

English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

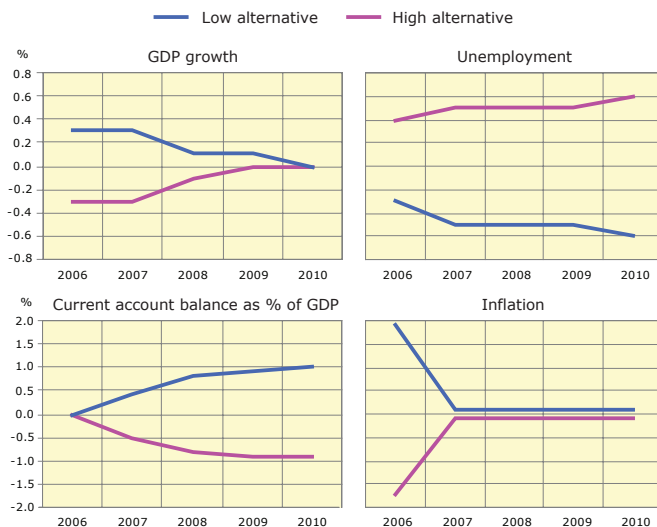
May 11th 2006

The exchange rate and the macroeconomic forecast

In the Ministry's latest macroeconomic forecast, the uncertainty regarding the future course of the exchange rate was discussed. Forecasts for the exchange rate have been subject to considerable change and it is therefore important to attach clear reservations to the forecast concerning exchange rate assumptions.

The following charts show examples of a 5 per cent deviation in each direction from the assumed exchange rate, as presented in the Ministry's [April forecast](#). The alternative examples are calculated with the Ministry's forecasting model, which is formulated on an economic basis and the statistical assessment of historic time series.

Alternative scenarios: Impact of a 5 per cent higher or lower exchange rate than the baseline scenario



The impact of exchange rate deviations is quite strong in the beginning. A weaker króna indicates that economic growth will be 0.3 per cent higher than in the baseline forecast for 2006 and 2007. The difference narrows to 0.1 per cent in 2008 and disappears altogether by 2010. The deviation impact of a stronger króna is almost asymmetrical to the lower-alternative scenario. The same applies to the impact upon the current account, inflation and unemployment.

The alternative scenarios convey the impression that the change in the current account balance as a ratio of GDP reacts more slowly than economic growth. According to the extrapolation, about half of the effect emerges in 2007 and the full effect by 2010 when the current account deficit will be 1 per cent lower in the low alternative than in the baseline scenario.

The inflation impact will be felt immediately and disappears almost fully in the second year. The impact on unemployment increases with time, at least over the period under consideration here.

Labour market growing sharply

The labour market survey for the first quarter this year shows that labour market participation is the highest recorded since regular quarterly surveys commenced in 2003. The participation rate, measured as the sum of persons employed and unemployed as a ratio of the total population of working age (16-74 years) turned out at 81.1 per cent, an increase of 1.3 percentage points from the corresponding quarter a year ago. The ratio increased more among men than women, the reason being that the overwhelming majority of newly arrived foreign workers are men. It is notable that the participation ratio in the oldest segment of the labour market (55-74 years) increased by 4 percentage points and by 2.2 percentage points in the 16-24-year age group. For the 25-54-year group, where the rate is

highest, the rate declined by 0.2 percentage points. It is clear from this survey that the state of the labour market has reduced the interest of persons in the oldest age group in withdrawing from the labour market. At the same time, the temptation to work rather than stay in school seem less than in the previous expansion. The participation rate has increased more in the capital area than outside it, and it is higher there than in the regions.

