



Ministry of Finance

THE ICELANDIC ECONOMY

An Economic Forecast for 2002-2004

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INTRODUCTION

The Ministry of Finance has reviewed its forecast for the Icelandic economy published on October 1. This report outlines the first forecast for 2004. These forecasts do not incorporate the effects of the power project developments that have been under discussion.

MAIN CONCLUSIONS

- The present review of the Ministry's October forecast is largely unchanged.
- GDP growth is estimated at $\frac{1}{4}$ per cent for 2002 and $1\frac{3}{4}$ per cent for 2003, an increase of $\frac{1}{4}$ per cent in both years from the previous forecast. The increase is primarily due to greater exports in 2002 and increased expenditure in 2003. Economic growth is expected to increase considerably in 2004 to about 3 per cent.
- The current account is expected to register a small deficit in 2002, equivalent to $\frac{1}{4}$ per cent of GDP, solely due to increased expenditure. For 2003 and 2004, the current account deficit is projected at $\frac{1}{2}$ per cent of GDP.
- National expenditure is expected to contract by 3 per cent in 2002, mainly because of a decline in business investment. Domestic demand is expected to increase in concert with GDP both in 2003 and 2004.
- Unemployment has been on the increase recently. For 2002, it is still estimated at $2\frac{1}{2}$ per cent, whereas for 2003 it is expected to increase to $2\frac{3}{4}$ per cent. Increased growth in output and demand is expected to lead to a decline in unemployment in 2004, down to the 2002 level.
- Inflation prospects are largely unchanged from the October forecast. Inflation is expected to decline from $4\frac{3}{4}$ per cent in 2002 to $2\frac{1}{4}$ per cent in 2003 and further to 2 per cent in 2004.
- Prospects for Treasury finances in 2002 and 2003 are largely unchanged from previous estimates as present revisions have raised revenue and expenditure figures by similar amounts. The 2002 revenue surplus of the Treasury is estimated at 17 billion krónur, equivalent to 2.2 per cent of GDP. For 2003, a surplus of $11\frac{1}{2}$ billion is forecast, equivalent to 1.4 per cent of GDP.

The cut-off date for this report is 29 November. All projections are made by the Ministry unless otherwise stated. Projections in tables are shaded.

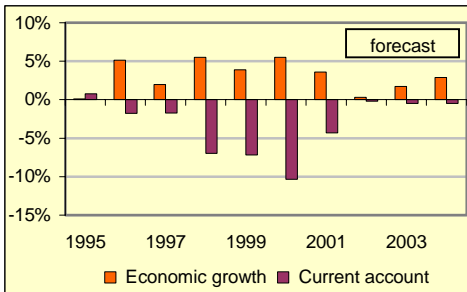
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The Ministry's October forecast predicted that real GDP would remain unchanged in 2002 from the previous year. This present revision estimates that there will be some

Slight pick-up of growth in 2002.

Economic growth and current account as % of GDP



growth of GDP this year, particularly because exports have increased more than estimated earlier, imports have contracted less and public consumption growth is greater.

On the basis of VAT returns for the first eight months of this year, private consumption is expected to decline by 1¼ per cent, as against 1 per cent in the October forecast. Due in part to less favourable terms of trade, the current account is expected to show a marginal deficit, one of 1½ billion krónur (close to ¼ per cent of GDP). In spite of growing unemployment, labour market participation is still high. Inflation has declined sharply in the course of 2002. At present it is estimated that inflation within the year will be below 2 per cent, compared with 9½ per cent in 2001.

The sharp decline in inflation and the return of the current account to near-balance shows a rapid return of the economy towards an equilibrium, thus strengthening the prospects for economic growth over the next years. In this context, a moderate recovery is forecast with a growth rate of 1¾ per cent for 2003, about a ¼ per cent higher than in the October forecast. The increase is mainly due to higher public consumption and investment than predicted earlier.

Deviations from the October forecast

Volume changes from the previous year unless otherwise indicated

	2002	2003
Private consumption	-¼	0
Public consumption	¼	1¼
Investment	¾	¼
National expenditure	0	¼
Exports of goods and services	1¼	-½
Imports of goods and services	½	0
Current account as % of GDP	-¼	-½
Gross domestic product	¼	¼

Moderate recovery in 2003.

The revised forecast assumes that public consumption will rise by 2¼ per cent in real terms, whereas the October forecast predicted a 1 per cent increase, as assumed in the proposed fiscal budget. Public investment is now expected to increase by 1½ per cent, as against ½ per cent earlier. Despite better growth prospects, the outlook is for increased unemployment, rising to 2¾ per cent in 2003. The 2003 inflation forecast is unchanged at 2¼ per cent, both between yearly averages and within the year. This forecast assumes that the exchange rate index will remain at 130 and that wage rate changes will be in accordance with wage agreements.

