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Icelandic letters:

ð/Ð (pronounced like th in English this)
þ/Þ (pronounced like th in English think)
In *Monetary Bulletin*, ð is transliterated as d and þ as th in personal names, for consistency with international references, but otherwise the Icelandic letters are retained.

Symbols:

*	Preliminary or estimated data.
0	Less than half of the unit used.
-	Nil.
...	Not available.
.	Not applicable.

To be successful, monetary policy must be forward-looking

Inflation targeting implies that monetary authorities seek to be forward-looking when deciding on policy, rather than responding to current or past conditions. The Central Bank's rises in its policy interest rate amounting to almost 4 percentage points over one year were a response to foreseeable inflationary pressures two years ahead rather than inflation over the preceding year, although the two are certainly connected.

Inflation slowed down in April and May after climbing sharply in the opening months of the year. Measured by the Harmonised Index of Consumer Prices for the European Economic Area (EEA), inflation in Iceland in April was below the average in EEA countries. Excluding the housing component of the index, the price level in May was unchanged year-on-year and merchandise prices had gone down. Thus it is natural to ask whether a tighter monetary stance is necessary.

There is a high probability that the slowdown in inflation over the past two months will be short-lived. Inflation will probably pick up when the impact of the appreciation of the króna since December 2004 and changed method for calculating average mortgage interest cost in the housing component of the CPI have petered out and exceptionally fierce price competition in the supermarket sector has waned.

The exchange rate of the króna on which the inflation forecast in this edition of *Monetary Bulletin* is based is 6% weaker than in the forecast published in the previous *Monetary Bulletin* in March. As it happens, the króna strengthened after the current forecast was made, but not by enough to alter the Bank's assessment of economic prospects to any degree. A weaker króna channels demand into the domestic economy and also directly affects consumer prices. Furthermore, private consumption may grow even faster than was forecast in March, marginally widening the output gap. The inflation outlook over the next two years has therefore deteriorated since March. On the other hand, there is less probability that the rate of inflation two years ahead will be higher than in the base forecast.

The short-term inflation outlook is broadly unchanged, i.e. inflation will slow down and approach the target early next year. One contributing factor is Statistics Iceland's changed method for calculating mortgage interest cost in the housing component of the CPI. However, this change has no effect on the Central Bank's assessment of underlying inflation. It has a minimal effect on inflation prospects two years ahead, because the base effect of the change will fade out within two years. Assuming an unchanged policy rate, the outlook is still for inflation to exceed the target in the first half of 2007, possibly at a higher rate than was forecast in March.

Although the Central Bank has to take a forward-looking approach in its interest rate decisions, its forecasts are always based on current and historical data. The reliability of such data varies and they are subject to various interpretations. Interest rate decisions can thus never be absolutely right, not even in retrospect. When the macroeconomic balance has been severely disrupted by major events such as the present build-up of the aluminium industry and structural changes in the financial system, it is impossible to fine-tune monetary policy measures closely enough to prevent volatility or temporary difficulties in the economy. The crucial consideration is for the Central Bank to apply as professional and systematic methods as possible to assess the inflation outlook, and not to lose sight of its long-term objective of price stability.

Monetary policy implementation is unusually challenging at the moment. A particular problem is that when macroeconomic imbalances occur and economic variables shift way beyond a level that seems compatible with long-term stability, the timing and speed of readjustment is crucial for subsequent developments. This applies to economic variables such as asset prices, the exchange rate and the current account deficit. However, it is extremely difficult to pinpoint when and under what conditions the inevitable adjustment will take place.

Asset prices, the strength of the króna, the current account deficit and lending growth all appear to have reached levels that are unsustainable in the long term, even after taking into account the effect of investments in the aluminium and power sectors. In the long run there appears to be a strong case for a correction of real estate prices, at least in real terms, a depreciation of the króna and a reversal of the current account deficit. Such an adjustment will have a substantial effect on output growth and inflation. The foreseeable contraction in investment may conceivably produce a widespread adjustment throughout the economy after two or three years, although it is uncertain whether this will be as rapid as some have argued. A tight monetary policy stance at present may contribute to a more gradual adjustment, by inducing a timely slowdown in economic activity. Some action apparently remains to be taken in this respect.

