



Highlights

Budget Proposal

2006

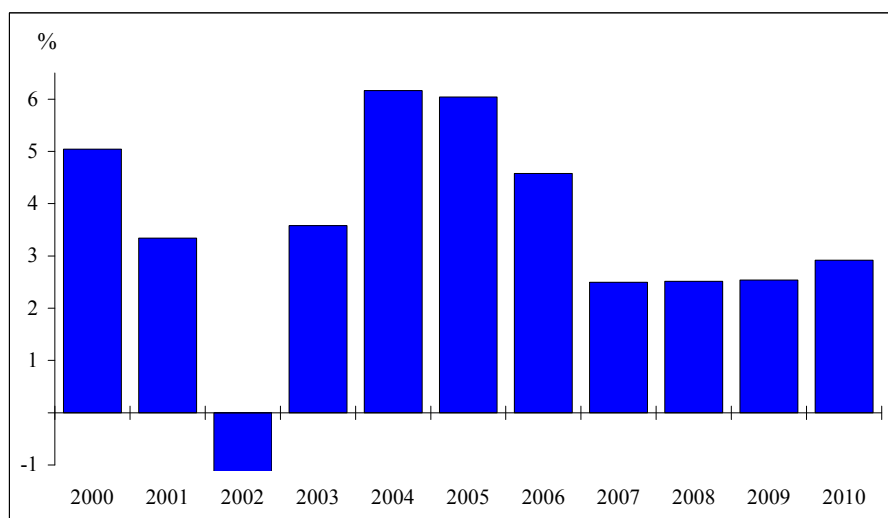
Budget highlights for 2006

1 Economic policy objectives

The economy is going through a vigorous expansion ...

Economic growth has gradually been increasing in recent years. Due to power project investments, growth is expected to be at its peak in 2004 and 2005 and continue vigorous in 2006. For the years 2003 to 2007, real GDP is estimated to increase by 25 per cent and real disposable household income by 17 per cent. Jobs are increasing in number and unemployment has been reduced, a situation that is expected to continue into next year. The productive capacity of the economy is being put to the test with inflation near the upper tolerance limit set by the Central Bank.

Economic growth



... and demands a tight fiscal policy

In order to maintain stability under these conditions, a tight fiscal policy must be pursued in 2006. The fiscal policy pursued in recent years has led to improved expenditure efficiency, both as regards wages and salaries as well as other current expenditure. Both central government consumption expenditures as well as its transfer payments are growing more slowly. Government investment has been cut this year and that will also continue next year when power project investments will still be substantial. Government investment will be increased in 2007 as the economy returns to a better balance.

The fiscal budget reflects a responsible economic policy

The 2006 budget is tight, in line with expectations that economic growth will slow down in coming years. The budget is presented with a revenue surplus of 14.2 billion, equivalent to 1.4 per cent of GDP. This surplus is almost 16 billion below the revised estimate for 2005, excluding the profit from the sale of Iceland Telecom. In this regard, the tight expenditure policy pursued in 2004 and 2005 should be kept in mind. The decision on the allocation of the proceeds from the Iceland Telecom sale has also had regard to the need for restraining demand in 2005 and 2006.

A tight fiscal policy is a prerequisite for tax cuts

A tight fiscal policy is not only a basic prerequisite for maintaining economic stability but also for the implementation of the tax cut measures as stated in the Government's policy platform and that have already been passed into law. In light of economic prospects and the timing of power project investments, the main impact and the final phase of the tax cuts will take place in 2007. The second phase of the cut in the personal income tax will take place next year and the net wealth tax, both on individuals and legal entities, will be abolished.

Policy for the next four years

In the fiscal budget for 2006, a four-year indicative programme for the next four years is presented. This is the third year in succession that such an exercise is made. The presentation of such a programme reflects a firm economic policy and contributes to economic stability. As in previous programmes, a strong role for fiscal policy is assumed in order to contain domestic demand when power project investments are at their peak and stimulate growth upon their completion. The main points of the 2006-2009 programme are as follows:

- A tight fiscal policy will be pursued. The average annual increase in government consumption is not to exceed 2 per cent in real terms and for transfer payments the limit is 2.5 per cent.
- Government investment will be cut by 2 billion krónur in 2006 for the third year in succession. Investment will be increased again by 2 billion in 2007 and further by 2 billion in 2008. In addition, funds from the sales proceeds of Iceland Telecom will be allocated in accordance with the Government's decision.

Substantial amounts will be used to cut taxes in the first half of the 2006-2009 period in accordance with the Government's policy and for priority projects in the latter half of the period.

The economy is developing rapidly ...

The economy has been developing rapidly in recent years. Economic activity has become more diverse. Fisheries are still the backbone of exports, but the increase in power-intensive production, tourism and high-tech branches have diversified export earnings. Economic stability has been strengthened and the means of sustaining a rise in real incomes in an international environment has thereby been improved. Icelandic companies have forged links abroad, attracting international attention, and Icelandic assets abroad are increasing.

... in connection with economic restructuring and increasing globalisation

The ongoing restructuring of the economy in an international setting has led to a profound change in the economic environment of households and businesses in recent years, bringing it on par with or surpassing the level prevailing in our main trading partner countries. The large tax cuts are an important step in the Government's endeavour in this direction. Improvements in economic policy have contributed towards maintaining a low inflation rate and strengthening the Treasury budget balance. The privatisation of government enterprises in the financial and

communications sectors has increased competition and created a benefit for consumers. The restructuring of the economy has also helped businesses and individuals participate in the increasing globalisation of the economy in the past decade. The result of these profound changes has been translated into a sharply increasing purchasing power of households and stronger foundations of business operations.