Return to trend-growth in 2004.

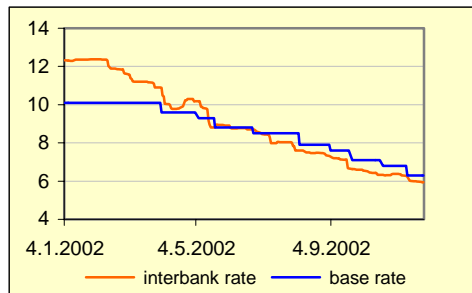
The forecast for 2004 predicts economic growth of close to 3 per cent and a similar growth in national expenditure. This implies a closing of the output gap of the economy, since the long-term trend growth of the economy is close to 3 per cent. The main contribution to growth is increased export income, a significant increase in business

investment and rising private consumption. The current account is expected to remain stable, showing a deficit equivalent to ½ per cent of GDP. Inflation is expected to recede still further, down to 2 per cent, and unemployment should decline to 2½ per cent.

FINANCIAL MARKETS

The Central Bank lowers its base rate...

Interest rates in 2002



Source: The Central Bank.

...and the króna is getting stronger

The Central Bank has lowered its base rate in several steps since April 2001 and thereby loosened its monetary policy stance. In 2002, the rate was cut nine times by a total of 3.8 per cent, from 10.1 per cent at the beginning of the year to 6.3 per cent at the end of November. In real terms, i.e. adjusted for the inflation margin on Treasury bonds, the rate has declined by 3 per cent from the beginning of the year to 4¼ per cent at the end of November. The lower decline in the real rate than in the nominal rate is due to the fact that inflation has declined faster than the base rate. The interest rate differential vis-à-vis other countries has also declined from 7 per cent at the beginning of the year to 3½ per cent at present, based on three-month Treasury bills.

In spite of these interest rate reductions, the króna exchange rate strengthened sharply in the early part of the year and reached its peak at the beginning of August. Since then the exchange rate has weakened slightly but has largely been stable with the exchange rate index fluctuating within a narrow margin from 128 to 131 points. This is primarily due to a current account surplus, plans to privatise the government-owned banks and increased investment by nonresidents in domestic securities.

Bond interest rates are also declining

Money market interest rates have also declined with 90-day money market rates having been below the base rate since the beginning of July. Bond interest rates have also declined, both on indexed and non-indexed bonds.

The stock market has been buoyant

Transactions in the stock market have been very lively in the course of this year with the total turnover on the Stock Exchange amounting to 270 billion krónur in the first ten months of the year, compared with 140 billion krónur last year. The stock market index has fluctuated, rising at the beginning of the year, declining in the second and third quarters, and reviving again in the fourth quarter. For the year as a whole, the index has risen by 13 per cent.

Foreign stock markets have behaved differently

Following a steady decline in foreign stock market prices in the first nine months of the year, the bottom was reached at the beginning of October after which stock price indices have begun to recover. The difference in price trends in the Icelandic market compared to foreign markets is explained by several factors. The Icelandic market is in many respects isolated and the proportion of companies in the ITC sectors is considerably lower than in other markets. It is precisely in these sectors that the largest declines have taken place. Furthermore, the Icelandic business environment has been favourable with declining interest rates and a sharp reduction in income and net

wealth taxes. Exchange rate developments have also been favourable for financial transactions. This has helped company profits and thus stock prices.

FOREIGN TRADE

Rapid increase of exports this year...

Merchandise exports increased by 9 per cent in volume in the first ten months of this year. The bulk of the increase is in marine products, whereas exports of manufactured products have also increased rapidly. Aluminium exports rose substantially due to increased production capacity. The total value of merchandise exports is 9 per cent higher in the first ten months of 2002 than in the corresponding period a year earlier. According to the revised forecast export volume will rise by 8¼ per cent in 2002. In 2003 and 2004, however, a considerable slowdown is envisaged, especially in manufactured goods. For 2003, an increase of just over 1½ per cent is forecast and 2 per cent for 2004.

...while the contraction of imports is slowing down

Merchandise imports declined in volume by more than 4 per cent in the first ten months of this year. This follows a 10 per cent contraction for 2001 as a whole. The main source of the decline lies in investment goods, the imports of which have contracted by nearly one-fifth. Imports of consumer goods declined by just under 3 per cent in volume while imports of intermediate goods have increased. The revised forecast estimates that merchandise imports will decline by 2½ per cent in volume in 2002. For 2003, however, an increase of 3¾ per cent is foreseen and 3½ per cent for 2004.