The Board of Governors of the Central Bank of Iceland has therefore decided to raise the Bank's policy interest rate by 0.5 percentage points as of June 7. A further tightening may be necessary in order to contain inflation, and the Central Bank will continue to monitor unfolding events closely in order to assess the need for further action.

Economic and monetary developments and prospects[1]

Inflation outlook has deteriorated two years ahead

The macroeconomic outlook is broadly the same as was described in Monetary Bulletin *2005/1 at the end of March. The economy is still characterised by large and growing imbalances. Among the clearest signs of imbalances are soaring housing prices, a surge in lending growth and a mounting foreign trade deficit. Indicators released since* Monetary Bulletin *was published in March by no means suggest that demand growth has slowed down. Inflation has edged down over the past two months. However, this is caused by transitory factors, e.g. an appreciation of the króna since December, a change in the method of calculating interest rates in the housing component of the CPI and a supermarket price war. None of these factors affects the inflation outlook over the coming two years. On the contrary, prospects have deteriorated, since the exchange rate used in the current forecast is lower than in March. Furthermore, greater-than-expected housing price rises since March will drive private consumption next year.*

I Overview of macroeconomic and inflation forecast

Assumptions of the current forecast

The forecast presented here is an update to the macroeconomic and inflation forecast that the Central Bank of Iceland published in March. In the update, only the most important assumptions have been revised in light of unfolding events and most recent data, but in other respects it is based on the same assumptions as the March forecast.[2]

As usual, the inflation forecast is based on the technical assumption of an unchanged policy interest rate (currently 9%) over the forecast horizon and an unchanged effective exchange rate index from the day of the forecast, May 17, when it was close to 116. The exchange rate in the revised forecast is therefore 6% weaker than in March. The forecast horizon is until Q2/2007.

The economic outlook has not changed much since the last forecast

The economic outlook two years ahead has not changed much over the relatively short interval since the last forecast in March, with little new information emerging to warrant a substantial revision. Growth is expected to remain robust over the next two years. The outlook is for a slightly wider output gap than in the March forecast. Restoring economic balance without a hard landing will be test of the resilience of the economy and a challenge to economic policies.

The main changes since the March forecast are that the Central Bank's policy interest rate has risen slightly, the króna has depreciated

1. This article uses data available on May 27, 2005, but the forecast is based on data until May 17.
2. Comprehensive macroeconomic and inflation forecasts are published in the second half of March and September, and updates in June and December. The comprehensive forecasts are scheduled to include national accounts data which are published for the preceding year in March and for the preceding half-year in September.

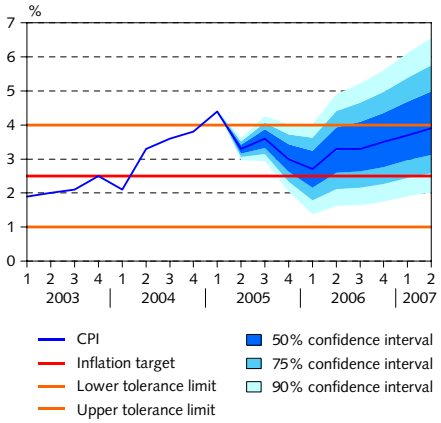
Table I-1 Update Central Bank macroeconomic forecast

	Policy rate and exchange rate assumptions[1]					
	Current forecast			*Change from previous forecast (percentage points)*[2]		
	2004	*2005*	*2006*	*2004*	*2005*	*2006*
Central Bank policy interest rate (%)	6.14	8.85	9.00	-	0.17	0.25
Foreign exchange index[3]	121.0	114.2	116.0	-	4.4	6.4

