6 billion proceeds from the sale of the Treasury's stake in Hitaveita Suðurnesja.

## **2.2 The main elements of the 2008 fiscal budget**

### **A continued Treasury surplus**

The 2008 Treasury surplus is estimated at 30 billion krónur, a better result than the medium-term forecast foresaw in the budget of last year, when a deficit of 5 billion was predicted. Cash at hand from operations is projected to amount to 24 billion and the net financial surplus to 32 billion of which 4 billion will be used to prepay future pension commitments of the Treasury, repay 14.5 billion in outstanding debt and deposit 13 billion with the Central Bank. The Treasury's position is thus seen to strengthen next year in spite of a considerable increase in spending on communications and on measures to offset the cut in the cod catch.

Treasury revenue is estimated to amount to 461.6 billion in 2008, an increase of 77.3 billion over the medium-term projection presented in the autumn of 2006. Most of the increase is attributable to the revenue forecast for 2007 that in turn is based on a new macroeconomic forecast. It is also being assumed that wages and prices will rise more next year than was assumed in the Ministry's spring forecast. The Treasury's interest income is also projected to increase due to an increased cash reserve.

### **Expenditure increases due to infrastructure investments**

Total expenditure in 2008 is estimated at 430 billion, an increase of 48 billion over the estimate for this year. Expenditure would thus increase by about 8 per cent in real terms between years, based on this year's estimate. The increase is largely due to higher appropriations for roads and other communications in line with the Communications Projection and the use of the proceeds from the sale of the government telephone company. The general current expenditure, covering wages and purchases of goods and services, are projected to increase by 1.7 per cent in real terms from this year's estimate, of which 0.7 per cent are due to the fact that the Treasury is assuming responsibility for tasks arising from the departure of the US Defence Force. Transfer payments are expected to increase by just over 4 per cent in real terms, in part on the basis of a forecast of increasing unemployment and the reduced income linkage in the social security system. Appropriations for investment will increase by 116 per cent in real terms, mostly, as noted before, because of a sharp increase in spending on roads and other communications. This increase constitutes the bulk of the increase on overall expenditure.

## Education and welfare a priority

In accordance with the Government's policy, the growth in current expenditure is kept small, 1.7 per cent, and most of it goes to education and welfare. On the welfare, side, appropriations are increased to make a special effort to meet the needs of the mentally disabled and place emphasis on issues related to children and young people. Increases in education expenditures are primarily directed to universities and research funding. Defence expenditures increase considerably due to the departure of the Defence Force, especially due to the takeover of the radar system. Finally, there are appropriations for measures intended to mitigate the impact of the cut in the cod catch and for aid to developing countries.

Transfer payment increase by more than 4 per cent in real terms. The increase is in part due to forecasts of rising unemployment, in addition to an increase in pensions in accordance with an agreement with the Association of Senior Citizens and the decision of the Government to ease the income linkage associated with pension payments. Appropriations to the Student Loan Fund increase because of the rising number of student borrowers. Outlays to the Municipal Equalisation Fund increase because of their direct link to total Treasury revenue and the local government income tax base. Furthermore, the Government has decided to allocate temporary appropriations to the Fund to help communities with declining populations. Finally, spending for job retraining will be increased.

Treasury investment spending more than doubles between 2007 and 2008. The increase is particularly directed to communications, where investments were temporarily postponed in earlier years, in addition to the fact that the allocation of proceeds from the sale of the government telephone company, will now be allocated. Spending on roads will thus increase by 14 billion, on harbours by 1.4 billion and on aviation by 1.5 billion. Furthermore, 2 billion will go to a new coast guard vessel and purchases of aircraft for the Coast Guard.

## Expenditure restraint

A number of measures have been undertaken to reduce the expenditure side of the budget bill next year, for a total saving of 5.6 billion. A part of the appropriation to the so-called Sundabraut project will be postponed for a saving of 1.5 billion. Secondly, the ministries have implemented savings in the current expenditures of their respective agencies and their tasks amounting to 2 billion. Finally, a number of measures are going to be implemented to reduce transfer payments and price equalisation spending in addition to a postponement of construction projects.