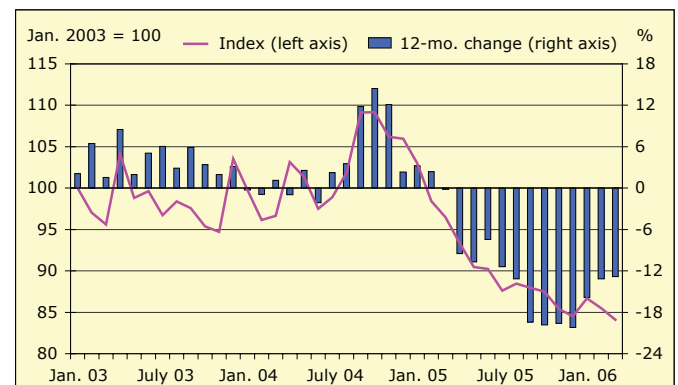
The number of employed persons has increased by 7,700 or 4.9 per cent from the first quarter of last year. About 800 come from those previously unemployed. Another 2,100 is explained by increased labour market participation. The natural rate of increase of the population of working age, taking account of labour market participation, accounts for another 3,000. That leaves about 1,800, one-fourth of the total, which can be explained by labour immigration. The immigration of persons of working age in 2005 is estimated at 3,500, which could mean that employment increased by at least 2,800 persons, considerably more than could be discerned from labour market surveys. Such surveys may perhaps not cover foreign workers as well as other sectors of the labour market, even if Statistics Iceland tries its best to reach foreigners as well as others.

The number of working hours has increased at the same time as the population and labour market participation. Hours worked have increased by 1.2 per cent between years. All told, the volume of labour rose by 6.2 per cent in the first quarter of this year from the corresponding quarter a year earlier. The volume of labour increased by nearly 4 per cent last year from the previous year, and the growth this year will probably be higher, to judge by present indications.

Housing affordability is shrinking

Housing affordability is subject to several parameters, such as the rate of interest, housing prices and the length of available mortgages. Lower interest rates and a longer repayment period reduce the mortgage payment amount, whereas higher housing prices increase it. Disposable income also enters the equation. Wage increases and tax cuts strengthen affordability whereas inflation erodes it.

Affordability in the housing market, January 2003-March 2006



The above chart shows how affordability in the housing market has developed since the beginning of 2003. The calculation is based on wage rates alone, since data on disposable income is not available on a monthly basis. The increase in the last quarter of 2004 prompted rising demand which in turn led to rising housing prices, since supply did not increase in line with demand. Affordability began to decline from the beginning of 2005. It may therefore be asserted that the gain created by a lower repayment burden – due to a lower interest rate and a longer repayment period – had all but disappeared by the first quarter of 2005 despite wage increases and tax cuts. In addition mortgage interest rates have been creeping up from the autumn of 2005.

Treasury revenue January-March	2004-2005	2005-2006
12 month changes (%)	2005	2006
Total tax revenue	22.8	25.9
Taxes on income & profit	23.3	40.0
Taxes on property	51.4	-16.3
Taxes on goods & services	20.7	20.5
Social contributions	20.5	16.1
Total revenue	22.9	25.5

Treasury expenditure January-March	2004-2005	2005-2006
12 month changes (%)	2005	2006
General public services	12.0	-2.0
Health	13.1	6.3
Social security & welfare	3.4	8.6
Economic affairs	5.2	-4.4
Education	11.5	13.9
Total expenditure	8.0	5.9

Treasury finances January-March	2005	2006
Million krónur		
Cash from operations	9 301	23 741
Net financial balance	15 511	21 286
Debt redemption	-11 404	-9 070
Gross borr. requirement	3 257	11 226
Net borrowing	1 094	1 532
Overall cash balance	4 351	12 758

Economic indicators	2004-2005	2005-2006
12 month changes (%)	2005	2006
Inflation (May '06)	2.9	7.6
Core inflation (May '06)	3.4	6.4
Wage index (March '06)	6.5	8.6
Total turnover (Jan. - Dec. '05)	12.2	8.9
Retail turnover (Jan. - Dec. '05)	5.1	5.5
Unemployment rate (April '06)	2.1	1.1