Income tax rates



The Central Bank has increased its policy rate ...

In addition to a tight fiscal policy, monetary policy has also been tightened through a gradual increase in the Bank's policy rate in order to counter the expansion in domestic demand. The rising policy rate has helped strengthen the exchange rate which in turn has lowered import prices but has at the same time reduced the growth of export earnings in krónur terms. Households have better access to loanable funds that are partly financed abroad, which has reduced the effectiveness of monetary policy. The effectiveness of the level of domestic interest rates may be expected to increase as soon as the exchange rate begins to decline, since it will thereby increase the service on foreign debt. It is also probable that international interest rates may increase in coming years, since at present they are at an historical low.

Increased expenditure for important priorities

The sale of Iceland Telecom and the robust state of the Treasury has created room for repaying 57.7 billion krónur of Treasury debt this year, thus greatly reducing the Treasury's interest cost. A part of the sales proceeds will in future years be used to finance special projects, partly in the health sector as well as for roads, without increasing government debt.

Iceland ranks high in international comparison

Most economic indicators reflect the favourable rank of Iceland in international comparisons. Economic growth is higher than that of most other countries. Unemployment is far below the level prevailing in neighbouring countries. Icelandic companies are known for their enterprise and their strong entry into foreign markets.

The fiscal situation is considerably better and the same applies to Treasury debt. The inflation rate is also similar, although at present it is close to the upper tolerance limit, which is wholly attributable to a higher rate of growth than elsewhere. Looking further down the road, it is also evident that Iceland's economy is ahead of most other economies. Our pension system is strong since it is largely based on an accumulation of funds instead of being a pay-as-you-go system.

Continued economic stability

The main conclusion to be drawn from the fiscal budget and the Government four-year fiscal programme is that stability in the economy will be maintained in spite of increased power project construction activity and rising domestic demand, partly caused by changed circumstances in the housing market. The tight fiscal policy projected here also creates room for cutting taxes in accordance with the Government's policy without endangering the main policy emphasis of maintaining stability. A tight fiscal policy is an important prerequisite in this respect, as has been described above.

2 Main elements of fiscal finances

2.1 Prospects for fiscal finances in 2005

The Treasury's revenue and expenditure have been revised in light of developments this year. The sale of Iceland Telecom has had a profound impact in fiscal finances in 2005. The following table shows the estimate for Treasury finances with and without the sale of Iceland Telecom. The revenue surplus in the fiscal budget for 2005 was projected at 10 billion krónur. The revised estimate puts it at close to 30 billion, excluding the sale of Iceland Telecom and at 85 billion including the sale. The financial surplus was projected at 10 billion but is now expected to turn out at 35 billion without the Iceland Telecom sale and at 98 billion including it. The financial surplus will be used to repay Treasury debt and the remainder will be deposited with the Central Bank for later allocation to projects that the Government has proposed.

Treasury finances

Billion krónur, current prices	Accounts 2004	Budget 2005	Estimate ¹ 2005	Estimate ² 2005	Budget proposal 2006
Revenue.....	300.9	306.4	334.1	397.3	327.4
Expenditure.....	300.4	296.4	304.4	312.3	313.2
Revenue surplus.....	0.5	10.0	29.7	85.0	14.2
Non-financial curr. items..	-6.8	-10.9	-7.1	-64.6	-3.5
Cash from operations.....	-6.3	-0.9	22.6	20.4	10.7
Financial transactions.....	26.7	11.0	12.0	77.7	-1.1
Net financial balance.....	23.5	10.1	34.6	98.1	9.6

¹ Excluding the sale of Iceland Telecom.

² Including the sale of Iceland Telecom.

Tax revenue is growing

In the 2005 budget, total Treasury revenue was estimated at 306.4 billion krónur. A revised projection of revenue is based in the development of principal economic indicators, the provisional 2004 Treasury accounts and the development of revenue collected in the course of 2004, turns out at 397.3 billion krónur for this year. This represents an increase of 90 billion from the budget figure, mostly on account of the profit from the sale of Iceland Telecom. Excluding it and interest earned thereon, Treasury revenue is estimated at 334.1 billion, 27.7 billion in excess of the budget estimate. Treasury revenue has increased considerably in line with increased economic activity and rising consumption. Amongst individual taxes, estimated revenue is expected to turn out to be 20 billion higher than projected in the fiscal budget; the personal income tax by 5.5 billion, the stamp tax by 4.4 billion, the value added tax by 7 billion and the import excise tax on motor vehicles by 3.3 billion. In addition, the Treasury is paying itself 6.3 billion in capital income tax, all in excess of budget, mainly on the profit from the sale of Iceland Telecom. Finally, Iceland Telecom paid the Treasury an extra dividend of 4.3 billion prior to the sale of the company.

The allocation of the sales proceeds of Iceland Telecom

Total Treasury expenditure is estimated at 304.4 billion krónur in 2005, increasing by 8 billion from the 2005 budget. In addition, expenditure related to the sale of Iceland Telecom amounted to nearly 8 billion. Of that amount, 5,700 million were paid in capital income tax on the sale of Iceland Telecom alone, and 750 million in other associated costs. In addition, 1,000 million were allocated to the Telecommunications Fund, 300 million to the design and planning of a new high-tech hospital and 200 million to housing for the mentally disabled. The total increase in Treasury expenditure for these items amounts to 7,950 million. The intention is also to allocate a 1,000 million krónur capital contribution to the New Business Venture Fund in 2005. This amount will go over the capital account of the Treasury books and thus not affect the revenue balance, only reduce the financial balance.

