



Ministry of Finance

# ECONOMIC OUTLOOK FOR ICELAND

## Autumn 2003

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*The latest data used in this report is from September 19. All forecasts and estimates are made by the Ministry of Finance unless otherwise stated. The accuracy of percentages in forecasts is 1/4 of a percentage point.*

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## 1 INTRODUCTION

### *The main conclusions of the forecast*

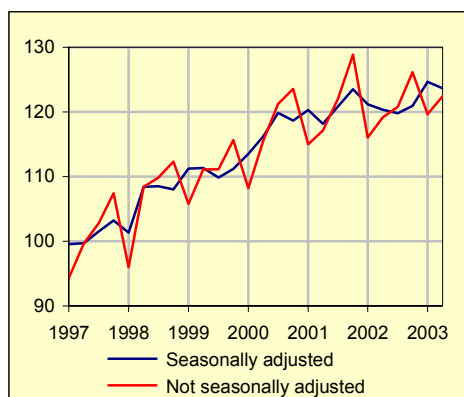
In this report, the Ministry of Finance presents a new economic forecast, covering the years 2003 to 2005. A medium-term forecast up to 2010 is also outlined, incorporating the Government's policy goals for its newly begun four-year term of office, as they are presented in the fiscal budget proposal and the national budget.

- There will be substantial economic growth over the next several years, although it will be lower than in the Ministry's earlier forecast due to the fact that the expansion of the Norðurál plant at Grundartangi has been postponed. A stricter fiscal policy will lead to lower interest rates than otherwise would have been the case, create room for tax cuts and ensure continued economic stability.
- The main sources of growth will be the power construction projects in the eastern part of the country and a substantial increase in household real disposable income, leading to increased consumption and investment. This is in part offset by the fact that a substantial part of the increase in national expenditure will be met by imports and an increased deficit on the current account over the next several years. Economic growth will slow down considerably once the construction projects are completed, but this slowdown will be dampened by the impact of tax cuts and increased public investment.
- In spite of a considerable increase in economic activity, it is forecast that inflation will be stable over the next several years, although a temporary rise may be expected at the peak of construction activity. A tight monetary and fiscal policy will play an important role in this respect.
- The impact of the expansion in the economy, particularly that of the energy construction projects, will be reflected in general wage increases which may be expected to be greater when construction activity will be at its peak. At the same time, unemployment will decline to negligible levels. Household real disposable income will therefore continue to grow over the next several years.
- Fiscal finances will strengthen in line with expanding economic activity. The Treasury's revenue surplus will rise substantially at the peak of construction activity in spite of the planned tax cuts. Once the construction period is over, a deficit may be expected, partly because of increased outlays for public investment. The expansion of the Norðurál plant would change these prospects considerably.
- The most important task of economic policy over the next several years is to pursue a tight fiscal policy in order to manage domestic demand, particularly due to the construction activity in the eastern part of the country. A delay of public investments is of importance here as well as a general restraint on public expenditure, particularly on wages and salaries.

## 2 OVERVIEW OF THE FORECAST

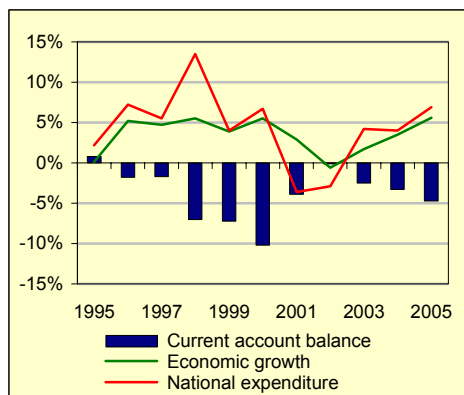
### Developments in 2003

#### Quarterly economic growth index 1997 = 100



Source: Statistics Iceland and Ministry of Finance.

#### Economic growth, national expenditure and current account balance, % of GDP



Source: Statistics Iceland, Ministry of Finance projection.

In the Ministry's forecast this past spring, the main conclusion was that a new economic upturn had commenced with considerable growth in output and expenditure this year. Economic developments since then have confirmed this expectation. There are several factors that have contributed to this course of events. Construction activity on the Kárahnjúkar project has begun and the Government has accelerated public investment activity, although the impact of the latter has weakened in the course of the year.

According to the latest revision of national account figures, real GDP declined by 0.6 per cent in 2002. This year's growth is forecast at 1¾ per cent, 1 per cent less than forecast this spring. The most important change here is that it is no longer assumed that the expansion of the Norðurál plant in Hvalfjörður will take place along with congruent power construction activity. Imports of goods and services have increased more than previously assumed and the current account deficit has widened. A closer comparison with earlier forecasts of the Ministry is discussed below.

Despite less growth in 2003 than earlier forecast, national expenditure is expected to increase more, by 4¼ per cent in real terms, compared with a projection of 3½ per cent this past spring; the difference being due to higher private and public consumption. Investment is expected to increase by 7¾ per cent in real terms this year, of which business investment is expected to increase by 14½ per cent. This is a substantial turnaround from the declines in 2001 and 2002. Imports of goods and services are expected to increase substantially this year. Total exports, however, are expected to decline by half a per cent, which to a considerable extent is due to a 2 per cent decline in marine export production as a result of a declining fish catch. All told, the current account deficit will be larger in 2003 than previously estimated, about 2½ per cent of GDP. By comparison, last year's current account was roughly in balance. The 2003 terms of trade are thought to deteriorate with the result that gross national income is expected to decline by ¼ per cent in spite of low inflation in Iceland's main trading countries and a relatively low import price in most categories. This is due to an increase in the world price of oil between 2002 and 2003. In addition, prices for fisheries products in foreign currency are not expected to rise in concert with general inflation in trading countries.

Inflation has declined rapidly in recent months and fell to the 2.5 per cent inflation target of the Central Bank in November 2002. Inflation has further abated since then due to the stronger exchange rate; the real exchange rate is expected to rise by 7 per cent, as measured by relative prices, in the course of 2003. In addition, there is the influence of continued excess capacity in the economy and a relatively high rate of unemployment in recent months. A 2 per cent inflation rate is forecast between the averages of 2002 and 2003, and the unemployment rate for 2003 is expected to average 3¾ per cent. The latest unemployment figures indicate that the employment situation is rapidly improving. The wage cost per man-year is expected to increase by 5 per cent in 2003. Real disposable income per capita is expected to increase by 1½ per cent this year.

Construction activity in the eastern part of the country, both the construction of a 322 thousand tonnes-a-year aluminium plant as well as of the Kárahnjúkar hydro-power facility, will have a substantial impact upon economic developments in this country up to the year 2007. The Ministry's forecast puts next year's GDP at 862 billion krónur in 2004-prices and projects a GDP growth at 3½ per cent, increasing to 5½ per cent in 2005. For purposes of the forecast, the assumption is made that the exchange rate index will average 125 points in 2004 and rise to 127 points in 2005.

**Summary of the forecast**

	Billion krónur	Volume changes from previous year			
		Prov.	Forecast	Forecast	Forecast
	2002	2002	2003	2004	2005
Private consumption	418.3	-1.1	3¼	3½	5
Public consumption	198.8	4.0	3½	1	2
Gross fixed investment	146.8	-14.8	7¼	8½	16½
Change in stocks <sup>1)</sup>	-0.2	0.4	0	0	0
<b>National expenditure</b>	<b>763.6</b>	<b>-2.9</b>	<b>4¼</b>	<b>4</b>	<b>7</b>
Exports of goods and services	309.0	3.7	-½	4½	3
Imports of goods and services	293.7	-2.3	5¼	5¼	6¼
<b>Gross domestic product</b>	<b>779.0</b>	<b>-0.6</b>	<b>1¼</b>	<b>3½</b>	<b>5½</b>
<b>Gross national income</b>	<b>762.0</b>	<b>0.6</b>	<b>2¼</b>	<b>3½</b>	<b>5¼</b>
Impact of terms of trade <sup>2)</sup>	-	0.2	-¼	-½	0
<b>GNI, including the terms of trade impact</b>	<b>-</b>	<b>0.8</b>	<b>2</b>	<b>3</b>	<b>5¼</b>
<b>Current account balance</b>	<b>-0.5</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
in per cent of GDP	-	-0.1	-2½	-3¼	-4¾
Change in per capita purchasing power in p.c.	-	-0.2	1½	2½	4
Change in consumer prices, p.c.	-	4.8	2	2½	3

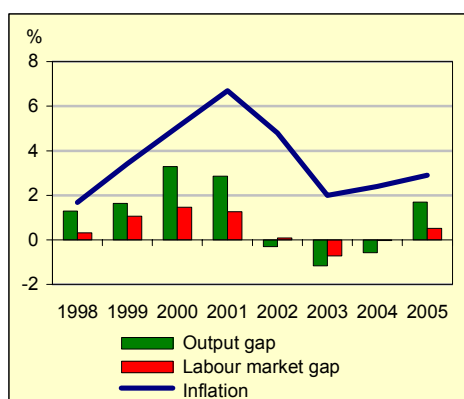
1) In per cent of the previous year's GDP at constant prices.

2) In per cent of national income of the previous year, at fixed prices.

National expenditure is expected to increase by 4 per cent in real terms in 2004, in large part due to an 8½ per cent increase in investment, where business investment is expected to be up by 15 per cent and housing by 4 per cent, whereas public investment is expected to decline by 8 per cent. Private and public consumption together is forecast to increase by 4½ per cent in 2004. The current account deficit is expected to widen in spite of a 6 per cent increase in marine production; it is forecast to reach 3¼ per cent of GDP in that year. The wider deficit is due to rising national expenditure, particularly on account of the construction activity in the eastern part of the country.

As the economy goes into an upturn, demand for labour increases and unemployment declines, heading towards 2½ per cent of the labour force in 2004. The average increase in prices is forecast at 2½ per cent between 2003 and 2004. The negative output gap in the economy is expected to recede but will to some extent exist into 2004. However, the employment situation is expected to be in balance as measured by an equilibrium unemployment rate (NAIRU). If the actual unemployment rate falls below the equilibrium rate, it indicates that inflation is rising. These measurements of an output gap and an equilibrium rate of unemployment are subject to some uncertainty and should be viewed with reservation.

**Output gap and inflation**

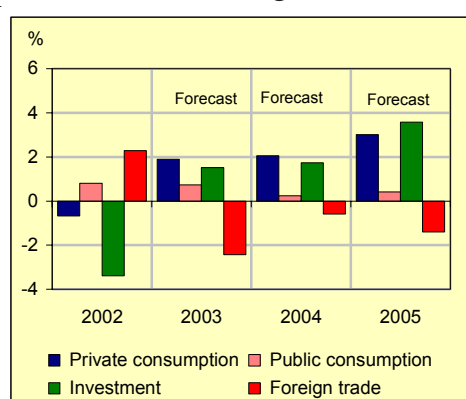


## Key economic indicators

Volume changes in per cent over previous year unless otherwise indicated.

Macroeconomic indicators	2002	2003	2004	2005
Economic growth	-0.6	1¾	3½	5½
National expenditure	-2.9	4¼	4	7
Current account in p.c. of GDP	-0.1	-2½	-3¼	-4¾
Net external debt in p.c. of GDP	-75.0	-69¾	-70¾	-72
National saving in p.c. of GDP	18.8	17½	17¾	18¼
<b>Labour market</b>				
Labour force (1000's)	145.7	146.6	148.6	151.4
Unemployment in p.c. of labour force	2.5	3¼	2½	2
Purchasing power of hourly wage	2.2	3	2½	4
Real disposable income per capita	-0.2	1½	2½	4
<b>Foreign trade</b>				
Exports of marine products	5.1	-2	6	2
Total merchandise exports	6.6	-1¼	5½	3
General imports	-4.6	7¼	2¼	4½
Terms of merchandise trade	0.2	0	-1	½
<b>Money and prices</b>				
Consumer price index, per cent	4.8	2	2½	3
Exchange rate index	131.5	123¾	125	127
Real interest rate on 3-5 yr. Treasury bonds, %	5.4	4	4½	4¾
<b>External conditions</b>				
Growth in euro area	0.9	½	2	2½
Inflation in euro area	2.3	2	1½	1¼
Export prices of marine products	3.3	0	1	2
Foreign prices excluding oil	2.1	1	1½	2

## Contribution to GDP growth



The Ministry forecasts a 5½ per cent growth rate in 2005, at which time construction activity in the East will be at its peak. The construction of the aluminium plant at Reyðarfjörður will be at its peak in 2006. Business investment is expected to increase by more than one-fourth in real terms in 2005 and private consumption by 5 per cent. National expenditure is expected to increase by 7 per cent in 2005 and the current account deficit is forecast to reach 4¾ of GDP.

Unemployment is expected to decline to 2 per cent in 2005. If this forecast is realised, there will be a considerable positive output and employment gap in evidence at that time. This is expected to lead to an inflation rate in 2005 of ½ per cent in excess of the 2½ per cent target rate of the Central Bank. In this forecast, the base interest rate of the Central Bank is expected to increase at the time of the peak in construction activity, by up to 2½ per cent over the present rate. This assumption is subject to much uncertainty and the outcome will depend on economic conditions at that time. It is also assumed that public investment will be held back in 2004 and 2005.

## A comparison of forecasts

In this section, this current forecast is compared to earlier forecasts in order to explain the main deviations between forecasts and increase the transparency of the Ministry's forecast practices. New forecasts are often interpreted without distinguishing between altered economic circumstances and policy changes. It is therefore useful to compare the Ministry's forecasts for 2003 and 2004 that have been released in the past twelve months.

## Why do forecasts change?

There are many reasons why forecasts change. First, the economic assumptions underlying the forecasts may change. This is usually the most important reason for changes in the fore-

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casts. Changes in the exchange rate, wage agreements, oil prices, the fish catch are but a few examples of underlying assumptions that are constantly subject to change and form an important part of explaining changing forecasts in this country, especially in earlier years.

Secondly, the public authorities may have altered their policy decisions since the last forecast, thus changing its underlying assumptions. Changes in taxes and expenditure are examples of this kind as well as the recent decision of the Government to accelerate public investment this year to reduce unemployment and create room for the construction activities of coming years. The Government's decisions altered the assumptions of the 2004 fiscal budget and thereby influenced the economic forecast. Tax legislation has also frequently been amended, often in association with wage agreements which in turn has altered the assumptions behind the fiscal budget and the macroeconomic forecast.

Thirdly, there are a number of technical issues, such as a retrospective revision of national accounts. Although these would not be counted as a change in underlying economic assumptions, such revisions tend to alter many of the econometric relationships that form a basis for the forecasting model.

Finally, economic expectations fluctuate and can alter the assessment of an economic situation at a given point in time.

All these factors may have an impact on the forecast. Even if most elements of risk and uncertainty in any forecast are duly noted, the general rule is that it is difficult to assess the possible change in underlying assumptions. The only thing that is certain is that some of the underlying assumptions will almost certainly change before the next forecast.

### *The change in underlying assumptions of the forecast*

The Ministry issued its first macroeconomic forecast a year ago at the beginning of October 2002, following a transfer of the forecasting task from the National Economic Institute to the Ministry. The forecast was issued in conjunction with the presentation of the 2003 fiscal budget proposal which was based on the forecast assumptions. The forecast was revised at the end of November at which time the Ministry's first forecast for 2004 was issued.

The next forecast was issued in the middle of April of this year. Many of the underlying assumptions had changed by then. The most important change was that decisions on the power project and aluminium plant in the East had been confirmed and there was an increasing probability that the Norðurál plant at Grundartangi would be expanded. In addition, the decisions of the Government and several municipalities to accelerate public investment to reduce unemployment were at hand. The exchange rate strengthened considerably following these decisions.

The main message of the April forecast was that the economy was recovering after a short recession. Data on economic developments in 2003 were at that time only available for two to three months. Although these data gave an indication that an expansion was under way, it was still considered uncertain how fast the economy would recover, especially in light of the consider-

### Comparison of forecasts for 2003 and 2004

	Forecasts for 2003				Forecasts for 2004		
	Oct. 2002	Dec. 2002	April 2003	Oct. 2003	Dec. 2002	April 2003	Oct. 2003
<b>Volume change, %</b>							
Private consumption	1 ¼	1 ¼	1 ¼	3 ¼	1 ¾	3 ¼	3 ½
Public consumption	1	2 ¼	2 ¼	3 ½	2 ½	2	1
Investment	1 ¾	2	11 ¼	7 ¾	6¼	11	8 ½
Total national expenditure	1 ½	1 ¾	3 ½	4 ¼	3	4 ¾	4
Total exports	3 ½	3	1	- ½	3 ½	2 ¼	4 ½
Total imports	3	3	2 ½	5 ¾	3 ½	5	5 ¾
Gross domestic product (GDP)	1 ½	1 ¾	2 ¾	1 ¾	3	3 ¾	3 ½
Current account balance, % of GDP	- ¼	- ½	-1 ¼	-2 ½	- ½	-2	-3 ¼
General government balance, % of GDP	¼	¼	-0	-1	...	½	¼
<b>Income and price changes, %</b>							
Disposable income per capita	4 ¼	5	3 ¾	3 ½	3 ¾	6	5
Wages	4 ½	4 ¼	5	5	3 ½	6	5
Real disposable income per capita	2	2 ½	2	1 ½	1 ¾	3 ½	2 ½
Inflation	2 ¼	2 ¼	2	2	2	2 ½	2 ½
Exchange rate, index	130	130	122	124	130	122	125
Unemployment, % of labour force	2 ½	2 ¾	3	3 ¼	2 ½	2	2 ½

able debt burden of both businesses and households following the economic expansion of recent years.

#### *A revised 2003 forecast*

Economic developments have confirmed the April forecast in most respects, i.e. that the economy is recovering. The clearest indications are to be found in data on turnover, particularly imports. Imports are now thought to rise twice as much as was predicted in the April forecast, both because private consumers are buying more cars and other consumer durables and because imports of investment goods have exceeded expectations.

On this basis, the increase in private consumption is now forecast to be twice as large as in the April forecast. Public consumption is also thought to increase more than assumed earlier. Public investment is, however, expected to increase less in 2003, and a part of the acceleration in public investment is now expected to move into 2004. This is offset by lower exports due to lower catches than assumed earlier. It is also evident that the stronger exchange rate has discouraged high-tech exports more than had been assumed earlier. An increase in the current account deficit is a direct result thereof and consequently economic growth is expected to be lower than forecast earlier. Furthermore, unemployment has turned out to be protracted and is expected to be slightly higher for the year than in the earlier forecast. This is attributable to difficulties in export- and import-competing sectors as well as to the need of many businesses to rationalise their operations due to reduced domestic demand and debt accumulation in previous years. Finally, it appears that the revenue balance of the public sector will be weaker than assumed, primarily because of increased public expenditure, including accelerated public investment.



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One major assumption has changed from the previous forecast: It is no longer assumed that the Norðurál plant at Grundartangi will be expanded. This has a broad impact with both a direct and indirect impact upon the forecast, as is discussed more fully in the following box.

### *The revised 2004 forecast*

The main differences in the revised forecast for 2004 are in many respects the same as for the 2003 forecast. National expenditure is expected to grow faster, particularly private consumption and investment, whereas public consumption is expected to grow more slowly. Import growth is forecast to increase more, almost all because of investment goods imports. The increase in exports has been doubled from the previous forecast due to improved prospects for exports of fisheries products, mainly because of an increased catch quota. The exchange rate is forecast to be lower than had been assumed earlier which should have a positive impact on the export sectors. The current account deficit is forecast to be slightly higher than predicted earlier which may for the most part be attributed to a less favourable outcome in 2003. In spite of a lower exchange rate assumed for 2004, inflation is expected to be about the same as before, which in part is due to lower inflation in 2003 and lower wage increases predicted for

### *Changed assumptions for power projects*

This latest forecast no longer includes the assumption that the Norðurál aluminium plant at Grundartangi will be expanded and that the associated power project construction will be realised. This has a broad direct and indirect effect on the forecast. Economic growth will be lower, primarily because of lower investment expenditure which in turn will reduce the increase in wages. The exchange rate is assumed to be lower as a result which in turn will increase inflation, which will reduce the growth in disposable incomes and household expenditure for consumption and investment. The current account deficit will also be lower, both due to lower imports of investment goods for power projects as well as to a slower growth in national expenditure.

On this occasion it is appropriate to explain the work practices that apply to the economic forecast in each instance. It should be recalled that last January the Ministry issued a report on the economic impact of different power project and aluminium plant alternatives, i.e., on the Reyðarfjörður plant on one hand and the Norðurál expansion at Grundartangi on the other. By February, Landsvirkjun decided to enter into discussions with Norðurál on the supply of energy for the expansion of its plant at Grundartangi in conjunction with the Reykjavík Energy and the Suðurnes Regional Heating. The intention was that the three suppliers would jointly provide Norðurál with the needed energy. The Althingi passed an authorisation law in March that empowered the Minister of Industry to permit the necessary power projects that the suppliers of energy needed to provide power to the expansion of Norðurál.

In light of these decisions it was assumed normal that the Ministry's forecast would incorporate these intentions in its mid-April forecast, even if all preparations had not been completed. By comparison, it was assumed in the same

forecast that the catch quota for the 2003-2004 fisheries year would be increased even if a final decision had not been reached. For this purpose, available assessments and reports of the Marine Research Institute were used. Such factors must be assessed in each instance. No firm rules can be applied to make such judgements. A national economic forecast must reflect most probable developments in each instance, based on the latest available information. Such assessments should not be interpreted as policy decisions regarding particular projects. It should be recalled that the analyst departments of the commercial banks had also incorporated the same assumptions into their forecasts, and the stronger exchange rate was particularly thought to be associated with these developments which reflected the expectations of the market. These same assumptions were also included in the forecasts of the Central Bank's quarterly reports in May and August.

During the half-year period since the Ministry issued its last forecast, the likelihood that the Norðurál project would be realised this year and next has gradually faded. At the beginning of September the Landsvirkjun board of directors decided to postpone its power supply project for Norðurál until it had completed the construction of the Kárahnjúkar project. This decision inevitably upset all plans for starting the first part of the Norðurál expansion this year and completing it in 2006 and it became clear that further developments would be subject to much uncertainty.

The Ministry therefore decided that it would not be advisable to base a new economic forecast on such uncertain assumptions. It would be more appropriate to assume that the Norðurál project would not be started at this time although it has been no means been permanently abandoned – only postponed.

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2004 than had been assumed in the earlier forecast. Unemployment, however, is expected to exceed the earlier prediction by a small margin. Prospects for the public sector balance are largely in line with the earlier forecast.

### *Conclusion*

The deviations of a new economic forecast from the previous one can thus be explained both by changed economic circumstances as well as by policy decisions, including the acceleration of public investment, increased pensions and catch quotas. Last but not least, there is the postponement of the Norðurál project. These factors will be individually discussed below as well as their impact upon the forecast.

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### 3 MEDIUM-TERM PROSPECTS

In recent years, decisions on public policy have increasingly been taken with a view towards a period extending beyond one year. Such policy decisions make it possible to gain a better view of the economic situation and prospects, thus creating a better foundation for economic management and a sound economic policy, which in turn helps to foster economic stability.

The construction of a power project and an aluminium plant in the eastern part of the country places heavy demands upon economic management over the next several years. The most important policy task is to apply fiscal policy so as to restrain domestic demand.

#### *The main elements of fiscal policy*

The Government has set the following goals for fiscal policy for its term of office over the next four years:

- About 20 billion krónur will be used for tax cuts in the years 2005-2007 and up to 3 billion krónur for specific tasks, such as increasing child benefits.
- Public investment will be cut by 3 billion in 2005 and 2 billion in 2006. Public investment will again be increased by 3 billion in 2007 and 2 billion in 2008.
- Fiscal policy will be tightened. The annual increase in public consumption shall be limited to 2 per cent real terms in 2005-2007. Wage rises in the central government sector will be limited so as not to exceed those of the private sector. The annual increase in transfer payments will be limited to 2½ per cent in real terms in 2006-2007.
- The Treasury revenue surplus will not be less than 1¾ per cent of GDP in 2005 and 1 per cent in 2006.

#### *Assumptions underlying the medium-term forecast*

**International outlook.** The economic developments in Iceland's principal trading countries is of great importance in medium-term forecasting. This forecast is mainly based on the latest forecasts of the OECD and the IMF. On this basis it is assumed that annual average economic growth in trading countries will be about 2½ per cent a year, inflation will be in the range of 1½-2 per cent and interest rates will increase by about 1 per cent from their present level. Forecasts on oil prices are, by their very nature, quite uncertain, particularly in light of the volatile situation in the Middle East. For this forecast, it is assumed, following considerable vicissitudes in 2003-2004, that oil prices will be relatively stable for the remainder of the forecast period and even decline in real terms.

**Wages and the exchange rate.** Since most wage agreements in the private labour market expire at the end of this year it will be difficult to forecast wage developments for the next several years. The high exchange rate has constrained the competitive position of the domestic economy. The share of wages in national income is close to a historical peak which is expected to be a central issue in upcoming wage negotiations. For the purposes of this forecast, it is assumed that the conclusion of the wage agreements will not interfere with the principal goal of maintaining stability and low inflation.

**Marine production.** One of the main assumptions behind a medium-term forecast relates to fish catch prospects and marine production. For this purpose, the assessment of the Marine Re-

### Main economic indicators

	Budget	Medium-term forecast		
	2004	2005	2006	2007
<b>Volume change, %</b>				
Private consumption	3½	5	3¾	3
Public consumption	1	2	2	2
Investment	8½	16½	6	-19¾
Total national expenditure	4	7	4	-2¾
Total exports	4½	3	2½	11½
Total imports	5¾	6¼	4¼	1¾
Gross domestic product (GDP)	3½	5½	3¼	¾
Output gap, % of potential GDP	-½	1¾	1¾	0
Current account balance, % of GDP	-3¾	-4¾	-5¾	-3¾
Structural balance, % of GDP	¾	1¼	½	-¾
<b>Income and price changes, %</b>				
Disposable income per capita	5	7	6	4½
Wages	5	7	4½	3½
Real disposable income per capita	2½	4	2¾	1¾
Inflation	2½	3	3	2½
Exchange rate, index	125	127	128	129
Unemployment, % of labour force	2½	2	2½	3

search Institute regarding fish stock and catch prospects for the next several years is being relied upon. The Ministry has opted for a fairly conservative view of catch and production developments over the next several years and estimates that marine production for export will increase by 2 per cent in real terms.

**Prices of marine products.** Prices for marine products have fluctuated considerably in recent months, mainly due to exchange rate fluctuations. Prices have been quite stable in foreign currency terms. The assumption is made that prices for marine products in foreign currencies will increase by 2 per cent on average per year throughout the forecast period, thus remaining roughly constant in real terms.

**Aluminium production.** The assumption is made that the Reyðarfjörður aluminium plant will commence production as scheduled, whereas the expansion of the Norðurál plant will not take place. The latter assumption will be kept under review should circumstances change.

**Other export production.** Exports of various high-tech products, such as pharmaceuticals, medical equipment, software etc., have increased rapidly in recent years. For the forecast, it is assumed that this export growth will slow down to a rate of 6-7 per cent in real terms per year.

**Main assumptions for fiscal finances.** On the revenue side of the fiscal budget, it is assumed that tax cuts of about 20 billion will take place in 2005-2007, mainly through a cut in the personal income tax, the elimination of the net wealth tax and a reduction in the value added tax. The implementation of these changes have yet to be worked out in detail

The main assumption on the expenditure side is that fiscal expenditures will be exercised with utmost restraint. The aim is to reduce the increase in public consumption of the central government to a maximum of 2 per cent in real terms, 1 per cent less than the average growth of recent years. In addition, public investment will be cut substantially over the next several years and increased again following the completion of the construc-

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**Main elements of fiscal finances**

Bn.krónur, accrual basis	Budget	Medium-term projection		
	2004	2005	2006	2007
Total revenue	279.4	300	313	320
Of which: Tax revenue	252.3	270	281	286
Total expenditure	273.0	285	303	325
Current expenditure	124.3	131	139	147
Interest expense	15.1	15	15	15
Transfer payments	112.9	121	129	138
Maintenance	4.0	5	5	5
Investment	16.7	13	15	20
Revenue balance	6.4	15	10	-6
Financial balance	13.7	7	8	-8
Net Treasury debt	155.0	155	149	160
<b>in p.c. of GDP</b>				
Total revenue	32.4	32	31¼	31
Of which: Tax revenue	29.3	29	28	27¾
Total expenditure	31.7	30½	30½	31½
Revenue balance	0.7	1¾	1	-½
Financial balance	1.6	¾	¾	-¾
Net Treasury debt	18.0	16½	15	15½

tion projects in the eastern part of the country. Transfer payments will increase somewhat over the next several years, based on present legislation, partly because of an increase in the number of pensioners. The increase in the number of disabled persons is, however, expected to decline, in part because labour market conditions are expected to improve. Unemployment is also expected to decline, thus lessening the need for unemployment compensation. Taken together, it is expected that transfer payments will increase by an annual average of 2½ per cent. This implies that restraint will be applied and no cost-increasing measures will be introduced unless they are met with cuts in other programmes.

**Other assumptions.** In the medium-term forecast it is also assumed that certain monetary policy measures will be taken in accordance with the main goals on which the forecast is based. It is expected that interest rates may rise temporarily during the peak of construction activity. Fiscal restraint will help in keeping the rise in interest rates to a minimum.