	Current macroeconomic forecast					
	Volume change on previous year			*Change from previous forecast (percentage points)*[2]		
		Current forecast				
GDP and its main components	*2004*	*2005*	*2006*	*2004*	*2005*	*2006*
Private consumption	7.5	8.0	7.0	-	-	0.4
Public consumption	3.6	2.5	2.6	-	-	0.1
Gross fixed capital formation	12.8	34.2	-8.0	-	0.7	-0.1
Industries	12.9	52.8	-13.9	-	0.5	-0.9
Excl. power-intensive projects, ships and aircraft	6.7	1.7	-1.6	-	-1.0	1.2
Residential housing	3.0	21.9	9.9	-	2.4	0.3
Public investment	27.3	-11.6	-4.7	-	-0.6	3.4
National expenditure	7.7	12.4	2.4	-	-0.1	0.2
Exports of goods and services	8.3	4.0	7.6	-	-0.9	-1.8
Imports of goods and services	14.3	18.5	-1.2	-	-1.1	-1.2
Gross domestic product	5.2	6.6	6.2	-	0.2	0.1
Other key aggregates						
Current account balance (% of gross domestic product)	-8.1	-12.0	-10.1	-	0.2	-0.8
Output gap (% of production capacity in the economy)	1.1	3.3	4.4	-	0.2	0.3
Private sector wages (change between annual averages in %)	4.5	6.0	6.1	-	-	0.1
Labour productivity (change between annual averages in %)	3.1	2.5	2.5	-	-	0.1
Unemployment (% of labour force)	3.1	2.1	1.9	-	-0.2	-0.2

1. Annual averages. assuming unchanged interest rates and exchange rate from the day of forecast. 2. Change since *Monetary Bulletin* 2005/1. 3. Percentage-point change in index from previous forecast.

Chart I-1
Central Bank inflation forecast
Forecasting period: Q2/2005 - Q2/2007



and housing prices have increased by more than had been expected. Higher housing prices and the greater incentive they provide for residential investment will boost household asset value. Increased housing wealth will drive up private consumption next year by more than was forecast in March, in spite of the higher policy rate. The weaker króna will channel much of this increased demand towards domestic factors of production, which will be reflected in lower import growth. Despite the lower real exchange rate, the export forecast has also been revised downwards, reflecting new information about fish stocks.

Inflation outlook has deteriorated slightly since March

The weaker króna and wider output gap have caused the inflation outlook two years ahead to deteriorate from the forecast published in *Monetary Bulletin* 2005/1 in March. One year ahead the outlook is broadly the same as before. Inflation is expected to slow down in the near term and come close to target in the first half of next year. Afterwards it is forecast to regain pace. Assuming that the policy rate remains unchanged, inflation will measure 3.7% at the beginning of 2007, which is some way above the March forecast of just over 3%

Table I-2 Updated Central Bank inflation forecast

Change in the CPI between periods

	Change on previous quarter	*Annualised quarterly change*	*Change on same quarter of previous year*
Measured inflation (%)			
2004:1	0.3	1.3	2.1
2004:2	1.7	7.0	3.3
2004:3	0.5	1.9	3.6
2004:4	1.3	5.2	3.8
2005:1	0.9	3.7	4.4
Inflation forecast (%)			
2005:2	0.6	2.4	3.3
2005:3	0.8	3.1	3.6
2005:4	0.7	2.9	3.0
2006:1	0.6	2.4	2.7
2006:2	1.1	4.6	3.3
2006:3	0.8	3.4	3.3
2006:4	0.8	3.4	3.5
2007:1	0.8	3.3	3.7
2007:2	1.3	5.4	3.9

	Change year-on-year	*Change within year*
Measured inflation (%)		
2003	2.1	2.4
2004	3.2	4.0
Inflation forecast (%)		
2005	3.6	3.0
2006	3.2	3.6

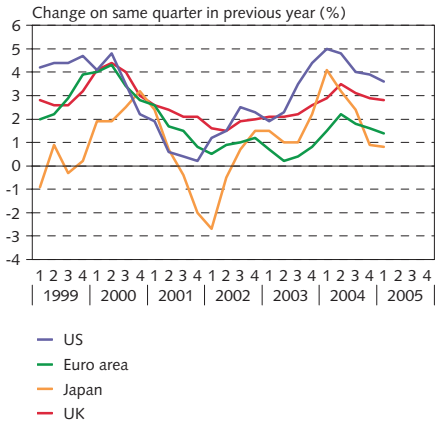
for the same period. As in March, the forecasting risk is symmetric one year ahead but to the upside two years ahead. However, the upside risk has diminished since March, because part of the currency depreciation in the risk profile in March has already occurred and been incorporated into the main forecast now.