Increasing road construction

The main reasons for the 8 billion krónur increase in general expenditure of the Treasury is that tax claims written off are expected to be 4 billion higher than estimated in the fiscal budget. Road construction will exceed the budget by 1.3 billion, since unspent funds carried over from previous years are being used this year. A 500 million krónur spending authorisation for the construction of a cultural centre is also going to be used. The contribution to the Municipal Equalisation Fund will exceed the budget by 600 million krónur, since such contributions are based on a share of total Treasury revenue. The expenditure of the Childbirth Leave Fund will exceed the budget by 360 million. Finally, several government agencies are exceeding their budget, mainly in the health sector. These increases are offset by a lower cost of unemployment insurance than budgeted, 520 million, and a lower than budgeted interest cost of 1.3 billion.

Allocation of the revenue surplus for the future

The 2005 revenue surplus is estimated at 85 billion krónur and cash from operations at just over 20 billion, which represents the actual return from the core activities of the Treasury. The financial surplus is estimated at 98 billion of which 57.7 billion will be used to repay debt and 4 billion will be allocated to the Government Employees Pension Fund. The remainder, 36.4 billion, will be deposited with the Central Bank, either in the Treasury accounts or through the issue of a note. Treasury assets with the Central Bank are estimated to amount to 54 billion at the end of the year. These funds will be later spent on projects that the Government has already announced, once the economic expansion recedes. Further debt repayments will also take place in 2006.

2.2 The highlights of the 2006 budget

Debt will continue to decline

The 2006 revenue surplus is estimated at 14.2 billion krónur, cash from operations at close to 11 billion and the financial surplus at 9.6 billion. Debt repayment is scheduled to amount to 6.6 billion next year. Total debt repayments will thus amount to 64.3 billion over a period of two years. The decline in the revenue surplus between years is mainly attributable to a lower projected growth in private consumption next year, to the cut in the personal income tax and to the fact that the net wealth tax will be abolished; the tax cuts account for 8.5 billion in reduced revenue. Expenditure is being restrained across the board whereas appropriations for priority tasks are increased, such as for child allowances, help to the disabled and for research and education.

Tax cuts

The revenue estimate for the 2006 budget incorporates the forecast that the national economy will not grow as fast in 2006 as it is doing this year. GDP growth is estimated at 4.6 per cent in 2006 as against 6 per cent for this year. Inflation is assessed at 3.8 per cent and real disposable income is thought to rise by 2.7 per cent. On this basis, it is estimated that Treasury tax revenue will amount to 301.4 billion krónur, a similar amount as this year, excluding the capital income tax that the Treasury is paying itself from the sale of Iceland Telecom. The unchanged tax revenue between years is in part explained by the cut in the personal income tax, the elimination of the net wealth tax, greatly reduced revenue from the stamp tax and excise import taxes on motor vehicles. Total Treasury revenue is estimated at 327.4 billion, 6.7 billion less than this year's estimate, excluding revenue from asset sales. As noted earlier, the main reason for the decline is that the capital income tax paid by the Treasury is not repeated and that dividends are going to be reduced after the sale of Iceland Telecom. This is in part offset by increasing interest income from deposits with the Central Bank.

Increased spending on education

Total expenditure is budgeted at 313.2 billion in 2006, an increase of 16.8 billion or 5.7 per cent from the 2005 budget. Expenditure thus increased by 1.8 per cent in real terms between budgets, based on the consumer price index. Based on the expenditure estimate for 2005, total expenditure is budgeted to remain virtually constant in

nominal terms and decline by about 2 per cent in real terms, or by close to 1 per cent excluding expenditure associated with the sale of Iceland Telecom in 2005. The main changes between years are in education, research, help to the disabled and in assistance to developing countries. Child allowances increase by 1.2 billion krónur in line with increased child benefits in connection with amendments in the income tax. Appropriations for the Municipal Equalisation Fund increase by 1.3 billion krónur from this year's budget, mainly because of a temporary 700 million krónur appropriation that was agreed to between the central government and the municipalities. The cost of unemployment insurance is expected to decline between years as well as investment appropriations. Finally, the interest on government debt is going to decline by 2 billion from the 2005 budget. The cut in investment expenditure is in accordance with the Government's medium-term programme that calls for the postponement of public investment during the peak phase of power project construction. Road construction will be sharply increased in 2007, and the use of the funds from the sale of Iceland Telecom will also begin in that year.