The main conclusion of the medium-term forecast is that economic stability can be maintained in spite of increased domestic demand. Economic growth will be quite pronounced in 2004-2006, followed by a slowdown in 2007 which will in part be offset by increased public investment. The power project and aluminium plant construction inevitably leads to an increase in imports and consequently to a deficit on the current account which will shrink substantially upon the completion of construction when aluminium exports of the new plant come on stream. Inflation may be expected to increase temporarily at the peak of construction activity and decline thereafter. Real wages will increase substantially while unemployment will be low throughout the period.

A substantial fiscal surplus is expected at the peak of construction activity in spite of the planned tax cuts. The debt of the Treasury is also expected to be reduced. Following the construction peak, a Treasury deficit may be expected, partly on account

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**The conclusions of the medium-term forecast**

of increased investment expenditures. It should be emphasised that the medium-term forecast does not incorporate an expansion of the Norðurál plant. This does not mean that this expansion is abandoned, only that it can not be counted on during the forecast period.

Fiscal policy will aim at mitigating the upswing in 2004-2006 and in turn the slowdown in 2007. These mitigating influences can be clearly seen in the chart on page 54 which shows the Treasury revenue surplus on a national accounts basis on one hand and the cyclically adjusted balance on the other. The restraint effect increases during the cyclical upswing when the cyclically adjusted balance is in surplus, reverting to a deficit during the slowdown in 2007.

The medium-term forecast up to 2010 is subject to the uncertainty as to what happens to the Norðurál project. There is a good possibility that this project will commence during the forecast period, although this can not be assumed. The forecast must be viewed in light of this caveat.

#### **Main economic indicators 2003 - 2010**

	Annual averages		Annual averages
	2003-2006	2007	2008-2010
<b>Volume change, %</b>			
Private consumption	4	3	2¾
Public consumption	2¼	2	2
Investment	9¾	-19¾	-¾
Total national expenditure	4¾	-2¾	2
Total exports	2¼	11½	4½
Total imports	5½	1¾	3¼
Gross domestic product (GDP)	3½	¾	2½
Current account balance, % of GDP	-4	-3¼	-2¼
<b>Income and price changes, %</b>			
Disposable income per capita	5¼	4½	5
Wages	5¼	3½	4½
Purchasing power of DI per capita	2¾	1¾	2½
Inflation	2½	2½	2¼
Exchange rate, index	126	129	129
Unemployment, % of labour force	2½	3	2¾

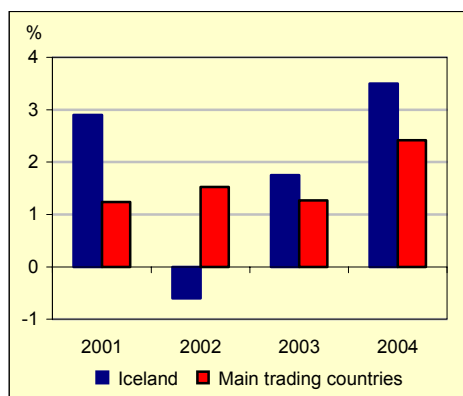
#### *Economic prospects up to 2010*

The period covering the year 2003-2010 is divided into several phases. The first phase lasts into 2006 and is characterised by substantial economic growth, averaging 3½ per cent a year. This period is followed by a slowdown in 2007 when growth will decline to 1 per cent. This low growth rate does not fully describe the actual economic situation since it primarily reflects the impact of a 15 billion krónur decline in power project investment between 2006 and 2007, equivalent to 1½ per cent of GDP. This contraction is expected to be offset by the impact of increased private and public consumption, and export earnings are forecast to increase by 11½ per cent, mainly due to increased aluminium exports. The economy will thus not be in a slump even though construction activity will mostly have been completed.

The main economic aggregates for the period 2008-2010 present a more realistic picture of the economic situation. As this forecast implies, annual economic growth could average 2½ per cent, inflation about 2 per cent and the current account deficit about 2¼ per cent of GDP. These projections reflect a return to stability, following the expansion of the previous years.

## 4 INTERNATIONAL ECONOMIC OUTLOOK

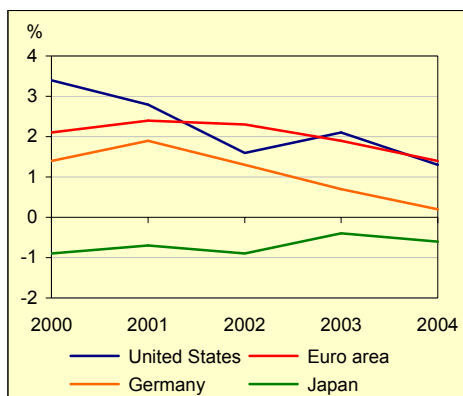
### Economic growth in main trading countries and Iceland<sup>1)</sup>



1) Weighted average based on the Central Bank's currency basket.

Source: IMF and the Ministry of Finance.

### International inflation



Source: IMF

The world economy appears to be going through a phase of slow recovery in the course of this year and next. Uncertainty has declined, oil prices have receded, and interest rate cuts as well as tax reductions are expected to stimulate economic growth in the second half of this year, albeit at a slow pace. Much depends on developments in the US economy. It is difficult to predict the lasting of the impact of earlier declines in share prices. The latest IMF forecast indicates that the growth in world output will reach 3.2 per cent this year and rise to 4.1 per cent in 2004.

Amongst the external factors that particularly affect the Icelandic economy, a considerable rise in oil prices is expected this year, followed by a decline next year. International interest rates are declining in 2003 but expected to increase in 2004. Prices for fish products are expected to remain fairly constant this year and rise marginally in 2004. Aluminium prices should be rising in 2003, followed by a decline in 2004.

Indicators of business and consumer confidence have been on the rise since spring, particularly in the US. Other economic indicators have been mixed. World output and trade have been slowing down, unemployment has increased and investment in industrial countries has not fully recovered. Interest rates and taxes have declined in many countries and further reductions are expected, although they differ between countries. The largest declines have been in the US and the UK, less so in the euro area and Japan.

Inflation has been low of late, below 2 per cent both this year and last. This is expected to continue next year. Inflation is forecast at 1.3 per cent in industrial countries in 2004. If this is realised, inflation will not have been lower for the past thirty years. Inflation in developing countries is expected to be 5 per cent which also is lower than before. Deflation has only been felt in a few countries – mainly Japan – whereas about 15 per cent of the developed countries are expected to have an inflation rate below 1 per cent next year. The danger of deflation is considered marginal, although temporary price declines are expected in a number of countries, such as Germany.

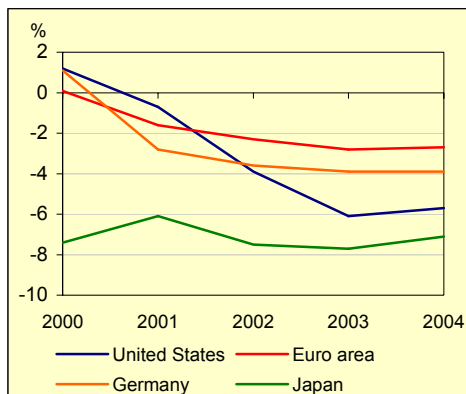
Financial markets have improved in the aftermath of share price declines on account of the war in Iraq earlier in the year. Interest rates have declined sharply and long-term rates were last June at a 40-year low. They have been rising since but are still low in an historical context. Low interest rates, widespread corporate restructuring and reduced risk aversion has meant that yields on high-risk debt have also declined. The dollar exchange rate has declined in the course of the year, since US interest rates have been lower than in the euro area. The dollar has declined by 12 per cent in nominal terms from its peak last year, and the euro has risen.

Public sector deficits are generally expected to rise this year. It is expected to reach 6 per cent of GDP in the US, close to 3 per cent in the euro area and close to 7½ per cent in Japan. The public sector is expected to recover next year by a small margin.

Unemployment has continued to increase. In the US, unemployment now exceeds 6 per cent and has not been higher since 1994.

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### General government balance, % of GDP



Source: OECD

In Europe, unemployment is at a three-year high of 9 per cent and in Japan it is at an historical high of 5½ per cent this year. Unemployment is expected to decline slightly in the US and Japan next year but increase in Europe.

The main uncertainties in the forecast pertain to the aftermath of earlier declines in stock prices since it is uncertain how long the resulting asset decline of households will restrain private consumption. Although it is probable that these downside factors have peaked, the household asset situation is still weak. Enterprises and financial institutions have not completed the necessary restructuring aimed for example at the elimination of excess production capacity and pension fund reform. These effects could last longer than had been assumed, and investment may be late in recovering, thus affecting growth.

The persistent current account deficit of the US is also a source for concern, especially if an adjustment of this payments imbalance turns out to be too abrupt. In spite of the recent decline in the dollar exchange rate, the deficit is expected to reach 5 per cent of US GDP this year. Although the decline in the dollar exchange rates is considered beneficial, it could pose a problem if the dollar declines too fast which would be mirrored in a rise in the euro rate. Interest rate reductions in the euro area have mitigated this trend in part, but if the dollar continues its slide, uncertainty continues, especially if the declining dollar is mirrored in a rising euro instead of being spread over other currencies.

On balance the risks to the outlook still appear somewhat tilted towards the downside. However, economic growth could exceed expectations in the US due to the impact of tax cuts, a sustained productivity increase and corporate restructuring. This would benefit the rest of the world except for the fact that the US current account deficit would most likely rise. Oil prices could also decline more than predicted.

### *The United States*

As before, the recovery of the world economy is to some extent dependent upon the course of the US economy. Despite increasing unemployment and excess production capacity the outlook for the near future is slightly better than elsewhere. Interest rate and tax reductions have been larger there than in other countries. The IMF forecasts a 2.6 per cent growth for this year and 3.9 per cent for 2004.

The US economy slowed down after the middle of 2002, both due to uncertainty surrounding the war in Iraq and the aftermath effects of the stock market decline. Domestic demand has been anaemic, excess production capacity substantial and inflation on the decline. The current account deficit increased and was largely financed by sales of Treasury debt. The decline of the dollar in recent months has not helped to increase exports since growth in customer countries has been slow.

Recent data indicate that private consumption and investment are increasing. Despite high unemployment rates, various economic indicators – notably consumer and business confidence – have strengthened. Oil prices have also declined and interest rate and tax cuts have been substantial. In fact, interest rates have not been lower since 1958 with the policy rate at 1%. Stock prices have also increased in recent months.



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**Development and prospects in the international economy**

Volume changes unless otherwise specified

	2001	2002	Recent forecasts	
			2003	2004
<b>GDP growth</b>	<b>2.4</b>	<b>3.0</b>	<b>3.2</b>	<b>4.1</b>
Advanced economies	1.0	1.8	1.8	2.9
United States	0.3	2.4	2.6	3.9
Euro area	1.5	0.9	0.5	1.9
Japan	0.4	0.2	2.0	1.4
Developing countries	4.1	4.6	5.0	5.6
in Africa	3.7	3.1	3.7	4.8
in Asia	5.8	6.4	6.4	6.5
Countries in transition	5.1	4.2	4.9	4.7
Russia	5.0	4.3	6.0	5.0
<b>International trade</b>	<b>0.1</b>	<b>3.2</b>	<b>2.9</b>	<b>5.5</b>
<b>Inflation</b>				
Advanced economies	2.2	1.5	1.8	1.3
Developing countries	5.8	5.3	5.9	4.9
Countries in transition	16.2	11.1	9.7	9.1
<b>6-month LIBOR rates, p.c. a year</b>				
US dollars	3.7	1.9	1.3	2.0
Euro	4.2	3.3	2.2	2.4
Japanese yen	0.2	0.1	0.1	0.2
<b>Oil prices, USD</b>	<b>-14.0</b>	<b>2.8</b>	<b>14.2</b>	<b>-10.5</b>

The IMF forecasts increased growth in the latter half of this year and continued tax cuts should help the expansion. It is thought possible that growth could exceed forecasts since the strength of the US economy in many areas could have a positive impact. The increase in productivity is likely to continue, since it is supported with continued progress in information technology with a consequent impact on other sectors of the economy. Furthermore, the US economy is flexible and accessible to investors.

On the adverse side, there are a number of factors at work, such as excess production capacity, recent corporate malfeasance incidents that discourage investors and high corporate and household debt. Deflation is still seen as a possibility, albeit improbable, and then there are the twin deficits, of the public sector and on the current account. Although the dollar exchange rate has declined in the course of last year, the dollar is still strong and has in fact been rising again in recent weeks. The dollar could, however, decline further. Finally, housing prices have been quite high and a decline could be in the offing, especially if interest rates rise again.

## Europe

The growth forecast for the euro area has been revised downwards once more, due to less private consumption than had been expected and a rise in the euro exchange rate. Interest rate and tax reductions have not been as large in Europe as in the US and the rise in the euro has tended to offset some of the impact of declining interest rates. Moreover, economic prospects in Germany are not bright. It is therefore assumed that foreign demand and lower oil prices will provide the main impetus for growth in the near future. The IMF forecasts a ½ per cent growth rate this year for the euro area and 1.9 per cent next year.

The downturn in the euro area appears to be more protracted than had been thought earlier. Business and consumer expectations are low, unemployment is increasing and industrial production is stagnant. A persistent low rate of investment is char-

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acteristic of economies in the euro area and corporate debt is high.

On the positive side, there is private consumption that has been increasing by a small margin this year – although the increase differs between countries – and may be expected to increase in concert with real disposable incomes and as inflation declines. Household debt has been declining and is now moderate, and household savings have increased more than in the US.

Inflation has been declining in the euro area and deflation is a possibility in Germany. The decision of the European Central Bank to lower its base rate by  $\frac{1}{2}$  per cent in June was therefore considered appropriate by the IMF. Central government deficits well in excess of 3 per cent are thought likely both in Germany and France this year and next. Italy's deficit is also thought to be approaching that limit.

All told, the European economic outlook is rather dim. Increased growth will depend on foreign demand, lower oil prices, low interest rates and a near-term completion of corporate restructuring.

The German economy is not expected to grow this year, despite rising business expectations, and only a marginal growth rate may be expected in 2004. France and Italy could reach  $\frac{1}{2}$  per cent growth but expectations are low and foreign demand weak. The same may be said for the Netherlands and Portugal, and growth in Austria and Belgium could be less than 1 per cent for the third year in succession. Spain's growth could be higher, thanks to robust investment in machinery and equipment. Finland is expecting an upswing in information technology, and an upswing is predicted for Ireland because of rising property prices. The same goes for Greece where domestic demand is rising.

Britain's prospects have deteriorated since last year because private consumption and investment have both declined. Exports increased in the first quarter of 2003, possibly because of a decline in the sterling exchange rate, particularly vis-à-vis the euro. Property prices are still rising fast, at a 17% annual rate. Inflation has been slowing down this past year, although a reversal of the trend can not be excluded. Unemployment has been low, however. The policy interest rate was lowered in July to  $3\frac{1}{2}$  per cent in spite of inflation being above the  $2\frac{1}{2}$  per cent target rate. Growth is expected to increase in the near term, in part on account of rising government expenditure and a low interest rate; it is forecast at 1.7 per cent for this year and 2.4 per cent for 2004.

Forecasts for growth in Denmark, Norway and Sweden have been lowered since leading indicators have been declining and unemployment increasing. The slack in neighbouring countries has also been influential. Interest rates have declined in all three countries. Growth is forecast to pick up in the latter half of 2003 and next year.

## *Japan*

The economic expansion in Japan that was in evidence in the second half of 2002 has proved difficult to sustain. Deflation and the weak state of the financial system have taken a toll on the economy, although growth has increased slightly in the course of this year. The IMF forecasts 2 per cent growth for this year and 1.4 per cent in 2004.

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Business confidence indicators remain weak and there is a need for extensive structural reforms in order to achieve sustainable progress in the fight against deflation. Success in restructuring banks and businesses has also been limited and these weaknesses will most likely hinder investment. Other risks include a further appreciation of the yen which would have a negative impact on business profits, investment, deflation and exports. Household saving could also increase, and high public sector debt could raise interest rates. Unemployment is rather high by historical standards although it has remained constant of late.

Foreign demand for Japanese products is expected to rise next year. Japanese exporters are already beginning to feel increased demand from the US, Japan's largest export market. Share prices have also risen, but the rise in the Nikkei index is mainly due to investor expectations of increased growth in the US. Despite these positive currents in the Japanese economy, forecasts for recovery are cautious.

### *Other countries*

Economic developments in other countries are in many respects dependent upon developments in the major industrial countries described above. If economic conditions in industrial countries are good, other countries will find it easier to obtain financing and expand their export markets. Other factors are, of course, also influential.

Growth in **Asia** is expected to increase again after a slowdown due to the SARS epidemic. The recovery is expected to be stable, partly because of good economic growth in China and easier economic policies. This will, however, depend on a recovery of private consumption, the information technology sector and foreign demand.

Prospects for **Latin America** have improved, especially because of easier financing. Capital flows to emerging market economies appear to have increased sharply this year and are now higher than they have been since the middle of the last decade. Investors appear to be especially positive towards Brazil. Still, further economic progress is vulnerable and many countries are still dealing with debt difficulties and political uncertainty.

The economic situation in the **Middle East** appears to be improving, following the end of the war in Iraq. Economic forecasts have been raised because of increased oil production, although lower oil prices may have a negative impact on prospects for next year.

Conditions in **Russia** and the **Ukraine** appear strong, and foreign direct investment will probably strengthen growth in prospective EU member countries in Middle and Eastern Europe, although weak demand in the euro area could prove to be a hindrance.

Economic growth in **Southern Africa** is expected to increase to more than 3 per cent this year, mainly due to better public governance, higher commodity prices and more foreign development aid. This has, however, been hindered by political instability, incipient weather which, along with sharply increasing incidences of HIV and AIDS, has led to a serious food shortage in many areas. Economic growth is expected to increase next year, but much will depend on the weather and political stability.

**Oil prices** increased sharply before the war in Iraq but declined again in April. Since then, they have risen again due to the uncertainty over when oil production in Iraq will come on stream, and also because of low oil stocks in industrial countries and possible production interruptions in Nigeria. The Ministry's forecast assumes that oil prices will rise by about 14 per cent this year and that the average oil price will be close to 28½ dollars a barrel. For next year, the price of oil is assumed to decline by 10½ per cent to 25½ dollars a barrel. Further declines of 7 and 2.5 per cent are assumed for 2005 and 2006 respectively.

**International interest rates** have continued their decline, benefiting the Icelandic economy by reducing the interest cost of the country's foreign debt. Most of Iceland's debt is on a floating rate basis which means that reductions in foreign interest rates are quickly reflected in reduced interest cost. The average interest rate on foreign long-term debt was 3.6 per cent in 2002 compared to more than 5 per cent in 2001. The average rate on short-term debt was lower because the weight of the dollar in the total is higher and short-term dollar interest rates have been lower than those for the euro. The Central Bank assumes that foreign short-term rates will be 3 per cent this year and 3½ per cent next year.

The development of six-month LIBOR rates are shown in the table which indicates where interest rates are going. It shows that dollar rates declined by 1.8 percentage points last year and euro rates by 0.9 percentage points. For this year, a decline in dollar rates of 0.6 percentage points and euro rates of 1.1 percentage point are predicted. For next year, an increase in interest rates is expected.

At the same time as the reductions in interest rates have helped in reducing the service on foreign debt, the decline in the dollar exchange rate has reduced Iceland's foreign debt in domestic currency terms. Last year, the dollar exchange rate declined by 25.5 per cent against the Icelandic króna.

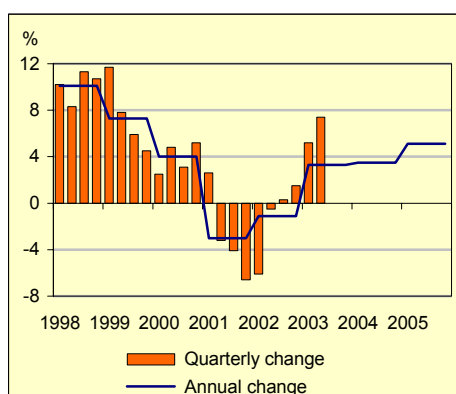
**Prices for fish products** increased by 3.3 per cent last year in foreign currency terms. For this year, prices are forecast to remain unchanged and a 1 per cent increase is expected for next year, whereas prices are assumed to increase by 2 per cent a year in the longer run.

**Aluminium prices** declined by 6.5 per cent last year and by 4.3 per cent in 2001. The Ministry's forecast for this year assumes a 3 per cent increase and an 8.5 per cent decline next year. Thereafter, a 1½ per cent annual increase is assumed.

## 5 NATIONAL EXPENDITURE

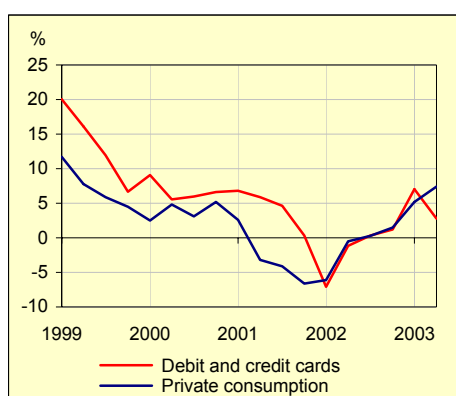
### Private consumption

#### Changes in private consumption



Source: Statistics Iceland, Ministry of Finance forecast.

#### Annual change in private consumption and debit and credit card turnover



Source: Statistics Iceland and the Central Bank

Most economic indicators point towards a sharp increase in private consumption, following the decline in 2001 and the first half of 2002. According to provisional quarterly national accounts, private consumption increased by 6.4 per cent in real terms in the first half of 2003 over a year earlier, thus having increased for four consecutive quarters.

**Import data.** Data on the imports of consumer goods so far in 2003 indicate that private consumption has recovered with vigour. In real terms, consumer goods imports were nearly 15 per cent higher in the first seven months of this year than at the same time a year ago. Imports of motor vehicles for private use rose by 54 per cent in real terms and by about one-fifth of other consumer durables, whereas imports of food and beverages only increased by 1.8 per cent.

**Domestic turnover.** Treasury revenue from indirect taxes increased by close to 8 per cent in real terms in the first eight months of this year over a year ago. Revenue from the value-added tax increased slightly less, by 7 per cent. Turnover data based on VAT returns show a similar picture.

#### Private consumption indicators

Changes from the same period the previous year, %	2002	2003
CPI, January-September	6.1	1.9
CPI, excluding housing, January-September	6.2	0.6
Wage index, January-August	7.9	5.6
Real wages, January-August	1.3	3.6
Taxes on turnover, January-August, volume change	-2.2	8.1
Of which VAT	5.0	6.9
Debit and credit card turnover, January-July	-3.5	4.8
Domestic	-2.8	4.2
Abroad	-16.9	19.5
Imports of consumer goods, January-July, volume change	-4.2	14.6
Automobiles	-10.7	46.9
Durable goods (e.g. home appliances)	-9.0	19.7
Semi-durables (e.g. clothes)	-10.2	10.7
Food and drink	7.2	1.8
Turnover in grocery stores, January-July		3.8
Registration of new automobiles, January-August	-13.2	60.0
Expenditure abroad of Icelandic citizens, January-June, fixed exchange rates	-15.0	23.5

Sources: Statistics Iceland, The Central Bank of Iceland, The Federation of Trade and Services, The Federation for Motor Trades and Repairs, The Ministry of Finance.

**Other indicators.** Other indicators regarding private consumption point to the same conclusion, i.e., there has been a substantial increase in private consumption from last year. The turnover through debit and credit cards increased by close to 5 per cent in real terms during the first seven months. The index for the retail turnover of non-durable goods that consumers purchase from day to day showed a 3.8 per cent real increase in the first seven months from a year ago. This index also shows that consumers spent more money on daily goods for all months of this year compared to the corresponding months last year, except in March, which may be attributable to the fact that Easter was in March in 2002 and in April in 2003. Furthermore, the Gallup index of consumer confidence is up for all of the first eight months of this year compared to last year. The index increased continually during the first five months of this year, peak-

ing at 136.8 points in May, a new high since the index was first measured in March 2001.

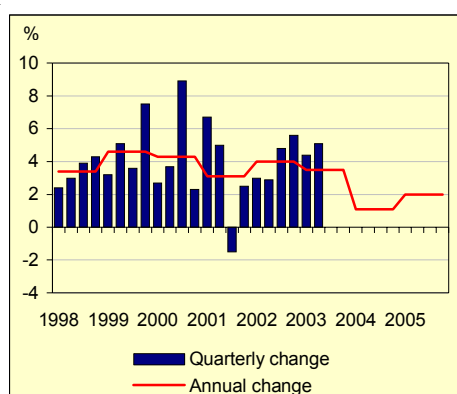
**New registration of private motor vehicles.** New registration of private motor vehicles is up by 60 per cent in the first eight months of this year over a year ago. A total of 8,118 vehicles have been registered in this period, compared to 7,412 for all of 2002.

**Conclusion.** These indicators point to the conclusion that private consumption is increasing rapidly this year, following a decline for most of the past two years. The forecast project a 3¼ per cent increase in real terms for 2003, whereas total real wages are estimated to increase less, or by 2 per cent. Household savings are therefore expected to recede this year. For 2004, private consumption is expected to increase by 3½ per cent and by 5 per cent in 2005.

According to provisional quarterly national accounts, public consumption increased by 4.7 per cent in real terms in the first half of 2003 compared to a year earlier. For the year as a whole, an increase of 3½ per cent is forecast. The increase is primarily due to hospital and school costs. Public consumption is expected to increase considerably less in 2004, by just over 1 per cent in

## Public consumption

### Changes in public consumption



Source: Statistics Iceland, Ministry of Finance forecast.

### Public consumption

<i>Billion krónur current prices</i>	2001	Prelim. 2002	Est. 2003	Forecast 2004	Forecast 2005
Public consumption	176.7	198.8	215.4	224.0	238.2
<i>Share of GDP</i>	23.7	25.5	26.4	26	25.5
Central government consumption	101.7	114.1	125.5	128.1	136.3
<i>Share of GDP</i>	13.6	14.6	15.4	14.9	14.6
Municipal consumption	58.7	66.6	70.8	74.8	79.6
<i>Share of GDP</i>	7.9	8.5	8.7	8.7	8.5
Social security consumption	16.2	18.1	19	21.1	22.3
<i>Share of GDP</i>	2.2	2.3	2.3	2.4	2.4

real terms. The low increase is due to the pursuit of a tight fiscal policy aimed at reducing current expenditure. An increase in public consumption of 2 per cent is forecast for 2005.

The Ministry's forecast implies that the share of public consumption in GDP will decline in 2004-2005, following a continual increase in recent years. The reversal is expected to

### Public consumption by type

<i>Billion krónur, current prices</i>	2001	Prelim. 2002	Est. 2003	Forecast 2004	Forecast 2005
Public consumption	176.7	198.8	215.4	224.0	238.2
- Wages and benefits	109.1	125.2	136.3	141.9	150.5
- Depreciation	14.5	15.8	17.6	18.0	19.6
- Purchase of goods and services	53.0	57.8	61.5	64.1	68.1
<i>Percentage breakdown</i>					
Public consumption	100.0	100.0	100.0	100.0	100.0
- Wages and benefits	61.8	63.0	63.3	63.3	63.2
- Depreciation	8.2	7.9	8.2	8.0	8.2
- Purchase of goods and services	30.0	29.1	28.6	28.6	28.6

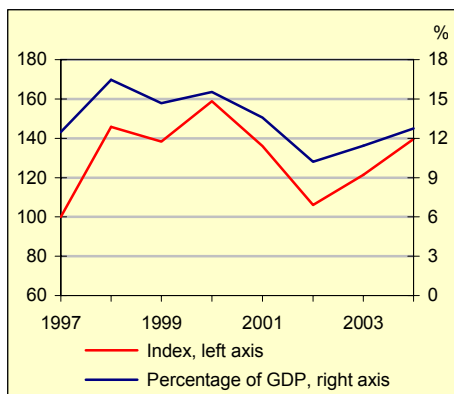
be based on lower increases in appropriations for current expenditure and lower salary increases for government

employees, which hitherto have been the primary cause of the rising relative share of public consumption in recent years.

Wages and salaries, including related emoluments, constitute the largest part of public consumption. It increased from 62 per cent in 2001 to 63 per cent in 2002 and is expected to be the same, about 63 per cent, in 2003-2005.

## Business investment

### Business investment



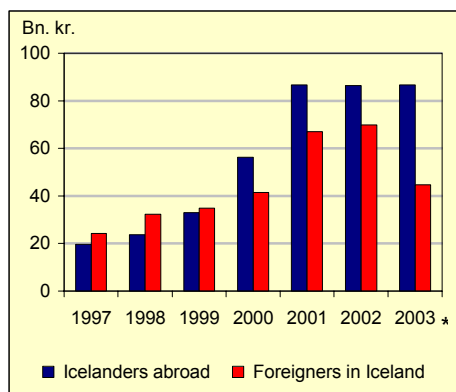
Source: Statistics Iceland, Ministry of Finance forecast.