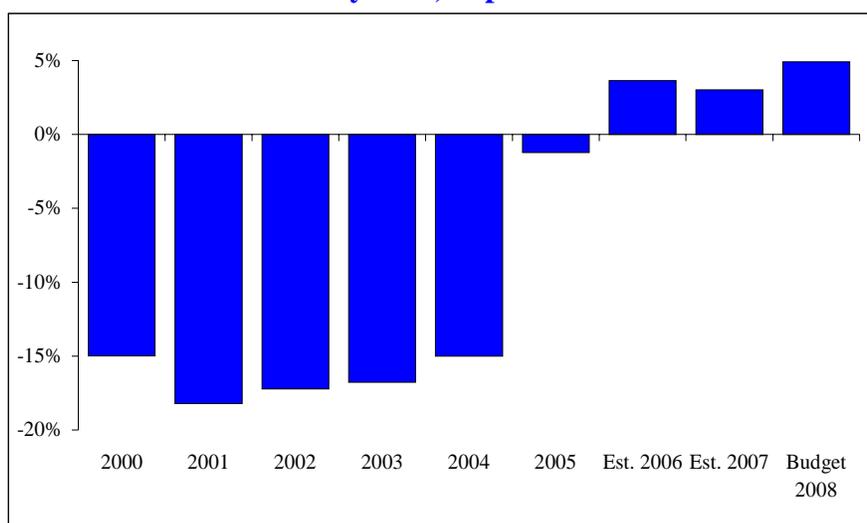
### Revenue surplus, excluding irregular items

Billion krónur	Acc. 2004	Acc. 2005	Acc. 2006	Budget 2007	Est. 2007	Budget proposal 2008
<b>Revenue surplus .....</b>	<b>0.5</b>	<b>112.8</b>	<b>81.8</b>	<b>9.1</b>	<b>66.0</b>	<b>30.8</b>
Irreg. expenditure.....	23.5	13.9	24.5	10.8	14.8	15.0
Irreg. revenue .....	1.1	64.1	15.3	0.5	6.1	0.5
<b>Rev. surpl. excl. irreg. items</b>	<b>22.9</b>	<b>62.6</b>	<b>91.0</b>	<b>19.4</b>	<b>74.7</b>	<b>45.3</b>

### A stronger Treasury surplus

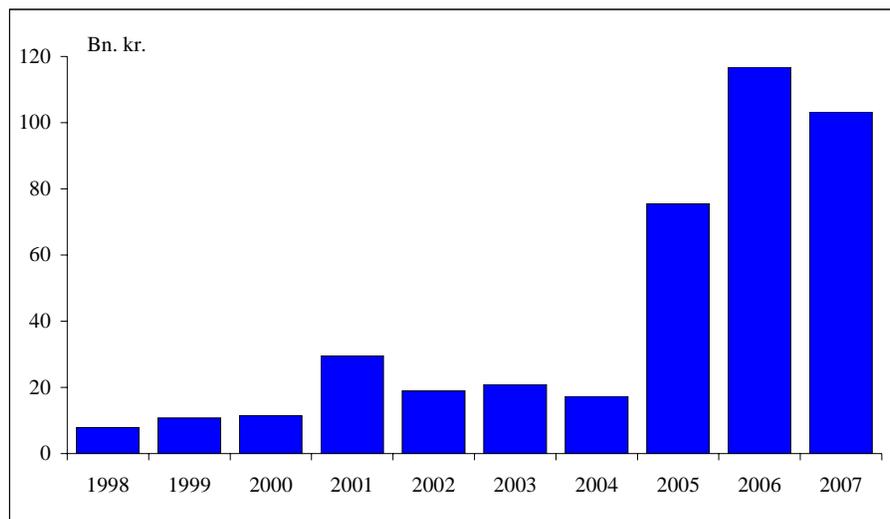
Adjusting for irregular revenues and expenditures, the Treasury surplus is estimated to amount to close to 46 billion next year. Irregular revenues cover such items as the profit from the sale of company shares and the revaluation of assets. Irregular expenditures include pension fund commitments and tax claims written off. The Treasury balance thus calculated, along with the net financial balance, gives a more realistic picture of the impact of Treasury finances. The financial surplus is estimated at 32 billion next year. The above table shows that the surplus, excluding irregular items, has averaged 59 billion a year in the past three years.