The main reason for the poorer inflation outlook since March is the weaker króna, which combined with other factors contributes to a wider output gap than was forecast then. Thus the probability of attaining the inflation target over the forecast horizon has decreased, assuming an unchanged policy rate. In order to reach target, the monetary stance will need to be tightened still further.

II External conditions

Chart II-1

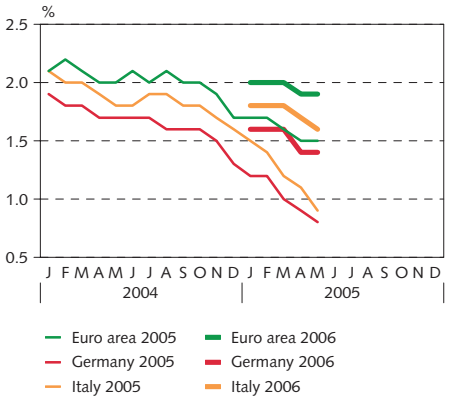
Economic growth in the US, UK, euro area and Japan Q1/1999 - Q1/2005



Source: EcoWin.

Chart II-2

Forecasts for economic growth in 2005-2006 in the euro area, Germany and Italy[1]



1. Horizontal axis indicates the date of forecasting.
Source: Consensus Forecasts.

The outlook for external conditions is marginally poorer now than in March. In Iceland's main trading partner countries, GDP growth has declined and growth prospects have worsened, prices of marine exports have slipped although they are considerably higher than a year before, and the outlook for the fish catch is slightly worse. The export forecast has therefore been revised slightly downwards for both this year and 2006.

Growth outlook sluggish in developed countries but robust in China

Growth prospects in major economies have taken a downturn in recent months, especially in continental Europe and Japan. Higher oil prices have had a sizeable impact on growth in these areas. First-quarter growth in the US was also lower than expected. Although the outlook is not as upbeat as before, fairly strong global economic growth is expected this year. Inflation is generally low, and so are interest rates. China and the US continue to lead growth and most emerging economies follow close on their heels.

Forecasts for euro area growth in 2005 have been revised downwards in recent months, in particular due to weaker growth in Germany and Italy. The main explanation is higher oil prices. At the end of 2004, oil futures indicated that prices would drop this year to roughly $40/barrel, but average prices this year are now expected to be close to $50/barrel.

Growth in the US slowed down earlier than expected, bringing down forecasts for the year as a whole. In Q1/2005 growth of both private consumption and business investment slowed down, but the current account deficit continued to widen. Imports soared by 14.7% in the first quarter, while exports rose by 7% (for a further discussion of the US current account deficit, see Box 1).

However, growth in China has continued apace. Growth in Q1/2005 measured 9.5%. Although it is expected to slow down later in the year, China's growth is still expected to remain robust for the year as a whole.

Box 1

The US current account deficit

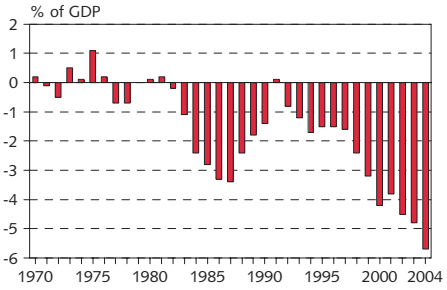
The US current account deficit is widening, especially with China ...

The US current account deficit has continued to widen this year. As discussed in *Monetary Bulletin* 2005/1 there are various explanations for the widening deficit, including lower private sector saving and the growing fiscal deficit. The deficit on the US merchandise account, which accounts for the bulk of the current account deficit, has widened with all major trading partner countries, and most of all with China. Since the mid-1990s the current account deficit with China has spread from virtually nothing to the annual equivalent of almost 200 b. US dollars in Q4/2004, which accounts for close to 30% of the total merchandise account deficit. It widened particularly rapidly after the dismantling of trade barriers with China's membership of WTO in 2002. US imports of oil and other commodities and manufactured goods have also grown substantially.