Business investment has contracted by close to one-third in the past two years. This two-year contraction period seems now to have come to an end and there are prospects for an appreciable increase over the next several years. The forecast predicts a 14½ per cent increase in 2003, 15 per cent in 2004 and 26 per cent in 2005. The most important element in the increase is power project investment and the construction of the Reyðarfjörður aluminium plant.

Although total business investment is forecast to increase, the increase is concentrated in a few isolated sectors. The bulk of the increase in 2003 is in electricity production; other business investment is expected to be stagnant. Landsvirkjun has already started its construction of the Kárahnjúkar hydropower project and the Reykjavík Energy has begun harnessing geothermal energy on Hellisheiði near Reykjavík and accelerated its expansion of the Nesjavellir geothermal station.

There is a considerable increase in investment within the telecommunications sector. A new cable is being installed between Iceland, the Faroe Islands and Scotland at a cost of 4.5 billion krónur. Investment in the transportation sector tends to fluctuate sharply due to large investments in aircraft and ships. Such investments are expected to be negligible this year and thus decline from 2002 when Icelandair purchased a passenger jet. Investment in fisheries is expected to contract for the third year in succession, since new fishing vessels are not being added to the fleet and major maintenance and vessel renewal seems limited. An investment survey of industrial companies indicated that their investment could increase by one-fifth this year and by 5 per cent in 2004.

### Direct foreign investment at year-end\*



Source: The Central Bank

\* June 2003.

Icelandic investment abroad and foreign investment in Iceland have both increased in recent years, particularly since capital movements were liberalised in the latter half of the past decade. Icelandic investments abroad amounted to 87 billion krónur at the end of 2002 compared to 20 billion at the end of 1997. Direct foreign investment in Iceland amounted to 70 billion at the end of 2002 as against 24 billion at the end of 1997. Foreign direct investment has declined this year, amounting to 45 billion at the end of June due to sales by foreigners of their stakes in Icelandic businesses in the first half of the year.

Total imports of investment goods increased by 3 per cent in volume in the first seven months of this year. Excluding ships and aircraft, the increase is 27½ per cent.

Business investment is forecast to increase by 15 per cent in 2004 and 26 per cent in 2005 in volume terms, primarily due to power project and aluminium plant investments. In spite of a crowding-out effect that these investments may cause, it is expected that other businesses will invest in renewals and replacements of capital and equipment, at least in order to maintain produc-

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### *Housing and the real property market*

tion capacity. In the Ministry's forecast it is predicted that such other business investment will increase by 11 per cent in 2004 and 12 per cent in 2005.

In addition, there are several large projects in the final planning stage. A steel pipe plant is being planned in Helguvík, near Keflavík Airport. The total cost of the project is estimated at 6.5 billion krónur, the bulk of which will be incurred in 2004. The plant is scheduled to begin operation in the first half of 2005. Furthermore, a number of construction projects are in the planning stage, including a new shipping warehouse under construction in Reykjavík. The total investment cost of the hydro-power project and the aluminium plant in the eastern part of the country is estimated at 180 billion krónur which is about equally divided between the power project and the aluminium plant and is distributed over the years 2003-2010. The construction of the hydropower project has begun this year whereas the construction of the aluminium plant at Reyðarfjörður will commence in 2005.

Despite the slack in the economy in 2002 that has continued into this year, the residential construction sector is still robust. The present forecast indicates that residential construction will increase by 3 per cent in 2003, compared with the expectation of 1¼ per cent this past spring. For 2004, an increase of 4 per cent is forecast, similar to the increase foreseen last April. For 2005, this increase is expected to be less, around 3¼ per cent. Internal migration from the countryside to the capital area is not expected to play a large role in residential construction. Expanded credit facilities from the Housing Finance Fund may, however, generate increased demand. Indeed, there are signs that expectations to that effect are influencing the market already.

There are a number of causes for the increase in residential construction in 2003. The Housing Finance Fund offers generous credit facilities, up to 90 per cent financing to low-income, first-time buyers and financing for construction developers as well as for social housing. Moreover, discounts on housing bonds have been declining and the market price for such bonds has recently surpassed their face value. In spite of the large increase in new housing units in recent years, the demand for housing seems unrelenting which is reflected in ever-increasing property prices. From the beginning of 2002 until August 2003, the housing component of the consumer price index rose by close to 15 per cent at the same time as the consumer price index excluding housing remained unchanged.

A survey of real estate agents reveals that housing demand is to some extent credit-fuelled. The credit terms of the Housing Finance Fund are more favourable than other terms available in the market, thus encouraging increased turnover in the market. Buying a new apartment helps in refinancing shorter-term debt with a long-term mortgage at more favourable terms. This view is supported by data from the Housing Finance Fund that shows increased refinancing of mortgage debt.

Earlier explanations – that applied in 1998-2000 when migration to the capital area was pronounced, thus creating housing demand and stoking property prices – no longer apply. Migration to the capital area from other parts of the country is now



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much less than before and will not have as much of a demand effect as before. As is observed in the chapter on population developments below, it is estimated that net internal migration to the capital area will come to about 600 persons this year, compared with 1600-1800 persons a year in the middle of the previous decade. Although the construction of a power project and an aluminium plant in the eastern part of the country will do much to revive the economy in the surrounding area, the impact upon housing demand there will not be immediately felt.

The plans of the Housing Finance Fund to increase their general mortgage facility to up to 90 per cent of the purchase price seem to be affecting the market already, even if the plans will not be fully implemented until after 3-4 years. Increasing household disposable income over the next several years is also expected to be reflected in increasing housing investment.

The Housing Finance Fund has made a special effort to finance rental housing units this year and for that purpose financed 1,100 rental units, both for new construction as well as for purchase in the existing market. This will have a significant impact upon the rental housing market which up to now has been rather tight. Such rental units will now be available from enterprises on a commercial basis, whereas up to now the only rental property available has either been from social housing agencies or from individuals.

In Reykjavík, the number of building permits for new housing units have increased by more than a third in the first half of this year from the same time a year ago, and by two-thirds of last year's entire number of permits. A new project of downtown high-rises is under construction and the construction in the Reykjavík suburbs is going at a good clip. The same is true for two nearby towns, Garðabær and Hafnarfjörður, where new subdivisions are being opened up and construction is under way.

Outside the capital area, housing is mainly being built in the south-western part of the country within an hour's driving distance from Reykjavík. In Akureyri, the main town in the northern part of the country, housing construction has slowed down in the course of this year due to some market saturation, following a considerable increase in 2002. Housebuilding activity in the north-eastern part of the country – where the new power project and an aluminium plant will be under construction over the next several years – is beginning to take off and is expected to increase over the next two years.

Although general inflation has been receding ever since the beginning of 2002, housing prices have continued to increase. The apartment price index for the capital area was 15.3 per cent higher in July of this year than twelve months earlier. As noted earlier, mortgage credit availability appears to have become facile enough to encourage increased housing demand.

This applies in particular to a mortgage credit facility for low-income, first time buyers. The largest part of credits by the Housing Finance Fund are channeled through this facility. The number of such credits were 1,747 in 2001, 2,595 in 2002 and are estimated to reach 3,000 in 2003. All told, 8,000 such credits have already been extended. One-fourth of all mortgage credits ex-

### *Housing prices and mortgage credits*

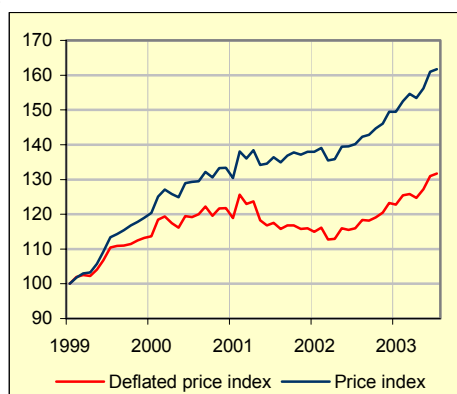
### Credits by the Housing Finance Fund

	2000	2001	2002	January - July		Increase in % 2002-2003
				2002	2003	
<b>Number of credits:</b>						
Existing housing	7,112	7,353	7,951	4,480	5,358	19.6
New construction by individuals	1,861	2,250	2,062	1,275	1,254	-1.6
New construction by developers	115	183	119	72	251	248.6
Renewals	195	269	270	111	138	24.3
New construction and renewals, total	2,171	2,702	2,451	1,458	1,643	12.7
Total credits	9,283	10,055	10,402	5,938	7,001	17.9
<b>Amounts, million krónur:</b>						
Existing housing	19,561	20,097	23,698	12,727	19,383	52.3
New construction by individuals	7,650	9,454	10,229	6,084	6,309	3.7
New construction by developers	588	1,166	814	476	1,634	243.3
Renewals	385	553	539	240	287	19.6
New construction and renewals, total	8,622	11,173	11,582	6,800	8,230	21.0
Total credits	28,183	31,270	35,280	19,527	27,613	41.4

Source: Housing Finance Fund

tended in 2002 were under this facility, and the proportion appears to be rising in 2003. As noted earlier, credits for rental units have increased sharply as well as for social housing. They were 587 in number in 2001, 611 in 2002 and are estimated to reach 1,100 in 2003. Rental units should be available in the commercial market in direct competition with owner-occupied units that are financed by 90 per cent mortgages.

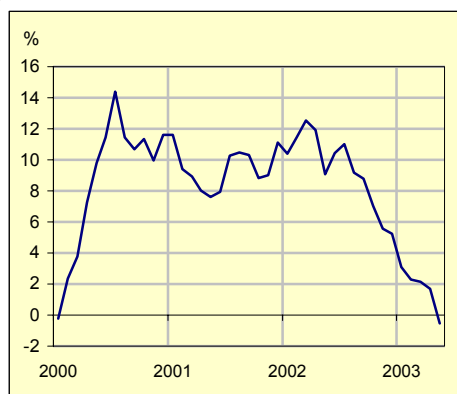
### Housing prices



Source: Valuation Office

Rising housing prices have had a considerable impact upon the supply side of the housing market. This is evident in the total credits for new construction and renewals which have increased by about one-fifth in the first seven months of this year over a year ago. This applies in particular to credits for building developers that have increased by 250 per cent between years following a decline in 2002. The number of credits for existing housing have increased by one-fifth and their total amount by more than half. The average mortgage credit amounted to just over 2.7 million krónur in the first seven months of 2002, rising to 3.5 million in the first seven months of this year. This increase is in part offset by early repayment of older mortgage credits that are being refinanced for longer maturities. The pattern of finance availability strongly points to the conclusion that the rise in housing prices and credit availability are strongly interrelated.

### Housing bond discounts



Source: Íslandsbanki

The trend in the market yield on housing bonds has also had a considerable impact on the market. Housing bonds carry a fixed 4.75 per cent rate of interest, whereas their actual yield is determined by supply and demand in the market. The higher the market yield, the lower the going bond price and vice versa.

The chart in the margin shows that discounts on housing bonds peaked in the middle of 2000 at about 15 per cent. They remained in the region of 8-12 per cent up to the middle of last year when they began to decline. By the middle of 2003 the market yield had dipped below the fixed rate of interest and bonds began to trade at a premium. This premium will probably remain for a while. Although the Central Bank's base rate has a direct impact on the money market, it has an influential indirect impact on the longer-term financial market. The base rate will probably not rise in the near future but may be expected to increase as power project construction activity increases, thus increasing housing bond yields. One element of uncertainty is that housing bonds are

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being marketed to foreign investors. They can be expected to hold such bonds as long as Icelandic yields surpass available terms in other international markets. This was the case early this summer when long-term bond yields in international markets were low. Since then they have begun to pick up, and the yield differential between Icelandic and international yields has begun to narrow. It is therefore difficult to predict how long foreign demand for housing bonds will continue.

### *Public investment*

In this forecast it is assumed that central government investment will increase by 18½ per cent in real terms in 2003. This sharp increase is in part due to the passage of a supplementary budget last spring that calls for an acceleration of public investment of 6.3 billion, of which 4.7 billion is scheduled for 2003 and 1.6 billion for 2004. Central government investment is expected to contract by 16 per cent in 2004 and by 9¼ per cent in 2005.

The investment plans of municipalities for 2003 indicate that their investment is contracting sharply after a considerable increase in 2002. This reflects the difficult finances of the municipalities this year. They have had to enter into heavy investments in elementary schools in recent years to eliminate double shifts in classrooms. These investments are now in their latter phase and it may be expected that the investment needs of municipalities will be slightly easier in the next several years. Several municipalities have resorted to privatisation of school buildings at the elementary and kindergarten stage. Such buildings are therefore no longer counted as public investment and are part of business investment. Furthermore, the uniform accounting code for municipalities has been substantially revised as of 2002 which makes comparison with earlier years difficult.

For municipalities, the Ministry's investment forecast is based on the investment plans of the 20 largest municipalities which cover more than 80 per cent of the municipal sector. Their investment is expected to contract by 12 per cent in 2003. The contraction is especially felt in the capital area whereas elsewhere the trend is more even. In the forecast it is assumed that municipal investments will remain unchanged in 2004 and increase in 2005 by 1½ per cent.

Total public investment, that of the central government and the municipalities combined, is forecast to increase by 1 per cent in 2003, followed by an 8 per cent decline in 2004 in spite of the 1.6 billion in accelerated investment spending discussed above. For 2005 a further 3½ per cent decline is forecast.

## 6 FOREIGN TRADE

The value of exports of goods and services is expected to decline in krónur terms between 2002 and 2003, due entirely to the strengthening of the exchange rate; in real terms the export value is close to unchanged from the previous year. The strong exchange rate also has a significant impact on the import side, where an increase in imports in real terms is offset by a lower import price; the total krónur value of imports increases between 2002 and 2003. Consequently, the current account turns to deficit in 2003, estimated at 20 billion krónur and equivalent to 2½ per cent of GDP. The current account deficit is expected to increase over the next two years and peak in 2005 due to imports for the construction of power facilities in the eastern part of the country and also to increased private consumption.

### Merchandise exports

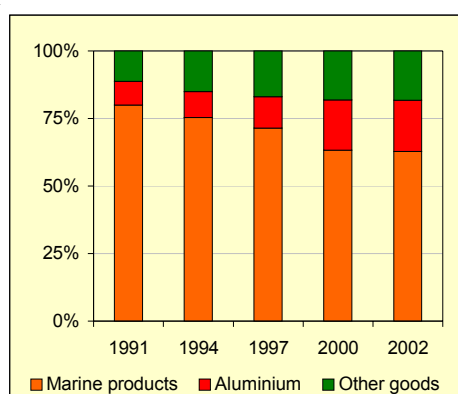
Merchandise exports amounted to 108 billion krónur in the first seven months of this year compared to 124 billion krónur in the corresponding period a year ago. They declined by 1 per cent in volume terms and export prices fell by 12 per cent resulting in a total of a 13 per cent decline in the krónur value of merchandise exports. The price fall is mainly attributed to the strengthening of the exchange rate of 10 per cent, based on the currency basket of the exchange rate index from January to July this year. A decline of exports in real terms of 1½ per cent is forecast for this year. For 2004 and 2005, however, a substantial increase in exports is forecast; 5½ per cent and 3 per cent respectively.

As before, marine products are still the mainstay of exports, although their weight has been diminishing in recent years. Their share in total merchandise exports was 62 per cent in the first seven months of this year, slightly less than for 2002 as a whole. This compares to 80 per cent at the beginning of the last decade when the catch of demersal species (fish close to the bottom of the ocean) was larger. Furthermore, since then exports of non-marine products, particularly aluminium, have increased. For 2003, export production of marine products is forecast to contract by 2 per cent from the previous year, turning to a 6 per cent increase in 2004 and 2 per cent in 2005. The assumptions behind the forecasts are discussed in the next chapter.

The share of aluminium in total merchandise exports was the same in the first seven months of this year as a year ago, about one-fifth or double the proportion in the first half of the previous decade. For 2003, export volume is assumed to remain constant. Aluminium prices have increased in the course of this year but the price increase is offset by a substantial decline in the dollar exchange rate and a stronger króna. The total value of aluminium exports will therefore most likely decline. For 2004, a marginal increase in export volume is expected. Aluminium prices are expected to increase by 8½ per cent in 2004 whereas long-term forecasts indicate that the 2005-increase will be much smaller, 1½ per cent in foreign currency terms.

Exports of other merchandise have increased rapidly in recent years, although they have slowed down this year and in some cases declined, particularly in pharmaceuticals, after having nearly doubled last year. Exports of medical equipment have on the other hand continued to increase as well as exports of electronic equipment and machinery for fish processing. The same applies to exports of ferro-silicon so far this year.

### Merchandise exports by type



Source: Statistics Iceland

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About 80 per cent of merchandise exports go to European countries and their share has been increasing in recent years. The share of the US has declined commensurably and stands now at about 10 per cent. Exports to Japan have also contracted to about one-fourth of their peak in the previous decade. There have been substantial changes in the relative exchange rates of major international currencies that undoubtedly have had an influence upon the course of exports. The differing developments of the economies of Iceland's customer countries have also been of influence. The difficulties of the Japanese economy have clearly led to reduced exports to that country. The 20 per cent decline in the dollar/krónur exchange rate has also discouraged exports to the US at the same time as the euro/krónur exchange rate only declined by 7 per cent.

Most international forecasts appear to agree that Iceland's customer countries are slowly recovering, creating conditions for increased private consumption. In fact, private consumption in the euro area has increased marginally this year, and there are indications in the same direction for the US, although these trends differ substantially between countries.

### *Merchandise imports*

The total value of merchandise imports amounted to just over 113 billion krónur in the first seven months of this year, increasing by 5 per cent in real terms. Imports of consumer goods rose by close to 15 per cent and of investment goods by more than one-fourth. Imports of private motor vehicles rose by more than half and of other consumer durables by one-fifth, reflecting increased domestic demand in the course of the year.

In the Ministry's forecast, imports are expected to increase by 5¾ per cent in real terms between 2002 and 2003, and a 6¼ per cent increase is expected in 2004, rising to 7½ per cent in 2005. The sharp increase in imports over the next two years is attributable to the construction activities in the eastern part of the country and to increased private consumption.

### *The trade balance*

There was a 14 billion krónur trade surplus in 2002, following a deficit in the previous four years. For the first seven months of this year there was a deficit of 6 billion krónur as against a 9 billion surplus in the corresponding period a year earlier. The main reason for the reversal is to be found in the stronger exchange rate and increased domestic demand. The exchange rate is expected to remain about on par with the rate prevailing during the same period a year ago. The adverse impact of the exchange rate upon exports is therefore expected to be reduced and higher import prices are therefore also expected to discourage import demand. The trade balance is therefore forecast to be in surplus in the last four to five months of the year, leaving merchandise trade in balance for the year as a whole.

### *Exports of services*

Exports of services declined by 10 per cent in value in the first six months of this year over the first half of last year, mainly due to the stronger exchange rate. On a constant exchange rate basis, they increased by 1 per cent. Exports of services fall into three major categories, transportation, travel and other services. Transportation includes both aviation and shipping, which declined from the first half of last year, whereas income from travel services increased. Of other services, about one-third are commercial services which earned about 8 billion krónur in the first half

of this year, a slightly lower amount than the receipts from tourism. Income from the Defence Force also falls under other services and amounted to 3.6 billion krónur in the first half of the year.

### Imports of services

Imports of services increased sharply in the first half of this year over a year ago. In krónur terms the increase amounted to 5 per cent and to 16 per cent at a constant exchange rate. The main reason for the increase is travel expenditure abroad and the category other services which increased about one-fifth. The largest item under this category are commercial services. Travel expenditure abroad increased by about one-fourth at a constant exchange rate.

### The balance on services

The services balance was in deficit by close to 9 billion krónur in the first six months of this year, compared with a deficit of 2 billion in the first half of last year. The balance for the remainder of the year is expected to improve for the same reasons as apply to the trade balance. A deficit of 4¾ billion is forecast for 2003. For the next two years, the deficit is forecast at 9 and 11 billion, respectively.

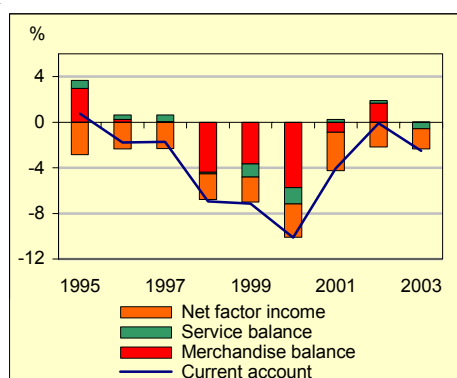
### Net factor payments

Net factor payments amounted to 8.3 billion in the first half of the year, 2.7 billion less than in the first half of last year. The largest factor payments item is interest on foreign debt which has declined due to an improvement in the country's foreign debt, partly due to the stronger exchange rate and also because floating interest rates abroad have declined and they apply to the majority of the foreign debt. Factor income includes wages earned by Icelanders abroad as well as interest and dividends of Icelandic assets abroad. All these items show an increase over the previous year. For the year as a whole, net factor payments are expected to be in deficit by close to 14¾ billion krónur. For 2004 and 2005, net factor payments are projected to increase to 15¾ and 20½ billion respectively. These figures reflect an increasing current account deficit and a rising foreign debt.

### The current account

The current account deficit is expected to increase up to 2006. For 2003, it is forecast at 20 billion krónur, equivalent to 2½ per cent of GDP. It is expected to increase over the next two years and peak in 2006 and be mainly attributable to investment goods imports in connection with construction activity in the eastern part of the country as well as to rising private consumption.

The current account, % of GDP



Source: Statistics Iceland, forecast by Ministry of Finance.

### Current account balance

Billions of krónur	Prel.	Forecast		
	2002	2003	2004	2005
Merchandise exports	204.3	193	203¾	216¾
Merchandise imports	-190.7	-192¾	-206½	-228½
<b>Balance of trade</b>	<b>-13.6</b>	<b>¼</b>	<b>-3</b>	<b>-11¾</b>
Export of services	104.7	100	104¼	110½
Import of services	-103	-104¾	-113	-121¼
<b>Balance of services</b>	<b>1.7</b>	<b>-4¾</b>	<b>-8¾</b>	<b>-11</b>
<b>Net factor income from abroad</b>	<b>-17</b>	<b>-14½</b>	<b>-15¾</b>	<b>-20½</b>
<b>Current account balance</b>	<b>-0.5</b>	<b>-20</b>	<b>-28½</b>	<b>-44½</b>
As per cent of GDP	-0.1	-2½	-3¼	-4¾

Source: The Central Bank, forecast by Ministry of Finance.

The net external debt of the Icelandic economy, i.e. gross debt less assets abroad, was about 10 billion krónur lower at the end of June this year than at the end of 2002. Foreign debt increased by 70 billion krónur in the first half of the year and amounted to more than 1,050 billion krónur at the end of June. Foreign assets increased by 80 billion at the same time, amounting to 490 billion at the end of June. The net external debt amounted to about 570 billion krónur at the end of June, corresponding to 71 per cent of GDP, 81 per cent at the end of 2002 and 76 per cent at the end of 2001. The Ministry's forecast projects external debt in GDP-terms in the range of 71-72 per cent over the next two years.

Iceland's foreign direct investment has remained stable in krónur terms since 2001. Investment in foreign shares has increased again in the course of this year, following a decline in 2002. Foreign direct investment in Iceland has declined this year but purchases by foreigners of Icelandic housing bonds have increased sharply.

The development of the exchange rate, interest rates, inflation and the labour market all have a substantial impact upon the business environment. The same applies to the environment created by public policies towards business which has been radically changed by a liberalisation of the financial market, privatisation of government enterprises, particularly of financial entities, and by tax cuts.

#### **Net external position**

<i>Billions of krónur, end of period:</i>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>June 2003</b>
<b>Total assets</b>	315.8	421.1	405.4	484.0
Direct investment abroad	56.2	86.7	86.4	86.7
Portfolio assets	186.3	202.5	169.8	201.6
Other investment assets	39.1	95.2	112.0	158.9
Reserves	34.2	36.6	37.2	36.9
<b>Total liabilities</b>	763.4	1 007.5	986.8	1 056.1
Direct investment in Iceland	41.4	67.0	69.9	44.7
Portfolio liabilities	346.7	468.0	468.3	571.4
Other investment, liabilities	375.3	472.4	448.6	440.1
<b>Intern. investment position</b>	- 447.6	- 586.4	- 581.4	- 572.1
Equity capital, net	193.3	202.1	159.9	218.7
Net external debt position	- 640.9	- 788.5	- 741.3	- 790.8
<b>External debt ratio:<sup>1</sup> p.c. of GDP</b>				
Intern. investment position	-64.0	-76.0	-80.9	-70.8
Net external debt <sup>2</sup>	91.6	102.1	103.2	97.8
External debt position <sup>3</sup>	103.1	121.1	126.5	124.6

1) The debt ratio is calculated in terms of foreign currency (SDR) to account for changes in the exchange rate of ISK.

2) IIP excl. net investment in equities.

3) Total debt (Total liabilities minus equities).

Source: The Central Bank

## 7 BUSINESS SECTOR

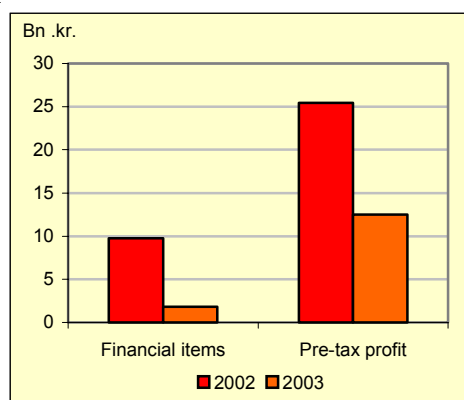
The Icelandic economy has gone through considerable fluctuations in 2000-2002. This applies in particular to the exchange rate which is reflected in a swing in the inflation rate from 1 to 10 per cent over this period. Indications are that this period is now over. Inflation has been stable so far this year and there has been some slack in the labour market. The exchange rate has also been stable in recent weeks.

The Ministry has collected data on 62 companies that have published their accounts for the first half of 2003 for the Iceland Stock Exchange. The main conclusion is that profits of these companies have deteriorated from the corresponding period a year ago. The total pre-tax profit declined more than a quarter, to 9 per cent of revenue from 13 per cent a year ago. The deterioration is primarily due to financial items in connection with the stronger exchange rate in the first half of this year.

### *Profit reports of companies listed on the Stock Exchange*

Profits by sector differ, but for finance and insurance they stand out. Revenues increased sharply between years and profits rose by 6 per cent. This sector is alone in earning larger profits than a year ago. Bank profits are ample, bolstered by large foreign exchange profits. Profits by insurance companies tripled between years. Cash from operations also increased sharply, by 21 per cent of revenue; this item does much to reflect actual business profits.

### **Profits of companies on the Stock Exchange, first half of each year**



Source: Iceland Stock Exchange

The revenue of fisheries companies declined by 15 per cent between 2002 and 2003, partly because of the rise in the exchange rate of 11 per cent in the first half of 2003 over a year earlier, based on the exchange rate basket in effect in the first half of 2003. Excluding exchange rate and price changes, the decline in revenue was 7 per cent which is explained by a decline in the fish catch between the two periods. Gross profits thus declined from 12 per cent to 10 per cent of revenue. Profits before tax declined by close to 9 billion. The impact of the rising exchange rate is reflected in working capital which declined by 3.5 billion, considerably less than profits.

Revenue of industrial production companies increased by 6 per cent between years, but profits before tax declined by 7 per cent. This group of companies includes manufacturing firms, construction companies and contractors as well as pharmaceutical companies. Revenue increased in all these branches between years and gross profits increased in construction by 1 per cent and in pharmaceuticals by 3 per cent.

The revenue of commerce and services increased by more than 3 billion krónur in the first half of this year over a year ago. Gross profits increased by 1 per cent to 12 per cent of revenue, the contribution from financial items declined and profit before tax declined by 12 per cent.

Profits of Icelandair and Eimskip (The Iceland Steamship Co.) declined sharply between the two year-halves. A profit of 2 billion before tax in the first half of 2002 turned to a 1 billion loss in the first half of this year. Operating revenue declined by 2 billion krónur and profit before tax fell from 10 per cent of revenue to 3 per cent. This is also reflected in working capital which fell from 8 to 5 per cent of revenue. The fisheries company Brim, a subsid-



**Key figures for the first six months of the year 2002-2003, companies registered on the Icelandic Stock Exchange**

	% of revenue	Gross profit	Financial items	Profits before tax	Changes in working capital
Marine production					
2003	10		1	5	8
2002	12		5	13	9
Industrial production					
2003	15		0	11	13
2002	15		1	13	12
Commerce and services					
2003	12		3	7	11
2002	11		5	9	11
Transportation					
2003	3		-1	-5	1
2002	10		4	8	8
Finance and insurance					
2003	-		-	25	35
2002	-		-	19	14
<b>Total</b>					
2003	-		-	9	14
2002	-		-	13	11
<b>Total without finance and insurance</b>					
2003	11		1	6	9
2002	12		4	11	10

iary of Eimskip, is excluded from these figures and included in the marine production sector in this survey.

Turnover data give an indication of output in individual sectors and their contribution to economic growth. In light of the considerable changes that have taken place in the business operating environment in recent years, a retrospective look at developments over the past decade is useful.