Revenue surplus excluding irregular items

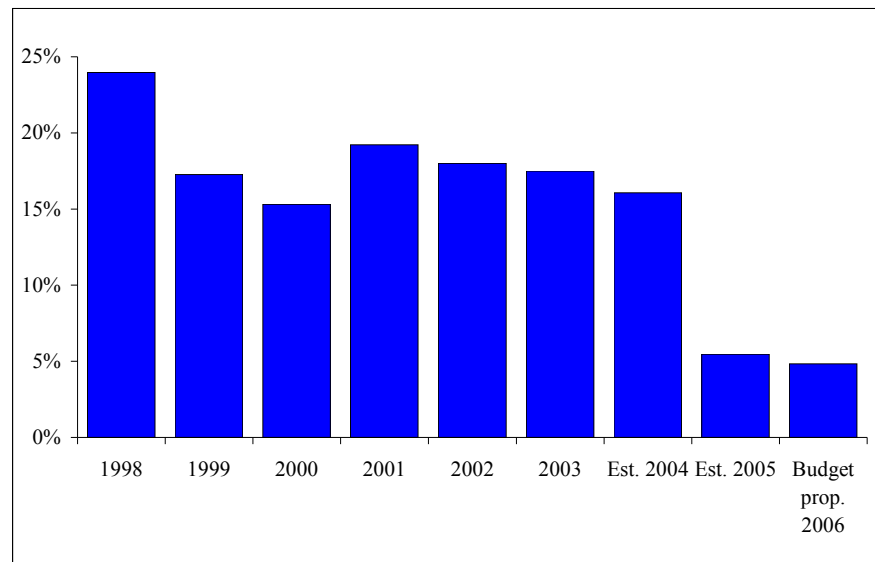
	Acc. 2002	Acc. 2003	Acc. 2004	Budget 2005	Est. 2005	Budget proposal 2006
Revenue surplus	-8.1	-6.1	0.5	10.0	85.0	14.2
Irregular expenditure	26.3	14.4	23.5	8.8	12.8	10.8
Irregular revenue	11.7	9.9	1.1	0.5	62.5	0.5
Rev. surpl., excl. irreg. items ...	6.5	-1.6	22.9	18.3	35.3	24.5

Excluding irregular items, the Treasury surplus amounts to close to 25 billion krónur in the 2006 budget. Irregular revenue covers profits from sales of assets and the revaluation of assets booked on the revenue side. Irregular expenditure covers expensed pension commitments and tax claims written off, since these items are to a large extent attributable to prior years. This measure of the Treasury surplus is more useful in describing the normal operations of the Treasury and the impact of the business cycle thereon. The revenue surplus will decline next year in line with the Ministry's forecast of slightly less economic growth. Still, a tight fiscal policy will be pursued.

Debt is declining

If the 2006 budget turns out as planned, the cumulative revenue surplus from 1999 to 2006 will amount to nearly 100 billion krónur and the financial surplus to 150 billion. The finances of the Treasury have strengthened considerably over this period, and the cumulative Treasury prepayment of future pension commitments to the Government Employees Pension Fund amounted to 80 billion krónur including interest by the end of 2004. Net repayment of debt is estimated to amount to 37 billion krónur from 1999 to 2006 at current prices. The net debt of the Treasury, defined as gross debt less lending, current accounts and liquid funds with the Central Bank, is expected to decline from 17.3 per cent of GDP in 1999 to 4.8 per cent in 2006.

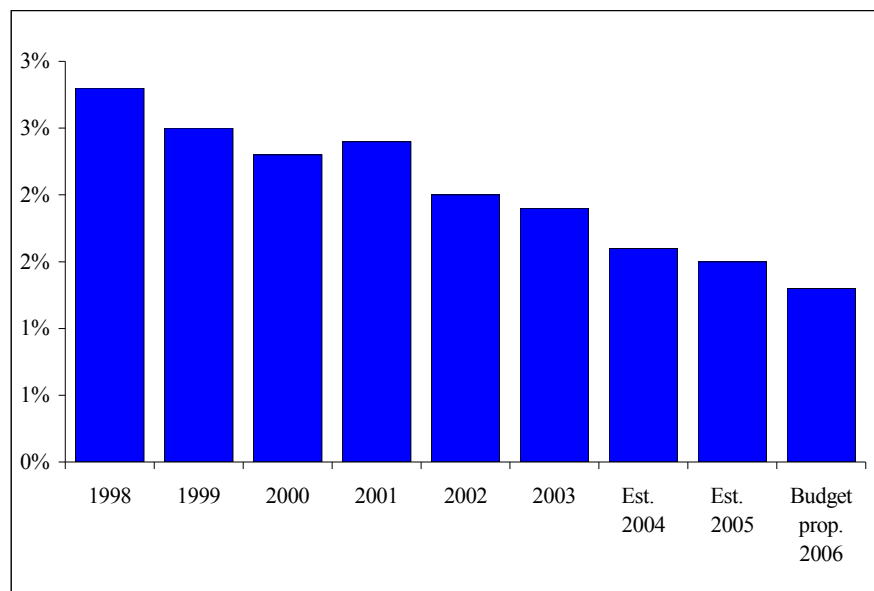
Net Treasury debt in per cent of GDP



Sound Treasury finances

The interest cost of Treasury debt will continue to decline in per cent of GDP from 2.8 per cent in 1998 to 1.3 per cent next year. If the ratio had remained unchanged, interest payments would be about 16 billion higher next year than the amount actually budgeted. Interest payments will for the first time be below interest income. These developments, along with vigorous economic growth in recent years, have created room for the Treasury to cut taxes at the same time as taking on new projects in education and social services. The decline in Treasury debt has made it possible for the economy to absorb unexpected shocks. This has meant that Iceland's credit rating has improved over time which in turn benefits business as well as individuals.