... but has been easily financed so far

Unlike the situation at the turn of the millennium, when much of the growing current account deficit was financed with foreign direct and portfolio investment in US companies, the recent US current account deficit has largely been financed with purchases of US bonds by non-residents, including central banks. Foreign investors have significantly increased their exposures in US assets and now own some 45% of outstanding US Treasury bonds and over 10% of equity in US companies. This is more than double the ratio a decade ago. Until now, the current account deficit has been easily financed. Asian central banks have been major buyers of US Treasury bonds. To a certain extent, these investments by Asian countries can be seen as an effort to build up reserves after the shocks they incurred over the period 1996-1998. However, Asian central banks have also intervened in FX markets in order to hold the exchange rates of their home currencies stable against the dollar. Although such funding is clearly unsustainable, it is difficult to predict when the turnaround will happen, or how quickly the adjustment will take place and what form it will take. Conceivably it will be effected through a further slide in the value of the dollar, but faster GDP growth in Europe and slower growth in the US could also contribute to a better balance.

Chart 1
US current account balance 1970-2004



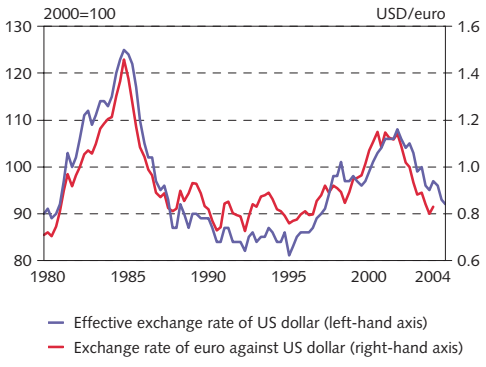
Source: EcoWin.

The depreciation of the dollar has hitherto had little impact on the current account deficit

The depreciation of the dollar has hitherto had virtually no impact on the current account deficit. This is not to say that it will not contribute to closing the deficit in the long run. International trade is known to respond to changes in exchange rates with a considerable lag.[1] Over time, however, imports should decrease and exports increase as a result of the weakening that the dollar has already undergone. Because exports are now equivalent to only 2/3 of imports, the current account deficit will take a long time to show a significant narrowing. The OECD expects the US current account deficit to peak in 2006.

If growth in the US continues to outpace that among most of its trading partner countries, the dollar will be more likely to need to slide even further in order to establish a sustainable external balance. There are no prospects that faster GDP growth in continental Europe will reduce the US current account deficit in the near future, since growth forecasts for the euro area have been revised downwards. The dollar may be more likely to depreciate against Asian than European currencies, since it is Asian central banks that are financing much of the deficit and the main depreciation of the dollar until now has been recorded against the euro. A counteracting trend is that interest-rate differentials between the dollar and the euro have widened, which strengthens the dollar.

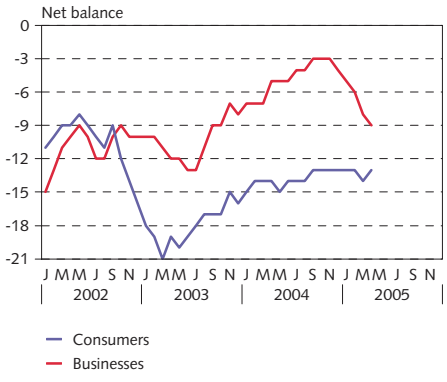
Chart 2
Exchange rate of the US dollar 1980-2005
Quarterly data



Sources: EcoWin, OECD.

1. The OECD has calculated the relative price elasticity of US exports as 0.1 between quarters, 0.4 over one year and 0.6 over a longer horizon. Under the J curve effect, a current account deficit may widen immediately after a depreciation. Export prices fall and import prices rise at once, but the time required to finalise new orders and business agreements creates a considerable lag in export volume growth and contracting imports. Thus a deficit on a merchandise account can worsen before it begins to improve. In the US, however, import prices have been highly inelastic, since manufacturers have tended to keep their dollar prices unchanged in order to defend their market share.