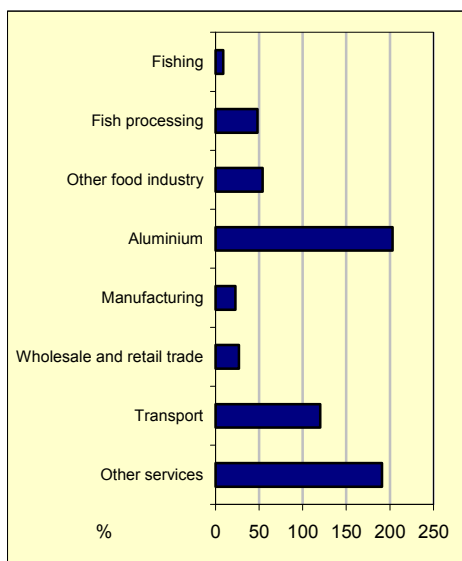
In constant prices the total turnover of all sectors has increased by close to 50 per cent from 1991 to 2002. By comparison, the population increased by 11 per cent over this period. Turnover in per capita terms thus increased considerably, although not evenly for the period as a whole. Up to 1995, turnover contracted after which it recovered with a vigorous expansion.

The wholesale and retail sector is largest by far, including car dealerships, petrol stations and commission agents. Turnover in this sector has increased by one-fourth since 1991, but its share in total turnover has declined from 42 per cent in 1991 to 36 per cent in 2002.

Fish processing is the second-largest sector covered by this survey. Its share of total turnover was 9 per cent in 2002, the same as in 1991. Its share peaked in the middle of the last decade at 11 per cent. The turnover in this sector has increased by 50 per cent since 1991, a year when it was at a low because the total fish catch was also very low at the time, lower than it has been since. By comparison, the turnover in fishing proper increased by only 9 per cent over this period. The difference between the turnover between fishing and fish processing could indicate that fish processing is creating greater value-added out of each unit of landed

**Production and turnover**

**Change in turnover 1992 - 2002 at constant prices**



Source: Statistics Iceland

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fish. The share of fishing in total turnover was 6 per cent in 2002.

Transportation is one of the largest sectors in the economy with more than 8 per cent of total turnover of all sectors in 2002. The growth of this sector has been considerable since 1991, about 120 per cent. However, turnover declined in 2002 and there was a further decline in the first four months of this year.

The turnover of computer services and software design, along with miscellaneous commercial services has tripled since 1991, increasing its share to 7 per cent compared with 3 per cent in 1991. The turnover in this sector in 2002 exceeded that of the fisheries sector.

The industrial production sector consists of four subsectors, fish processing, other food processing, energy-intensive production and other industrial production. Fish processing is the largest of these sectors, followed by other industrial production. The share of the latter in total turnover of all sectors has declined by 1½ per cent since 1991 in spite of an increase of one-fourth in its turnover over this period. Other food processing maintains its share in total turnover at about 4 per cent and the share of energy-intensive manufacturing was 3½ per cent in 2002, double that of 1991. The turnover in this sector has tripled over this period due to construction of the Norðurál aluminium plant at Grundartangi and the expansion of the Straumsvík aluminium plant.

### *The fish catch and its prospects*

**The fish catch in the first seven months of this year.** The total fish catch of Icelandic vessels declined sharply in the first seven months of this year. The capelin catch declined by 355 thousand tonnes to 680 thousand tonnes. The herring catch declined by 20 thousand tonnes or 16 per cent, whereas the blue whiting catch increased by close to half to 236 thousand tonnes. The catch of demersal species declined slightly; the cod catch was down by 9 per cent which was offset by an increase in the catch of haddock and saithe. These species are not comparable in value; the value of cod for example is normally double that of saithe.

**Demersal species.** The total catch quota was increased for several species for the fishing year that commenced at the beginning of September 2003. The increase was greatest for cod, 30 thousand tonnes or 17 per cent, but catch quotas were also increased for haddock and saithe, whereas for redfish they were cut by 5 per cent. Despite the increase in the cod quota, it is assumed, for purposes of the Ministry's economic forecast, that the cod catch will decline by 17 thousand tonnes in the calendar year 2003 from the previous year. The haddock catch is expected to increase by one-fourth and that of saithe by 12 per cent.

**The pelagic catch.** The capelin catch will evidently decline this year. The catch quota for capelin was also sharply cut between 2002 and 2003. The catch quota applies to the period from June 20<sup>th</sup> to the end of April, and the bulk of the catch is caught in winter, mostly at the beginning of the year. The initial capelin quota for 2003 is just over half of last year's initial quota, 362 thousand tonnes. A final quota is usually not decided upon until later in the catch season, following further measurement surveys by the Marine Research Institute. For the Ministry's forecast, a 30 per cent decline in the 2003 capelin catch is assumed.

### Total allowable catches (TACs) for main species

Tonnes	Fishing year		Changes
	2002/03	2003/04	%
Cod	179,000	209,000	16.8
Haddock	55,000	75,000	36.4
Saithe	45,000	50,000	11.1
Redfish	60,000	57,000	-5.0
Wolffish	16,000	16,000	0.0
Greenland halibut	23,000	23,000	0.0
Herring	105,000	110,000	4.8
Shrimp*	23,000	20,000	-13.0
Inshore shrimp	1,700	1,350	-20.6
Lobster	1,600	1,600	0.0
Scallop	4,150	0	-100.0

\*Provisional TAC

The herring catch of the last season (the Icelandic summer-spawning herring) was rather poor as in recent years. The catch fell short of the quota. It is assumed that this year's catch will come to about 100 thousand tonnes, slightly more than last year. The quota allotment for the Atlantic-Scandian herring is based on a calendar year and declined by more than 20 per cent from last year. It is expected that the entire quota will be caught. The quota for blue whiting was nearly doubled between years. The quota will probably not be fully used; the catch is estimated in the range of 420-450 thousand tonnes, an increase by a half from last year.

### The shellfish catch

The quota for deep-sea shrimp was 30 thousand tonnes for the last fisheries year in addition to 7 thousand tonnes carried over from the previous fisheries year, a total of 37 thousand tonnes of which 24 thousand tonnes had been caught by the end of August when the fisheries year ended. For purposes of this forecast, it is estimated that the total shrimp catch will come to 29 thousand tonnes (including the catch from the Flemish Hat), which indicates a decline by about one-fifth from the previous year. The scallop catch has declined sharply due to a rising ocean temperature in Breiðafjörður, the main catch area. The catch of scallops has been suspended this year in order to prevent a total collapse of the scallops stock.

### The production forecast

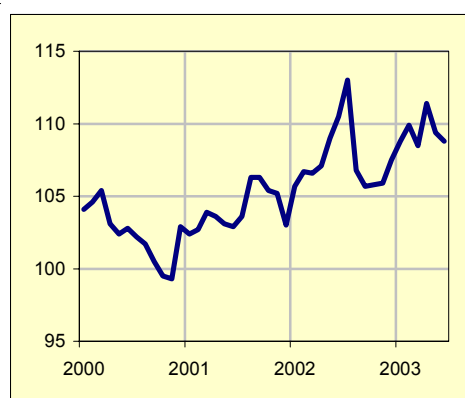
#### Catch forecast

Catch in thous.tonnes	Forecast		
	2002	2003	2004
Cod	207	189	214
Haddock	50	63	77
Saithe	42	47	52
Redfish	66	59	57
Wolffish	14	17	16
Greenland halibut	19	22	23
Herring	97	100	95
Shrimp	29	23	26
Capelin	1 079	735	800
Blue whiting	286	420	350
Atl.-Scand. herring	127	103	103
Oceanic redfish	45	55	50
Flemish Cap shrimp	5	6	8

For purposes of the Ministry's forecast, it is assumed that marine production for export will decline by 2 per cent in 2003, followed by a recovery of 6 per cent in 2004, primarily reflecting increased catch quotas. The increase in catch quotas as of the beginning of September of this year do not suffice, however, to increase marine production in calendar 2002 over the previous year during the four remaining months of the year. The catch estimate is based on the latest situation report of the Marine Research Institute. The cod catch is expected to increase as well as the catch of haddock and saithe. The capelin catch is difficult to predict, especially given the present environmental circumstances where the latest marine research results reveal that ocean temperatures and salinity are well above the long-term average. Not much capelin could be found during the last fishing season. It was thought that ocean temperatures were too high and the capelin had therefore retreated to other waters. The sampling measurements of the Marine Research Institute conducted last August yielded the lowest capelin fry index (sometimes referred to as the O-group

## Prices for marine products

**Marine product price index in SDR**  
1990=100



Source: Statistics Iceland.

## The outlook for profits in the fisheries industry

index) ever measured. The Ministry assumes in its forecast that the capelin catch will come to 800 thousand tonnes in 2004, well below the average of the past ten years.

Exports of marine products amounted to 67 billion krónur in the first seven months of this year, 15 per cent less than in the corresponding period a year ago. Export production declined by just over 3 per cent in this period but prices in krónur terms declined by 12 per cent, much of which is due to the stronger exchange rate. In SDR-terms, prices have changed little, from an average index of 109.2 in the first seven months of this year to 108.3 last year.

Although the SDR-price index has changed little as a whole – regardless of whether one compares the first seven months of this year or the period from August 2002 to July this year with the corresponding periods a year earlier – there are still considerable changes from one product and species to another. The largest changes are for haddock and whole shrimp frozen ashore; both declined by 9 per cent in price between the twelve-month periods. The price for salted herring rose by close to 18 per cent and for lobster by 13 per cent. Prices for other products changed less.

In the Ministry's forecast it is assumed that prices for marine products in foreign currencies will on average be unchanged in 2003 and increase by 1 per cent and 2 per cent in 2004 and 2005, respectively.

Profits in fisheries were exceptionally good in 2001 and 2002. This year, profits are expected to decline on account of the stronger exchange rate, higher oil prices and a reduced catch. Next year, profits could recover due to an increased catch quotas and lower oil prices.

### Profitability of fisheries 2001 - 2004\*

Billions of Kronur	2001	Estim. 2002	Estim. 2003	Estim. 2004
Revenues	126.5	132.3	121.1	130.7
Operating expenses	89.9	99.6	98.6	105.3
Gross operating surplus	36.6	32.7	22.5	25.4
% of revenues	28.9	24.7	18.6	19.4
Imputed cost of capital	17.1	17.9	18.3	18.7
Pre-tax profits	19.5	14.8	4.2	6.7
% of revenues	15.4	11.2	3.5	5.1
<b>Changes from previous year, %</b>				
<b>Main assumptions</b>		<b>2002</b>	<b>2003</b>	<b>2004</b>
Catch		4¼	-2	6
Export prices (foreign currency)		3¼	0	1
Fish prices (raw material)		15¾	-3¾	0
Exchange rate of IKR		3¼	7	-1
Wages		7	5	4½
Oil price (foreign currency)		-10½	14½	-10¼
Other domestic prices		4¾	2	2½

\* Consolidated income statement for harvesting and processing.

As outlined in the table on the preceding page, gross profits (EBITDA) in 2003 are expected to amount to 18.6 per cent of revenue and profits before tax to 3.5 per cent of revenue. Despite this rather favourable outlook for the fisheries sector as a whole,

individual branches and firms are not faring as well, particularly the shrimp and scallops industries. For 2004, profits before tax are estimated at 5 per cent of revenue, nearly half of the 2002-result. These projections are largely based on the same main assumptions on fish catch and price changes that are underlying the present economic forecast.

### Energy-intensive production

Aluminium prices have been rising in recent months in the world market. So far this year, aluminium prices have risen by 4 per cent and it is assumed that this increase will hold for the rest of the year. Aluminium prices were 9 per cent higher in August than at the same time last year. This price increase is expected to roll back in 2004 when an 8½ per cent price decline in foreign currencies is forecast. Energy-intensive production increased by close to 10 per cent in 2002 due to the expansion in productive capacity of the Norðurál plant coming fully on stream in that year. This year and next, however, energy-intensive production is expected to change little.

As noted before, an aluminium plant with an annual production capacity of 322 thousand tonnes is scheduled for construction at Reyðarfjörður. The plant will be completed in 2007 and full production capacity will be achieved by 2008. The total construction cost of the plant along with harbour facilities is estimated at about 86 billion krónur at 2003-prices.

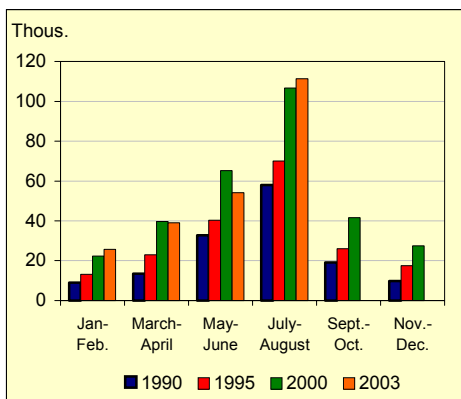
Aluminium production will more than double when the new Reyðarfjörður plant will be operational in 2007. Production will go from 267 thousand tonnes a year in 2002 to 589 thousand tonnes in 2008 and the weight of aluminium in merchandise exports will increase from 19 to 28 per cent.

### Tourism

The number of foreign tourists has increased sharply this summer. There were 14 per cent more arrivals in July and 16 per cent in August at Keflavik Airport than in the corresponding months a year ago. The number of tourists in the first eight months came to about 240 thousand, including tourists arriving with the Norræna car ferry. This number exceeds that of the corresponding period in 2000 which was a record year with 300 thousand foreign travellers for the year as a whole. The number of overnight stays in hotels increased by 7 per cent in 2003 and by 19 per cent over the year 2000, both on a seven-month basis. It is therefore evident that tourism has recovered, although prospects this spring were not favourable. World tourism was slow in April and May due to the Iraq war and the SARS-epidemic.

According to the Icelandic Travel Industry Association, an industry group, it appears that the travel habits of tourists visiting this country have changed. The number of tourists travelling on their own is increasing and they appear more price-conscious than before. The number of American tourists has declined and there are fewer tourists arriving for pure fun tours, a market segment that so far has been popular with Americans. Perhaps this is a temporary phenomenon related to a worldwide discussion of the decline in tourism. Tourists travelling on their own thought perhaps that they could achieve better terms than before by arranging their own travel. The change could also be permanent through the advent of the Internet and the possibilities it presents for offering tourism services.

Number of tourists\*



Source: Iceland Tourist Board

\* In 2003 only passengers in Leif Ericsson terminal.

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Tourism revenue declined by 6 per cent in the first half of this year from a year ago, mostly through lower airfares. On a fixed exchange rate and constant prices basis, the turnover of the tourism sector has increased by about 1 per cent. Airfare revenue has however declined by 7 per cent and spending by foreign tourists has increased by 8 per cent. The number of tourists increased by 2 per cent in the first half over a year ago.

Ever since the 1950's the number of births has been in the range of 4,000-5,000 with the exception of four years when the number dropped below 4,000. The largest number of children under the age of one was in 1960 when they were 4,856 at year's end. The annual number of births exceeded 4,600 in the first years of the 1990's. These children are now entering growing upper classes of elementary schools. The number of births declined considerably after 1993 and has continued to decline, save for the year 2000. Still, the annual number of births has never been less than 4,000. The birth rate has declined slowly in recent years but is still higher than in European countries and about on par with the United States.

The annual number of deaths has been in the range of 1,700-1,900. Life expectancy has increased considerably in recent years which will have a considerable impact in the future. Life expectancy in Iceland is one of the highest in the world. Since the first half of the 1970's male life expectancy at birth has increased by 6.6 years to 78.2 years and by 4.7 years for females to 82.2 years.

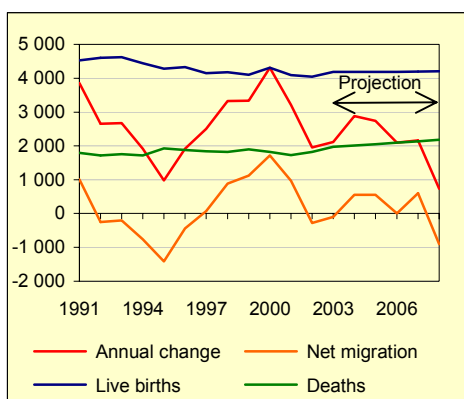
The most important element of change in the Icelandic population is international migration. Immigration of Icelandic citizens was unchanged in the first half of 2003 from the first half of 2002. It amounted to 945 in the first half of this year as against 927 in the first half of 2002. Emigration figures for the corresponding periods were 1,106 and 1,099 respectively. Immigration of foreign citizens was considerably lower in the first half of this year than last, 564 as against 914. Emigration of foreign citizens was about the same, 372 and 400 for last and this year respectively.

International migration is generally greater in the second half of the year than in the first. Net immigration of foreign citizens is now estimated to be at 700 for 2003 as a whole and net emigration of Icelandic citizens is estimated at 100. Experience shows, however, that these population movements are difficult to predict.

The chart in the margin of this page shows the principal population developments in recent years and the forecast of the Ministry for the next few years. It is forecast that the annual number of new births will be similar to those of recent years. The number of deaths is expected to increase slowly. The estimate of international migration is based on developments in recent years as well as on an estimate of the impact of the power and industrial construction projects upon the population.

The population projection for the next several years reveals a number of important observations. The number of children in elementary schools will decline. New school construction will therefore primarily fulfil demand for improved standards and to meet demand for space arising from internal migration. Under such circumstances the danger arises that there is a mis-match between supply and demand for school buildings. (erfitt að skilja þessa setningu) The size of the secondary school age cohorts will be fairly constant next year compared to this year but in the next four years thereafter they will increase by a total of 2,000. In addition, the secondary school participation rate is increasing and therefore it is clear that there will be increased activity at the secondary school level over the next years.. The number of

**Population**



Source: Statistics Iceland, Ministry of Finance projection.

**Population projection**

persons aged 67 years or older – who thereby qualify for a basic old age pension from the social security system – will increase in line with the general population over the next several years. The number of persons aged 80 years and older will increase by 2-3 per cent a year.

Figures for internal migration in the first half of 2003 show that they are similar to 2002. It is therefore to be expected that net migration to the capital area from the rest of the country will be about 600 for this, the third year in a row. This is a considerable change from the middle of the tenth decade, when it was to the order of 1,600 - 1,800 a year. The forecast for international migration takes account of what is expected to happen in the second half of the year in connection with the construction project in Eastern Iceland.

In the first half of the year there is not much change to be seen in the population development in Eastern Iceland and this is to be expected. It is to be noted that development in Egilsstaðir and vicinity continues to strengthen but the change is less marked in Fjarðabyggð. The change in all communities in the vicinity of the construction project is towards growth. A significant change for the worse is only to be seen on the northern coast of Snæfellsnes where the closure of shellfish catching and production is sure to play a significant part.

Labour market participation measures the proportion of the population of working age that is employed or wishes to be employed. The latter group comprises those persons that are out of work but wish to work, whether they are registered as unemployed or not. Labour market participation has in recent years mainly been measured through the labour market surveys conducted by Statistics Iceland. These surveys have been conducted twice a year, in April and November. As of this year, the surveys are continuous and published quarterly.

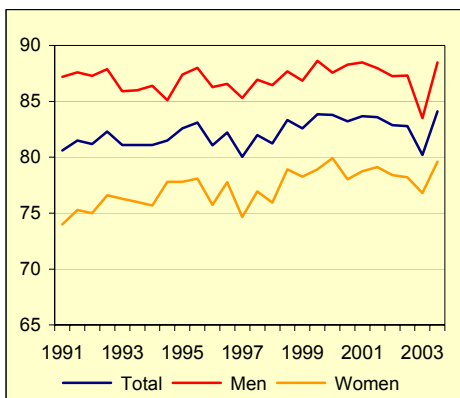
Labour market participation can be discerned indirectly from tax collection data, a method used by the Ministry of Finance to assess seasonal participation fluctuations and, thereby also estimating labour supply on a monthly basis. The surveys of Statistics Iceland are based on a working-age standard of 16-74 years, and participation rates are based on that age group. Other sources define working age as the range from 15 to 64 years. This age group is widely used by international institutions and is presumably based on the notion that people tend to retire earlier in other countries than in Iceland.

The chart in the margin shows male and female labour market participation since 1991 when labour market surveys began. Male participation is higher than that of females, fluctuating between 86 and 88 per cent. It generally increased from 1998 to 2001 during the period of sharp economic expansion which also led to substantial imports of labour.

Female labour participation has also fluctuated, although there has been a gradual trend of increase, averaging 0.3 per cent a year. The two last surveys in the graph stand apart. Statistics Iceland has cautioned against comparing the latest assessments with earlier ones due to a change in methodology. In addition, labour market surveys have not taken place during the first quar-

## The labour market

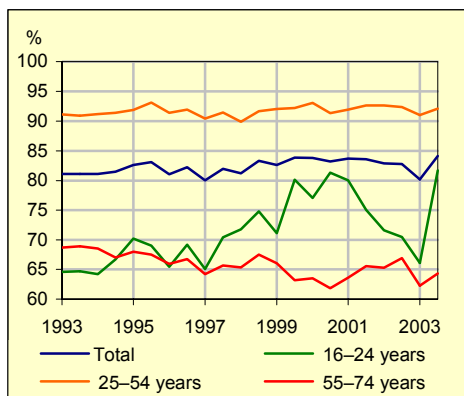
### Activity rates in labour market surveys



Source: Statistics Iceland



## Activity rates by age



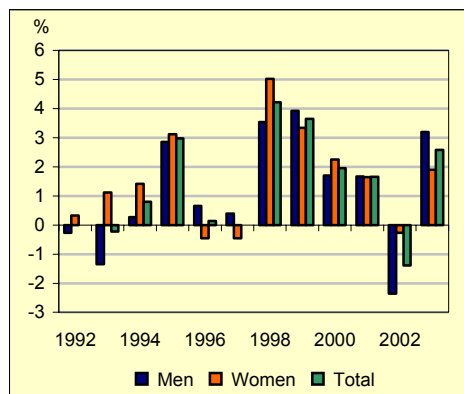
Source: Statistics Iceland

ter of this year, but from tax data it is known that labour market participation is at its lowest during that quarter. Low participation rates in the first quarter of 2003 are therefore not an indication of an unusual slack in the labour market. Data for the second quarter indicate that participation is similar to that recorded in earlier April surveys.

Activity rates differ by age, as can be seen in the chart in the margin. The changes observed in recent years have been most pronounced in the younger age groups. The participation rate rose sharply in the expansion at the end of the last decade but also declined sharply following its end. The participation rate appears to be approaching a previously normal level in the second quarter of 2003. Another characteristic is that the rate for persons 55 years or older, particularly for those over 65, has gradually declined. This is probably attributable to improved pension terms that encourage earlier retirement than before. It is notable that this trend is more pronounced for men than women.

Participation in the labour market is divided into those who are employed and those unemployed. These concepts are sometimes defined as man-years which constitutes an attempt to estimate the actual volume of labour where account is taken of part-time and part-year work. As an example, about one-third of actively working persons work part-time, one-eighth of men and 42 per cent of women. The ratio of women in full-time employment has been increasing in recent years.

## Annual change in labour force



Source: Statistics Iceland.

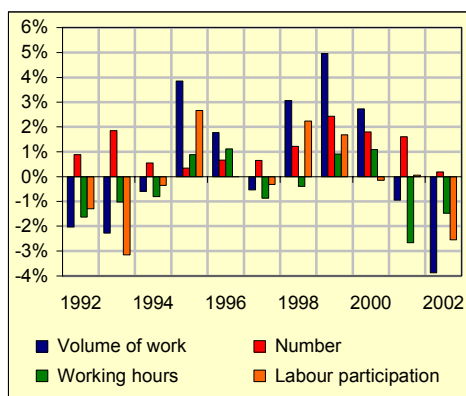
The number of persons in the labour market is both dependent upon participation and the number of persons of working age which has been increasing in recent years. According to the labour market surveys of Statistics Iceland, the number of persons in the labour market has increased from 137,000 in 1991 to more than 160,000 this year, based on the average for the first two quarters. Statistics Iceland has warned against discontinuity in the series for this year compared with earlier figures. Nonetheless both are estimating the same statistic.

The number of active male participants has increased by 15 per cent over this period and the number of females by 20 per cent. The chart shows the fluctuations in the number of participants from year to year. There is a fair correlation with changes in GDP, for example in the latter half of the 1996-2001 growth period, whereas in the early part of this period the labour market did not increase despite considerable economic growth.

During periods of contraction in GDP, however, employment has always decreased. During the period 1998-2001 the number of employed of both sexes rose, well beyond the natural rate of increase in the population of working age. The labour market contracted more in 2002 than it had ever done since Statistics Iceland began conducting labour market surveys. So far this year, there are indications that the labour market has grown by 2.5 per cent in the first half of this year over a year ago.

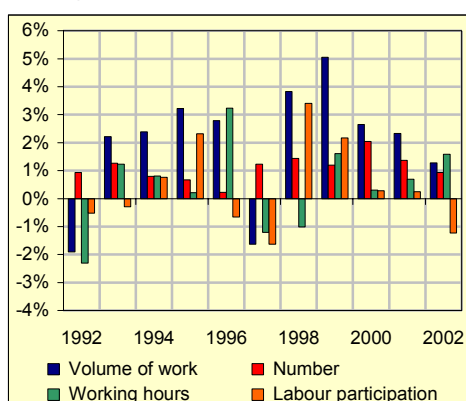
The third factor of change in the labour market is the number of hours worked. The labour market surveys indicate that the number of hours worked does not fluctuate significantly in concert with economic fluctuations. The number of hours worked by

### Men: Volume of work, annual change



Source: Statistics Iceland

### Women: Volume of work, annual change



Source: Statistics Iceland

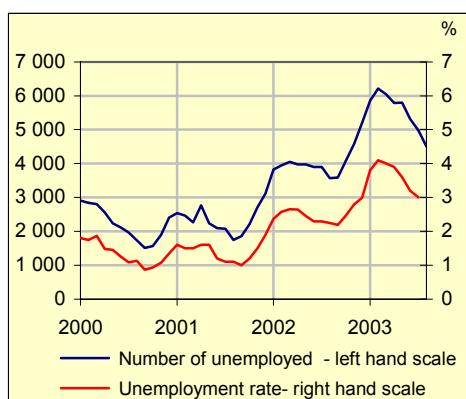
men appears to have declined in recent years, particularly in the last recession, whereas the hours worked by women is increasing. The Wage Investigation Committee surveys hours of work for the company sector of the labour market but directs its attention primarily at full-time employment. The conclusions of the data from the committee are broadly in concert with the labour market surveys of Statistics Iceland for comparable groups of workers. A large number of women, however, are part-time employed.

Taking all these factors together, an impression may be gained on the contribution of each of them to the change in labour volume in recent years. The conclusions are summarised in the charts in the margin of this page for men and women respectively. Looking at the beginning of the brief recession early in this present decade, male employment declined by 1 per cent in 2001 from the previous year. The number of men of working age increased so as to lead to a 2 per cent increase in employment volume, since their participation rate remained unchanged but the number of hours worked declined and did more than offset the increase in the number of employed. In 2002, both employment of men and hours worked decreased, whereas as the number of men of working age increased marginally.

For women, the situation is quite different. During the recession, the growth in employment volume contracted, whereas in recent years, all these factors discussed here have contributed to an increase in the employment volume of women in the economy. Only in 2002 did their labour market participation contribute negatively; nonetheless employment volume of women increased by 1.3 per cent. For 2003, there are indications that the number of persons employed as well as the participation rate will increase employment volume, but hours worked could have offset this increase to some extent.

## Unemployment

### Unemployment

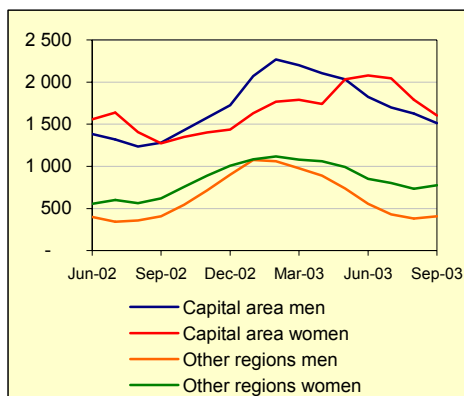


Source: Labour Directorate.

Unemployment was at its lowest level at the end of 2000 and again at the same time a year later. The number of unemployed reached 3,000 towards the end of 2001 and 4,000 early in 2002. Despite a customary seasonal decline over the summer, unemployment reached 6,000 and the unemployment rate exceeded 4 per cent in February of this year. At that time, the Government announced measures to counter growing unemployment by accelerating public construction projects, providing funds for building cultural centres and for employment development schemes. Unemployment declined rapidly thereafter and stood at 4,300 persons or 3 per cent of the labour force as this is written.

The decline in unemployment was not even throughout the labour market. Male unemployment in the capital area and that of both sexes outside it has declined steadily since winter, whereas female unemployment in the capital area increased. More than 2,000 women were registered as unemployed in the middle of the summer. Their number did not begin to decline until August, and the decline has been rapid in recent weeks, undoubtedly because they are filling vacancies left by students returning to school in the autumn. It is also possible that some of those unemployed last summer have gone to school in the autumn and thus disappeared from the labour market.

## Unemployment by region\*



Source: Labour Directorate.

\* end of month, latest figure for September 15.