Treasury interest payments in per cent of GDP



3 Medium-term programme for Treasury finances

3.1 Three-year policy objectives

The Government policy objectives have increasingly been set for more than one year at a time. This strengthens the credibility of economic policy and contributes towards economic stability. The drafting of such policy objectives are laid out in the Government Financial Reporting Act of 1997 where it says in Article 28:

“A projection of government finances for the next three years following the next fiscal year shall accompany the fiscal budget bill each year. It shall outline the prospects for government finances with a view towards general economic conditions on one hand and the policy of the government with respect to fiscal finances on the other. The projection shall include an assessment of the fiscal impact on the economy and employment, intentions for the procurement of revenue and the division of expenditure, appropriations for investment and a summary of the government's debt operations and debt service. Once the fiscal budget bill has been passed into law the medium-term projection shall be reviewed and placed before the Althingi if significant changes have taken place in its premises.”

This provision of law was discussed in special sections in the text accompanying the fiscal budget proposals of 1998-2003. That discussion was in general terms and specific items were not discussed in line with the Government's policy objectives. An important change took place in the autumn of 2003 when the Government passed a formal resolution on fiscal policy objectives for the period of 2004 to 2007, i.e. the 2004 budget year and the subsequent three years. The fiscal policy objectives were based on the Government's [Policy Statement](#) of May 23rd 2003 as follows:

“Ensuring a balanced and stable economy. This will create conditions for even further growth in national income and higher real wages for the public at large. Economic stability is also a precondition for the improved competitiveness of Icelandic businesses.

Maintaining fiscal balance. Fiscal policy will play a key role in economic policy implementation over the coming years and needs to be flexible towards economic developments. Reforms aimed at cutting costs in central government operations will continue and procedures will be evolved further for more efficient handling and implementation of the Treasury budget. In this respect it is important to take a longer-term view than one year at a time.

Taking advantage of the Treasury's improved scope for securing higher real wages, through systematic tax policy measures.”

The Government agreed to another medium-term programme for fiscal finances in the autumn of 2004 for the years 2005-2008, since the Financial Reporting Act stipulates that such a programme should be redrafted each year, regardless of the remaining parliamentary term of office.

3.2 Main objectives of fiscal policy

The Government has agreed to the following objectives of fiscal policy for the years 2006-2009:

- A tight fiscal policy will be pursued. The annual growth in public consumption shall not exceed 2.0 per cent in real terms. The annual increase in transfer payments shall no exceed 2.5 per cent in real terms.
- Government investment will be cut by 2 billion in 2006 for the third year in succession. Investment will be increased again by 2 billion in each of the years

2007 and 2008 in addition to funds allocated in accordance with the Government's decision regarding sales proceeds from Iceland Telecom. These expenditures will be met by drawing on the Treasury's deposits with the Central Bank.

- Substantial sums will be allocated towards tax cuts in 2006-2007, as was done in 2005, in accordance with the Government's Policy Statement.

3.3 The main assumptions underlying the medium-term programme

On the basis of the Government policy objectives, the Ministry of Finance has assessed economic and fiscal prospects for the years 2006-2009.

Substantial tax cuts

As is the Government's stated intention, the drafting of prospects for fiscal finances in 2006-2007 includes substantial tax cuts that are to take place in those years. This mainly covers the cut in the personal income tax, the elimination of the net wealth tax and the revision of the value added tax. In light of current economic prospects and the timing of power project construction, the main impact of the tax cuts will take place in 2007. The second phase to the cut in the personal income tax is expected to take place in 2006 along with the elimination of the net wealth tax on individuals and legal entities. The final phase of the cut in the personal income tax will take place in 2007.

Expenditure restraint

On the expenditure side, the main assumption is that restraint will be exercised in the Treasury's general operations and that measures will be taken to deal with deviations from general objectives. The growth in public consumption is expected to continue at about a 2 per cent annual rate in real terms over the period. For purposes of the 2006 budget, the individual ministries are will be committed to adhere to the budget frames on which the programme is based. The largest increase in current expenditure is for education, in accordance with the Government's policy, as well as for homes for the disabled and assistance to developing countries. Government investment will be cut in 2006 by 2 billion and increased again by 2 billion in each of the years 2007 and 2008. These changes will take place in road construction. The programme additionally takes into account the allocation of the sales proceeds of Iceland Telecom in 2007-2009. A total of 6.1 billion of the sales proceeds will be allocated in 2007, 10.1 billion in 2008 and 9.3 billion in 2009. Treasury investment will thereby increase by nearly 10 billion in 2007 and 6 billion in 2008. Transfer payments will increase over the next several years on the basis of existing legislation, partly because of the future increase in the number of persons of pensionable age. This is in part offset by the assumption that unemployment will decline next year. Transfer payments will increase because the Government intends to increase child benefits and development assistance by substantial amounts. All told, transfer payments are assumed to increase by an average of 2.5 per cent a year. No costly amendments to transfer payments will be implemented without expenditure cuts in other areas.

The proposed allocation of sales proceeds from Iceland Telecom

Million krónur, accrual basis	2007	2008	2009	2010-12	Total
Investment:					
Roads.....	3,700	5,000	3,700	2,600	15,000
High-tech hospital.....	200	1,500	4,000	12,000	17,700
Coast guard.....	1,000	2,000	0	0	3,000
Housing for the mentally disabled....	200	300	300	0	800
Premises for the Univ. of Iceland.....	0	300	300	400	1,000
Current expenditure:					
Communications Fund.....	500	500	500	0	1,500
Capital contributions¹:					
New Business Venture Fund.....	500	500	500	0	1,500
Total	6,100	10,100	9,300	15,000	40,500

¹Capital contributions go over the capital account and are therefore not counted as current expenditure.