As a result, a substantial trade surplus has emerged

The surplus on merchandise trade is estimated at more than 14 billion krónur in 2002. This is a sharp turnaround from last year when the trade account was in deficit by 6 billion. A continued surplus, albeit declining, is forecast for the next two years, 9 billion in 2003 and 6 billion in 2004.

The surplus on services is also growing

The revised forecast for this year estimates that the surplus on service transactions will be close to 10 billion krónur, slightly higher than earlier envisaged. The surplus is expected to increase in 2003 to 15 billion krónur and further to 19 billion krónur in 2004. Expenditures on services are declining in 2002, whereas they are expected to increase again in 2003 and 2004. The income from services has continued to increase and this increase is expected to continue in the next two years, particularly from tourism.

The current account will be in slight deficit

Despite a large surplus on the trade and services account, the overall current account is expected to be in slight deficit, equivalent to ¼ per cent of GDP, as a result of large interest payments on foreign debt. The deficit is expected to increase slightly in 2003 and 2004 in line with increased economic growth, reaching the equivalence of ½ per cent of GDP in both years.

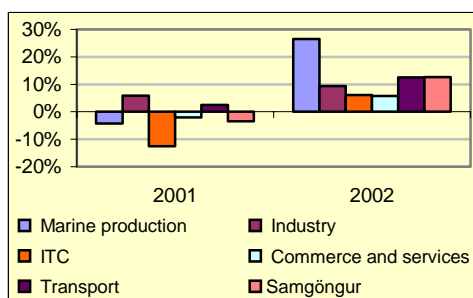
THE BUSINESS SECTOR

The business environment has improved significantly from the previous year. Inflation has declined below the Central Bank's inflation target, interest rates have declined and the króna exchange rate has been stable in recent months. Business expectations are optimistic, as

A favourable business environment has led to increased optimism among industry leaders

indicated in a recent Gallup survey for the Ministry and the Central Bank where 46 per cent of businesses questioned took an optimistic view of the economy and only 13 per cent took the opposite view. Looking further ahead, 69 per cent thought that circumstances will have improved after twelve months and only 7 per cent thought they will be worse. Gallup will conduct these surveys twice a year, in February and September, where the directors of the 400 largest companies in the country will be polled. The first such survey was conducted last September with a response rate of 81 per cent.

Profits before taxes as % of income January-September



Source: Icelandic Stock Exchange

Business profits have generally improved as shown in the accompanying graph, based on the interim accounts for the first nine months of this year of 45 companies registered on the Iceland Stock Exchange. The main explanation for the improvement lies in the favourable development of the exchange rate. The exchange rate index rose by 16 per cent in the first nine months of 2001, whereas it declined by 10 per cent in the first nine months of this year, compared with a year earlier. Profits of fisheries companies have improved the most since their income and debt are mostly in foreign currencies.

The Gallup survey also showed that company directors generally expected that profits and turnover will be similar or greater this year than last. Only 24 per cent thought that these would decline. Views differed, however, by the size of companies, with the larger companies generally expecting more profits than the smaller ones. The analyst departments of commercial and investment banks are also positive in their forecasts on company profits for this year.

Production has increased...

The fish catch, both in value and volume terms, has increased from last year. Although prices have declined slightly in krónur terms from the first half of this year in line with the stronger króna exchange rate, the SDR-denominated price index for fisheries exports is 4 per cent higher in the first ten months of this year than last year. Aluminium production has also increased in volume this year, but prices have been declining. A 10 per cent volume increase has been slightly more than offset by price declines, leading to a marginal decline in export value. Aluminium prices are expected to continue their decline into 2004 when a renewed increase is expected to take place.

...but companies intend to shed labour to some extent

The revised forecast estimates that private consumption will decline by 1¼ per cent in 2002. This has an impact on business operations, particularly in commerce and services. The Gallup survey indicates that companies expect to reduce staff by an average of 2.4 per cent in the course of 2002. Industrial and manufacturing companies expect the largest reduction, 5.3 per cent, whereas commercial and service companies foresee a 4.9 per cent reduction. Companies differed by size. Those with a staff of 20 to 200 foresee a reduction whereas companies with a staff of 20

The contraction in business investment is coming to an end

or less are looking to expand their staff. About one-fifth said that they would reduce their staff in the next six months.