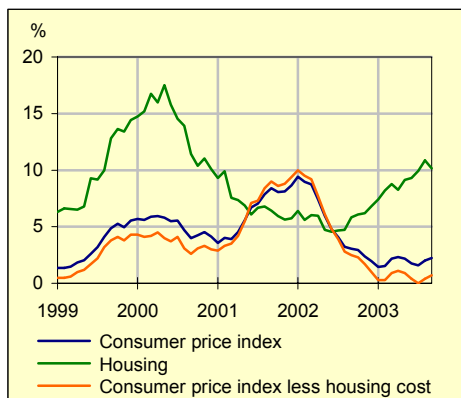
Unemployment has declined in nearly all sectors in recent weeks with the exception of fish processing where unemployment is highest and in education which reflects the fact that teachers have presumably had difficulty in finding work in the course of this past summer. Unemployment has declined most rapidly in the hotel and restaurant sector during the summer, as is to be expected.

Long-term unemployment (more than 26 weeks) has ceased to increase for both sexes, a significant trend reversal. When unemployment was growing it rose fastest in younger age groups. At present, when unemployment is receding, it also declines most rapidly in the same age groups. Unemployment peaked at 7 per cent for women from February to June in the 20-24 age bracket and for men it peaked at 9 per cent in February for the same age group.

The issue of work permits for foreigners from outside the EEA-area has been rising gradually in recent months, although the rate of issue has been slower than in the past five years. The number of work permits has been increasing in connection with construction of the Kárahnjúkar project. A new class of 6-month permits has been created for workers with special skills. At present, there are 250 vacancies associated with the power project. It is estimated that it will be difficult to find domestic workers that have suitable qualifications.

## Prices

### 12-month price changes



Source: Statistics Iceland

Prices have been quite stable this year. The increase in the consumer price index was close to 2 per cent for the past twelve months. This represents a major change from the beginning of 2002 when the twelve-month increase was more than 9 per cent. The increase of the past year is primarily due to higher housing costs and the cost of services, whereas prices of goods have declined. Imported inflation has all but disappeared, particularly because the exchange rate has strengthened at the same time as inflation in Iceland's major customer countries has declined.

In the Ministry's forecast, inflation is projected at 2 per cent between the averages of 2002 and 2003 and 2½ per cent from the beginning to the end of this year. For next year, a 2½ per cent increase is forecast, both within the year as well as for the year-on-year increase. For 2005, a further 3 per cent increase is projected.

The consumer price index increased by 2.2 per cent in the past twelve months up to September of this year. More than the entire increase is attributable to housing costs and to services, as noted above. The housing cost component had increased by more than ten per cent in the past twelve months; it weighs about 17 per cent in the index basket and thus accounts for 1.8 percentage points of the increase over this period.

Housing prices in the capital area have increased rapidly this past year, by 14 per cent up to June. The price increase can be attributed to increased purchasing power at the same time as general inflation is receding, interest rates are declining and the supply of credit is rising.

Charges for public services have increased by 6.2 per cent in the past twelve months and by 1.4 per cent for other services. Taken together, these two items account for about a third of the con-

sumer price index basket and contribute 0.8 percentage points towards the rise in the index. Prices of alcohol and tobacco also increased last December, following an increase in excise taxes. Finally, oil prices have been high throughout the year.

General prices for goods have declined over the past year, both for domestic and imported goods. Domestic goods have declined by 1 per cent, of which farm products and vegetables have declined most, by 2.8 per cent. Imported goods, excluding alcohol and tobacco, declined at the same time by 0.8 per cent, since the rise in the exchange rate is primarily reflected in imports prices.

All told, the consumer price index rose by 2.2 per cent in the past twelve months. Core inflation, however, has been higher. Core index 1, which consists of the consumer price index excluding farm products, vegetables, fruit and petrol, rose by 3 per cent and Core index 2, which in addition excludes public service charges, rose by 2.7 per cent.

The sharp decline in inflation has brought Iceland below the average for the EEA-area for most of the period since last December. The EEA-area index rose by 2 per cent in the twelve months up to August as against 1 per cent in Iceland.

The Ministry's forecast projects inflation as measured by consumer prices at 2 per cent between the averages of 2002 and 2003. So far this year, i.e. since January, the index has increased by 1.4 per cent. Over the next several months, the weakening of the exchange rate is expected to lead to an increase in goods prices, particularly on goods with a high turnover such as petrol. The stronger dollar is also expected to raise petrol prices over the near future. Inflation is forecast at 2½ per cent from the beginning to the end of 2003.

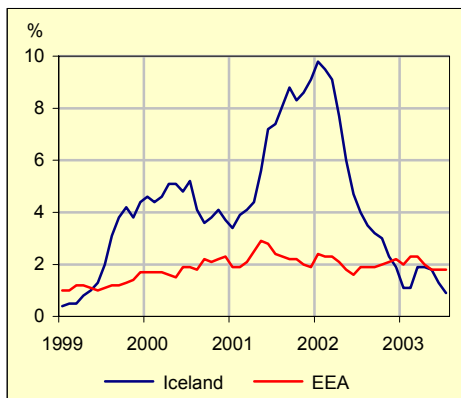
For 2004, inflation is forecast at 2½ per cent, both within the year and between yearly averages. Inflation could accelerate by a small margin towards the end of next year, and the rise within the year could slightly exceed 2½ per cent. Housing prices are thought to continue their increase in excess of general prices. The housing market is influenced by factors such as housing supply, the development of purchasing power and by prospective changes in the mortgage finance system which undoubtedly have an influence already.

The principal assumptions behind the inflation forecast are that the exchange rate index will average 124 points this year and rise to 125 points next year. It is also assumed that the conclusion of general wage agreements will be in concert with prospective economic conditions and that they will contribute to continued low inflation.

The Ministry's forecast is similar to the latest Central Bank forecast. The forecast is also in concert with general inflation expectations, as reflected in the inflation component in yields on unindexed bonds. For two-year Treasury bonds, it was close to 2 per cent, for 3-year bonds 2½ per cent and nearly 3 per cent for 5-year bonds.

The main uncertainties in the forecast have to do with wage agreements, the development of the exchange rate and housing prices. The outcome of wage agreements is, as always, uncertain. The forecast is based on the assumption that agreed wage

### Inflation in Iceland and the European Economic Area



Source: Statistics Iceland

increases will be in accordance with the goal of maintaining price stability. Uncertainty over wage agreements could also have an impact on the exchange rate, as was the case last year when the exchange rate weakened at the time when the wage clause of the agreements was reviewed in February.

The development of housing prices are seen as uncertain, as before. Housing prices are expected to increase more than other prices, due to rising demand and increased purchasing power. Future housing prices are difficult to predict. It is thought probable that plans for raising the maximum mortgage credits have already been reflected in housing prices, as can be seen in the rise in housing prices in recent months.

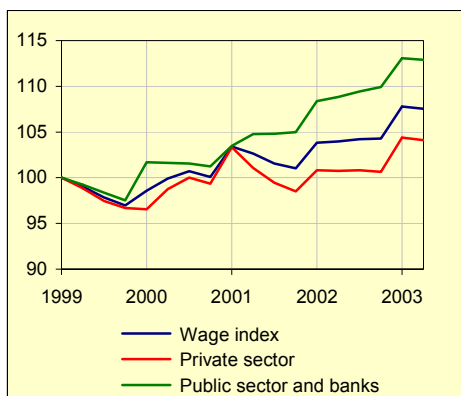
### The household sector

Wage increases were somewhat lower last year whereas real wages continued to increase due to a decline in inflation. The year 2002 was the eighth year in succession when real wages increased. For 2003, the increase is estimated at 3 per cent and for 2004 an increase of 2½ per cent is forecast. Real disposable income has also increased from year to year until last year when it remained unchanged. This year it is expected to increase by 1½ per cent, 2½ per cent in 2004 and 4 per cent in 2005.

### Wage agreements

Wage agreements in the private sector, covering about 80 per cent of the labour market, will mostly be in effect until the latter half of this year and into next year. The contractual wage increases at the beginning of this year were of the order of 3-3.4 per cent, 0.4 per cent higher than originally had been negotiated since an increase was agreed upon at the end of 2001 to compensate for higher inflation than had been assumed earlier. Inflation has changed for the better since and last February, when wage agreements came under review, 12-month inflation was well within the limits assumed in the wage agreements. The wage component of the agreements thus did not qualify for revision.

### Real wages



Source: Statistics Iceland

Most wage agreements with central government employee unions, covering about 10 per cent of the labour market, expire in November 2004. Exceptions are agreements with secondary school teachers, university-educated ministry employees and technical engineers, all of which expire in April 2004. Also, several agreements will be in effect until 2005. Nearly all government agreements with unions of the Federation of Labour expire at the end of this year. Contractual wage increases at the beginning of this year were in the same range as in the private sector, 3-3.4 per cent.

Wage agreements with unions of municipal employees cover close to 10 per cent of the labour market and are generally in effect until 2005. However, 11 such agreements expire in 2004, including an agreement with the unions of elementary school and kindergarten teachers.

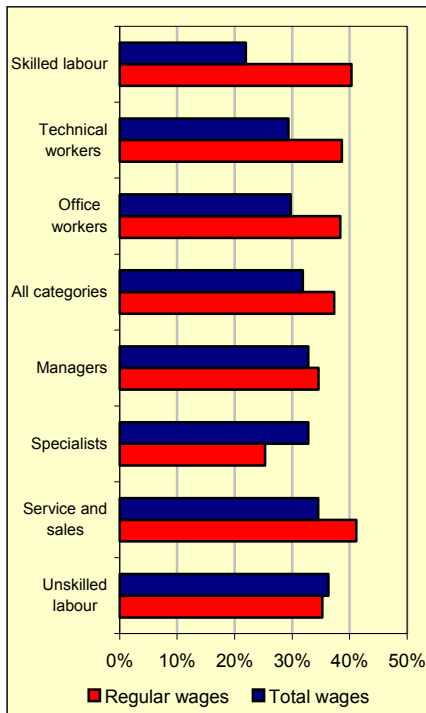
### Wage developments

Wage developments have largely been in concert with earlier forecasts of the Ministry. The wage index of Statistics Iceland increased by 5.4 per cent from December 2001 to December 2002, whereas the increase between the yearly averages of 2001 and 2002 was 7.1 per cent. So far this year, the wage index has increased by 4.6 per cent.

Real wages have continued to increase. They rose by 2.2 per cent between the averages of 2001 and 2002, an increase similar to

## Wage developments in the private sector

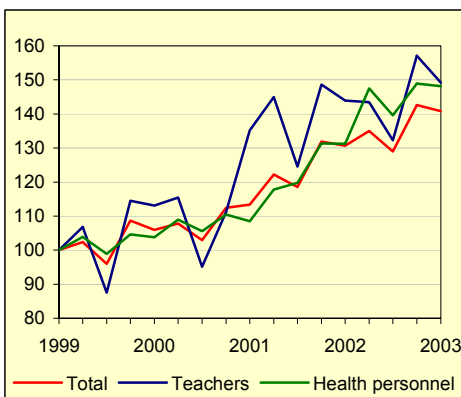
### Wage developments in the private sector 1999-2003



Source: Institute of Labour Market Research

## Wage developments in the public sector

### Wage developments in the public sector



Source: Public Sector Labour Market Institute

that of the previous year when both nominal wage increases and price increases were considerably higher. So far this year, real wages have increased by 3.7 per cent.

The Institute of Labour Market Research conducts a quarterly survey of wages based on a sample of companies and agencies with ten or more employees. The survey covers four sectors and close to 38 per cent of the labour market. According to these surveys, regular wages in the private sector increased by just over 37 per cent from the first quarter of 1999 until the first quarter of 2003. Regular wages are defined as wages paid for agreed working hours according to wage agreements, whether for day-time work or shift work. Such wages are then imputed to a monthly basis for full-time work, regardless of whether the employee is employed full-time or part-time, whether paid by the hour or on a monthly basis.

Wage developments have differed by occupation as can be seen from the chart in the margin. Wages in the service sector, in commerce and the retail trade increased most or by 41 per cent and the pay of professional specialists least, by 25 per cent. Total pay rose less, by 32 per cent. It rose most for unskilled labourers and least for skilled tradesmen, 36 per cent and 22 per cent, respectively. The difference is in part due to the fact that working hours for tradesmen have declined whereas they have remained constant for unskilled labourers.

Total wages increased slightly more in the regions than in the capital area in this period, or by 34 per cent as against 32 per cent. Regular wages, however, increased by a similar percentage. A difference in working hours partly explains this discrepancy since the number of working hours has declined more in the capital area than in the regions.

Although the number of working hours is higher in the regions, the pay is higher in the capital area. Total pay in the regions amounts to about 95 per cent of capital area pay. Regular pay in the regions is 87 per cent of capital area pay whereas working hours in the regions are 7 per cent longer. The difference is probably in part attributable to differences in the level of education, which generally is higher in the capital area.

According to figures from the Public Sector Labour Market Institute, the total pay of central government employees increased by close to 41 per cent from the first quarter of 1999 to the first quarter of 2003 and day-time pay increased by close to 45 per cent. Central government employees are defined as those employees who are paid on the basis of pay contracts pursuant to Act no. 94/1986 regarding the pay contracts of public employees or on the basis of emolument verdicts pursuant to Act no. 120/1992 regarding the Wage Court and the Wage Committee.

During this four-year period, pay contracts were concluded with all groups of central government employees that are able to negotiate their terms. Substantial revisions were made to the pay systems of secondary school teachers, university teachers, police officers, customs officers, paramedics and physicians. The verdicts of the Wage Committee also included certain systematic revisions, where particular tasks, which earlier were paid separately, were now merged into regular daytime duties. These

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changes were in concert with amendments to pay contracts with most central government employee unions in 1997-1998.

The pay of teachers generally increased more than that of other central government employees. The total pay of teachers rose by an average of 49 per cent with the highest increase for secondary school teachers within the Teacher's Federation, 54 per cent. The pay of employees within the health sector rose by an average of 48 per cent.

Figures for wages paid by municipalities are not available for the first quarter of 2003. Between the fourth quarters of 1999 and 2002, daytime pay of employees of the City of Reykjavik increased by 39 per cent and total pay increased by 23 per cent. For central government employees the respective increases were 36 and 31 per cent.

### *The wage index of Statistics Iceland*

The wage index rose somewhat less than shown by the above data. It rose by 31 per cent between the first quarters of 1999 and 2003. In the private sector, wages rose by just over 27 per cent and those of public and bank employees by close to 38 per cent. When comparing the wage index with the conclusions of the Institute of Labour Market Research, a comparison of total pay rather than regular pay is more appropriate in spite of the impact of differing working hours. This is due to the fact that a number of changes have taken place in pay systems, including the transfer of overtime pay into regular pay.

### *Gender difference in pay*

According to data of the Institute of Labour Market Research, the gender difference in pay has remained fairly unchanged in recent years. In terms of regular pay, women earn 76-78 per cent of the pay of men and 75 per cent of men's total pay. The difference in regular pay is less than in total pay, partly because working hours of men are longer than of women.

According to the Public Sector Labour Market Institute, total pay of women was 72 per cent of men's pay, both at the beginning and at the end of this period, i.e. in the first quarter of 1999 and 2003. The daytime pay of women was 80 per cent of men's pay at the beginning of the period and 79 per cent at the end. On the other hand, the day-time pay of women in the Union of State and Municipal Employees, the Union of University-educated Employees and in the Teacher's Federation was 93 per cent of men's pay at the beginning of the period and 90 per cent at the end. The total pay of women in these unions was 80 per cent of men's pay, both at the beginning and at the end of the period.

It may be concluded from inquiries of the Commercial Workers' Union of Reykjavik that the difference in pay between men and women has gradually narrowed in recent years. At present, the difference in total pay is 22 per cent as against 29 per cent in 1999.

A simple comparison of the gender difference in pay may be misleading if account is not taken of factors that may cause the difference, such as education, job position, work experience and working hours. The education of men is generally higher than that of women and the choice of education is also different which in turn leads to different career choices, in addition to the difference in working hours. The work experience of men is generally higher than that of women with that difference increasing with

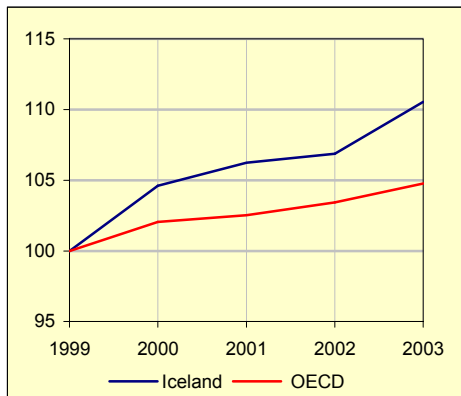
age. This in part due to women holding more part-time jobs than men and their working day is generally shorter than that of men. Research on the difference in gender pay has shown that a large part, but not all, of the pay difference is due to these factors. According the inquiry of the Commercial Workers' Union of Reykjavík, the gender difference in pay, after accounting for the difference in job position, education, age, working age and overtime hours, is 14 per cent today as against 18 per cent in 1999.

### *Income according to tax returns*

According to tax returns, total income from employment increased by 8 per cent between 2001 and 2002 compared with 12.6 per cent the year before. Income from employment is defined as wages and salaries plus per diem expense compensation and vehicle benefits. On a per capita basis, the increase was 6 per cent. The average income of women increased by 8 per cent and that of men by 5 per cent, thus narrowing the gender difference. The pay of women, according to income tax returns, amounts to 59 per cent of the pay of men.

### *International comparisons*

#### **Real wages**



Source: Statistics Iceland and OECD.

A comparison of wage developments between Iceland and its main trading countries reveals that wage increases in Iceland have been considerably larger than abroad. Icelandic real wages in the private sector have increased twice as fast from 1999 to 2003 as those of the OECD as a whole, 10.5 per cent in Iceland compared with 4.8 per cent in the OECD. The difference is larger if a longer period is used for comparison.

Data on household disposable income have been revised on the basis of tax returns since 1999. These are provisional figures, subject to later revision by Statistics Iceland. According to these figures, disposable income increased considerably more in 1999 and 2000 than had been estimated earlier. The increase in 2001 is similar whereas disposable income in 2002 increased less than estimated earlier. The changes are primarily due to the fact that income from assets was underestimated in 1999-2001.

### *Household disposable income*

Disposable income rose by 5.3 per cent in 2002, which is considerably less than in 2000 and 2001 when it increased by 11 per cent on average each year. Income from employment is the largest item in disposable income, accounting for 72 per cent. Total income from employment, including the contributions of employers to pension funds, increased by 8.4 per cent last year and amounted to 472 billion krónur. Income from employment in 2000 and 2001 rose on the other hand in concert with total disposable income, by 12 per cent each year.

Income from assets rose by nearly 7 per cent last year. Their share of total disposable income has been increasing and amounted to 52 billion krónur or 8 per cent last year. Although the income from assets is increasing faster than disposable income as a whole, the increase is less than in 2000-2001 when it amounted to 29 per cent on average per year. The largest item in asset income in 2002 was the profit from the sale of stocks, close to 22 billion, an increase of 35 per cent from the year before. Dividends from stocks amounted to 8 billion, a 13 per cent increase from the previous year, whereas interest on bank deposits declined by 17 per cent.



Payments from the Social Security Institute increased by nearly 7 per cent and from pension funds by nearly 16 per cent. Unemployment benefits more than doubled, since the unemployment rate increased by one percentage point between 2001 and 2002.

In total, household income increased by 7.3%. Household disposable income, i.e. total income less interest payments, pension fund contributions and direct taxes, increased less, or by 5.3%. The difference stems mainly from a considerable increase in interest payments on housing mortgage debt, which amounted to 14%. In the years from 1999-2002 mortgage interest payments increased by 51%. The increase in tax payments was, however, in concert with the increase in total household income in the year 2002.

### *Real disposable income*

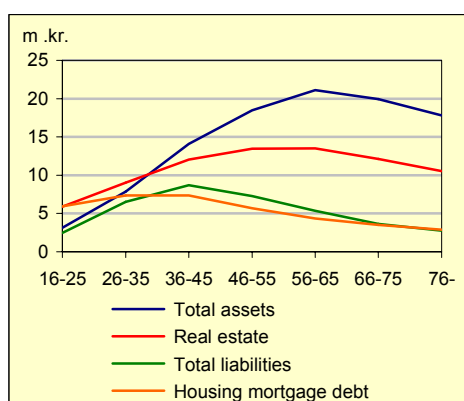
Per capita disposable income increased by 4.6 per cent in 2002, after accounting for a population increase of 0.7 per cent. Real disposable income per capita declined by 0.2 per cent, however, since the average increase in prices between 2001 and 2002 amounted to 4.8 per cent.

### *Household assets and liabilities*

According to 2003 tax returns, total assets of Icelanders amounted to 1,525 billion krónur at the end of 2002 of which 1,053 billion were in real property. Total debt amounted to 586 billion. These figures are not fully comparable to those of the Central Bank, which estimates that household debt to the credit system amounted to 760 billion at the end of 2002, 174 billion more than accounted for in tax returns. It may therefore be assumed that a substantial part of household debt is underreported in tax returns.

In spite of these differences it is interesting to use tax returns to review the development of assets and liabilities in recent years. According to tax return data, the assets of households have increased by an average of 14 per cent a year in 1998-2001. Real property increased more, by an average of 17 per cent a year and the share of real property in total assets rose from 63 per cent in 1998 to 69 per cent in 2003. Over the same period, debt rose by 14 per cent a year and mortgage debt on housing by 15%. Increased mortgage debt on housing has also cut into disposable income, since interest on housing mortgage debt has increased by an average of 15 per cent a year since 1998. Asset and debt formation both slowed down in 2002; assets rose by 6 per cent and debt by 7 per cent.

**Average assets and liabilities by age in 2002**

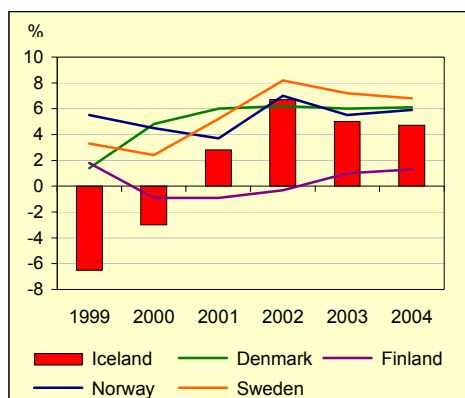


According to tax returns and estimates of the Ministry, the ratio of debt to disposable income was 143 per cent in 2002. This ratio is high, both seen historically and in international comparison. One of the explanations for this high ratio is that Icelanders tend to own their homes rather than rent. This increases the debt ratio in two ways. On one hand, debt is thereby higher since housing mortgage debt is high and, on the other, disposable income is reduced since interest payments for housing mortgages reduce disposable income.

It should also be pointed out that the average age of Icelanders is lower than in many comparable countries. Since debt is generally higher for younger age groups, a part of debt can be explained by the nation's age structure. The chart in the margin shows the average debt profile by age. Debt is highest in the age group 36-45 years and assets are highest in the 56-65-year age group.

## Household saving

### Saving in per cent of disposable income



Source: OECD and Ministry of Finance forecast for Iceland.

### Forecast on wage developments, real wages and disposable income

The liberalisation of the capital market and increased competition in the market has opened access to loanable funds and made it easier for households to borrow more and refinance older loans with new ones. The pension fund system may also have an impact, since a secure pension will entail that people find less reason to save and are therefore less afraid of debt in their later years.

Saving has for a long time been negative in Iceland. This appears to be changing with increased pension saving, following the adoption of new rules on supplementary pension saving. Saving is defined as disposable income, including pension fund contributions less payments from pension funds and private consumption. Since contributions to pension funds have increased in concert with increased supplementary pension saving, total saving has increased in recent years. Since 2001, saving has been in surplus; last year it amounted to 6¾ per cent of disposable income as against 5 and 4¾ per cent estimated for this year and next.

The rules on supplementary pension saving have helped increase household saving. Employees can now contribute up to 4 per cent of total pay as supplementary pension savings, deductible from tax. The employer then contributes up to 2 per cent, depending on the contribution of the employee. This is further supplemented by up to 0.4 per cent paid by the employer, which he can in turn deduct from his social security payroll tax. A new provision became law in 2002 for the private labour market where the employer must pay 1 per cent of total pay of all employees into supplementary saving, irrespective of whether the employee in question avails himself of supplementary saving or not.

According to figures from the Financial Supervisory Authority, supplementary saving in pension funds amounted to 60 billion krónur at the end of 2002. Information from tax returns shows that 71,640 taxpayers are saving a part of their pay as supplementary saving in individual retirement accounts. The number of savers has increased from 47,000 in 2000 and 61,000 in 2001.

Household saving has thus improved. A comparison with other countries shows that saving out of disposable income in 2002 is similar in this country to Denmark. The ratio is slightly higher in Norway and Sweden, 7 per cent in Norway and 8 per cent in Sweden, whereas in Finland it is negative by 0.3 per cent of disposable income. The ratio has been still higher in continental Europe, for example in France and Germany where it is in the range of 10-12 per cent. The ratio in the UK and US is lower; 5 and 4 per cent in 2002, respectively.

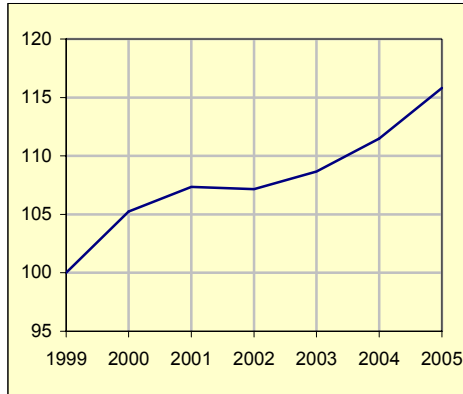
In the Ministry's forecast, it is assumed that the total increase in wages will amount to 5 per cent this year and also next year. The number of man-years is estimated to remain unchanged in 2003 and increase by nearly 2 per cent next year. Real wages will accordingly increase by 3 per cent this year and by 2½ per cent next year, based on 2 per cent inflation this year and 2½ per cent next year.

Total income from employment, including employer contributions to pension funds, is estimated to increase by 5½ per cent this year and 7 per cent next year. Income from assets is expected

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### Real disposable income

index 1990=100



to increase less than in the previous year, by 2 per cent this year and 5 per cent next year.

Social security payments are estimated to increase by 13 per cent this year, partly because of legislative changes that were aimed at reducing the means testing of benefits. Social security benefits are estimated to increase by just over 5 per cent next year, including a 40 per cent increase in disability payments in accordance with an agreement reached between the Government and the Association of Disabled Persons. The agreement is primarily aimed at increasing the regular disability benefit of persons becoming disabled early in life.

Unemployment benefits are estimated to increase by over 50 per cent this year, since the number of unemployed is higher than in several previous years. These payments should decline next year by 26 per cent in line with declining unemployment.

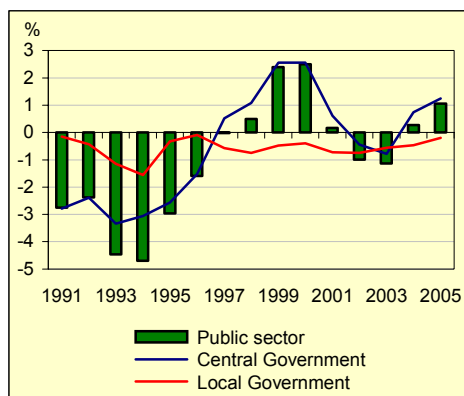
Disposable income is forecast to increase by 4 per cent this year and 6 per cent next. Real disposable income per capita would thereby increase by 1½ per cent this year and 2½ per cent next.

In 2005, total wages, i.e., contractual wage increases, wage drift and the impact of a change in hours worked, is expected to increase by 7 per cent and real wages by 4 per cent. Per capita disposable income is also expected to increase by 7 per cent and real disposable income by 4 per cent.

## 9 PUBLIC FINANCES

### Finances of the total public sector

#### General government balance, % of GDP\*



\* National accounts basis.

### Central government finances

The public sector deficit as measured on national accounts basis is estimated at 7.7 billion krónur in 2002, about 1 per cent of GDP. The Ministry estimates that the 2003 deficit could amount to 9¼ billion, just over 1 per cent of GDP. For 2004, however, the forecast is for a 2¼ billion krónur surplus, about ¼ per cent of GDP, and for 2005 a 9¼ billion surplus is forecast, just over 1 per cent of GDP.

Total public sector revenue is expected to increase by 4½ per cent in real terms between 2002 and 2003. For 2004, the increase is thought to be slightly lower, close to 4 per cent, as well as in 2005. Present estimates for 2003 indicate that expenditure could increase by close to 5 per cent in real terms. This is expected to be reversed in 2004 and 2005 when the increase is forecast at ½ per cent and 2 per cent, respectively.

Tax revenue and total revenue as a ratio of GDP changes primarily in concert with the state of the economy. These ratios rose in the expansion towards the end of the previous decade, declined again when economic growth slowed down and are increasing again this year and next when growth is picking up. The reduction in the revenue ratio in 2005 is attributable to the planned tax cuts that are scheduled for that year. Total public expenditure amounted to 42 per cent of GDP in 2002. The Ministry estimates that the ratio will nudge up to 43 per cent in 2003, mainly because public authorities decided to accelerate public investment, to be followed by a decline in 2004 and 2005, to 42 and 41 per cent, respectively. Public investment is expected to increase by 1 per cent in 2003 but in 2004 and 2005 it is forecast to shrink by 8 and 3½ per cent, respectively, due to the pursuit of a tighter fiscal policy.

