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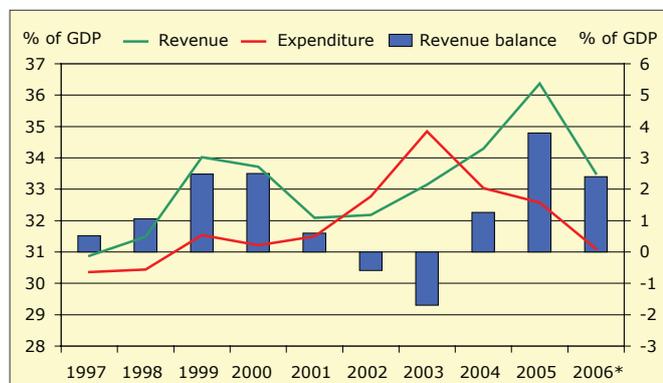
A new report on financial stability in Iceland

[A new report on financial stability in Iceland](#) by Frederic S. Mishkin and Tryggvi Þór Herbertsson has been published. In the report, many of the points made by the Ministry of Finance regarding the present condition of the Icelandic economy are supported. The report points out that the foundations of the economy are sound; the economic system is flexible, the pension fund system is self-sustaining and Treasury finances are especially sound. The increased current account deficit and accumulation of foreign debt are not signs of difficulty but rather a consequence of borrowing for profitable investment projects. Icelandic households are behaving rationally when they take advantage of a strong exchange rate to import durable consumer goods and in turn reduce such imports when the currency weakens. It is also pointed out that in spite of the rapidly increasing foreign borrowing of Icelandic banks, their foreign loans and assets have also increased rapidly. Since the risk assessment of the banks is sound and they are not vulnerable to fluctuations in the exchange rate, a sharp change in the exchange rate is not expected to threaten financial stability. Since the regulatory regime and the supervision of the financial market are efficient, the authors of the report reject that Iceland's position today can be compared to conditions in some Asian countries before the onset of a financial crisis almost one decade ago.

Fiscal restraint

In the above mentioned report, possible reforms of public sector finances in Iceland are discussed. On the one hand, it is considered helpful to adopt a fiscal rule whereby expenditure growth of central and local governments is limited to the productivity growth of the economy, and in doing so increasing automatic stabilisation and the efficacy of economic policy. On the other hand, it is observed that the degree of restraint in public finances has been insufficient when defined in terms of the cyclical impact calculated by the Central Bank.

Fiscal restraint



Since the Government adopted medium-term targets for Treasury finances in 2003, a determined effort has been made to reduce the growth in central government expenditure. The target was set of limiting the growth in public consumption to 2 per cent and that of transfer payments to 2.5 per cent. No target was established for investment, but a number of public investment projects were postponed in 2004-2006. Because of these measures, Treasury expenditure as share of GDP is projected to decline from 34.8 per cent in 2003 to 31.1 per cent in 2005, or by close to 4 per cent. Treasury revenue as share of GDP has, however, risen considerably and the revenue surplus increased considerably. In 2004 the surplus amounted to 1.3 per cent of GDP, to 3.8 per cent in 2005, and in 2006 it is estimated to amount to 2.4 per cent of GDP. This development is quite different

from the previous expansion when Treasury expenditure increased faster than GDP.

The present fiscal policy strategy is close to following a fiscal rule and is likely more restrictive than proposed in the report. The report supports the view of the Ministry of Finance that it is probably more efficacious to achieve fiscal restraint through setting of expenditure targets than to apply substantial discretionary measures. Such measures carry the risk of time-inconsistency which can amplify the business cycle rather than dampen it.

