

# English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

October 5<sup>th</sup> 2006

## Merchandise imports in September

Provisional figures indicate that the trade deficit amounted to 7.7 billion krónur in September. The deficit has thereby shrunk for two months in a row. The steady increase in aluminium exports and the slower growth of imports, especially of investment goods, are most influential in the decline of the deficit. Exports amounted to 22.3 billion and imports to 30 billion. If provisional import figures based on the collection of the value added tax are viewed more closely, it emerges that imports have slowed down demonstrably since last year. At constant prices, three-month imports have increased by 3 per cent from last year, compared to a 40 per cent increase in the same period last year. Nevertheless, September imports are close to two billion higher than in August. The increase is mostly due to a higher fuel bill, which fluctuates from month to month. Imports of investment goods continue to decline for the third month. The same applies to raw materials and intermediate goods compared to the previous month. Imports of durable consumer goods declined between months while vehicle imports remained unchanged.

## A new forecast by the Ministry

The Ministry of Finance published a new [macroeconomic forecast](#) earlier this week. No major revisions were made to the previous forecast, published last June. The main conclusions are:

Provisional figures indicate that real GDP increased considerably in recent years, by 7.7 per cent in 2004 and 7.5 per cent in 2005, due to rapidly rising national expenditure. Business investment played a large role as well as increasing activity in the property market and the sharp growth in private consumption. The vigorous growth in domestic demand in recent years can to a large extent be attributed to innovations in the financial market that were mostly unforeseen.

Although these innovations are no doubt of benefit for the economy in the longer term, they exacerbated the imbalances in the economy in the short run in spite of increased economic policy restraint. Turbulence in financial markets earlier in the year led to a decline in the exchange rate and share prices. Currently, there are signs of slowing activity in the property market as well as in the growth of private consumption. For this year, GDP growth is forecast at 4.2 per cent.

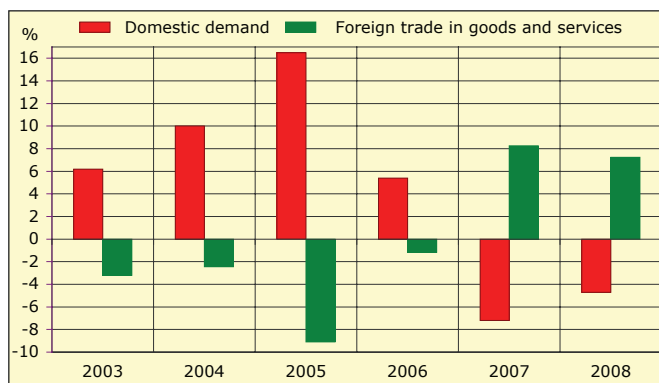
Investment is forecast to decline sharply as power-project investment will largely be completed in 2007 whereas private consumption is expected to decline less. A pronounced turnaround in foreign trade, due to increasing aluminium exports and declining imports, will drive economic growth over the next several years. Growth is forecast at 1 per cent in 2007 and 2.6 per cent in 2008.

The current account deficit amounted to 16.1 per cent in 2005 and is forecast to increase to 18.7 per cent this year, declining sharply to 10.7 per cent in 2007 and 3.8 per cent in 2008. The decline in the exchange rate facilitates the adjustment of the economy. Unemployment has declined sharply and is estimated at 1.3 per cent of the labour force this year, but is forecast to rise to 2.1 per cent in 2007 when the economy slows down. Due to a revision of the national accounts, the output gap is estimated to be bigger at present than previously thought, but is expected to unwind rapidly in coming years.

Due to a significant rise in property prices, inflation averaged 4 per cent in 2005. A decline in the exchange rate is expected to raise the inflation rate to an estimated 7.3 per cent on average this year. Inflation is forecast to decelerate to the Central Bank's inflation target of 2.5 per cent in the latter half of 2007, but to average 4.5 per cent for the year as a whole and 2.5 per cent in 2008. The main elements of uncertainty relate to the exchange rate, further power-intensive investments and international economic developments.