The 2003 budget as measured on government account basis was passed with a revenue surplus of 11½ billion krónur, with revenue at 271½ billion and expenditure at 260 billion. A revised estimate indicates that the revenue surplus may come to 6.2 billion, 5.3 billion less than in the budget. Total revenue is estimated at 277 billion, 5½ billion above budget estimates, and total expenditure is thought to increase from the budget figure of 260 billion to an estimated 271 billion.

The main reason for the increase in revenue over budget estimates is to be found in increasing proceeds from the sale of assets, higher dividends from government enterprises and increased revenue from indirect taxes. Revenue from direct taxes increases less, in spite of an upturn in the economy, since increased unemployment has held back the rise in the total wage bill. The increase in expenditure is mainly due to increased road investment that was passed in the supplementary budget this past spring in order to counter increasing unemployment. Furthermore, operating expenditures of schools and hospitals have also increased significantly and unemployment compensation has increased in line with increased unemployment.

The 2004 fiscal budget proposal calls for a 6.4 billion revenue surplus. The revenue side reflects an awaited upturn in the economy with an estimated tax revenue of 252 billion, an increase of 6 per cent. The share of tax revenue of GDP is thought to rise by a small margin, from 29.2 to 29.3 per cent. Total Treasury revenue is estimated at 279½ billion, thus rising much less than the

### Treasury balance

<i>Bn. krónur, current prices</i>	Budget	Forecast	Budget
	2003	2003	prop. 2004
Revenues	271.6	277.2	279.4
Expenditure	260.1	271.0	273.0
<b>Financial balance</b>	<b>11.5</b>	<b>6.2</b>	<b>6.4</b>
<b>Cash flow from operations</b>	<b>11.5</b>	<b>-13.9</b>	<b>-2.1</b>
<b>Net financial surplus</b>	<b>11.5</b>	<b>17.6</b>	<b>13.7</b>

previous year, since no revenue from the sale of assets is expected in 2004.

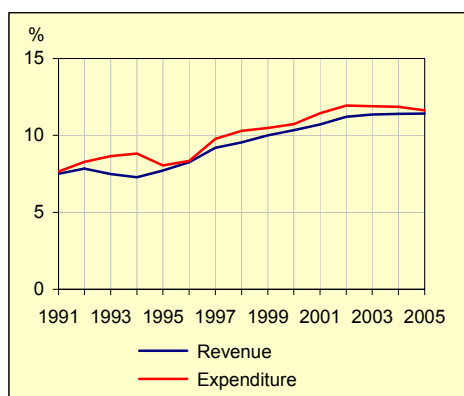
Treasury expenditure in 2004 is estimated at 273 billion, rising by 2 billion from the revised estimate for this year, an increase of less than 1 per cent. In real terms, expenditure is expected to decline by 1½ per cent, and the share of expenditure in GDP would thus decline from 33.3 to 31.7 per cent. The decline is attributable to a tight fiscal policy, where new projects are being postponed and special measures are being adopted to cut expenditure. Such special measures are expected to total 3.7 billion krónur, of which 700 million are current operational expenditures, 1,500 million are transfer payments and investments amount to 1,500 million. Investment is scheduled to decline by 18 per cent between years, both in road construction and in other investment. Current operational expenditure is expected to remain roughly constant or decline slightly in real terms. Transfer payments will however increase by 4 per cent, wholly due to the Government's agreement with the associations of senior citizens and disabled persons on a special increase in social security benefits.

### Municipal finances

Municipal finances have been in deficit in recent years, running at 5.3 billion in 2001 and 5.8 billion in 2002. Total municipal expenditure amounted to 93 billion in 2002 and revenue to 87 billion.

Municipal finances have increased significantly in recent years. Their share of revenue in per cent of total public revenue amounted to 27.3 per cent in 2002 compared with 21 per cent in 1992 with the expenditure ratios rising from 20½ per cent in 1992 to 28.4 per cent in 2002.

**Municipal revenues and expenditure, % of GDP**



Source: Statistics Iceland, Ministry of Finance forecast.

The share of the municipal income tax in total municipal revenue has increased from 50 per cent in 1992 to 68 per cent in 2002. This increase is largely attributable to the transfer of public tasks from the central government to the municipalities, i.e. of running primary schools. With this transfer the government cut its income tax rate with a commensurate increase in the municipal income tax.

Furthermore, municipal property taxes have been increasing, although not as a percentage of their total revenue. Property taxes increased by 22½ per cent in 2000, which is mainly due to a countrywide revision of real property assessments. In 2002, property taxes increased by 14 per cent, amounting to 9 billion or 10.4 per cent of total municipal revenue. Contributions from the Municipal Equalisation Fund are added to income from assets, municipal agencies and enterprises. The Fund awards contributions to the municipalities in order to equalise their differ-

ent needs and tax income. It also pays out regular contributions to the municipalities' organizations and institutions in accordance with law. The Fund is financed by an appropriation from the Treasury equal to 2.12 per cent of tax revenue, as well as a share in municipal income tax revenue and through interest income.

The Ministry estimates that total municipal revenue will increase by 6 per cent in 2003 and 6¼ per cent and 8¼ per cent in 2004 and 2005. Total municipal expenditure increased by 9¼ per cent in 2002, whereas in 2003 the increase is estimated at 4 per cent. For the next two years, an increase of 5¼ and 6¼ per cent is forecast. Current municipal plans indicate that their investments will be declining over the next several years, since they have been unusually heavy in recent years, partly because of an expansion of the elementary schools in order to accommodate all pupils on a full-day basis.

Accordingly, it is thought that the deficit accumulation of the municipalities will gradually decline. A deficit of 4½ billion is estimated for 2003 and a similar deficit for 2004, whereas in 2005 it is forecast to decline to 2 billion.

The public debt situation has changed significantly in recent years. In terms of GDP, public debt increased in the first half of the last decade in the wake of a long stagnation and decline in output. The debt/GDP ratio declined in the second half of the decade, especially Treasury debt, because a reduction in such debt has been emphasised in recent year, whereas municipal debt has increased as a result of protracted deficits.

Treasury debt is estimated to amount to 35 per cent of GDP at the end of 2003 and net debt to 19 per cent. According to the 2004 fiscal budget proposal, the equivalent debt ratios are estimated close to 32 and 18 per cent. Foreign debt constitutes a larger share of Treasury debt than with municipalities, since only the largest municipalities borrow abroad. Sixty per cent of Treasury debt is foreign debt vs. 40 per cent of municipal debt.

Total public debt has declined in line with the decline in Treasury debt, from nearly 60 per cent of GDP in 1995 to 44 per cent at the end of 2002, an estimated 42 per cent at the end of 2003 and 40 per cent at the end of 2004. Net public debt has declined faster still, from nearly 40 per cent of GDP in 1995 to 25 per cent in 2002. For this year and next, the net debt ratio is expected to change little.

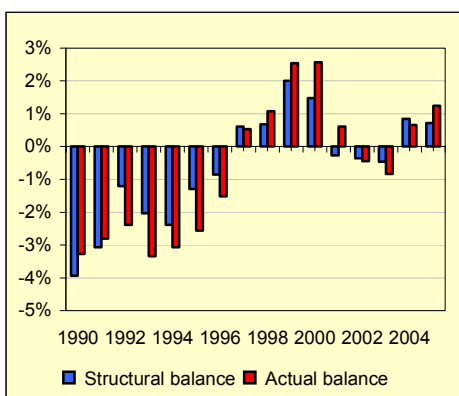
Public finances play a key role in cyclical adjustment. In times of expansion the automatic stabilisation effect of fiscal finances serves to dampen the business cycle and, conversely, it tends to soften the impact of a cyclical downswing. It is therefore important to identify the cyclically adjusted balance of the public sector as distinguished from the actual balance.

These two measurements are shown for the Treasury in the graph in the margin. As noted earlier, the Treasury balance has improved markedly from the first half of the previous decade, both in actual terms as well as on a cyclically adjusted basis. By both measurements, there was a significant surplus in the years 1999-2000, which helped in dampening the expansion at the time. The surplus turned into deficit when growth slackened, partly

## Public debt

### Structural balance

Treasury balance, % of GDP



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because the Government introduced stimulus measures to help counter the adverse effects of the cyclical downswing. For 2004 and 2005, a significant surplus is expected, both in actual terms and on a cyclically adjusted basis, since it is seen as important to apply fiscal policy in order to dampen the expansive effects of the large power project investments taking place at that time.

*A comparison of accounting methods for the fiscal budget government accounts and the national accounts*

An international comparison of economic statistics is difficult because different countries use different definitions, in many cases rendering inter-country comparisons meaningless. International institutions have for many years sought to align statistical country standards to international norms, particularly the IMF, the OECD, the UN and Eurostat. These institutions have not quite been able to align accounting standards between them, although differences have become minimal, particularly in national accounts. Still, countries differ in their statistics, such as in government accounts and measures of unemployment.

Iceland revised its central government budget presentation and accounts as of 1998. Since then, both have been presented on an accrual basis instead of a cash basis. The definition of what belonged to the central government sector was also sharpened. A cash basis basically shows the flow of in- and outpayments whereas the accrual basis shows the total operations of the Treasury in any given year, even if the financial flows are not incurred in the same year.

Only a few OECD-countries have adopted the accrual approach to government accounting. This poses little difficulty, however, since international institutions such as the IMF and the OECD have sought to align accounting standards as much as possible. Still, there remains the difficulty in relations with international institutions, credit rating agencies and other foreign parties that Ice-

land's accrual-based budget and accounts are not quite in line with international standards. In brief, the difference is threefold:

- First, the profit from the sale of government assets is booked as revenue, both in the budget and the accounts, whereas in the national accounts this profit is booked over the revaluation account and thus does not affect the revenue balance.
- Second, according to national accounting standards, only that part of accrued pension commitments for government employees that is associated with the payroll of that year is expensed in the same year, not the re-assessed accrual of a future commitment.
- Third, the tax claims that are written off in the government accounts each year due to bankruptcies of tax payers are neither expensed nor counted against revenue in the national accounts. They are fully entered over the revaluation account.
- In addition, there are a number of minor adjustments to be made, but none are important enough to make a difference in the two approaches.

The table on the next page illustrates the difference between these two accounting methods for the estimated outcome for 2003 and the fiscal budget proposal for 2004.

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***The adjustment of Treasury accounts to national accounts, 2002-2004***

	2002	2003	2004
<b>Total revenue</b>	<b>259 210</b>	<b>277 179</b>	<b>279 425</b>
<i>subtracted items:</i>			
Inheritance tax	769	800	800
Contributions of the University lottery to the University	330	1 074	350
Misc. licence and service charges	6 251	5 592	5 811
Profit from sale of monetary assets	10 545	12 400	0
Profit from sale of non-monetary assets	1 177	540	540
Share of municipalities in collection expenses	278	270	276
Supplementary pension contrib. to municipalities for teachers	478	420	420
Tax claims written off	2 808	3 982	2 738
<b>Treasury revenue by national accounts standards</b>	<b>236 574</b>	<b>252 101</b>	<b>268 489</b>
<b>Total expenditure</b>	<b>267 332</b>	<b>270 194</b>	<b>273 339</b>
<i>subtracted items:</i>			
Inheritance tax	769	800	800
Contributions of the University lottery to the University	330	1 074	350
Misc. licence and service charges	6 251	5 592	5 811
Profit from sale of monetary assets	1 177	540	540
Share of municipalities in collection expenses	278	270	276
Supplementary pension contrib. to municipalities for teachers	478	420	420
Tax claims written off	10 103	4 000	4 000
Supplementary pension contributions due to wage system changes	9 043		
Misc. collection charges	62	59	59
Settlement with Social Security Agency	-1 200	-1 000	-1 000
<b>Treasury expenditure by national accounts standards</b>	<b>240 041</b>	<b>258 439</b>	<b>262 083</b>



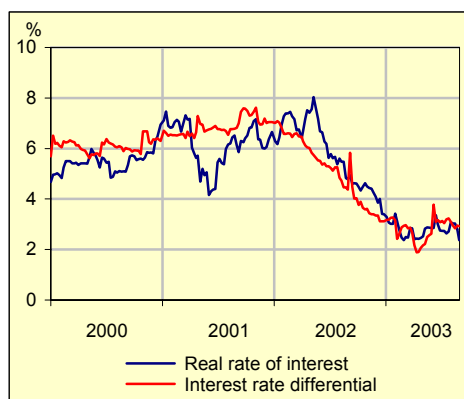
## 10 DOMESTIC FINANCIAL MARKET

### *The financial market and the exchange rate*

The domestic financial market has been quite lively so far this year. The exchange rate strengthened steadily from the beginning of the year until May after which it declined. The Central Bank base rate has remained unchanged since February at 5.3 per cent. The short-term interest rate differential vis-à-vis foreign countries declined until May when it reached 1.8 per cent but has edged upward since then and now stands at about 2.9 per cent. The trade in shares and bonds has grown sharply in the course of the year. Bond yields have been declining and share prices have been rising, both in domestic and foreign markets.

The exchange rate strengthened steadily from the beginning of the year 2002 until May of this year. The exchange rate index stood at 125 points at the beginning of the year and by May it had declined to 118 points. Since then the rate has weakened by 7 per cent and the index has fluctuated in the range of 124-128 points in recent weeks. The stronger exchange rate early in the year is largely attributable to expectations of foreign exchange inflows in connection with power project construction. Explanations of the weakening of the exchange rate from early summer includes increased foreign exchange purchases of the Central Bank, a reduced inflow of foreign exchange and an increased net outflow of debt repayments. In recent months, the increased uncertainty regarding the expansion of the Norðurál plant as well as a growing trade deficit have been reflected in a lower exchange rate.

#### Interest rates



Source: The Central Bank

The factors that influence the exchange rate in coming months include a continuing current account deficit, the Central Bank's purchases of foreign exchange in the open market to strengthen its reserves, speculation in the currency market, sales of Icelandic bonds abroad and foreign portfolio investments by Icelandic pension funds. One of the assumptions behind the Ministry's forecast is that the exchange rate index will average 125 points in 2004 and weaken to 127 points on average in the course of 2005.

The Central Bank base rate stands now at 5.3 per cent. The Bank has once reduced its rate this year. The real base rate, i.e. the nominal base rate less the inflation premium implicit in the yield on 4-year Treasury bonds, stood at about 3.1 per cent at the beginning of the year but has fluctuated around 2.3 per cent in recent weeks. The interest rate differential vis-à-vis foreign countries has fluctuated considerably; it stood at 3.1 per cent at the beginning of the year and was down to 1.8 per cent at the end of April. Since then it has edged upward and, as this is written, is close to 3 per cent.

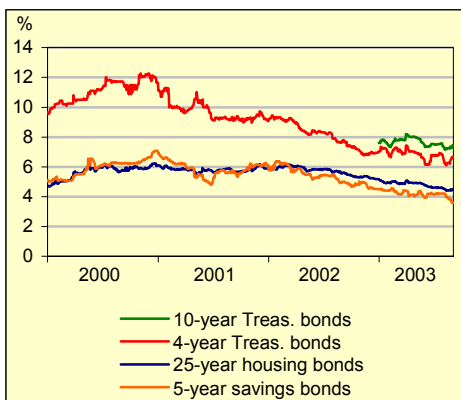
Although the Central Bank has kept the base rate unchanged since early this year, its monetary stance has been eased through other measures. The Bank has increased the domestic money supply through its regular purchases of foreign exchange, which is estimated at 44 billion krónur this year, and through an easing of reserve requirements for deposit money banks to bring them into line with rules applying elsewhere in Europe. The required reserve ratios have been lowered and the definition of the reserve base has been eased. A part of the change was implemented in the spring and the intention is to implement them fully before the end of the year.

The twelve-month growth in broad money (M3) up to the end of July was 15.1 per cent and has been rising in recent months. The twelve-month increase up to June was 19.4 per cent but fluctuated around 12-13 per cent in the first months of the year. The domestic credit and securities purchases of deposit banks have also increased in recent months. Their twelve-month growth reached 16.7 per cent by the end of July of this year compared to 15.4 per cent a year earlier. Credits to enterprises rose most, by 22.3 per cent, but by 3.4 per cent to households.

## The bond market

The bond market has been quite lively in the course of this year. Foreign investors have entered the market and made their mark on it. According to the Central Bank, net purchases by foreign investors amounted to 11.7 billion krónur in the first six months of the year, compared with 6.1 billion in the first six months of last year. The turnover of bonds and short-term paper increased by 45 per cent in the first eight months of the year over a year ago. Housing bonds make up the bulk of the turnover, 46 per cent of the total.

### Bond yields



Source: The Central Bank

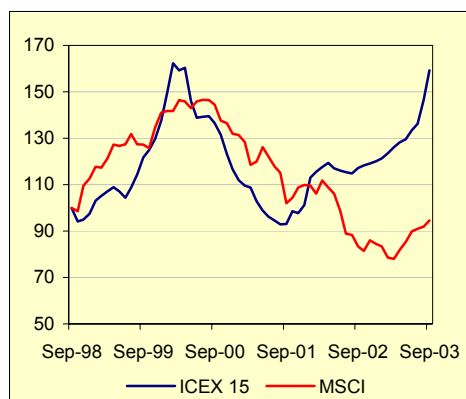
Bond yields have been declining since the beginning of 2002, both on indexed and non-indexed bonds. The yield on 25-year indexed housing bonds was 5.8 per cent at the beginning of 2002 and stands now at 4.5 per cent. The yield stands at its lowest level at present despite a substantial increase in issuing which has been met with heavy demand recently, in part from abroad. The yield on government bonds declined sharply following the issue of the Central Bank's Monetary Bulletin at the beginning of August where it was hinted that a base rate increase was not to be expected for a while and that the next base rate change could just as well be downward. The yield on non-indexed 5-year Treasury bonds was 7 per cent at the beginning of this year and now stands at 6.5-6.6 per cent. For 11-year bonds the yield has declined from 7.6 per cent down to 7.16 per cent at the beginning of August and now stands at 7.3-7.4 per cent.

## The stock market

The stock market has been buoyant in the course of this year. The market index has risen by 30 per cent since the beginning of the year and total turnover has increased by 40 per cent in the first eight months over a year earlier. One company listed its stock on the Iceland Stock Exchange in 2003 whereas eleven companies delisted their stock, mostly because of mergers or takeovers. At the end of August there were 54 companies listed on the Exchange of which seven were on the OTC market. The total capitalisation of listed stocks amounted to 580 billion at the end of August compared to 504 billion a year earlier. The capitalisation at present is equivalent to 70 per cent of GDP. According to tax returns nearly 54,000 families and individuals owned stocks at the end of last year. This figure has changed little since 1999 and 2000 when stock ownership increased rapidly.

The stock index rose by 16.6 percent in the month of August, the second highest monthly increase from the beginning. The biggest increases have been in the pharmaceutical and financial sectors. The pharmaceuticals index has risen by 95 per cent since the beginning of the year and the index for financial firms and insurance by more than 35 per cent. Other stock markets have begun to revive, although their increases have generally been lower than in Iceland. Stocks declined in the US up to the mid-

## Share price indices



Source: Búnaðarbanki Íslands and Morgan Stanley Capital International.

dle of March but have increased steadily since then. The S&P 500 index has risen by 15 per cent this year. European stocks have also been rising; the German DAX index is up by 20 per cent and the British FTSE by close to 8 per cent from the beginning of the year.

The chart in the margin compares the Icelandic stock index with the Morgan Stanley World Index. The Icelandic index has increased by 30 per cent this year and the World Index by 16 per cent. The Icelandic index moved in concert with the World Index up to the end of 2001 but has since then moved independently. This indicates that domestic stock prices are not as dependent on developments in the world economy as foreign stock indices seem related to each other. However, there are three companies in the index that make up about one-fourth of the index basket with most of their business abroad. It would therefore seem logical that external circumstances could start to have a greater influence upon the domestic stock market.

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**CHRONICLE OF ECONOMIC  
EVENTS**

2002

*January*

The corporate income tax was reduced from 30 per cent to 18 per cent. The income tax for partnerships was reduced from 38 per cent to 26 per cent. Companies were permitted to keep their books and draw up their annual accounts in foreign currency.

At the same time, the PAYE income tax declined from 38.75 per cent to 38.54 per cent. The share of the Treasury out of the tax declined from 26.08 to 25.75 per cent and the average municipal tax collected under the PAYE system rose from 12.68 to 12.79 per cent. The annual tax-free income threshold was increased by 3.6 per cent, from 781,579 to 809,611 krónur.

Social security and unemployment benefits increased by 8.5 per cent.

Child benefits increased by 3 per cent and income thresholds for benefit curtailment were raised by 5 per cent to 677,364 krónur a year for a single parent and to double that amount for a couple. The curtailment of benefits for one child was reduced from 5 to 4 per cent of income above the curtailment threshold, for two children from 9 to 8 per cent and for three children or more from 11 to 10 per cent. This was the second stage of three in raising child benefits; the third stage became effective at the beginning of 2003.

Finally, the taxation of rent subsidies was abolished as of the beginning of the year.

*February*

The Central Bank of Iceland and the Union Bank of Norway signed a credit facility of 200 million dollars for a period of five years.

Fitch Ratings, the credit rating agency, confirmed the Treasury's rating of AA-for foreign currency debt, AAA for long-term krónur debt and F1+ for short-term debt. Prospects for ratings on long-term debt were regarded as negative whereas previously they were viewed as stable.

*April*

The Central bank lowered its base rate by 0.5 percentage points as of April 1, from 10.1 to 9.6 per cent.

The Treasury savings bond issue RS02-0401, amounting to 10 billion krónur, matured on April 1.

Moody's, the credit rating agency, announced that improved economic stability supported an unchanged credit rating for the Treasury, Aa3 for debt in foreign currencies and Aaa for Treasury debt in krónur.

*May*

The consumer price index stood at 221.8 points in May. The collective bargaining parties in the labour market had agreed in December 2001 to postpone the decision on a revision of the wage clause of their wage agreements from February to May. They agreed that if the consumer price index in May would fall below 222.5 points, the inflation assumptions underlying the wage agreements would have worked out as expected. Therefore, the wage clauses of the agreements would not come under revision.

Bank base rate The Central bank lowered its base rate by 0.3 percentage points as of May 1, from 9.6 to 9.3 per cent.

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Unindexed 11-year Treasury bonds, maturing in May 2013, were introduced. This is the longest unindexed Treasury bond issue so far.

The Central Bank lowered its base rate by 0.5 percentage points as of May 21, from 9.3 to 8.8 per cent.

*June* On June 5, the Minister of Fisheries issued a regulation for catch quotas for the 2002/2003 fisheries year. The new quotas were about 2.4 per cent higher, as counted in cod equivalents, than in the previous fisheries year.

The Treasury sold 20 per cent of the total shares in Landsbanki, thus reducing the Treasury's share in the bank to 48 per cent.

The Central Bank lowered its base rate by 0.3 percentage points as of June 25, from 8.8 to 8.5 per cent.

*July* A new currency basket for the exchange rate index took effect. The weight of the dollar declined by just over 2 percentage points to 25 per cent, the share of European currencies rose by 3 percentage points to 70 per cent and that of the yen declined by 0.7 percentage points to 3.7 per cent.

*August* The Central Bank lowered its base rate by 0.6 percentage points as of August 6, from 8.5 to 7.9 per cent.

*September* The Central Bank lowered its base rate by as of September 1, from 7.9 to 7.6 per cent.

On September 2, the Minister for Industry issued a permit to Landvirkjun to construct a hydro-power facility at Kárahnjúkar.

On September 10, the Government decided to enter into negotiations with the Samson Holding Company Inc. to sell a controlling interest in Landsbanki. At the same time, it decided to commence preparation for selling a controlling interest in Búnadarbanki.

The Central Bank lowered its base rate by 0.5 percentage points as of September 21, from 7.6 to 7.1 per cent.

*October* On October 1, the Minister of Finance presented the 2003 fiscal budget proposal. Revenue was estimated at 264 billion krónur, expenditure at 253.3 billion and the revenue balance at 10.7 billion.

The Central Bank lowered its base rate by 0.3 percentage points as of October 21, from 7.1 to 6.8 per cent.

On October 21, the Government agreed to sell the Samson Holding Company Inc. a 45.8 per cent share in Landsbanki after which the Treasury's remaining stake was 2.5 per cent.

Moody's, the credit rating agency, raised Iceland's credit rating for bond issues and foreign currency deposits to Aaa, the highest rating available. Previously, Iceland had a rating of Aa3.

*November* On November 5, the Government decided to enter into negotiations with a group of investors regarding the sale of a controlling interest in Búnadarbanki.

The Central Bank lowered its base rate by 0.5 percentage points as of November 11, from 6.8 to 6.3 per cent.

Statistics Iceland began publishing two core indexes to measure underlying inflation. Both are based on the consumer price in-

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dex. The former excepts vegetables, fruit, agricultural produce, petrol and the latter adds public services to the above exceptions.

The rating agency Standard & Poor's raised Iceland's credit rating from negative to stable at the same time as it confirmed Iceland's rating of AA+/A-1+ for debt in krónur and A+/A-1+ for debt in foreign currencies. The main reasons for the raise in the ratings were the improvement in the economic situation, the success achieved in privatising commercial banks and the banks' continued good earnings record.

*December* The fiscal budget was passed on December 6. Revenue was estimated at 272 billion krónur, expenditure at 260 billion and the revenue balance at 12 billion.

The Central Bank lowered its base rate by 0.5 percentage points as of December 18, from 6.3 to 5.8 per cent.

2003

*January* The PAYE tax rate remained nearly unchanged from the year before at 38.55 per cent compared with 38.54 per cent in 2002. The Treasury's share remained unchanged at 25.75 per cent and the average municipal income tax collected under the PAYE system increased by 0.01 per cent to 12.80 per cent. The annual tax-free income threshold was increased by 3.1 per cent, from 809,611 to 835,019 krónur. The personal income surtax was reduced from 7 per cent to 5 per cent. The tax will be collected at the 5 per cent on the basis of 2002-income after the annual income tax assessment at the end of July 2003. The new 5 per cent rate will apply to income earned in 2003 and will be finally assessed at the end of July 2004 when 2003- tax returns are in and assessment on their basis has been computed. The surtax applies to 2002-income in excess of 4,089,450 krónur per individual and double that amount for a couple. The surtax income threshold increased by 15 per cent from the previous year.

Social security and unemployment benefits increased by 3.2 per cent.

The net wealth tax on individuals and companies was reduced to 0.6 per cent. It begins to apply at net assets in excess of 4,720,000 krónur for an individual and 9,440,000 krónur for a couple. Previously, the tax was 1.2 per cent, rising to 1.45 per cent on net assets in excess of 6,332,500 krónur for an individual and 12,665,000 krónur for a couple.

Child benefits increased by 2.75 per cent and the income thresholds for benefit curtailment were raised by 4 per cent to 704,459 krónur for an individual and to double that amount for a couple. The curtailment of benefits for one child was reduced from 4 to 3 per cent of income in excess of the curtailment threshold, for two children from 8 to 7 per cent and for three children or more from 10 to 9 per cent. This was the third stage and last in raising child benefits; the previous two became effective at the beginning of the past two years.

Alcohol and tobacco levies were increased. For liquor, they rose by 15 per cent, and by 27.7 per cent for tobacco. The latter increase was offset by reducing the markup of the State Wine and Tobacco Monopoly from 17 per cent to 11 per cent. The retail

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price of liquor thus increased by close to 10 per cent and of tobacco by an average of 12 per cent. The Treasury revenue from this increase is estimated to 1,100 million krónur on an annual basis, and the consumer price index is expected to increase by less than 0.3 per cent as a result.

The tax credit resulting from investment in shares was abolished. The credit will for the last time apply to 2002-income at the time the tax thereon is finally assessed at the end of July 2003. The maximum deduction before tax is 80,000 krónur for an individual and 160,000 krónur for a couple.

Social security benefits increased by 0.5 per cent

On January 3, the Government signed an agreement with the Samson Holding Company Inc. for the sale by the Treasury of 45.8 per cent of the shares in Landsbanki.

On January 16, it signed an agreement with a group of investors for the sale by the Treasury of 45.8 per cent of the shares in Búnadarbanki.

On January 30, the temporarily appointed Minister of the Environment, Mr. Jón Kristjánsson, issued an administrative decision regarding an environmental assessment of the proposed water reservoir at Norðlingaalda.

### *February*

Landsvirkjun decided to continue discussions with Norðurál, the aluminium producer, on the procurement of energy for the expansion of the aluminium plant at Grundartangi. At the same time, discussions were continued with Reykjavík Energy and the Suðurnes Regional Heating on participating in the project with the intention that the three energy providers would cooperate in supplying energy to Norðurál.

The Central Bank lowered its base rate by 0.5 percentage points as of February 18, from 5.8 per cent to 5.3 per cent.

On February 25, the remaining 2.5 per cent of the Treasury's stake in Landsbanki were sold.