### Net Treasury debt, in per cent of GDP



The strength of Treasury finances has since 2006 led to a net surplus on interest income in excess of interest payments. Next year, net interest income is estimated at 3.5 billion krónur. The reason for this net balance is that the surplus of recent years has been used to increase deposits with the Central Bank, reduce Treasury debt and to prepay future pension commitments. At the end of 2006, Treasury deposits with the Central Bank amounted to 117 billion, excluding the support to the foreign exchange reserves that was financed with a Eurobond issue. Total prepayments of future pension commitments amounted to 126 billion at the end of last year, including accumulated interest. The net debt of the Treasury is estimated at 4.9 per cent of GDP next year compared with 23.4 per cent in 1998. Prospects are that the net debt ratio will improve further this year and next, if the projections of the budget bill are realised.

### Treasury balance with the Central Bank



#### A diverse economy demands education

The robust growth of the Icelandic economy and its rapid diversification is in no small measure due to the influence of globalisation and the opening of the economy to international market forces. The labour market has thus become more diverse, and demand for highly educated people is keen. The Government will support these changes by strengthening the education system and research efforts at the same time as the operating environment of businesses will be improved. The strength of Treasury finances will make it possible to mitigate the impact of the cut in the cod catch with measures that will strengthen the economy and education. Furthermore, strong Treasury finances will be used to improve the lot of senior citizens and the disabled. The Ministry of Social Affairs has appointed a committee that is entrusted with the task of revising the social security system. The affairs of senior citizens and a part of social security are being transferred to this Ministry as of the beginning of next year. The mandate of the committee is to present uniform proposals for a long-term policy and legislation needed for achieving such goals in accordance with the Government Policy Statement. It is evident that the task of the committee is wide-ranging and therefore important that improvements in one area will not lead to cuts in another. The committee is expected to present its initial proposals before the end of this year so as to hasten their implementation. In the budget proposal, substantial amounts are allocated to strengthen the foundations of the economy with a special effort in communications. By repaying debt next year, a basis is being laid for further improvements.

### 2.3 Changes in the division of tasks between ministries

#### Simplification and modernisation of government operations

In accordance with the Government's Policy Statement, public administration will be modernised and simplified. Electronic public administration will be strengthened in order to increase efficiency and simplify the communication between the people and the public authorities. A

reorganisation of the task between ministries is an important part of this effort. The Government Offices Act was amended in the spring session of the Althingi. The ministries of agriculture and fisheries were merged, and Statistics Iceland was changed from a ministry into an independent government agency. Certain tasks were transferred between the ministries of health and social affairs. Further work on the division of tasks between ministries in accordance with the goals of the Government towards a more efficient public administration is well under way. Such tasks, along with associated funding, will be transferred between ministries in the second reading of the budget proposal. By presenting a uniform set of proposals at the second reading, a suitable platform for discussion of reorganising the public administration will take place in the Althingi. This will include a comparison with the fiscal budget of the previous year and the government accounts. The intention is to let the changes take effect at the beginning of next year, at which time an amended Government Offices Regulation will be issued.

### **3 The medium-term projection, 2008-2011**

#### **3.1 Introduction**

##### **Expenditure kept within limits**

The Government presents every year, along with the fiscal budget proposal, its medium-term economic and fiscal projection, where limits are placed on the growth of fiscal expenditure, but without setting out specific priorities through budget frames for the next three years. Instead, the priority of tasks is reviewed in the fiscal budget proposal each year in accordance with the Government's goals.

