

# English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

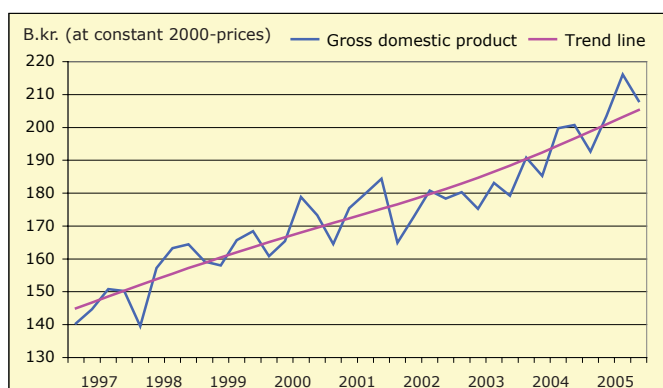
March 16<sup>th</sup> 2006

## Economic growth in 2005

Statistics Iceland recently released its estimate for GDP in 2005 along with its revision of the 2004 GDP figures which puts GDP-growth in 2004 at 8.2 per cent, two percentage points higher than estimated earlier. This revision could lead to the conclusion that the imputed output gap was in fact higher than earlier estimated. This is in part offset by the fact that potential output could also have been higher than thought earlier. These issues will be discussed in the Ministry's spring forecast to be published on April 25<sup>th</sup>.

Last year's GDP is estimated to have increased by 5.5 per cent, a figure that is subject to revision when Statistics Iceland will have obtained further data, especially on business investment. The present estimate is close to the Ministry's forecast of last January of 5.1 per cent GDP growth in 2005 and a 14 per cent increase in national expenditure, whereas Statistics Iceland currently estimates national expenditure growth at 15 per cent for 2005. The growth in private consumption is almost identical, whereas Statistics Iceland shows a 2005 current account deficit that is slightly higher, 16.5 per cent of GDP vs. the Ministry's forecast of 15 per cent.

Quarterly gross domestic product 1997Q1 - 2005Q4



The quarterly national accounts present an interesting picture. GDP has been rising over the recent quarters, as can be seen in the above chart. The quarterly growth rate peaked at 12 per cent in the fourth quarter of 2004 over the corresponding quarter a year earlier. By comparison, the quarterly growth in the 1997-2000 expansion peaked at just over 14 per cent in the first quarter of 1999. On average, GDP growth has been 4.3 per cent in the 1997-2005-period.

But what has driven increased growth of late? Investment, particularly business investment, together with private consumption, have been the main engines of growth. Public consumption has at the same time contributed less. It is therefore evident that the contribution of private consumption is of great importance. But what items weigh most heavily?

As may have been expected, those items in private consumption that are dependent on the exchange rate have increased most as part of household expenditure in real terms between 2004 and 2005, particularly travel expenditure by Icelanders abroad and auto as well as appliance imports, as can be seen in the table in the next column.

Finally, it should be noted that Statistics Iceland estimates that public consumption increased by 3.2 per cent in 2005. This figure should be viewed with the caveat that the volume increase in public consumption could have been overestimated. This view is supported by the fact that public purchases of goods and services are increasing as a proportion of public consumption. A large part of this item represents wages. According to the methodology of Statistics Iceland, the purchase of goods and services by the public sector is deflated by the

## The breakdown of private consumption in 2005

<i>Change between 2004 and 2005 in per cent</i>	<i>Volume change</i>	<i>Price change</i>
Food, beverages and tobacco	4.3	-2.0
Clothing and footwear	8.1	-0.8
Housing, incl. utilities	1.8	15.1
Furniture, appliances & other household furnishings	16.6	-1.9
Pharmaceuticals and medical assistance	3.7	3.4
Transport and communications	21.5	1.6
Recreation and education	9.9	0.4
Misc. goods and services	8.9	0.5
Other		
Non-profit institutions serving households	2.6	6.2
Expenditure by foreign travellers in Iceland (subtr.)	-2.0	0.8
Expenditure by Icelandic travellers abroad	36.7	-7.6
<b>Total</b>	<b>11.9</b>	<b>1.9</b>

Source: Statistics Iceland.

consumer price index excluding the cost of housing. This index has not increased as much recently as the public employee wage index or the general wage index. If the wage component in public sector purchases of services were deflated by the wage index instead of the consumer price index, excluding housing cost, the volume increase in public consumption may be expected to turn out lower than currently estimated. This matter is under consideration by Statistics Iceland.

## The minimum turnover requirement in VAT legislation is increased

The Minister of Finance has presented a bill to the Althingi proposing a change in the VAT Act, whereby the annual minimum of sales subject to VAT be raised from 220,000 to 500,000 krónur. According to Clause 3, Paragraph 4 of the present VAT Act, those taxpayers who sell goods or services subject to VAT for less than 220,000 krónur a year are tax-exempt. Engagement in a business activity is a prerequisite for a registration in the VAT register. The original purpose of this provision was to exempt small businesses or occasional or part-time operations from VAT, mainly for practical reasons. One of the main criteria for determining whether one is engaging in a business activity is the extent of such activity. A small business operation indicates that this is in fact not a business. The threshold amount, 220,000 krónur, is an indication of the extent of activity to qualify it as a business activity. From this viewpoint, it may be stated that the determination of the turnover minimum is partly a tax-technical issue, i.e. it defines the concept of business activity from a tax viewpoint. The present minimum has been unchanged since July 1997, when the amount was fixed and a tie-in to the consumer price index was abolished. If the present threshold were updated by the consumer price index since July 1st 1997, it would be 300,622 krónur. The comparable amounts in the Nordic countries, converted into Icelandic krónur are at present 495,000 for Denmark, 625,000 krónur for Finland and 440,000 krónur for Norway. Sweden has no minimum amount. The Icelandic minimum is therefore quite a bit lower than in neighbouring countries, except for Sweden. In view of these circumstances, having regard to practical considerations and to the definition of what constitutes a business enterprise as well as to practices in neighbouring countries, the Minister of Finance has presented a bill to the Althingi that proposes to raise the minimum turnover amount subject to VAT from 220,000 to 500,000 krónur.

Treasury revenue in January	2004-2005-2005	2005-2006
12 month changes (%)		
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	2004-2005-2005	2005-2006
12 month changes (%)		
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	2005	2006
Million krónur		
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	2004-2005-2005	2005-2006
12 month changes (%)		
Inflation (March '06)	4.7	4.5
Core inflation (March '06)	4.7	4.2
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 (Febr. '06)	2.4	1.2