On March 7 the Treasury sold its remaining stake of 9.11 per cent in Búnaðarbanki. That transaction ended all holdings by the Treasury in commercial banks. Shortly thereafter, the two banks, Búnaðarbanki and Kaupþing, merged to become Kaupþing Búnaðarbanki.

### *March*

On March 14, a supplementary fiscal budget was passed that authorised a 6.3 billion krónur supplemental appropriation of which 4.7 billion were to be spent in 2003 and 1.6 billion in 2004. The purpose was to strengthen the economy up to the period when power project construction would have a full impact on the economy. The funds would go to road construction and to erect several cultural centres around the country and provide financing for economic development. The proceeds from the sale of the remaining shares in the two commercial banks, as well as proceeds from the sale of shares in Icelandic Prime Contractors, were to be used to finance the supplemental expenditure. The sale of assets was estimated to yield a total of 2.6 billion krónur.

On March 15, Alþingi passed a law on the expansion of the aluminium plant at Grundartangi and authorised the Minister of Industry to permit the water reservoir at Norðlingaalda, the ex-

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pansion of the geothermal power plant at Nesjavellir and the construction of a new geothermal power plant at Reykjanes.

On March 15, an agreement was signed between Alcoa Inc. and Landsvirkjun on the construction of an aluminium smelter at Reyðarfjörður. This was the final step in deciding to go ahead with construction of the Kárahnjúkar power project and the aluminium plant at Reyðarfjörður.

On March 31, Fitch, the rating agency, confirmed Iceland's credit ratings of AA- for long-term debt in foreign currencies, AAA for long-term debt in Icelandic krónur and F1+ for short-term foreign debt. Prospects for long-term debt were raised from negative to stable.

*May* Elections to the Alþingi took place on May 10. The Government of Prime Minister Davíð Oddsson held on to its majority and continues in office. It issued a new policy statement on May 23.

The formal preparations for the merger of Kaupþing and Búnaðarbanki were completed on May 26, following an agreement of shareholders of both concerns. The merger was agreed to by the Financial Supervisory Authority the following day.

*June* On June 19, Standard & Poor's, the rating agency, confirmed its ratings for Iceland, including AA+/A-1+ for debt in krónur and A+/A-1+ for foreign currency debt. Prospects for future credit ratings were deemed stable.

*July* On July 3, the Minister of Fisheries issued a regulation on the catch quota for the 2003/2004 fisheries year. The quota is increased by 11.3 per cent from the previous year. The catch value is estimated to increase by close to 8 billion krónur as a result and the export value by about 12.5 billion.

The decision is mainly based on the proposals of the Marine Research Institute as laid out in its report on the state of the fish stocks in 2002/2003. Exceptions are made in four instances. The quota for Greenland halibut will remain unchanged from the 2002/2003 fisheries year, at 23,000 tonnes instead of 20,000 tonnes as proposed by the Institute. The same applies to wolffish, where the quota remains at 15,000 tonnes, plaice with a quota of 4,500 tonnes and monkfish of 2,000 tonnes. The Institute's proposals for these three species were 15,000, 4,000 and 1,500 tonnes, respectively.

Special quotas are for the first time set for golden redfish and deep-sea redfish in accordance with the Institute's proposals.

On the same date, the Ministry of Fisheries issued a regulation on the amendment of the catch quota for blue whiting in 2003, increasing the quota from 318,000 tonnes to 547,000 tonnes. This is in accordance with the decision of the European Union, as in 2002, when the Ministry followed its example. Regard is had to the decisions of Norway and the Faeroes, both of which anticipate a substantial increase in the blue whiting catch during the year.

On July 4, the currency basket for the exchange rate index was reviewed. The weight of European currencies rose by 0.41 percentage points to 70.70 per cent, whereas the weight of North-America declined by 0.24 percentage points to 25.82 per cent and that of the yen by 0.17 percentage points to 3.48 per cent.

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*August* On August 6, the Minister of Fisheries issued a regulation authorising whale hunting for scientific purposes. The hunt will be a part of a two-year research project during which the intention is to catch 100 minke whales, 100 fin whales and 50 sei whales each year. Due to the fact that the catch commences late this year, only 38 minke whales are authorised.

The Treasury accounts for 2002 were published on August 21. The revenue surplus on normal operations amounted to 6.5 billion krónur compared with 16.6 billion in 2001. This excludes non-recurrent revenue and expenditure such as the sale of assets on the revenue side and the accumulation of pension commitments and estimated tax claims written off on the expenditure side.

Total Treasury expenditure, including extraordinary items, exceeded total revenue by 8.1 billion or 3.1 per cent of revenue, a deterioration of 16.8 billion from the previous year when the surplus amounted to 8.6 billion. The 2002-result is primarily due to a higher accounting entry on the expenditure side in respect of pension commitments as well as due to an increase in a write-off of tax claims. These two items prove difficult to assess beforehand. Pension fund commitments amounted to 16.3 billion krónur in 2002 compared with 2.6 billion in 2001, and tax claims written off increased to 10.1 billion in 2002 as against 5.9 billion in the year before.

Treasury revenue amounted to a total of 259.2 billion in 2002, equivalent to 33.5 per cent of GDP, compared to 237.4 billion and 32.0 per cent the year before. The increase between the two years amounted to 21.9 billion or 9.2 per cent, equivalent to 4.2 billion in real terms, as deflated by the consumer price index.

Treasury expenditure amounted to a total of 267.3 billion krónur in 2002, equivalent to 34.5 per cent of GDP. This compares to 228.7 billion and 30.9 per cent in 2001. Expenditure increased by 38.6 billion between the two years or by 11.5 per cent in real terms. The main cause of the increase is attributable to increased accounting entries for pension fund commitments and estimated write-offs of tax claims, as observed earlier.

Net debt amounted to 149.5 billion at the end of 2002, compared with 168.8 billion at the end of 2001, a decline of 19.3 billion.

*September* On September 5, the Board of Directors of Landsvirkjun decided to postpone the construction of the Nordlingalda water reservoir. The plans for the construction of the reservoir called for delivery of energy to Nordural before the end of 2005, and that the project would be completed before construction activity at the Kárahnjúkar power project and the aluminium plant at Reydarfjordur would reach its peak.

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*TABLE APPENDIX*

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**Table 1. Output and expenditure**

	Billion krónur current prices				Volume changes on previous year, per cent <sup>1)</sup>			
	Prel.	Forec.	Forec.	Forec.	Prel.	Forec.	Forec.	Forec.
	2002	2003	2004	2005	2002	2003	2004	2005
1. Private consumption	418.3	441.4	468.4	505.2	-1.1	3¼	3½	5
2. Public consumption	198.8	215.4	224.0	238.2	4	3½	1	2
3. Gross fixed investment	146.8	163.2	181.1	215.1	-14.8	7¾	8½	16½
Business sector investment	79.6	93.2	110.0	141.4	-22,1	14½	15	26
Residential construction	37.4	39.3	42.1	44.9	5.2	3	4	3¼
Public investment	29.7	30.7	28.9	28.8	-12.2	1	-8	-3 ½
4. Final domestic demand	763.8	820.0	873.5	958.5	-3.2	4¼	4	7
5. Stock changes <sup>2)</sup>	-0,2	0.2	0.0	0.0	0.4	0	0	0
<b>6. Total national expenditure</b>	<b>763.6</b>	<b>819.9</b>	<b>873.6</b>	<b>958.5</b>	<b>-2.9</b>	<b>4¼</b>	<b>4</b>	<b>7</b>
7. Export of goods and services	309.0	293.1	308.0	327.2	3.7	- ½	4½	3
8. Import of goods and services	293.7	297.6	319.8	350.0	-2.3	5¾	5¾	6¼
<b>9. Gross domestic product</b>	<b>779.0</b>	<b>815.4</b>	<b>861.7</b>	<b>935.8</b>	<b>-0.6</b>	<b>1¾</b>	<b>3½</b>	<b>5½</b>
10. Net factor income from abroad	-17.0	-14.4	-15.7	-20.6	-	-	-	-
11. Net current transfers	1.2	-1.2	-1.0	-1.0	-	-	-	-
12. Current account balance (7.-8.+10.+11.)	-0.5	-20.0	-28.6	-44.4	-	-	-	-
<b>13. Gross national income (9.+10.)</b>	<b>762.0</b>	<b>801.0</b>	<b>846.0</b>	<b>915.1</b>	<b>0.6</b>	<b>2¼</b>	<b>3½</b>	<b>5¼</b>
14. Effects of changes in terms of trade <sup>3)</sup>	-	-	-	-	0.2	-¼	-½	0
15. Real gross national income	-	-	-	-	0.8	2	3	5¼
<b>16. Current balance, % of GDP</b>					<b>-0,1</b>	<b>-2½</b>	<b>-3¼</b>	<b>-4¾</b>

**Notes:**

<sup>1)</sup> Volume changes are based on 1990-prices.

<sup>2)</sup> In per cent of GDP of the previous year at constant prices.

<sup>3)</sup> As percentage of previous year's GNI, constant prices.

**Table 2. Export production and foreign trade**

	Billion krónur current prices				Volume changes on previous year, per cent <sup>1)</sup>			
	Prel. 2002	Forec. 2003	Forec. 2004	Forec. 2005	Prel. 2002	Forec. 2003	Forec. 2004	Forec. 2005
<b>Export production</b>								
Marine products	128.6	118.6	128.3	135.6	5.1	-2.0	6.0	2
Aluminium	38.5	37.5	34.8	35.8	9.8	½	¼	0
Other products	34.8	35.0	38.8	43.4	10.7	-1¾	11	8½
<b>Total</b>	<b>201.9</b>	<b>191.1</b>	<b>201.9</b>	<b>214.9</b>	<b>7.0</b>	<b>-1½</b>	<b>5½</b>	<b>2¾</b>
Export of old ships and aircraft	2.2	1.8	1.9	2.0	-	-	-	-
Stock changes in export production	-0.2	-0.2	0.1	0.0	-	-	-	-
<b>Merchandise exports, total</b>	<b>204.3</b>	<b>193.0</b>	<b>203.7</b>	<b>216.8</b>	<b>6.6</b>	<b>-1¼</b>	<b>5½</b>	<b>3</b>
<b>Merchandise imports, total</b>	<b>190.7</b>	<b>192.8</b>	<b>206.6</b>	<b>228.6</b>	<b>-3.2</b>	<b>5¾</b>	<b>6¼</b>	<b>7½</b>
General merchandise imports	159.7	164.1	170.1	183.3	-4.6	7¼	2¼	4½
of which: Oil imports	16.0	16.6	15.3	15.1	3.8	¾	2.0	3½
Of which: Other imports	143.7	147.5	154.9	168.2	-5.4	8.0	2½	4¾
Special imports	31.0	28.7	36.5	45.4	3.6	-1½	24¾	19¼
<b>Balance of trade</b>	<b>13.6</b>	<b>0.2</b>	<b>-3.0</b>	<b>-11.8</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Export of services (excl. factor income)	104.7	100.0	104.2	110.4	-1.8	1	2	2¾
Import of services (excl. factor income)	103.0	104.8	113.1	121.3	-0.5	6.0	4¾	3½
<b>Balance of services (without factor inc</b>	<b>1.7</b>	<b>-4.7</b>	<b>-8.9</b>	<b>-10.9</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Net factor income from abroad</b>	<b>-17.0</b>	<b>-14.4</b>	<b>-15.7</b>	<b>-20.6</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
Net current transfers <sup>2)</sup>	1.2	-1.2	-1.0	-1.0	-	-	-	-
<b>Current balance</b>	<b>-0.5</b>	<b>-20.0</b>	<b>-28.6</b>	<b>-44.4</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>

**Notes:**

<sup>1)</sup> Volume changes are based on 1990-prices

<sup>2)</sup> Net transfers from abroad other than factor income

**Table 3. Gross domestic product\***

Millions of krónur at current prices and volume and price indices 1990=100

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Est. 2001	Est. 2002
1. Private consumption	235 542	236 290	233 462	243 708	253 929	274 031	293 221	325 905	358 687	389 574	408 413	418 269
2. Public consumption	81 501	83 926	88 618	93 824	98 961	105 563	112 776	127 752	142 430	157 934	176 656	198 777
3. Gross fixed investment	81 047	74 697	70 807	73 160	73 441	93 630	104 420	140 162	137 493	159 436	166 416	146 780
4. Stock changes	1 233	122	2 307	260	3 052	25	102	906	120	2 494	-2 084	-182
5. Total national expenditure	399 322	395 035	395 194	410 952	429 383	473 249	510 519	594 726	638 729	709 438	749 400	763 644
6. Exports of goods and services	125 671	121 597	135 694	157 436	161 250	176 836	190 948	204 214	212 166	231 632	303 067	308 976
6.1 Goods, fob	91 560	87 833	94 658	112 654	116 607	125 690	131 213	136 592	144 928	149 272	196 582	204 303
6.2 Services	34 111	33 764	41 036	44 782	44 643	51 146	59 735	67 622	67 238	82 360	106 485	104 673
7. Less: Imports of goods and services	130 491	121 784	122 466	134 631	144 725	173 755	187 717	230 055	241 482	278 637	307 279	293 660
7.1 Goods, fob	94 634	87 910	82 386	92 992	103 251	124 489	130 959	161 611	167 310	186 752	202 518	190 674
7.2 Services	35 857	33 874	40 080	41 639	41 474	49 266	56 758	68 444	74 172	91 885	104 761	102 986
8. Gross domestic product	394 502	394 848	408 422	433 757	445 908	476 330	513 749	568 885	609 413	662 433	745 188	778 960
9. Net factor income from abroad	-10 661	-9 086	-10 108	-13 659	-12 828	-11 317	-11 918	-12 647	-12 567	-19 353	-25 122	-16 997
10. Gross national product (8.+9.)	383 037	391 939	403 223	425 449	439 311	473 875	501 831	556 238	596 846	643 080	720 066	761 963
11. Current account balance with net current transfers	-15 991	-9 542	2 909	8 520	3 391	-8 700	-9 123	-39 491	-42 608	-67 120	-30 293	-511
11.1 Balance of trade fob/fob	-3 074	-77	12 272	19 662	13 356	1 201	254	-25 019	-22 382	-37 480	-5 936	13 629
11.2 Balance of services	-1 746	-110	956	3 143	3 169	1 880	2 977	-822	-6 934	-9 525	1 724	1 687
11.3 Net factor income from abroad	-10 661	-9 086	-10 108	-13 659	-12 828	-11 317	-12 116	-12 647	-12 567	-19 353	-25 122	-16 997
11.4 Net current transfers from abroad	-510	-269	-211	-626	-306	-464	-238	-1 003	-725	-762	-959	1 170
12. Current balance, % of GDP	-4.1%	-2.4%	0.7%	1.9%	0.7%	-1.9%	-1.8%	-6.9%	-7.0%	-10.1%	-4.1%	-0.1%
<b>Volume indices 1990=100</b>												
1. Private consumption	102.9	99.7	95.1	97.8	100.0	105.4	110.7	122.0	130.9	136.1	132.0	130.4
2. Public consumption	103.1	102.3	104.7	108.9	110.8	112.1	114.9	118.8	124.4	129.7	133.7	139.1
3. Gross fixed investment	103.3	91.8	82.0	82.4	81.5	102.4	112.6	149.8	145.1	166.6	154.9	132.0
4. Total national expenditure	103.8	99.1	95.3	97.3	99.5	106.6	112.5	127.7	133.1	142.2	137.1	133.1
5. Exports of goods and services	94.1	92.2	98.2	107.5	105.1	115.4	121.7	124.1	129.1	135.5	145.9	151.3
5.1 Goods, fob	92.1	91.2	95.8	107.4	105.1	114.6	116.3	113.3	121.3	119.7	128.4	136.9
5.2 Services	99.7	95.2	104.9	107.7	105.1	117.7	136.9	155.0	151.2	180.5	195.9	192.4
6. Less: Imports of goods and services	105.3	99.0	91.3	95.0	98.7	115.0	123.9	153.0	159.4	172.2	156.7	153.1
6.1 Goods, fob	104.9	99.8	87.2	93.7	99.7	116.3	122.3	152.0	156.9	161.2	145.1	140.5
6.2 Services	106.2	96.7	102.4	98.7	96.0	111.5	128.4	155.6	166.4	202.1	188.2	187.3
7. Gross domestic product	100.1	96.8	97.6	101.5	101.6	106.9	111.9	118.1	123.0	130.0	133.6	132.8
8. Gross national income	101.9	98.8	98.1	101.5	102.3	107.0	112.9	121.8	126.6	131.3	134.6	135.7

Table 3 continued

Prices indices 1990=100	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Est. 2001	Est. 2002
1. Private consumption	106.7	110.5	114.5	116.2	118.4	121.2	123.5	124.6	127.8	133.5	144.3	149.5
2. Public consumption	108.2	112.3	115.9	118.0	122.3	128.9	134.4	147.2	156.8	166.7	180.8	195.6
3. Gross fixed investment	106.1	109.3	114.3	117.8	120.8	124.7	127.3	128.7	130.1	131.4	147.6	152.8
4. Total national expenditure	106.9	110.7	114.7	116.9	119.7	123.5	126.5	129.8	133.8	139.1	152.4	159.9
5. Exports of goods and services	106.9	105.5	110.6	117.2	122.8	122.6	125.6	131.7	131.6	136.8	166.2	163.4
5.1 Goods, fob	107.5	104.2	106.9	113.4	120.1	118.6	122.0	130.4	129.2	134.9	165.6	161.5
5.2 Services	105.3	109.2	120.4	128.0	130.8	133.8	134.3	134.3	136.9	140.5	167.3	167.5
6. Less: Imports of goods and services	103.3	102.6	111.9	118.1	122.2	125.9	126.3	125.4	126.3	134.9	163.4	159.9
6.1 Goods, fob	102.9	100.5	107.8	113.2	118.1	122.1	122.2	121.3	121.7	132.2	159.2	154.8
6.2 Services	104.5	108.4	121.1	130.6	133.8	136.8	136.8	136.2	138.0	140.7	172.3	170.2
7. Gross domestic product	108.1	111.7	114.2	116.6	120.0	122.4	126.3	132.4	136.3	140.2	153.4	161.3
8. Gross national income	106.9	110.7	114.6	117	119.8	123.6	126.5	130.1	130.5	135.2	142.6	141.8
<b>%-change from previous year, volume</b>												
1. Private consumption	2.9	-3.1	-4.6	2.8	2.2	5.4	5.0	10.2	7.3	4.0	-3.0	-1.2
2. Public consumption	3.1	-0.8	2.3	4.0	1.7	1.2	2.5	3.4	4.7	4.3	3.1	4.0
3. Gross fixed investment	3.3	-11.1	-10.7	0.5	-1.1	25.6	10.0	32.9	-3.0	14.8	-7.0	-14.8
4. Total national expenditure	3.8	-4.5	-3.8	2.1	2.3	7.1	5.5	13.5	4.2	6.8	-3.6	-2.9
5. Exports of goods and services	-5.9	-2.0	6.5	9.5	-2.2	9.8	5.5	2.0	4.0	5.0	7.7	3.7
5.1 Goods, fob	-7.9	-1.0	5.0	12.1	-2.1	9.0	1.5	-2.6	7.1	-1.3	7.3	6.6
5.2 Services	-0.3	-4.5	10.2	2.7	-2.4	12.0	16.3	13.2	-2.5	19.4	8.5	-1.8
6. Less: Imports of goods and services	5.3	-6.0	-7.8	4.1	3.9	16.5	7.7	23.5	4.2	8.0	-9.0	-2.3
6.1 Goods, fob	4.9	-4.9	-12.6	7.5	6.4	16.6	5.2	24.3	3.2	2.7	-10.0	-3.2
6.2 Services	6.2	-8.9	5.9	-3.6	-2.7	16.1	15.2	21.2	6.9	21.5	-6.9	-0.5
7. Gross domestic product	0.1	-3.3	0.8	4.0	0.1	5.2	4.7	5.5	4.1	5.7	2.8	-0.6
8. Gross national income	1.9	-3.0	-0.7	3.5	0.8	4.6	5.5	7.9	3.9	3.7	2.5	0.8
<b>%-change from previous year, prices</b>												
1. Private consumption	6.7	3.6	3.6	1.5	1.9	2.4	1.9	0.9	2.6	4.5	8.1	3.6
2. Public consumption	8.2	3.8	3.2	1.8	3.6	5.4	4.3	9.5	6.5	6.3	8.5	8.2
3. Gross fixed investment	6.1	3.0	4.6	3.1	2.5	3.2	2.1	1.1	1.1	1.0	12.3	3.5
4. Total national expenditure	6.9	3.6	3.6	1.9	2.4	3.2	2.4	2.6	3.1	4.0	9.6	4.9
5. Exports of goods and services	6.9	-1.3	4.8	6.0	4.8	-0.2	2.4	4.9	-0.1	4.0	21.5	-1.7
5.1 Goods, fob	7.5	-3.1	2.6	6.1	5.9	-1.2	2.9	6.9	-0.9	4.4	22.8	-2.5
5.2 Services	5.3	3.7	10.3	6.3	2.2	2.3	0.4	0.0	1.9	2.6	19.1	0.1
6. Less: Imports of goods and services	3.3	-0.7	9.1	5.5	3.5	3.0	0.3	-0.7	0.7	6.8	21.1	-2.1
6.1 Goods, fob	2.9	-2.3	7.3	5.0	4.3	3.4	0.1	-0.7	0.3	8.6	20.4	-2.8
6.2 Services	4.5	3.7	11.7	7.8	2.5	2.2	0.0	-0.4	1.3	2.0	22.5	-1.2
7. Gross domestic product	8.1	3.3	2.2	2.1	2.9	2.0	3.2	4.8	2.9	2.9	9.4	5.1
8. Gross national income	6.9	3.6	3.5	2.1	2.4	3.2	2.3	2.8	0.3	3.6	5.5	-0.6

**Table 3 continued**

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Est. 2001	Est. 2002
<b>Per capita volume indices</b>												
1. Private consumption	101.6	97.3	91.8	93.7	95.3	99.8	104.1	113.5	120.3	123.3	118.0	115.6
2. Public consumption	101.8	99.9	101.1	104.3	105.6	106.2	108.0	110.6	114.4	117.5	119.5	123.2
3. Gross fixed investment	102.0	89.6	79.2	79.0	77.7	97.0	105.9	139.4	133.4	151.0	138.5	117.0
4. Total national expenditure	102.5	96.7	92.1	93.2	94.8	101.0	105.8	118.8	122.3	128.9	122.5	117.9
5. Exports of goods and services	92.9	90.0	94.8	103.0	100.1	109.4	114.5	115.5	118.7	122.8	130.4	134.1
5.1 Merchandise, fob.	91.0	89.0	92.5	102.9	100.2	108.6	109.4	105.4	111.5	108.5	114.8	121.3
5.2 Services	98.5	92.9	101.3	103.2	100.2	111.5	128.7	144.2	139.0	163.6	175.1	170.5
6. Less: Imports of goods and services	104.0	96.6	88.2	91.0	94.1	109.0	116.5	142.4	146.6	156.1	140.1	135.7
6.1 Merchandise, fob	103.6	97.4	84.2	89.7	95.0	110.2	115.0	141.5	144.2	146.1	129.7	124.5
6.2 Services	104.9	94.4	98.9	94.5	91.5	105.6	120.8	144.8	153.0	183.2	168.2	166.0
7. Gross domestic product	98.9	94.5	94.2	97.2	96.8	101.3	105.3	111.1	114.2	119.0	120.8	118.6
8. Gross national income	100.6	96.4	94.8	97.2	97.5	101.4	106.2	113.3	116.4	119.0	120.3	120.2
<b>Gross domestic product per capita, US dollars</b>												
1. GDP per capita, current exchange rates	26 373	26 690	23 178	23 601	26 139	27 130	26 717	29 217	30 361	29 873	26 741	29 619
2. GDP per capita, current PPPs	18 155	18 482	18 902	19 628	22 279	23 492	24 469	25 972	27 076	28 319	29 014	28 972

\* Corrections have been made due to change in base year of time series

Source: Statistics Iceland

**Table 4. Gross fixed capital formation**

Million krónur, current prices	1997	1998	1999	2000	2001	2002
<b>Business sector investment total</b>	<b>64 117</b>	<b>93 663</b>	<b>89 430</b>	<b>102 902</b>	<b>101 134</b>	<b>79 627</b>
Agriculture	3 185	4 066	5 202	5 993	5 462	5 134
Fishing	590	6 610	3 608	6 536	7 707	3 310
Fish Processing	7 809	3 682	1 050	1 142	120	...
Food industry, other	915	1 954	2 779	3 160	2 628	...
Metal and power intensive industry	11 017	11 673	4 025	5 852	4 446	1 536
Manufacturing, other	3 258	5 196	4 672	4 986	4 572	4 691
Electricity and water supply	9 521	17 559	15 708	12 748	16 421	15 704
Construction	8 397	12 794	8 269	8 246	8 238	8 954
thereof: harbours and lighthouses	2 491	4 469	1 714	1 413	888	2 532
thereof: airports	569	499	1 156	555	1 072	455
Wholesale and retail trade, repairs	5 511	5 725	7 504	3 664	5 525	4 643
Hotels and restaurants	1 521	1 072	3 507	2 384	1 143	1 624
Transport and telecommunications	5 247	11 142	5 626	18 216	11 710	11 113
Financial intermediation and insurance	1 218	2 424	3 910	955	2 250	1 977
Real estate and business activities	1 019	6 979	15 742	23 351	24 341	9 831
Education	82	36	277	51	33	96
Health services, social work	249	409	864	1 757	955	1 019
Other social work, recreational, cultural and sporting activities	2 115	1 149	2 074	1 871	1 886	1 819
Unclassified	2 461	1 194	4 610	1 989	3 696	3 345
Residential construction total	20 807	21 768	22 327	26 574	33 226	37 426
<b>Public works and buildings</b>	<b>19 495</b>	<b>24 731</b>	<b>25 736</b>	<b>29 960</b>	<b>32 055</b>	<b>29 726</b>
Roads and bridges	3 485	3 547	4 196	4 595	6 067	5 354
Streets and sewers	3 752	4 122	4 378	5 333	5 107	6 225
Public buildings	9 291	12 799	11 656	13 257	14 146	12 977
Other	2 967	4 264	5 507	6 775	6 736	5 171
<b>Gross fixed capital formation total</b>	<b>104 419</b>	<b>140 163</b>	<b>137 493</b>	<b>159 436</b>	<b>166 416</b>	<b>146 780</b>

Source: Statistics Iceland



**Table 5. Operation of 62 companies listed on the Iceland Stock Exchange**

	Number of firms	Revenues million kr.	Gross profits % of revenue		Financial items % of revenues		Pre tax profit % of revenues		Changes in working capital % of revenues		Cash flow from operating activities % of revenues	
			m.kr.	m.kr.	m.kr.	m.kr.	m.kr.	m.kr.	m.kr.	m.kr.		
Marine production												
	2003	88 540	10	866	1	4 759	5	6 063	7	3 695*	4	
	2002	103 858	12	5 567	5	13 547	13	9 560	9	7 479*	7	
Industrial production												
	2003	45 025	15	- 197	0	4 950	11	5 633	13	8 825	20	
	2002	42 515	15	611	1	5 341	13	5 247	12	4 595	11	
Commerce and services												
	2003	53 825	12	1 500	3	3 901	7	5 865	11	6 685	12	
	2002	50 426	11	2 444	5	4 427	9	5 436	11	5 716	11	
Transportation												
	2003	24 254	3	- 345	-1	- 1 099	-5	1 117	5	2 020*	8	
	2002	26 323	10	1 124	4	2 107	8	2 145	8	4 203*	16	
Finance and insurance												
	2003	49 471	-	-	-	12 158	25	17 219	35	12 032	24	
	2002	44 071	-	-	-	8 477	19	6 206	14	10 156	23	
<b>Total</b>												
	<b>2003</b>	<b>261 115</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>24 669</b>	<b>9</b>	<b>35 897</b>	<b>14</b>	<b>33 258</b>	<b>13</b>	
	<b>2002</b>	<b>267 193</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>33 898</b>	<b>13</b>	<b>28 593</b>	<b>11</b>	<b>32 149</b>	<b>12</b>	
<b>Total without the finance and insurance</b>	<b>2003</b>	<b>211 644</b>	<b>11</b>	<b>1 825</b>	<b>1</b>	<b>12 512</b>	<b>6</b>	<b>18 678</b>	<b>9</b>	<b>21 225</b>	<b>10</b>	
	<b>2002</b>	<b>223 122</b>	<b>12</b>	<b>9 746</b>	<b>4</b>	<b>25 422</b>	<b>11</b>	<b>22 387</b>	<b>10</b>	<b>21 993</b>	<b>10</b>	

\* Eimskipafélag Íslands and Brim are not included in cash flow from operating activities.