The contraction in business investment which began in 2001 appears to be coming to an end. This is primarily attributable to improved operating conditions for companies following the reduction in income and net wealth taxes, a lower interest rate and a favourable development of the exchange rate. All of these factors have helped to strengthen the business environment and contribute to new investments. Business investment is expected to increase by 3½ per cent in 2003 and by up to 10 per cent in 2004. This represents a major reversal since 2001 and 2002 when business investment is estimated to have declined by close to 28 per cent. Imports of investment goods, however, declined by 18 per cent in the first ten months of this year, compared to a year earlier.

POPULATION AND LABOUR MARKET

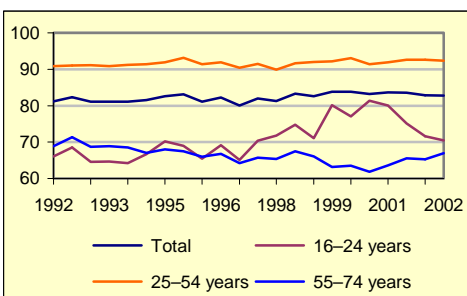
International migration is in balance...

Information on population developments in the first nine months of the year indicates that emigration has increased and immigration declined in the third quarter, compared to the corresponding quarter of the previous year. Net emigration amounted to about 300 persons in the third quarter, the first quarter in four years with net emigration. Figures for the migration of foreign citizens do not give rise to a revision of the previous forecast for the year as a whole, although at present it appears that their net immigration will slightly exceed the previous estimate. It is evident, however, that 3,600 Icelandic citizens will emigrate this year, a figure similar to emigration in 1995. This is offset by a larger number of immigrating Icelandic citizens than previously estimated. The total figure on net migration is therefore about the same as in the previous forecast, with the increase in the number of foreigners offsetting the decline in the number of Icelanders. The impact on the labour market is that the labour force will increase by a small margin as a result of migration, since the labour market participation of foreign citizens is slightly higher than in the emigrating age groups.

...in spite of an increase in the number of Icelanders emigrating

Labour market participation for young people has decreased

Labour participation rates



Source: Statistics Iceland Labour Market Survey

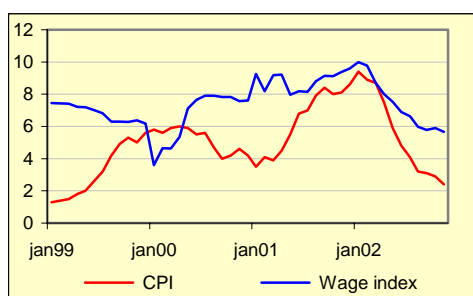
According to the labour market survey of Statistics Iceland, conducted at the beginning of November, there has been a net loss of 3,100 jobs in the labour market in the past year. The job loss is mostly due to a 10 per cent reduction in labour market participation in the 16-24 years age group. Labour market participation has decreased more among female than male workers. Participation in the 25-54 years age group remains largely unchanged, and for those older than 55, participation is increasing, mainly due to an increasing number of women in the labour market that remain employed as they move into this age group. Participation by men older than 55 years has been declining. Weekly working hours, however, have not changed in recent years.

Unemployment has increased

Registered unemployment rose in October after having declined since March. According to the labour market survey, only about one-third of the decline in labour market participation has been reflected in increased unemployment. It may be assumed that an increasing number of young people have gone back to school without working part-time alongside their studies. Recent labour market developments have prompted a reassessment of unemployment prospects for next year. A rate of 2¾ per cent is forecast for 2003, as against an earlier prediction of 2½ per cent.

PRICES

12 month changes, %



Source: Statistics Iceland

Increased price stability

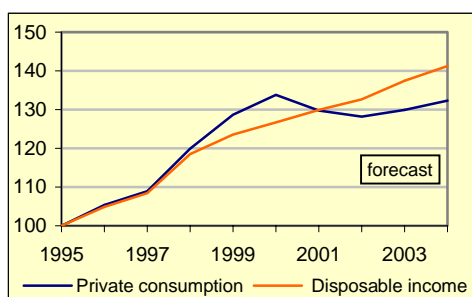
Inflation has declined rapidly with consumer price increases in the course of 2002 expected to be less than 2 per cent. The main cause for declining inflation is a stronger króna exchange rate which has been reflected in lower import prices; these have declined by more than 7 per cent in the past twelve months. Domestic demand has also weakened which in turn has reduced wage drift. Against this trend, however, weigh price increases in several services as well as in housing.