Pursuant to the Government Financial Reporting Act of 1997, the Government now presents its medium-term fiscal projection for the years 2008-2011. In the Government's Policy Statement, it is stated that the Government will present a frame budget for the next four years each year, where the main elements of economic policy are presented in addition to references regarding the revenue and expenditure of the Treasury at the same time as the service tasks and investments of the Treasury will be placed in an order of priority. The drawing up of a frame budget is thus a logical compliance with the policy set out in the Government Financial Reporting Act.

##### **The frame budget for coming years**

The Government is currently working on the priority of its tasks. This is the first time that this is done. Since the present Government has only been in office for a short while, it is a formidable task to prioritise its service tasks for the next four years. A revised projection is being drawn up and will be presented in the spring session of the Althingi, where the Government will present its prioritisation of tasks in line with the points of emphasis in the Government's Policy Statement.

### **The oldest and the youngest generations will receive priority**

The frame for the next several years places emphasis on the issues affecting the oldest and the youngest generations. Furthermore, the Government intends to continue its investment in communications, health and social affairs. A comprehensive policy has already been drafted for issues affecting children and young people. The number of nursing home beds will be increased and nursing assistance to older people living at home will be strengthened.

### **Emphasis on improving the lot of older people and disabled persons**

A special effort will be made to help older people and the disabled by simplifying the social security system and especially review the interaction between social support payment, payments from pension funds and income from employment. The aim is to ensure greater fairness and encourage the procurement of income and saving. In accordance with the Government's Policy Statement, the income linkage and curtailment of benefits in the social security system will be eased. The first steps in this direction have already been taken with the resolution of the Althingi this past summer to abolish the cut in pensions from the social security system due to income from employment for persons 70 years or older.

### **Investment in education and research**

The Government will endeavour to continue its investment in research and the educational system of the nation and the increase in appropriations to research funds over the next several years. The variety of educational choices will be increased, emphasis will be placed on greater choice of courses and individually directed education will be increased, in part to reduce the drop-out rate of students from secondary schools. Emphasis will be placed on education in art and crafts as well as occupational and educational counselling. New educational opportunities will be created for those who only have completed their compulsory education. Adult education within the school system and in the labour market will be strengthened. The teacher education projection will be extended, and the Student Loan Fund Act revised with the aim of further improving the lot of students.

### **Infrastructure investment**

The frame budget for the next several years will emphasise infrastructure investments in roads, harbours and other transport as well as in telecommunications. This is already evident in sharply increased appropriations to communications in the budget proposal, a 150 per cent increase from the 2007 fiscal budget.

### **Preventive healthcare**

Preventive healthcare will be sharply increased in all areas. The drug crisis will be met with increased education and preventive measures, support to families in difficulty and a range of detox and rehabilitation facilities. The cost analysis of health services will be improved and financing will be reorganised so as to create a direct financial link to patients. Services to the mentally disabled will be increased, especially to shorten the waiting lists of children and young people with mental disturbances.

### **3.2 The main points of the Government's economic policy**

#### **Economic stability**

The Icelandic economy has become vigorous on the basis of structural reforms, infrastructure investments and the increased involvement in the international economy. The substantial creation of wealth in recent years has led to an unprecedented improvement in the living standard of the people. This significant success has on the other hand led to a temporary imbalance that is reflected in inflation in excess of the inflation target, a rising level of interest rates and an increasing current account deficit. The aim of the Government in economic policy is to ensure stability in the economy with low inflation, a low level of interest rates, a better balance on the current account, a continued strong and even rate of GDP growth and sound Treasury finances.

#### **Tax cuts**

In accordance with the Government's Policy Statement, the aim is to cut personal taxes during the term of office in order to improve the lot of people with low and middle incomes. Ways will be sought to reduce company taxes. Changes in the tax regime and other economic policy measures will be timed with respect to the main economic policy goals of the Government.

The main guideline for managing Treasury revenue will be to see to it that the Treasury revenue balance will be in equilibrium over the business cycle and that it will contribute to economic stability at all times. The aim with tax changes and the strengthening of the welfare system is to increase the productive capacity of the economy and the economic wellbeing of the people.