In assessing the impact of the business cycle on the degree of fiscal restraint, account is taken of the productive capacity of the economy or the economic growth rate consistent with price stability. It is evident that a growth rate of 5 per cent or more for several years in a row is likely to exceed the equilibrium growth rate. The question therefore is not whether there is excess demand in the economy at present but rather how much. The Ministry of Finance, which bases its calculations on internationally recognised methods, finds that there is considerable excess demand in the economy, although less than the calculation based on the special method of the Central Bank indicates. Furthermore, it is important to bear in mind that the opening up of the economy in recent years has increased productive capacity and reduced demand pressures, but the impact of globalisation to reduce inflation around the world has been evident in recent years. That effect, however, is likely only partially reflected in the above-mentioned calculations. On the basis of the Ministry's calculations of the output gap, the cyclically adjusted Treasury revenue surplus amounted to 0.8 per cent of GDP in 2004 and 2.8 per cent in 2005. For this year, it is estimated to be 1.3 per cent of GDP. In other words, the fiscal policy strategy is quite appropriate and fiscal restraint has been considerable in the current expansion.

New regulation on service agreements

The Ministry of Finance has issued a new regulation, [no. 343/2006](#) (available in Icelandic), concerning service agreements concluded by ministries and government agencies for a period longer than one year. This regulation replaces an earlier regulation, no. 262/1999, on the same subject. The agreements covered under this regulation are generally called service agreements. They are concluded under the provisions of Article 30 of the Government Financial Reporting Act no. 88/1997 and commit the Treasury for a longer period than one fiscal year. Such service agreements are concluded between the Treasury and the private entities, such as for the operation of nursing homes, educational institutions, services to the disabled, ambulance services and the operation of transport communications (buses, ferries etc.).

The regulation includes a number of amendments to improve the handling of cases and specifies work procedures, implementation, areas of responsibility and the role of those who represent the government sector. More specific demands are made regarding the professional preparation of those projects that constitute the basis for the agreements, especially their financial aspects.

The part of the regulation that deals with purchases has been considerably strengthened. Purchases on the basis of the regulation now come under laws and regulations on public purchasing and are therefore subject to general tender, if they exceed a certain minimum amount, unless special exemptions are provided for in law. Purchases shall be directed in such a manner that they strengthen and maintain competition and establish markets in areas where they presently do not exist. The State Trading Centre shall coordinate purchases and contractual negotiations in addition to providing general consulting counsel and instructions.

The regulation includes provisions covering the expiry of agreements where the service purchaser shall review the implementation of the agreement. Such a review shall constitute a basis for a decision regarding the continuation of the project or the renewal of a service agreement.

Treasury revenue January-March			Treasury expenditure January-March			Treasury finances January-March			Economic indicators		
12 month changes (%)	2004-2005	2005-2006	12 month changes (%)	2004-2005	2005-2006	Million krónur	2005	2006	12 month changes (%)	2004-2005	2005-2006
Total tax revenue	22.8	25.9	General public services	12.0	-2.0	Cash from operations	9 301	23 741	Inflation (April '06)	4.3	5.5
Taxes on income & profit	23.3	40.0	Health	13.1	6.3	Net financial balance	15 511	21 286	Core inflation (April '06)	4.6	4.6
Taxes on property	51.4	-16.3	Social security & welfare	3.4	8.6	Debt redemption	-11 404	-9 070	Wage index (March '06)	6.5	8.6
Taxes on goods & services	20.7	20.5	Economic affairs	5.2	-4.4	Gross borr. requirement	3 257	11 226	Total turnover (Jan. - Dec. '05)	12.2	8.9
Social contributions	20.5	16.1	Education	11.5	13.9	Net borrowing	1 094	1 532	Retail turnover (Jan. - Dec. '05)	5.1	5.5
Total revenue	22.9	25.5	Total expenditure	8.0	5.9	Overall cash balance	4 351	12 758	Unemployment rate (March '06)	2.3	1.2

Merchandise imports in April

Merchandise imports in April amounted to just over 27 billion krónur, to judge by provisional statistics derived from VAT proceeds. Imports are significantly lower than in March, when they amounted to 33 billion. At constant prices, it increased by 6.3 per cent over the past twelve months, and by 22.4 per cent based on a twelve-month change of quarterly averages.

The change from March is largely due to lower fuel imports. It is also notable that some consumer-related items are declining significantly. Auto imports decline in April, following unusually large imports in March, and well below the constant-price average of the past twelve months. Imports of other consumer durables (such as refrigerators and TVs) and semi-durables (such as apparel) also declined significantly between months. Imports of investment goods increase on the other hand, which is attributable to power project investments.