**Table 6. Fish catch**

	1999	2000	2001	2002	Forec. 2004	Forec. 2005
<b>Thousand tonnes</b>						
Cod	261	238	240	207	189	214
Haddock	45	42	40	50	63	77
Saithe	31	33	32	42	47	52
Redfish	67	71	50	66	59	57
Catfish	14	15	18	14	17	16
Greenland halibut	11	15	17	19	22	23
Herring	94	100	101	97	100	95
Shrimp	473	33	31	34	29	34
Capelin	704	892	924	1079	735	800
Blue whiting	160	259	365	286	420	350
Atlantic-Scandian herring	203	186	78	127	103	103
Oceanic redfish	43	45	42	45	55	50
Other marine products	56	51	49	67	60	60
<b>Total marine product</b>	<b>1 732</b>	<b>1 980</b>	<b>1 987</b>	<b>2 133</b>	<b>1 899</b>	<b>1 931</b>
<b>Percentage change in total catch value from previous year, fixed prices:*</b>		2.0	-3.5	2.0	-2.0	6.0

\* Fixed prices calculated using fish prices from May 2002 to April 2003  
based on figures from The Freshfish Price Directorate.

Source: Statistics Iceland, forecast from Ministry of Finance.

**Table 7. Balance of payments**

Million krónur

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<b>1 Balance on goods</b>	3 074	77	12 272	19 662	13 356	1 201	254	25 019	22 382	37 480	5 936	13 629
<b>1.1 Merchandise exports f.o.b.</b>	91 560	87 833	94 658	112 654	116 607	125 690	131 213	136 592	144 928	149 272	196 582	204 303
Marine products	73 236	69 881	74 571	84 838	83 872	92 582	93 648	99 233	97 682	94 498	122 046	128 592
Aluminium	8 076	8 053	8 259	10 833	12 303	12 104	15 197	18 416	22 539	27 691	39 361	38 583
Ships and aircrafts	157	523	1 093	3 370	4 108	4 146	5 201	2 245	6 390	3 136	3 311	2 330
Other goods	10 095	9 375	10 447	13 613	16 323	16 754	17 167	16 696	18 317	23 948	31 864	34 794
<b>1.2 Merchandise imports f.o.b.</b>	94 797	88 224	82 576	93 243	103 251	124 489	130 959	161 611	167 778	187 276	203 083	191 205
Investment goods	35 027	31 257	25 213	30 792	21 994	28 139	32 704	42 223	41 472	44 330	44 357	38 597
Transport equipments	16 291	14 628	8 940	11 734	12 883	18 205	18 065	26 018	29 370	31 914	28 258	25 943
Fuels and lubricants	7 801	7 334	7 518	7 596	7 318	9 633	9 896	8 049	8 924	17 300	17 725	15 984
Industrial supplies	25 042	22 879	22 401	24 765	28 750	32 810	33 460	41 123	38 970	43 236	55 429	53 967
Consumer goods	19 695	19 264	18 990	20 550	32 378	35 799	36 912	44 293	49 042	50 496	57 314	56 715
<b>2 Balance on services, total</b>	1 746	110	956	3 143	3 169	1 880	2 977	822	6 934	9 525	1 724	1 687
<b>2.1 Export of services, total</b>	34 111	33 764	41 036	44 782	44 643	51 146	59 735	67 622	67 238	82 360	106 485	104 673
Transportation	13 468	12 035	16 011	18 139	17 340	22 452	25 735	31 109	30 819	40 833	50 878	51 848
Air transport	...	...	...	...	10 847	14 963	17 380	22 692	23 097	30 194	37 782	38 957
Sea transport	...	...	...	...	6 493	7 489	8 355	8 417	7 722	10 639	13 096	12 891
Travel	8 684	8 124	9 764	10 595	12 004	11 722	12 316	14 633	16 070	17 967	22 881	22 846
Other receipts	11 959	13 605	15 261	16 048	15 299	16 972	21 684	21 880	20 349	23 560	32 726	29 979
Communications services	...	...	...	...	1 476	1 505	1 673	1 336	696	820	2 337	704
Insurance services	...	...	...	...	338	366	377	402	414	435	577	606
Government services	...	...	...	...	6 657	7 635	8 344	7 557	7 531	8 457	8 091	7 666
Other services	...	...	...	...	6 828	7 466	11 290	12 585	11 708	13 848	21 721	21 003
<b>2.2 Imports of services, total</b>	35 857	33 874	40 080	41 639	41 474	49 266	56 758	68 444	74 172	91 885	104 761	102 986
Transportation	10 710	9 421	10 794	12 077	13 371	16 614	17 916	22 766	25 622	32 697	37 106	39 516
Travel	17 685	16 886	18 261	17 892	18 194	20 472	22 893	28 049	31 487	37 082	36 401	33 509
Other receipts	7 462	7 567	11 025	11 670	9 909	12 180	15 949	17 629	17 063	22 106	31 254	29 961
Communications services	...	...	...	...	1 192	1 576	1 738	1 451	529	155	2 742	3 429
Insurance services	...	...	...	...	1 304	1 304	918	931	740	432	714	1 748
Government services	...	...	...	...	746	799	845	1 202	1 077	1 205	1 560	1 645
Other services	...	...	...	...	6 667	8 501	12 448	14 045	14 717	20 314	26 238	23 139

Table 7 continued

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
<b>3 Balance of income</b>	10 655	8 911	9 750	13 635	12 826	11 349	12 116	12 647	12 567	19 353	25 122	16 997
3.1 Receipts	4 929	5 771	6 053	5 251	5 277	6 880	7 132	8 509	9 328	11 603	16 822	16 060
Compensation of employees	2 994	3 037	3 175	2 993	3 260	4 242	4 128	4 742	4 901	5 516	5 772	5 417
Investment income	1 935	2 734	2 878	2 258	2 017	2 638	3 004	3 767	4 427	6 087	11 050	10 643
3.2 Expenditures	15 584	14 682	15 803	18 886	18 103	18 229	19 248	21 156	21 895	30 956	41 944	33 057
Compensation of employees	883	723	702	532	365	306	391	293	341	844	533	702
Investment income	14 701	13 959	15 101	18 354	17 738	17 923	18 857	20 863	21 554	30 112	41 411	32 355
<b>4 Current transfer</b>	510		211	626	306	464	238	1 003	725	762	959	1 170
<b>A Current balance</b>	15 990	9 540	2 909	8 519	3 390	8 684	8 899	39 585	43 448	67 120	30 293	511

... Data not available

Source: Central Bank of Iceland. Statistics Iceland

**Table 8. Income, prices and exchange rate**

	I Indices 1990=100													
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Forec. 2003	Forec. 2004	Forec. 2005
<b>I Income</b>														
Disposable household income	109.9	106.6	108.2	114.3	121.6	126.9	140.2	154.4	170.6	185.8	194.3	201	211	226
Wages <sup>1)</sup>	111.5	113.1	114.4	119.6	127.2	134.2	146.8	156.8	167.2	181.9	194.6	204	215	230
<b>Prices</b>														
Consumer price index	110.8	115.3	117.0	119.0	121.7	123.9	126.0	130.3	136.8	146.0	153.0	156	160	165
<b>Purchasing power <sup>2)</sup></b>														
Disposable household income	99.3	92.5	92.5	96.0	99.9	102.4	111.3	118.5	124.7	127.2	126.9	129	132	137
Wages <sup>1)</sup>	100.7	98.1	97.8	100.5	104.6	108.3	116.5	120.3	122.1	124.5	127.2	131	134	140
<b>Exchange rate</b>														
Effective price of foreign currency <sup>3)</sup>	100.7	110.6	116.0	116.1	116.1	114.7	112.8	112.7	112.7	135.3	131.2	124	125	127
Real exchange rate relative to price	102.6	97.0	91.8	91.9	92.1	92.9	94.4	96.1	98.9	86.4	91.2	98	98	98
Real exchange rate relative to wage	106.3	96.6	89.1	93.0	94.0	96.9	101.7	103.8	105.4	92.4	97.6	106	106	109
<b>II Changes on previous year, %</b>														
<b>Income</b>														
Disposable household income	0.9	-2.5	1.5	5.5	6.4	4.3	10.5	10.1	10.5	8.9	4.6	3½	5	7
Wages <sup>1)</sup>	2.9	1.4	1.2	4.5	6.4	5.4	9.4	6.8	6.6	8.8	7.0	5	5	7
<b>Prices</b>														
Consumer price index	3.7	4.1	1.5	1.7	2.3	1.8	1.7	3.4	5.0	6.7	4.8	2	2½	3
<b>Purchasing power <sup>2)</sup></b>														
Disposable household income	-2.7	-7.6	0.0	3.8	4.1	2.5	8.7	6.5	5.2	2.0	-0.2	1½	2½	4
Wages <sup>1)</sup>	-0.7	-2.6	-0.3	2.8	4.1	3.6	7.6	3.3	1.5	2.0	2.2	3	2½	4
<b>Exchange rate</b>														
Effective price of foreign currency <sup>3)</sup>	0.7	9.8	4.9	0.1	0.1	-1.3	-1.8	-0.2	0.1	20.1	-3.0	-6	1	1½
Real exchange rate relative to price	-0.1	-5.4	-5.4	0.1	0.2	0.9	1.6	1.8	2.9	-12.6	5.6	7	¼	-¼
Real exchange rate relative to wage	3.2	-9.2	-7.9	4.4	1.1	3.0	5.0	2.1	1.5	-12.3	5.6	8½	½	2

**Notes:**

<sup>1)</sup> Wage index

<sup>2)</sup> Deflated by price index

<sup>3)</sup> Official exchange rate of the króna vis-à-vis foreign currencies. 31.12.1991=100

**Table 9. General government finances**Million krónur, current prices <sup>1</sup>

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Prov. 2001	Prov. 2002	Est. 2003	Forec. 2004	Forec. 2005
<b>Total income</b>	<b>150.9</b>	<b>148.1</b>	<b>154.5</b>	<b>163.6</b>	<b>179.1</b>	<b>194.8</b>	<b>220.8</b>	<b>254.8</b>	<b>275.7</b>	<b>300.5</b>	<b>320.5</b>	<b>341.7</b>	<b>363.8</b>	<b>389.2</b>
1. Direct taxes	55.1	59.6	62.7	68.0	76.3	86.0	98.6	115.6	128.8	149.3	159.0	170.9	181.6	202.9
2. Indirect taxes	84.3	77.5	79.7	83.1	90.7	96.1	109.3	124.5	131.0	129.7	135.0	143.4	153.5	157.3
3. Interest income	6.8	6.8	7.0	6.8	6.8	6.6	7.5	8.7	10.1	14.6	15.5	14.6	15.6	15.9
4. Other income	4.7	4.2	5.1	5.6	5.3	6.2	5.5	6.0	5.8	6.8	10.9	12.8	13.2	13.2
<b>Total revenue</b>	<b>162.1</b>	<b>166.5</b>	<b>175.1</b>	<b>177.0</b>	<b>186.8</b>	<b>194.9</b>	<b>218.0</b>	<b>240.2</b>	<b>259.2</b>	<b>299.2</b>	<b>328.2</b>	<b>350.9</b>	<b>361.5</b>	<b>379.4</b>
1. Public consumption	83.9	88.6	93.8	99.0	105.6	112.8	127.8	142.4	157.9	176.7	198.8	215.4	224.0	238.2
Of which: Depreciation	7.9	8.6	9.3	9.9	10.5	11.1	11.9	12.6	13.5	14.5	15.8	17.6	18.0	19.6
2. Interest expenditure	15.6	16.5	18.0	20.0	19.5	19.6	21.2	22.7	22.6	28.6	26.9	26.4	26.9	26.1
3. Subsidies	12.5	9.7	8.7	8.7	9.2	9.2	9.2	10.0	10.8	12.8	13.7	14.7	15.0	16.1
4. Income transfers	30.6	33.0	33.9	36.2	37.2	38.8	40.1	42.7	47.2	53.8	65.8	71.6	74.7	79.2
5. Investment	17.8	19.7	19.5	16.0	17.6	18.4	23.6	26.1	25.8	32.0	30.2	31.4	29.7	29.5
6. Capital transfers	9.7	7.5	10.3	7.1	8.2	7.3	8.1	8.8	8.4	9.9	8.6	9.0	9.3	9.9
<b>Financial balance</b>	<b>-9.5</b>	<b>-18.4</b>	<b>-20.6</b>	<b>-13.4</b>	<b>-7.7</b>	<b>-0.1</b>	<b>2.8</b>	<b>14.6</b>	<b>16.6</b>	<b>1.3</b>	<b>-7.7</b>	<b>-9.2</b>	<b>2.3</b>	<b>9.9</b>
Percentage of GDP														
Revenue	38.2	36.3	35.6	36.7	37.6	37.9	38.8	41.8	41.6	40.3	41.1	41.9	42.2	41.6
Expenditure	41.1	40.8	40.4	39.7	39.2	37.9	38.3	39.4	39.1	40.2	42.1	43.1	42.0	40.6
Financial balance	-2.8	-4.5	-4.8	-3.0	-1.6	0.0	0.5	2.4	2.5	0.2	-1.0	-1.1	0.3	1.1
Taxes	35.3	33.6	32.8	33.9	35.1	35.4	36.5	39.4	39.2	37.4	37.8	38.6	38.9	38.5
Public consumption	21.3	21.7	21.6	22.2	22.2	22.0	22.5	23.4	23.8	23.7	25.5	26.4	26.0	25.5

<sup>1</sup>This table follows the national accounts standards of the EU, ESA 95.

**Table 10. Central government finances**Million krónur, current prices <sup>1</sup>

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Prov.	2001	Prov.	2002	Est.	2003	Forec.	2004	Forec.	2005
<b>Total income</b>	<b>121.6</b>	<b>119.0</b>	<b>125.1</b>	<b>131.3</b>	<b>144.6</b>	<b>151.3</b>	<b>170.5</b>	<b>198.9</b>	<b>212.6</b>	<b>227.1</b>	<b>236.6</b>	<b>252.1</b>	<b>268.5</b>	<b>286.5</b>					
1. Direct taxes	39.3	39.8	42.8	46.9	53.2	54.3	61.7	74.2	82.8	95.2	99.5	107.7	114.3	129.3					
2. Indirect taxes	72.7	70.6	72.5	74.8	82.1	87.3	98.9	113.5	117.5	116.2	119.7	127.3	136.7	139.6					
3. Interest income	5.9	5.9	6.4	6.2	6.2	5.9	6.7	7.6	8.7	12.4	13.2	12.1	12.9	13.1					
4. Other income	3.7	2.8	3.4	3.3	3.1	3.8	3.2	3.6	3.5	3.3	4.2	4.9	4.6	4.6					
<b>Total revenue</b>	<b>131.2</b>	<b>132.8</b>	<b>138.5</b>	<b>142.8</b>	<b>151.9</b>	<b>148.5</b>	<b>164.3</b>	<b>183.3</b>	<b>195.6</b>	<b>222.6</b>	<b>240.0</b>	<b>258.4</b>	<b>262.1</b>	<b>274.9</b>					
1. Public consumption	52.5	55.9	58.2	62.1	63.6	64.1	73.9	82.4	90.8	101.7	114.1	125.5	128.1	136.3					
Of which: Depreciation	5.9	6.3	6.8	7.3	7.7	8.1	8.7	9.2	9.8	10.4	11.1	12.9	13.1	14.3					
2. Interest expenditure	14.0	14.8	16.0	17.8	17.4	17.4	18.8	20.2	19.5	23.1	20.7	19.8	19.9	18.7					
3. Subsidies	11.8	9.0	8.0	8.0	8.1	8.2	7.9	8.6	9.0	10.8	11.4	12.3	12.5	13.4					
4. Income transfers	41.2	42.5	43.8	47.1	52.1	51.9	54.3	60.2	66.2	73.5	83.4	89.2	92.0	98.6					
5. Investment	7.6	9.4	9.5	8.9	9.9	8.0	10.1	12.4	11.9	14.1	12.9	15.6	13.5	12.6					
6. Capital transfers	10.0	7.5	9.7	6.2	8.4	7.0	7.9	8.7	8.0	9.7	8.8	9.0	9.1	9.7					
<b>Financial balance</b>	<b>-9.6</b>	<b>-13.8</b>	<b>-13.4</b>	<b>-11.6</b>	<b>-7.3</b>	<b>2.7</b>	<b>6.2</b>	<b>15.6</b>	<b>16.9</b>	<b>4.6</b>	<b>-3.5</b>	<b>-6.3</b>	<b>6.4</b>	<b>11.7</b>					
<b>Percentage of GDP</b>																			
Revenue	30.8	29.1	28.8	29.4	30.4	29.4	30.0	32.6	32.1	30.5	30.4	30.9	31.2	30.7					
Expenditure	33.2	32.5	31.9	32.0	31.9	28.9	28.9	30.1	29.5	29.9	30.8	31.7	30.4	29.4					
Financial balance	-2.4	-3.4	-3.1	-2.6	-1.5	0.5	1.1	2.6	2.6	0.6	-0.4	-0.8	0.7	1.2					
Taxes	28.4	27.0	26.6	27.3	28.4	27.6	28.2	30.8	30.2	28.4	28.1	28.9	29.1	28.8					
Public consumption	13.3	13.7	13.4	13.9	13.4	12.5	13.0	13.5	13.7	13.6	14.6	15.4	14.9	14.6					

<sup>1</sup>This table follows the national accounts standards of the EU, ESA 95.

**Table 11. Local government finances**Million krónur, current prices <sup>1</sup>

	1992	1993	1994	1995	1996	1997	1998	1999	2000	Prov. 2001	Prov. 2002	Est. 2003	Forec. 2004	Forec. 2005
<b>Total income</b>	<b>31.5</b>	<b>31.0</b>	<b>31.9</b>	<b>34.9</b>	<b>40.0</b>	<b>48.2</b>	<b>54.4</b>	<b>61.0</b>	<b>68.5</b>	<b>79.9</b>	<b>87.4</b>	<b>92.5</b>	<b>98.2</b>	<b>106.8</b>
1. Direct taxes	15.8	19.8	19.9	21.2	23.1	31.7	36.9	41.5	46.0	54.1	59.5	63.1	67.2	73.6
2. Indirect taxes	11.6	6.9	7.2	8.3	8.7	8.8	10.4	11.0	13.5	13.5	15.4	16.1	16.9	17.7
3. Interest income	0.8	0.8	0.5	0.5	0.5	0.6	0.7	0.9	1.2	1.6	1.8	2.0	2.1	2.2
4. Other income	3.3	3.4	4.3	5.0	7.8	7.2	6.5	7.6	7.8	10.6	10.7	11.4	12.1	13.2
<b>Total revenue</b>	<b>33.2</b>	<b>35.7</b>	<b>38.8</b>	<b>36.4</b>	<b>40.5</b>	<b>51.2</b>	<b>58.6</b>	<b>64.0</b>	<b>71.1</b>	<b>85.2</b>	<b>93.1</b>	<b>97.0</b>	<b>102.2</b>	<b>108.7</b>
1. Public consumption	20.8	22.6	25.0	25.6	29.6	37.3	41.3	46.1	51.5	58.7	66.6	70.8	74.8	79.6
Of which: Depreciation	2.1	2.2	2.5	2.6	2.7	3.0	3.2	3.4	3.7	4.1	4.6	4.6	4.9	5.3
2. Interest expenditure	1.6	1.7	2.0	2.2	2.1	2.2	2.4	2.6	3.1	5.4	6.2	6.6	6.9	7.4
3. Subsidies	0.7	0.7	0.7	0.7	1.0	1.0	1.2	1.4	1.8	2.1	2.3	2.4	2.6	2.7
4. Income transfers	2.3	2.6	3.0	2.7	3.0	3.1	3.3	3.6	4.2	5.0	5.6	6.1	6.5	7.1
5. Investment	10.1	10.3	10.0	7.1	7.7	10.4	13.5	13.7	13.9	17.9	17.3	15.7	16.2	16.9
6. Capital transfers	-0.4	0.0	0.6	0.8	-0.2	0.3	0.2	0.2	0.3	0.2	-0.2	0.1	0.1	0.2
<b>Financial balance</b>	<b>-1.7</b>	<b>-4.7</b>	<b>-6.8</b>	<b>-1.4</b>	<b>-0.4</b>	<b>-3.0</b>	<b>-4.3</b>	<b>-2.9</b>	<b>-2.6</b>	<b>-5.3</b>	<b>-5.8</b>	<b>-4.6</b>	<b>-4.0</b>	<b>-1.9</b>
<b>Percentage of GDP</b>														
Revenue	8.0	7.6	7.4	7.8	8.4	9.4	9.6	10.0	10.3	10.7	11.2	11.4	11.4	11.4
Expenditure	8.4	8.8	8.9	8.2	8.5	10.0	10.3	10.5	10.7	11.4	12.0	11.9	11.9	11.6
Financial balance	-0.4	-1.2	-1.6	-0.3	-0.1	-0.6	-0.7	-0.5	-0.4	-0.7	-0.7	-0.6	-0.5	-0.2
Taxes	6.9	6.5	6.2	6.6	6.7	7.9	8.3	8.6	9.0	9.1	9.6	9.7	9.8	9.8
Public consumption	5.3	5.5	5.8	5.7	6.2	7.3	7.3	7.6	7.8	7.9	8.5	8.7	8.7	8.5

<sup>1</sup>This table follows the national accounts standards of the EU, ESA 95.



**Table 12. Central government debt and claims <sup>1</sup>**

Million krónur, year-end values

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	Est. 2003	Budget 2004
<b>Gross debt</b>	<b>166 116</b>	<b>195 569</b>	<b>213 924</b>	<b>232 585</b>	<b>239 246</b>	<b>241 566</b>	<b>237 764</b>	<b>225 968</b>	<b>227 908</b>	<b>296 480</b>	<b>279 583</b>	<b>276 100</b>	<b>273 800</b>
Central Bank	13	6	-	-	-	-	-	-	-	-	-	-	-
Treasury bonds	51 793	60 796	69 008	74 140	73 889	84 424	82 865	82 618	68 898	64 243	50 818	45 000	43 500
Treasury notes	2 487	6 012	5 563	5 768	8 366	11 258	15 846	11 018	11 430	19 588	32 482	41 100	45 400
Treasury bills	12 545	13 742	14 630	16 406	15 811	12 296	15 209	9 899	5 970	12 003	12 004	21 000	18 000
Other domestic liabilities	12 005	12 709	11 090	9 010	8 962	6 960	6 526	4 297	2 285	2 357	2 274	2 200	2 100
Foreign debt	87 273	102 304	113 633	127 261	132 218	126 628	117 318	118 136	139 325	198 289	182 005	166 800	164 800
<b>Total claims</b>	<b>67 700</b>	<b>64 968</b>	<b>69 066</b>	<b>77 266</b>	<b>71 023</b>	<b>69 309</b>	<b>86 496</b>	<b>107 152</b>	<b>100 696</b>	<b>126 760</b>	<b>129 512</b>	<b>126 500</b>	<b>118 800</b>
Long term credit	41 654	46 875	55 469	64 134	63 663	65 278	64 739	69 347	70 443	90 248	78 785	75 600	56 800
Indexed to domestic price	22 644	26 405	36 965	45 176	50 565	52 885	53 215	57 699	58 786	76 828	71 710	-	-
In foreign currency	19 010	20 470	18 504	18 958	13 098	12 393	11 524	11 648	11 657	13 420	7 075	-	-
Taxes outstanding and other	26 046	18 093	13 597	13 132	7 360	4 031	21 757	37 805	30 253	36 512	50 727	50 900	62 000
<b>Net debt</b>	<b>98 416</b>	<b>130 601</b>	<b>144 858</b>	<b>155 319</b>	<b>168 223</b>	<b>172 257</b>	<b>151 268</b>	<b>118 816</b>	<b>127 212</b>	<b>169 720</b>	<b>150 071</b>	<b>149 600</b>	<b>155 000</b>
Claims as a percentage of GDP	40.8	33.2	32.3	33.2	29.7	28.7	36.4	47.4	44.2	42.8	46.3	45.8	43.4
<b>Percentage of GDP <sup>2</sup></b>													
<b>Gross debt</b>	<b>41.4</b>	<b>48.0</b>	<b>48.6</b>	<b>51.3</b>	<b>49.1</b>	<b>46.8</b>	<b>41.7</b>	<b>36.6</b>	<b>34.1</b>	<b>39.3</b>	<b>35.8</b>	<b>35.1</b>	<b>31.5</b>
Of which: foreign debt	21.8	25.3	25.9	28.2	27.3	24.6	20.6	19.4	21.0	26.6	23.4	-	-
<b>Total claims</b>	<b>10.4</b>	<b>11.5</b>	<b>12.6</b>	<b>14.1</b>	<b>13.0</b>	<b>12.6</b>	<b>11.3</b>	<b>11.1</b>	<b>10.5</b>	<b>11.7</b>	<b>10.0</b>	<b>15.5</b>	<b>13.8</b>
Of which: In foreign currency	4.7	5.1	4.2	4.2	2.7	2.4	2.0	1.9	1.8	1.8	0.9	-	-
Short term credit, net	6.5	4.4	3.1	2.9	1.5	0.8	3.8	6.0	4.5	4.7	6.5	-	-
<b>Net debt</b>	<b>24.5</b>	<b>32.1</b>	<b>32.9</b>	<b>34.3</b>	<b>34.6</b>	<b>33.4</b>	<b>26.5</b>	<b>19.4</b>	<b>19.2</b>	<b>22.9</b>	<b>19.3</b>	<b>19.0</b>	<b>17.8</b>

<sup>1</sup> Including accrued interest liabilities.

<sup>2</sup> Based on average price and average exchange rate of foreign currency.

**Table 13. General government debt and claims<sup>1</sup>**

Million krónur, year-end values

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
	Estimate												Forecast
<b>General government gross debt.....</b>	<b>185 639</b>	<b>220 084</b>	<b>245 071</b>	<b>267 611</b>	<b>274 447</b>	<b>279 351</b>	<b>280 460</b>	<b>272 031</b>	<b>277 715</b>	<b>346 170</b>	<b>343 627</b>	<b>344 697</b>	<b>346 482</b>
Domestic debt.....	95 466	113 296	126 467	135 881	138 088	145 149	153 144	142 048	124 812	129 834	134 799	-	-
Foreign debt.....	90 173	106 788	118 604	131 730	136 359	134 202	127 316	129 983	152 903	216 336	208 828	-	-
<b>General government total claims.....</b>	<b>79 127</b>	<b>76 905</b>	<b>79 577</b>	<b>88 313</b>	<b>82 925</b>	<b>82 820</b>	<b>99 746</b>	<b>124 552</b>	<b>118 850</b>	<b>152 671</b>	<b>148 259</b>	<b>142 945</b>	<b>134 244</b>
Long-term claims.....	48 346	54 091	61 559	70 760	71 249	74 449	74 482	79 505	80 569	110 747	93 616	88 610	69 018
Taxes outstanding and other short-term claims.....	30 781	22 814	18 018	17 553	11 676	8 371	25 264	45 047	38 281	41 924	54 643	54 335	65 226
<b>General government net debt.....</b>	<b>106 512</b>	<b>143 180</b>	<b>165 494</b>	<b>179 227</b>	<b>191 522</b>	<b>196 531</b>	<b>180 685</b>	<b>146 985</b>	<b>158 516</b>	<b>193 297</b>	<b>195 176</b>	<b>201 570</b>	<b>212 065</b>
Central government.....	98 417	130 602	144 858	155 319	168 224	172 256	151 268	118 816	127 212	162 788	150 071	149 600	155 000
Local governments.....	10 194	14 552	22 185	25 130	24 190	25 038	30 089	28 663	31 653	30 711	45 297	52 152	57 238
Social security system.....	-2 099	-1 974	-1 549	-1 222	-892	-763	-672	-494	-349	-202	-192	-182	-173
<b>Real values of gross debt, constant price</b>													
General government gross debt.....	232 987	246 543	261 883	279 595	280 731	282 828	280 460	263 872	259 516	311 268	299 168	291 689	287 374
General government net debt.....	134 047	160 515	176 805	187 215	195 893	198 944	180 685	142 599	147 927	172 410	168 292	170 572	175 887
<b>Percentage of GDP</b>													
<b>General government gross debt.....</b>	<b>46.4</b>	<b>53.2</b>	<b>55.8</b>	<b>59.2</b>	<b>56.6</b>	<b>54.4</b>	<b>49.3</b>	<b>44.6</b>	<b>41.9</b>	<b>46.5</b>	<b>44.1</b>	<b>42.3</b>	<b>40.2</b>
Domestic debt.....	23.8	27.4	28.8	30.1	28.5	28.3	26.9	23.3	18.8	17.4	17.3	-	-
Foreign debt.....	22.5	25.8	27.0	29.1	28.1	26.1	22.4	21.3	23.1	29.0	26.8	-	-
<b>General government total claims.....</b>	<b>19.8</b>	<b>18.6</b>	<b>18.1</b>	<b>19.5</b>	<b>17.1</b>	<b>16.1</b>	<b>17.5</b>	<b>20.4</b>	<b>17.9</b>	<b>20.5</b>	<b>19.0</b>	<b>17.5</b>	<b>15.6</b>
<b>General government net debt.....</b>	<b>26.6</b>	<b>34.6</b>	<b>37.7</b>	<b>39.6</b>	<b>39.5</b>	<b>38.3</b>	<b>31.8</b>	<b>24.1</b>	<b>23.9</b>	<b>25.9</b>	<b>25.1</b>	<b>24.7</b>	<b>24.6</b>

<sup>1</sup> The general government is defined according to the SNA-definition. Government enterprises and financial institutions are excluded.

<sup>2</sup> Domestic debt is converted to constant price based on consumer price index and foreign debt is based on foreign prices and average exchange rate.