The following chart shows the evolution in the composition of GDP growth in terms of contributions from domestic demand and foreign trade until 2008. It shows clearly that the share of domestic demand is greater in the years 2003-2006, but the shares are reversed in 2007 and 2008 when economic growth is forecast to be driven by a significant improvement in foreign trade.

Components of economic growth 2003-2008



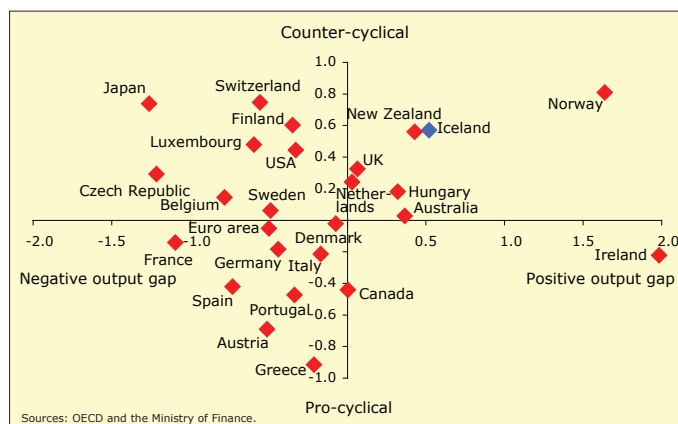
## Fiscal stabilisation in an international comparison

The Treasury surplus amounted to 5.6 per cent of GDP in 2005 and is estimated to amount to 4.0 per cent of GDP this year. The fiscal budget proposal projects a 1.5 per cent surplus in 2007. In light of the good structural surplus and small Treasury debt, it is evident that the state of Treasury finances is strong by international comparison. The favourable budget outcomes are also in line with automatic fiscal stabilisation role of the Treasury in the upswing.

An indication of this result is seen by viewing on the one hand the cyclically adjusted primary balance of the public sector and the output gap of the economy on the other. The contemporaneous correlation of these two economic indicators is of interest, since it reveals the impact fiscal policy has in the area of economic stabilisation. This has been researched for the OECD countries.

Reviewing the past decade, it emerges that up to eight countries have applied a counter-cyclical fiscal policy in a significant manner. Three of these countries, Norway, New Zealand and Iceland, also experienced a positive output gap over the period. The other five, Japan, Switzerland, Finland, the United States and Luxembourg, were on average dealing with slack in the economy. Iceland is therefore among the countries applying the most stabilising fiscal policy in the past decade. According to the data, only Norway pursued more restrictive fiscal policy under conditions of output pressure. By comparison, Japan applied counter-cyclical impetus through a significant build up of public debt in order to lift the economy out of a recession. This is a clear indication that fiscal policy in Iceland has had a greater counter-cyclical impact than in most other OECD countries.

Counter-cyclical impact of public finances in OECD-countries



Treasury revenue January-August			Treasury expenditure January-August			Treasury finances January-August			Economic indicators		
12 month changes (%)	2005	2006	12 month changes (%)	2005	2006	Million krónur	2005	2006	12 month changes (%)	2005	2006
Total tax revenue	18.5	14.9	General public services	22.1	-15.7	Cash from operations	16,298	35,558	Inflation (September)	4.8	7.6
Taxes on income & profit	15.7	29.7	Health	7.9	7.6	Net financial balance	27,558	33,219	Core inflation (September)	4.9	7.2
Taxes on property	50.3	-33.3	Social security & welfare	3.5	5.2	Debt redemption	-33,363	-32,592	Wage index (August)	6.7	10.6
Taxes on goods & services	18.6	10.5	Economic affairs	-4.0	1.9	Gross borr. requirement	-8,406	-2,013	Total turnover (Jan. - June)	8.0	12.5
Social contributions	16.6	15.5	Education	15.0	14.4	Net borrowing	15,832	25,247	Retail turnover (Jan. - June)	6.4	5.1
Total revenue	21.1	12.2	Total expenditure	7.6	2.9	Overall cash balance	7,426	23,234	Unemployment rate, sa (Aug.)	2.0	1.3