The expenditure programme is generally based on an extrapolation of existing expenditures in light of legislation currently in effect. General assumptions are used on one hand, for example that general administration expenditure will rise by 1 per cent a year in real terms, and economic and demographic forecasts on the other, such as for the number of senior citizens, the number of students in each age group of secondary and higher education etc. Expenditure on education and health is therefore expected to rise by 3-4 per cent a year in real terms. It is assumed that the growth in public consumption will be restricted during the phase of power project construction, and that the automatic growth in public expenditure will be reduced.

The economic assumptions underlying the medium-term programme are in part based on the forecasts of international institutions regarding economic developments in Iceland's main trading partner countries. Forecasts on population and the labour force are drawn up with regard to the timing of power project construction activity. The probable development of export production is also taken into account, where an assumption on the fish catch over the next several years is incorporated.

The programme is also based on the assumption of certain monetary policy measures that will support its main policy objectives. It is therefore assumed that the Central Bank will keep its policy rate high for some time. A tighter fiscal policy is expected to mean that the Bank's policy rate will be lower than otherwise.

3.4 The conclusions of the medium-term programme

The main conclusion of the programme is that economic stability will be maintained in spite of increased power project construction activity and domestic demand. Economic growth is expected to continue pronounced in 2006 and slow down in 2007 and 2008. Large imports on account of the power projects and aluminium plants inevitably leads to a large deficit on the current account which will be substantially reduced when construction activity declines and increased aluminium exports come on stream. Inflation has temporarily increased, now that construction activity is peaking, but it is expected to abate upon its completion. Real disposable incomes is expected to increase and unemployment decline in 2006, whereas the growth in real disposable incomes is projected to be slower in 2007 and 2008 and unemployment increase by a small margin.

Economic growth is slowing down

The tight fiscal policy that has been pursued creates room for tax cuts without disturbing the main goal of economic policy to maintain stability. The fiscal surplus has therefore been quite substantial when power project construction is at its peak. For 2005, the surplus is estimated at 2.7 per cent of GDP, followed by a 1.3 per cent surplus in 2006. Treasury debt will be reduced by 57.7 billion in 2005, paid for out of the sales proceeds from Iceland Telecom and the revenue surplus of the year. For 2007 to 2009, a revenue deficit is foreseen, since national expenditure is expected to decline outright and economic growth to slow down. The personal income tax cut will also be completed in 2007, and the sales proceeds from Iceland Telecom will begin to be allocated in that year, drawing on the Treasury's deposits with the Central Bank. The profit from the sale of Iceland Telecom is all booked in 2005 whereas the use of the sales proceeds gets expensed in years when they take place and therefore impact the revenue balance for those years.

Forecast of main economic aggregates

Volume changes in p.c.	2005	2006	2007	2008	2009
Private consumption.....	9.5	4.3	0.6	1.2	2.3
Public consumption.....	2.4	2.2	2.2	2.2	2.2
Investment.....	28.5	0.8	-23.8	-16.5	-1.0
Total national expenditure.....	12.8	2.9	-5.2	-2.2	1.7
Exports of goods and services.....	1.4	6.2	11.6	9.1	2.4
Imports of goods and services.....	18.2	2.0	-8.8	-2.7	0.1
Gross domestic product.....	6.0	4.6	2.5	2.5	2.5
Current account in p.c. of GDP.....	-13.3	-12.2	-6.4	-2.5	-2.0
Changes in incomes and prices, p.c.					
Disposable income per capita.....	7.6	6.5	6.1	4.3	4.3
Wages.....	6.3	5.0	4.5	4.2	3.5
Real disp. income per capita.....	3.7	2.7	2.1	1.5	1.8
Consumer price index.....	3.9	3.8	4.0	2.8	2.5
Exch. rate index, avg. change.....	-9.2	3.6	4.8	3.5	3.0
Unemploym. in p.c. of labour force.....	2.2	1.8	2.7	3.8	3.7

It should be kept in mind that this is a four-year projection of economic trends that is based on a number of uncertain assumptions, both foreign and domestic. The above figures should therefore be interpreted as indicative. The impact of the tax cuts creates particular uncertainty. It could lead to increased labour market participation, thus reducing demand pressures and unemployment compensation, increasing tax revenue and thereby improve the Treasury balance. The most likely impact of abolishing the net wealth tax is that saving increases which in turn would reduce domestic demand, inflation and the current account deficit.

The Treasury will mitigate the demand effects of declining power project construction

As noted earlier, the proceeds from the sale of Iceland Telecom will be allocated in accordance with the Government's decision to repay foreign debt and deposit the remainder with the Central Bank for the accumulation of interest and for subsequent

use. The Government has also decided to use about 20 billion krónur of the 2005 revenue surplus to further repay foreign Treasury debt. The annual interest cost on Treasury debt will therefore decline substantially, and the Treasury will receive interest income on its deposits with the Central Bank, thus improving the Treasury balance. The part of the sales proceeds that will be used domestically will be allocated in the years 2007 to 2010. The Treasury will thus mitigate the downturn in economic activity, once the power project construction phase is completed, through increased infrastructure investment and tax cuts. The need still prevails to exercise restraint in government consumption expenditure over the next several years in order to prevent public consumption from growing in excess of economic growth in the long run.

