

December 1, 2005

The world economy is improving

The OECD recently published its semi-annual Economic Outlook where it concludes that growth prospects in the world economy are generally favourable. In spite of sharp increases in oil prices this year, economic growth has been stable and is expected to continue so next year. Reasons for that include better use of fuels and more resilient national economies. Moreover, the expectations of investor indicate that inflation will generally remain moderate over the longer term.

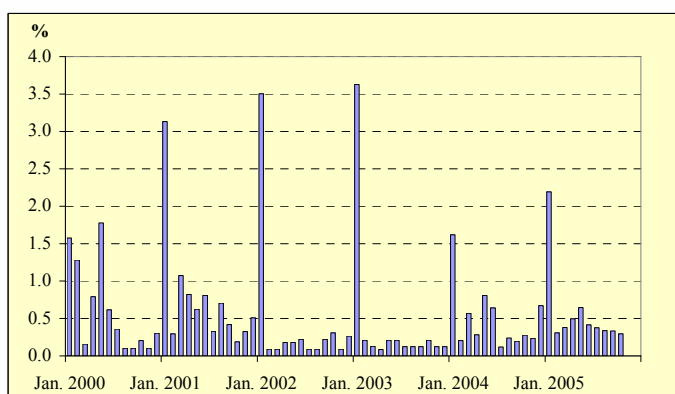
OECD area:	2005	2006	2007
Real GDP growth	2.7	2.9	2.9
Output gap	-0.6	-0.4	-0.1
Unemployment rate	6.5	6.3	6.0
Inflation	2.0	2.0	1.9
GDP growth, main countries			
US	3.6	3.5	3.2
Euro area	1.4	1.9	2.2
Japan	2.2	1.9	2.2

GDP growth has been pronounced in the US and quite high in many Asian countries as well as in some of the new EU members states. Growth in Japan and Western Europe shows signs of improving after an extended bout of sluggish activity, influenced by low long-term interest rates and strong export growth, as world trade is currently growing at around 10 per cent rate per annum. Domestic demand, however, is still slack. The decline in the euro exchange rate has had a positive impact on exports and growth in the Euro-area. Historically low international long-term interest rates have stimulated investment in many OECD countries, especially in housing, where prices have risen quite rapidly. With the growing international integration of domestic financial institutions this development has also taken place in Iceland.

Moderate wage increases despite buoyant activity

The October wage index of Statistics Iceland rose by 0.3 per cent from the previous month, about the same as a month earlier and slightly less than the month-to-month increase has been so far this year. The wage index is expected to measure general wage changes in the economy. The increases are divided into two parts, contractual wage increases and wage drift. This division is nonetheless of less importance than in previous years. Wage increases can be contractual without being general, such as increases based

The change in the wage index between months



on experience, education, years of work etc. For the economy as a whole, the overall wage developments are of importance, regardless of how they arise.

At present, there is much activity in the labour market, as has been discussed in earlier issues of this Web Release. In such circumstances, the demand for labour can easily outstrip supply, leading to wage increases. This is natural; all prices tend to rise in a situation of excess demand. This has been a source of concern. The index from Statistics Iceland shows that, despite pressures in the labour market and skilled labour shortages, there are no significant signs of wage increases beyond what could have been expected. This is in part due to imports of labour and increased participation in the labour market. The graph shows the month-to-month change in the wage index in recent years. The comparison with this year's developments with those of 2001 is particularly notable, since wages rose then well above contractual increases.

Treasury finances January-October

For the first ten months of this year, the surplus of cash from operations amounted to 20.3 billion krónur, 39.2 billion more than had been projected. This is explained by the sale of Iceland Telecom which has a profound impact on Treasury finances, as was discussed in the report for the first nine months.

Total revenue amounted to 336.6 billion, rising by 47.2 per cent or 107.9 billion. Tax revenue amounted to 256.9 billion, an increase of 20.8 per cent in nominal terms and 16.2 per cent in real terms, accounting for 4 per cent inflation.

Taxes on income and profits amounted to 82 billion, increasing by 15.1 billion. Revenue from the personal income tax rose by 10 per cent and from the corporate income tax by 11 per cent. Proceeds from the capital income tax rose by 99.1 per cent to 18.6 billion, a large part of which is due to a capital income tax on profits from the privatisation of Iceland Telecom that the Treasury is in fact paying itself (see below). Revenue from the social security tax amounted to 26.3 billion, an increase of 15.6 per cent. By comparison, the wage index of Statistics Iceland rose by 6.7 per cent in this period. Taxes on assets increased by 30.3 per cent in real terms, mostly reflecting income from the stamp tax. Other current revenue amounted to 21.4 billion, increasing by 5.8 billion, largely on account of a dividend payment from Iceland Telecom and fines imposed on oil companies.

The growth in indirect taxes, especially the value added tax, is a good indicator of general demand in the economy. Indirect taxes increased by 19.6 per cent in nominal terms and by 15 per cent in real terms. Revenue from the value added tax increased by 20.2 per cent in nominal terms and 15.6 per cent in real terms. The excise tax on motor vehicles at the point of import rose by 68.9 per cent, reflecting a 60 per cent increase in motor vehicle imports over last year.

Total expenditure amounted to 256.6 billion, increasing by 23.3 billion of which 5.6 billion is explained by the expensing of the capital income tax on the sale of Iceland Telecom which also appeared on the revenue side, as noted above. Another 5 billion is attributable to a payment of interest on a large issue of maturing savings bonds last April. Excluding these two items, expenditure rose by 12.7 billion or 5.4 per cent. Social expenditure, i.e., social security, education and health, is by far the largest item on the expenditure side, amounting to 162 billion or some two-thirds of the total and rising by 10.7 billion or 7 per cent between years. Expenditure on health rose by 4.2 billion and on education by 3.7 billion, an increase of 16.5 per cent. Payments for social security increased less, by only 2.1 billion. Other expenditure categories increase less. Payments in the category of economic affairs declined by 1.2 billion, mostly on account of a cut in road investments.

Treasury revenue, January-September			Treasury expenditure, January-September			Treasury finances, January-September			Economic indicators		
12 month changes %	2003-2004	2004-2005	12 month changes %	2003-2004	2004-2005	Million krónur	2004	2005	12 month changes %	2004	2005
Total tax revenue	15.4	22.0	Administration	9.2	3.2	Cash from operations	-10,405	14,581	Inflation - Nov.	3.8	4.2
Income taxes	20.4	23.9	Social affairs	10.0	6.3	Net financial balance	-2,436	59,746	Core inflation - Nov.	3.3	4.6
Social security taxes	10.1	16.4	Economic affairs	12.5	-3.1	Debt redemption	-30,843	-47,939	Wage index - Oct.	5.3	6.9
Asset taxes	21.6	44.8	Interest	-7.4	43.2	Gross borr. requirement	-38,904	8,857	Total turnover - Jan.-Aug.	9.6	9.2
Indirect taxes	13.4	20.2	Other	0.8	78.6	Net borrowing	40,679	11,698	Retail turnover - Jan.-Aug.	4.3	6.3
Total revenue	7.4	51.8	Total expenditure	8.7	9.7	Overall cash balance	1,775	20,555	Unemployment (%) - Oct.	2.7	1.4