### **3.3 The goals and premises of the medium-term projection**

#### **A responsible financial management**

In the Government's Policy Statement, the goal is stated that the ratio of Treasury expenditure to GDP should not increase from its present level. The Statement also includes goals of continued strong Treasury finances and prudence in Treasury operations. The aim is to maintain sound Treasury finances by aiming at a balance over the business cycle.

The Ministry of Finance has drawn up a forecast for the economic and financial prospects for the years 2008-2011. This forecast is used as a basis for the medium-term projection, together with the Government's Policy Statement.

#### **Increased economic activity used to reduce debt**

The increase in economic activity has produced a sizeable Treasury surplus in recent years. Most of the surplus is due to the automatic fiscal stabilisation effect that produces a surplus in times of expansion and a deficit during recession. The Treasury thus performs its counter-cyclical role by

withdrawing funds from the economy during an expansion and injecting funds in times of recession. Economic growth is forecast to be scant in 2008, about 1.2 per cent, but that the Treasury will continue to show a surplus, although revenue will increase less and expenditure more. Economic growth is expected to pick up in 2009-2011. The Treasury revenue balance is expected to dip slightly in 2009. Otherwise, assuming that Treasury finances will continue on their normal course, that the tax regime will remain unchanged but that public investment increases, the Treasury is projected to increase its surpluses over the next several years. The policy of the Government is to keep Treasury finances in balance over the business cycles by allowing automatic fiscal stabilisers to take place.

### Forecast of main economic aggregates

	Bn.kr. 2006	2006	2007	2008	2009
Private consumption.....	685.6	4.4	2.1	-0.9	-1.8
Public consumption.....	285.4	3.9	2.8	2.0	2.5
Investment .....	388.0	19.8	-22.2	-19.8	4.6
Change in stocks <sup>1</sup> .....	13.5	1.1	-1.0	0.0	0.0
<b>Total nat'l expenditure.....</b>	<b>1372.5</b>	<b>9.2</b>	<b>-5.2</b>	<b>-4.8</b>	<b>0.4</b>
Exports of goods and services.....	374.0	-5.1	8.7	9.2	3.9
Imports of goods and services.....	583.6	10.1	-9.8	-7.0	-0.5
<b>Gross domestic product.....</b>	<b>1162.9</b>	<b>4.2</b>	<b>0.7</b>	<b>1.2</b>	<b>2.1</b>
<b>Gross nat'l income .....</b>	<b>1076.2</b>	<b>1.2</b>	<b>3.4</b>	<b>1.2</b>	<b>2.3</b>
Impact of terms of trade <sup>2</sup> .....	-	1.3	0.0	0.2	-0.6
<b>GNI, incl. terms of trade .....</b>	<b>-</b>	<b>2.5</b>	<b>3.4</b>	<b>1.5</b>	<b>1.7</b>
<b>Current acc. balance.....</b>	<b>-298.7</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
In per cent of GDP.....	-	-25.7	-15.2	-8.7	-7.6

### Treasury finances in balance in the long run

The economic assumptions underlying the medium-term projection are in part based on forecasts by international institutions regarding economic developments in main customer countries. Forecasts on population and the labour force take account of developments in the construction of power projects and other power-based investments. Account is also taken of the probable development of exports, based on certain assumptions regarding the fish catch and aluminium production over the next several years. Should further power-based investments take place over the next several years, the medium-term projection must be revised with regard thereto.

The medium-term projection also assumes that a certain monetary policy will be pursued, in line with its main underlying assumptions. It is thus assumed that the Central Bank will keep its policy rate high but will begin to reduce it in the latter half of 2008.

### 3.4 The conclusions of the medium-term projection

### Economic growth and demand expected to moderate

The main conclusion of the medium-term projection is that economic stability will remain in spite of the rapid decline in power-based investments and a slowdown in the growth of domestic demand. Economic growth is expected to increase in 2008-2011. The current account deficit is expected to decline rapidly in the beginning of this period when aluminium exports start growing. Inflation has declined in 2007 and is forecast to decline down to the Central Bank's inflation target in the latter half of 2008. It is assumed that wages increases in collective bargaining agreements in 2008 will be modest, further price increases will be avoided and real wages will continue to increase.