Treasury finances

Billion krónur	Budget proposal	Forecast		
	2006	2007	2008	2009
Total revenue.....	305.8	319.4	316.5	328.1
Of which: Tax revenue.....	280.6	292.1	288.3	298.7
Total expenditure.....	294.6	308.4	328.4	345.4
Current expenditure.....	137.7	145.7	152.9	160.4
Interest payments.....	15.5	15.6	15.9	17.0
Transfer payments.....	122.3	128.7	138.0	146.0
Maintenance.....	4.6	4.8	5.0	5.1
Investment.....	14.5	13.6	16.6	16.9
Revenue balance.....	11.2	11.0	-11.9	-17.3
Financial balance.....	4.0	11.2	-10.9	-18.2
In per cent of GDP				
Total revenue.....	31.1	30.5	29.7	29.5
Of which: Tax revenue.....	28.7	28.0	27.2	27.2
Total expenditure.....	29.8	31.1	31.7	30.9
Revenue balance.....	1.4	-0.6	-2.0	-1.4
Financial balance.....	0.9	-0.9	-2.2	-1.7

The following table shows the development of Treasury expenditure by category on the basis of the above-mentioned assumptions as they are being projected on the basis of existing laws and demographic trends with respect to the number of senior citizens, the number of students in each age group, existing contractual commitments as well as a number of other parameters.

Expenditure by economic category

Million krónur, accrual basis	Budget proposal 2006	2007	Forecast 2008	2009
General administration	17,615	18,361	19,178	19,294
Police and security	13,967	14,999	16,045	14,164
Education	32,955	33,959	34,703	35,650
Health	83,586	85,933	89,606	94,555
Social services and welfare	72,593	76,812	80,542	82,339
Housing, zoning and environm.	3,567	3,651	3,574	3,655
Culture and church	11,926	12,046	12,093	12,205
Fuel and energy	2,342	2,312	2,326	2,340
Agriculture and fisheries	14,897	14,829	14,819	14,812
Industry.....	1,385	1,434	1,442	1,449
Transport and communications	18,633	27,071	29,760	25,532
Other economic affairs	4,794	4,867	4,960	5,017
Other expenditure	34,941	35,208	35,398	34,458
Change in wages, prices and interest ...	-	14,196	26,713	37,609
Total	313,201	345,678	371,159	383,079

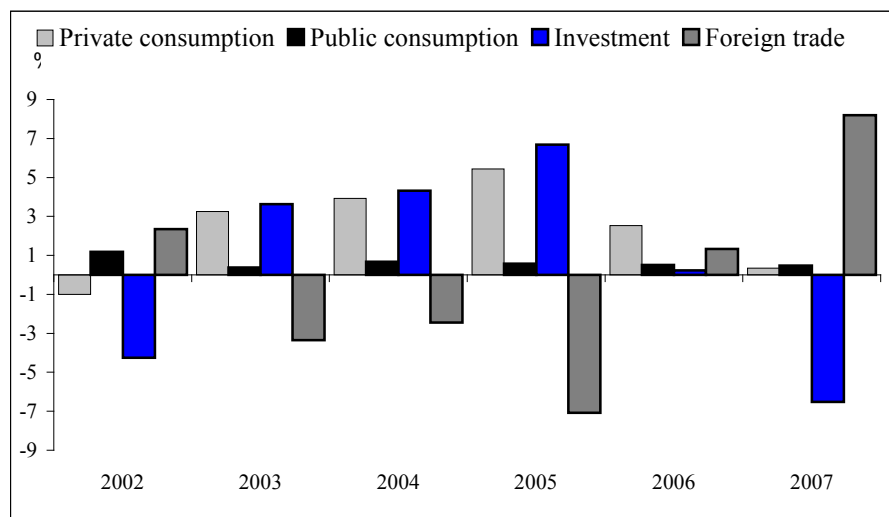
Figures for individual categories are presented at 2006 prices, whereas the cost assessment of wage, price and interest changes are entered as a separate item in order to bring total expenditure for each year to the current wage/price level.

4 A summary of the economic forecast

At the peak of the expansion

The current economic expansion has developed in line with earlier forecasts of the Ministry of Finance. According to the most recent national accounts data from Statistics Iceland, real GDP increased by 6.2 per cent in 2004 and the present forecast indicates a similar increase in 2005, 6 per cent. This is forecast to be followed by a slightly lower rate in 2006, 4.6 per cent, when power project construction will begin to taper off. For these three years, the average growth rate is estimated at 5.6 per cent. Such a high rate of growth tests the productive capacity of the economy and the ability of public authorities to sufficiently control domestic demand so that inflation can be kept within tolerance limits. Power project investments are expected to decelerate rapidly in 2007 and economic growth as a consequence will slow down. For the years 2007-2010, an average growth rate of 2.5 per cent is projected, bringing the economy into better balance.

Contribution to economic growth



Large investment projects

The construction of the Kárahnjúkar hydro-power project began in 2003 and will continue until 2008. Construction of the aluminium plant at Reyðarfjörður began in 2004 as well as the expansion of the Norðurál aluminium plant in Hvalfjörður and hydro- and geothermal energy projects that are intended to supply the expanded Norðurál plant with power. The total cost of these projects is expected to amount to 235 billion krónur at 2003-prices. General business investment revived quite strongly in 2003 and continued its growth in 2004. Total business investment has increased by more than 58 per cent in these two years. The foreign cost component of the power projects is estimated at 60 per cent and for the aluminium plants at 69 per cent. The share of foreign labour with these projects is estimated at 55 per cent over the construction period. The total number of man-years is estimated at just over 8,000, equivalent to nearly 2 per cent of the labour force at the peak of the construction in 2005 and 2006.

