

# English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

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## The restraint in economic policy in 2004 and 2005

The Icelandic economy has been going through a period of pronounced growth in recent years. The largest power project investments in Iceland's history commenced in 2003 and grew in size year after year but are scheduled to be completed in the first half of 2007. Following the privatisation of financial institutions and increased liberalisation of financial markets, substantial market innovations emerged that had a profound impact upon demand in the economy. The power project investments were foreseen, and the restraint of economic policy was prepared, both in fiscal as well as in monetary policy. It was not foreseen, however, that the financial resources of households would be as ample as they actually turned out. Due to increased domestic demand, economic growth is now estimated at 7.7 per cent in 2004 and 7.5 per cent in 2005. The growth rates are well in excess of those anticipated and led to a considerable temporary imbalance in the economy.

The Government adopted a medium-term policy objective for Treasury expenditure growth in 2003, in part to respond to increased demand pressure in the economy. Frame budgeting had been adopted earlier in order to manage the development of expenditure. At the same time it was decided to restrict Treasury investment expenditure. The result was that Treasury expenditure as a share of GDP shrank by 3.5 percentage points between 2003 and 2005 while the Treasury revenue share rose by 3.8 percentage points, despite cuts in income tax rates in 2005. The Treasury balance was thus strengthened by 7.3 per cent of GDP over this period. Measurements indicate that fiscal restraint in Iceland was among the strongest in OECD countries over this period. The result is in part due to expenditure restraint but also to automatic fiscal stabilisers that did their work virtually undisturbed. The Treasury surplus, along with the proceeds from the sale of Iceland Telecom, was used to repay Treasury debt and create a 76 billion krónur deposit with the Central Bank in 2005. The Treasury thus withdrew a significant amount of liquidity from the private sector and thus had a substantial restrictive impact on growth when it was at its peak.

Treasury finances 2003-2005

In per cent of GDP	2003	2004	2005	Change 2003-2005
Total revenue	33.1	33.4	36.9	3.8
Total expenditure	34.8	32.1	31.3	-3.5
Revenue balance	-1.7	1.2	5.6	7.3

The Central Bank seeks to influence the development of inflation through its policy interest rate. The transmission mechanism is complicated and changeable, but it may be said that the policy interest rate has an impact on credit interest rates, the exchange rate and asset prices that in turn influence the allocation of resources, both at home and abroad. The policy rate thus affects economic growth and the extent to which aggregate demand exceeds or lags behind the growth trend of the economy. It is therefore difficult to assess the impact of monetary policy on economic growth.

From the middle of 2004 up to the end of 2005 the Central Bank raised its policy rate from 5.3 per cent to 10.5 per cent, which led to a stronger exchange rate that in turn helped to suppress inflation. At the same time, it increased the purchasing power of households and businesses abroad, thus shifting demand out of the domestic economy. To the extent that the development of the exchange rate increased the current account deficit, it had the impact of reducing growth in the domestic economy. On the basis of recent information about economic developments in these years, it is now assessed that the policy interest rate could have been raised more than they did as inflation expectations increased and the policy rate increase did not translate sufficiently into higher real interest rates and thus reduced demand. It is likely that the globalisation of the financial market along

with financial market innovations reduced the efficacy of the policy interest rate with regard to market interest rates and asset prices. It is nevertheless evident that the policy interest rates helped to reduce growth through the exchange rate channel of the transmission mechanism, which also became more effective.

In light of the above, it is evident that both fiscal policy and monetary policy had a significant counter-cyclical effect on economic growth in 2004 and 2005 and that Treasury finances had no less an impact than monetary policy developments.

## The work environment examined

An extensive attitude survey has been launched where around 12,000 public servants within 150 government agencies received a questionnaire concerning their work environment. The aim of the survey is to examine employee attitudes towards their work environment where topics like job satisfaction, career development, the workplace environment, salary, stress, management etc. are examined. Additionally, managers are especially asked about human resource management issues within their agencies.

The survey, which is a co-operative project of the Ministry of Finance, the Institute of Public Management and Politics at the University of Iceland, and ParX Business Consulting, will provide an insight into human resource management issues within government agencies. The survey is also comparable to a survey implemented in 1998 and will therefore provide an important comparison on how the work environment has changed and developed in recent years.

The overall results will be published in spring 2007. All participant agencies will also receive a summary where they can compare themselves to the overall results. In addition to such summaries, agencies will be given an opportunity to analyse their data in greater detail.

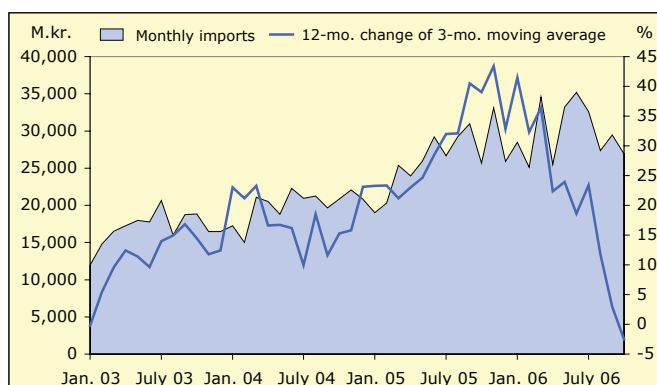
The survey will be carried out online. Employees that do not have e-mail addresses can answer a printed questionnaire. The survey represents an opportunity for employees to present their point of view regarding topics concerning their working environment. This is also a good opportunity for agencies to receive an assessment of their own environment and management which in turn can be used as a basis for improvement.

Therefore, the organisers encourage all concerned to respond to the questionnaire. Further information regarding the survey may be obtained in Icelandic on the website of the Ministry of Finance.

## Merchandise imports in October

Provisional import figures for October show a total imports of 26.8 billion krónur, about 3 billion less than in September. A twelve-month moving average of a three-month total at constant prices shows a decline of 2.5 per cent. The decline is wholly due to reduced fuel imports, an item that tends to fluctuate from month to month. Imports of foodstuffs increase somewhat and imports of raw materials, inter-

Merchandise imports in volume, January 2003 – October 2006



Treasury revenue January-September			Treasury expenditure January-September			Treasury finances January-September			Economic indicators		
12 month changes (%)	2005	2006	12 month changes (%)	2005	2006	Million krónur	2005	2006	12 month changes (%)	2005	2006
Total tax revenue	22.0	13.8	General public services	36.3	-24.8	Cash from operations	14,581	43,872	Inflation (October)	4.8	7.6
Taxes on income & profit	24.1	19.6	Health	6.0	7.6	Net financial balance	59,746	41,627	Core inflation (October)	4.9	7.2
Taxes on property	44.8	-36.6	Social security & welfare	4.4	3.1	Debt redemption	-47,939	-38,071	Wage index (September)	6.9	10.8
Taxes on goods & services	20.5	14.1	Economic affairs	-3.7	1.6	Gross borr. requirement	8,857	586	Total turnover (Jan. - June)	8.0	12.5
Social contributions	16.4	16.0	Education	14.8	12.5	Net borrowing	11,698	24,978	Retail turnover (Jan. - June)	6.4	5.1
Total revenue	51.8	-9.2	Total expenditure	9.7	0.0	Overall cash balance	20,555	25,564	Unemployment rate, sa (Sept.)	1.7	1.2

mediate goods and investment goods increase but far less than this past summer. Car imports remain roughly similar to those of recent months whereas imports of transport vehicles for business are continuing to decline. Imports of durable consumer goods declined slightly from the previous month.