### Much higher surplus than anticipated

The sizeable Treasury surpluses of recent years have been used to reduce debt and shrink the Treasury's interest payments. For 2007, the surplus is estimated at the equivalent of 5.4 per cent of GDP, declining to a projected 2.4 per cent in 2008. This represents a significant change from the previous forecast, which assumed a surplus of 9.2 billion in 2007, 0.8 per cent of GDP, and a deficit of 4.8 billion in 2008, 0.4 per cent of GDP. This is being achieved in spite of a sizeable increase in spending on measures to mitigate the cut in the cod catch and on improving the welfare system.

Based on the assumption that the public consumption expenditures of the Treasury will not increase on average by more than 2 per cent a year in real terms and that of transfer payments by no more than 2.5 per cent a year and that investment spending will be used to moderate the business cycle, the medium-term projection for fiscal finances is shown in the following table, based on estimated current prices.

#### Forecast of Treasury finances

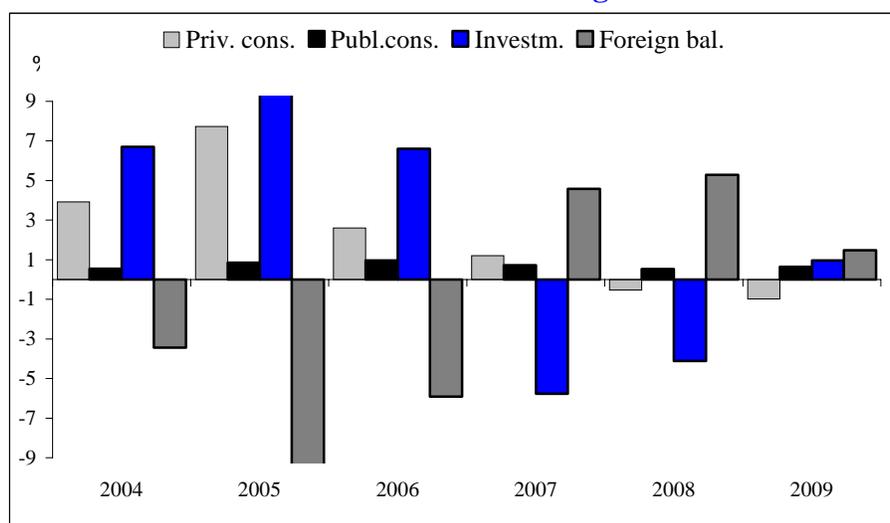
Billion krónur	Accounts	Estimate	2008	2009	2010	2011
	2006	2007				
Total revenue .....	422.0	448.3	461.2	465.9	495.7	520.6
Of which: Tax revenue .....	377.2	404.8	422.3	432.6	462.4	486.0
Total expenditure .....	340.2	382.2	430.4	454.6	468.8	485.3
Current expenditure .....	160.6	175.5	185.9	198.7	210.1	222.2
Interest payments .....	14.9	21.7	21.8	21.8	22.3	22.6
Transfer payments .....	141.9	160.4	174.0	183.1	192.4	200.6
Maintenance .....	5.8	5.5	6.1	7.2	7.7	8.0
Investment .....	17.0	19.1	42.7	43.8	36.3	31.9
Revenue balance .....	81.8	66.0	30.9	11.3	26.9	35.4
Financial balance .....	-17.2	-12.8	32.6	10.7	25.4	22.7
Hreinar skuldir ríkissjóðs .....	49.8	63.4	49.7	47.7	50.2	29.4
<b>In per cent of GDP: .....</b>						
Total revenue .....	36.3	36.5	35.7	34.3	34.6	34.6
Of which: Tax revenue .....	32.4	33.0	32.7	31.8	32.3	32.3
Total expenditure .....	29.3	31.2	33.4	33.4	32.7	32.2
Revenue balance .....	7.0	5.4	2.4	0.8	1.9	2.3
Financial balance .....	-1.5	-1.0	2.5	0.8	1.8	1.5
Net debt of the Treasury .....	4.3	5.2	3.9	3.5	3.5	1.9