Further projects not excluded

No formal decision has been taken on more such large power-based investment projects and they are therefore not incorporated into the Ministry's forecast. The second phase of the Norðurál plant expansion that would increase its production capacity by 40 thousand tonnes - on top of the 130,000 tonnes in the first phase - is therefore not included in this forecast, even if the second phase will most likely take place. The possibility of expanding the Alcan plant at Straumsvík in the capital area and the construction of aluminium plants in the North and on the Reykjanes peninsula has been under discussion, but no decision has been taken and the timing of such projects are unclear. If such projects are realised in future years, economic growth will be higher than outlined above.

Modest wage increases will help ensuring stability

The assumptions underlying the forecast incorporate an exchange rate that is slightly lower than last year. The exchange rate index is expected to average nearly 110 this year and rise to nearly 114 points in 2006 which is equivalent to a 3.5 per cent decline in the exchange rate of the króna. When power project construction activity decelerates, the inflow of foreign exchange will decline and a gradual weakening of the króna may therefore be expected. A growing current account deficit will also exert downward pressure on the exchange rate. Another important assumption is that the recently concluded wage agreements will apply to those unions that yet have to renew their agreements and that the present agreements will not be abrogated or markedly amended from their present form. On this basis, a continued increase in real disposable income is forecast and that inflation will remain close to the upper tolerance limit of the Central Bank.

A summary of the forecast

	Bn. kr.	Est.	Forecast		
	2004	2004	2005	2006	2007
Private consumption	506.1	6.9	9.5	4.3	0.6
Public consumption	226.3	2.8	2.4	2.2	2.2
Investment	207.2	21.0	28.5	0.8	-23.8
Change in stocks ¹	-3.3	-0.2	0.4	0	0
Total national expenditure	936.2	8.4	12.8	2.9	-5.2
Exports of goods and services	316.1	8.3	1.4	6.2	11.6
Imports of goods and services	367.3	14.2	18.3	1.9	-8.8
Gross domestic product	885.0	6.2	6.0	4.6	2.5
Gross national income	863.4	4.9	5.7	4.2	1.6
Impact of the terms of trade ²	-	-0.6	0.5	-0.1	-0.9
GNI, incl. the terms of trade impact	-	4.3	6.3	4.1	0.6
Current account	-73.9	-	-	-	-
In p.c. of GDP	-	-8.4	-13.3	-12.2	-6.4

¹ In p.c. of the previous year's GDP at constant prices

² In p.c. of the previous year's GNI at constant prices

Monetary and fiscal policy

In addition to the above assumptions, the forecast incorporates assumptions on a tight monetary and fiscal policy in order to maintain price stability. For purposes of the forecast, it is assumed that the Central Bank's policy interest rate will be increased to just over 10 per cent before the end of 2005 but will decline in the latter half of 2006. The pursuit of a tight fiscal policy has already begun through the fiscal budgets of

previous years by the restraint on current operating and transfer expenditures and the considerable cutback in government investment. For this year, the Treasury surplus is estimated at 2.7 per cent of GDP which is higher than at the peak of the previous expansion. For 2006, a surplus of 1 per cent of GDP is forecast. The decision of the Government to allocate the sales proceeds from the privatisation of Iceland Telecom for 2005 and 2006 is in conformity with a tight fiscal stance for those years.

Temporary increase in national expenditure

National expenditure is forecast to increase by close to 13 per cent this year. The largest component of the increase stems from private consumption which is expected to rise by 9.5 per cent. Total investment is expected to increase by 28.5 per cent of which business investment would increase by 48 per cent and residential construction by 12 per cent, whereas public investment is forecast to decline by 12 per cent. The increase in public consumption is estimated at 2.4 per cent. The current account deficit is estimated at the equivalent of 13.3 per cent of GDP this year, declining to 12.2 per cent in 2006 and 6.4 per cent in 2007. The increased current account deficit is directly and indirectly attributable to the ongoing power project and aluminium plant construction. The direct impact of this construction activity is estimated to account for 40 per cent of the current account deficit and to 70 per cent of the trade deficit when construction activity is at its peak in 2005 and 2006.

A return to balance at the end of the construction phase

Unemployment is forecast to average 2.2 per cent of the labour force in 2005 and decline to 1.8 per cent next year. The estimates of the Ministry indicate that a positive output gap emerged in 2004 and the gap in both output and the labour market will increase both this year and next after which both the internal and external imbalances will be reduced in 2007. Last year's average inflation rate of 3.2 per cent is forecast to rise to 3.9 per cent this year and remain similar next year. This forecast is somewhat uncertain, mainly in association with the development of the exchange rate. A large change in the exchange rate will impact on prices, and inflation will thereby increase or decline. Fortunately, such fluctuations are usually temporary and inflation returns to its norm.

International competition increases the resilience of the economy

The estimates of the Ministry indicate that the positive gaps in output and the labour market will be lower in the present expansion than in 1998-2001. Such measurements are subject to some uncertainty since the economy can grow fast without inflation taking off and the level of unemployment can also dip quite low before a wage drift emerges. The opening of the economy has increased international competition which places pressure on the prices charged by Icelandic companies and on the development of wages. Experience shows that this challenge leads to increased productivity which in turn deepens the resilience of the economy and its ability to grow fast without inflation or a wage drift emerging. The increased globalisation of the economy will benefit both consumers and investors. This represents a profound change in the circumstances and behaviour of market activity from earlier times. When the economy slows down in 2007, a better balance in the economy will be restored.