An inflation rate of less than 2 per cent is forecast from the beginning to the end of 2003, whereas a rate of 2¼ per cent is forecast between the averages of 2002 and 2003. For 2004, a rate of 2 per cent is forecast, both within the year and between years. The forecast is based on the assumption that the exchange rate index remains at 130 for both years and that contractual wage increases will be 3¼ per cent in 2003 and 3 per cent in 2004. The main factors of uncertainty of the inflation forecast are associated with prospective power and aluminium plant investments as well as the development of oil prices.

THE HOUSEHOLD SECTOR

Real household incomes continue to increase

Disposable income and private consumption, index 1995=100



Source: Statistics Iceland, forecast Ministry of Finance

The strengthening of the exchange rate has led to price stability...

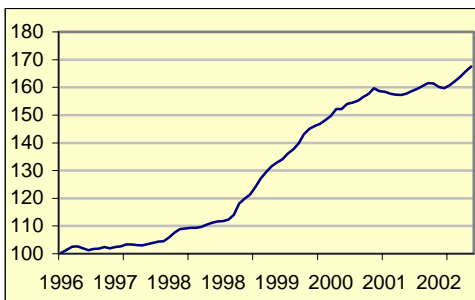
The wage index has increased by 5 per cent so far this year. The twelve-month increase to December is expected to reach 5¼ per cent which means that wage rates may increase by about 7 per cent between the averages of 2001 and 2002. Wage developments in 2003 are somewhat uncertain. Wage contracts generally call for a 3¼ per cent wage increase at the beginning of 2003. The slack labour market makes it unlikely that there will be much of a wage drift. On the other hand, the special increase in the wages of the lowest paid, in accordance with wage contracts, could influence general wage rates, especially those nearest to the lowest pay scales. This forecast projects a wage drift of close to ½ per cent during 2003 and ¾ per cent in the course of 2004. Accordingly, a general wage increase of some 4¼ per cent is forecast for 2003 and close to 3½ per cent in 2004.

Real wages have increased by close to 3½ per cent so far this year and for the year as a whole an increase of more than 2 per cent on average between 2001 and 2002 is expected. A similar increase, 2 per cent, is forecast for 2003

...making wage increases result in increased purchasing power

A temporary contraction in residential construction...

Residential property prices in the capital area, 1996=100



Source: State Valuation Office

and 1¾ per cent for 2004. Real disposable income has increased less than real wages since unemployment has increased. Hence, real disposable per capita income is estimated to increase by 1 per cent in 2002, 2½ per cent in 2003 and 1¾ per cent in 2004.

A small contraction in residential construction, of ½ per cent, is expected this year, following a substantial increase in recent years. For 2003, a further decline of 2 per cent is forecast while in 2004 residential construction is expected to pick up again, rising by 1¾ per cent.

Recent data regarding loan applications and loan amounts for new housing lend support to the above forecast with a 7 per cent increase in the amount of lending for new housing in the first ten months of this year. The increase is wholly due to higher loan amounts for each housing unit, whereas the number of applications declined by 5½ per cent. An 18 per cent decline in applications and a 28 per cent decline in lending to housebuilding contractors is particularly notable. Housing prices have, however, increased marginally from the middle of this year after a period of relatively stable prices in the months before.

TREASURY FINANCES

A Treasury surplus in 2002...

...and in 2003

Treasury finances have changed in several respects since this past autumn, both for 2002 and 2003. The revenue balance is nonetheless about the same, since estimates for revenue and expenditure have been revised upwards by about the same amount. Treasury revenue increases by close to 4½ billion krónur for 2002, largely because the recent corporate tax assessment yielded more revenue than had been anticipated. Sales of assets are also expected to yield more revenue than earlier anticipated. Expenditure is expected to exceed the fiscal budget by a similar amount, due mainly to increased health and social security outlays, including special outlays following an agreement to increase expenditures benefiting senior citizens. The revenue surplus for 2002 is estimated at about 17 billion krónur, equivalent to 2.2 per cent of GDP.

Treasury revenue in 2003 is estimated to increase by 7½ billion krónur from the fiscal budget proposal. The causes are essentially the same as in 2002, i.e. the estimate for the corporate income tax has been raised and the same applies for revenue from the sale of assets. The personal income tax is expected to yield less revenue than estimated earlier, mainly due to a higher estimate for unemployment and hence a lower increase in aggregate personal incomes. Treasury expenditure increases by close to 6½ billion krónur from the budget proposal. The increase is mainly due to outlays for health and social security, as well as to education and social services. The revenue balance for 2003 is estimated at 11½ billion krónur, equivalent to 1.4 per cent of GDP.