## 4 A summary of the forecast

### Growth exceeded forecast for 2006

The Icelandic economy has been expanding continuously since 2003. Real GDP increased by 23.2 per cent from 2003 to 2006 and the population by 5.2 per cent, leaving an increase in per capita GDP of 17 per cent for the entire period, about 4 per cent a year. Services and construction have been the main sectors contributing to the increase. Real wages have increased in line with economic growth. The revised figures from Statistics Iceland show that GDP growth in 2006 was 4.2 per cent, whereas its earlier figure was 2.4 per cent lower. Gross national income, i.e. GDP plus net factor income from abroad, increased by 1.2 per cent, and national income including the impact of the terms of trade increased last year by 2.6 per cent in real terms. National expenditure on consumption and investment increased by more than 9 per cent of GDP, the difference being reflected in the current account deficit that amounted to nearly 26 per cent of GDP.

### Contributions to economic growth



### Real wages increase rapidly

Real wages increased sharply last year, by 8.6 per cent per capita. At the same time, private consumption spending increased by 4.4 per cent in real terms per capita. This indicates that consumers have not financed their private consumption with borrowing or reduced saving, as has been the case in recent years when the growth in private consumption exceeded the growth in real wages. The sharp and consistent growth in private consumption in recent years has undoubtedly been associated with the rise in asset prices, a high level of employment and sharp wage increases along with a strong rate of exchange and, last but not least, expectations of a rise in real wages in coming years.

### **Labour shortage**

Registered unemployment declined still further last year, to 1.6 per cent of the labour force. The number of unemployed declined by close to 700 persons from the year before. Substantial imports of foreign labour have characterised the domestic labour market. The foreign workers have been working on the power-based construction projects but are to an increasing extent engaged in general construction work and in various service sectors. Their entry into the labour market has undoubtedly helped reduce strains on the economy. In spite of this influx of foreign labour, the labour market is still quite strained which indicates that pressures for wage increases will be somewhat higher than assumed in earlier forecasts. Unemployment is expected to average 1.1 per cent of the labour force this year. There is a labour shortage and vacancies are difficult to fill. Wages are therefore expected to increase by 9 per cent and the consequent pressure on prices is still great.

Inflation, as measured by the consumer price index, was 4.0 per cent in 2005 and 6.8 per cent in 2006. The rise in the inflation rate is mostly attributable to housing prices and an increasing output gap between 2005 and 2006. The structural changes in the economy and the impact of globalisation have made economic management more complicated than before. In spite of a tight economic policy in recent years, the growth in domestic demand has been higher and more persistent than predicted. The changed circumstances have stimulated business initiative and improved household finances.

### **Sizeable power-based construction projects about to be completed**

Power-based investment projects are coming close to completion in the course of this year. As a share in total investment, they have declined by about half between 2006 and 2007. The total investment in power projects, transmission lines and the construction of aluminium plants in Reyðharfjörður and Grundartangi is estimated to amount to 310 billion krónur at 2006 prices. The foreign share in these projects is estimated at 59 per cent and the total use of man-power about 10,400 man-years of which more than 60 per cent comes from foreign labour. Upon completion, the production capacity of aluminium plants is expected to increase by 525,000 tonnes a year or by close to 190 per cent over the 2003-level, before the present power-based projects commenced. At the same time as power-based investments were accelerating, other business investment increased sharply in the wake of a considerable decline in the years before the power-based investments began.

### **No further power-based investments are assumed**

In the Ministry's forecast, it is not assumed that power-based investments will continue in the near future. It is customary in the Ministry's forecast not to assume that such investments take place until their go-ahead is actually confirmed, even if they are likely to be realised. Power-based investments will be timed in accordance with economic policy objectives.

In the Ministry's forecast, GDP growth in 2007 is estimated at 0.7 per cent, accelerating in 2008 and 2009. Inflation is forecast to decline over time, but the Central Bank's 2.5 per cent inflation target is not expected to be reached until in the first half of 2009. Unemployment is expected to increase slightly in 2008 and 2009.

### **Increased exports forecast to carry economic growth**

A sizeable reversal on the external account is expected to take place in 2007, mostly because of sharply increasing aluminium exports along with a decline in imports. Furthermore, the services account and net factor payments are also expected to improve. Together, the current account deficit is forecast to shrink to about 15 per cent of GDP from 26 per cent the year before. The high prices for fish exports and aluminium are expected to lead to an improvement in the terms of trade, despite high oil prices.

In the national economic forecast, it is assumed that the exchange rate index will average close to 119 in 2007, 2 per cent stronger than the year before. The exchange rate strengthened substantially around the middle of this year, when the index stood at 110. This temporary strength only led to limited price declines. Conversely, the subsequent decline in the exchange rate is not expected to be fully reflected in rising prices. The exchange rate is assumed to remain broadly unchanged between years and strengthen by 0.4 per cent in 2008, followed by a slow exchange rate decline in subsequent years until 2012 at which time the exchange rate index is assumed to stand at 130. Account is thereby taken of a reduced foreign exchange inflow and a declining real interest rate level. It is seen as uncertain that the issue of so-called krónur (or glacial) bonds will continue. These bonds have mostly been bought by foreign investors.

### **Short-term inflation prospects have become worse**

Inflation declined in the first half of 2007, but inflation prospects have deteriorated slightly in the wake of the exchange rate decline in the latter half of the year. Inflation is expected to average 4.5 per cent this year over last year's average. For next year, inflation is forecast to average 3.3 per cent and 2.8 per cent in 2009. Should the exchange rate actually decline in the near term and inflation prospects as a result, an economic policy response may be called for. A high real rate of interest will in the end reduce household and business demand and pave the way towards a better equilibrium in the economy. The objective of the Central Bank is to prevent high inflation expectations from imbedding themselves when inflation prospects worsen in the short run. This is especially important since the wage agreements of large unions will be up for negotiations in early 2008 and public sector wage negotiations will take place in the spring.

A tighter fiscal policy may also prove necessary, in excess of the restraint provided by automatic fiscal stabilisers. It is important that the Treasury's fiscal rule will hold and that the local governments adopt such a rule for their finances. This would place a clear limit on the demand of the Treasury and the local governments. It is seen as important that fiscal policy operates in concert with monetary policy in order to ensure economic stability in future years.

### **The policy interest rate expected to be reduced in 2008**

In the national economic forecast, it is assumed that the Central Bank will maintain its high policy rate of 13.3 per cent and begin to reduce it in the latter half of 2008 as the output gap narrows in the course of that year. Inflation is expected to average 3.3 per cent between 2007 and

2008. The policy rate is therefore assumed to average 12.2 per cent in 2008 and decline to 6.8 per cent in 2009.

### **Continued adjustment towards equilibrium in 2008**

The course of economic developments in 2008 will be dominated by the adjustment of the economy towards equilibrium. Economic growth is expected to increase again, to 1.2 per cent. In spite of a 4.8 per cent contraction in national expenditure, the favourable development of the external account is expected to carry economic growth in 2008. The current account deficit is forecast to amount to 8.8 per cent of GDP in that year. As in 2007, the decline in national expenditure is attributable to reduced investment, although public investment is expected to increase substantially, by 27 per cent in real terms. Private consumption is expected to decline by close to 0.9 per cent and the growth in real hourly wages and disposable income is forecast to be lower in 2008 than the year before. Furthermore, unemployment is forecast to increase, the excess demand for labour to decline as well as wage drift. Unemployment is forecast to approach its equilibrium rate and average 2.9 per cent of the labour force.

### **Equilibrium reached in 2009**

A slight slack in the economy is forecast for 2009, even if national expenditure is projected to increase slightly, following a 10 per cent contraction in the previous two years. Economic growth is forecast at 2.1 per cent. The current account deficit is projected to decline further, to 7.8 per cent of GDP, and the year-on-year inflation rate is forecast at 2.8 per cent. Unemployment is expected to increase further and reach 3.6 per cent of the labour force.