Chart II-3
Consumer and business confidence indicators in the euro area January 2002 - April 2005



Source: EcoWin.

Growth outlook remains subdued in main European economies

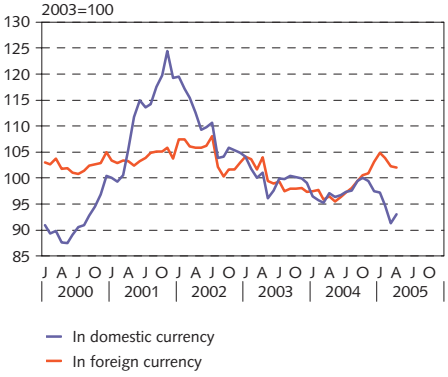
Prospects of a pick-up in growth in Europe appear weak for the near future and higher oil prices have presumably delayed recovery even further. As mentioned above, growth forecasts have been revised downwards, especially for Germany and Italy. In fact, Germany recorded much higher-than-expected growth in Q1/2005, at 1%. However, because this growth was largely export-driven at the same time as domestic demand contracted, the prospects for this year are not considered to have improved significantly. Exports may be sensitive to the sustained strength of the euro and fluctuations in global trade. In Italy, growth expectations have also plunged. In Q1/2005, output declined year-on-year for the second consecutive quarter, the technical definition of a recession. Hence the growth outlook for the year as a whole is very poor, for similar reasons to Germany. Italy's manufacturing sector faces especially weak prospects, according to latest data. It has had trouble adapting to fiercer global competition and Italy's share in world exports has been on the decline.

Surveys reveal that business confidence in the service and manufacturing sectors has continued to dwindle across the euro area, while consumer confidence has stayed broadly unchanged so far this year. Growth has been faster in services than most other sectors, but recent data suggest a slowdown, especially in Germany and Italy. Private consumption growth is still subdued in the euro area, although it has picked up slightly. Higher oil prices and the strong euro are slicing into profits, making businesses unlikely to step up investment and recruitment in the near future. Consumers can therefore be expected to show restraint for as long as the present uncertain employment prospects continue.

Subdued growth in Europe has not had much effect on marine product prices

The depressed state of the continental economies does not appear to have had a marked effect either on demand for marine products from Iceland or prices of them. For most marine products, the market outlook is currently quite upbeat. Sales have been a little sluggish in fresh fish markets recently, however, probably due to the temporary impact of increased supply from Norway and the Faroe Islands. In the first four months of this year, average prices of marine products were 7% higher year-on-year in foreign currency terms. Prices rose most for frozen-at-sea products, at 18%, but for land-frozen products by 4% and for saltfish by only 2%. Most market analysts expect prices of the main frozen, salted and fresh demersal products to keep on climbing this year, since demand is growing and Iceland's competitive position is strong. A minor slide in demersal product prices in March can be traced to the seasonal downturn in saltfish prices. Eastern European markets for frozen products are building up and the outlook for fish meal and fish oil prices is considered favourable.

Chart II-4
Estimated marine product prices[1]
January 2000 - April 2005



1. An index calculated by Statistics Iceland translated into foreign currency using the export-weighted currency basket.
Sources: Statistics Iceland, Central Bank of Iceland.

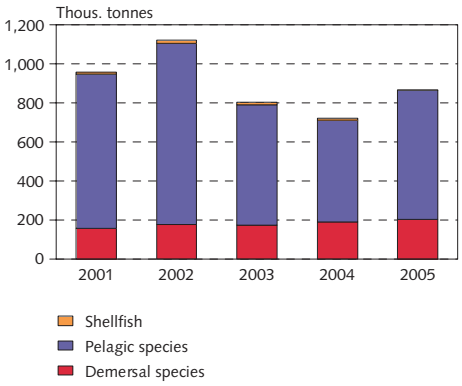
Smaller cod stock than previously thought, but other species appear to be in good condition

The Marine Research Institute's (MRI) recent spring survey suggests

that the 2003 year-class of cod was below average and the 2004 year-class substantially below average. The abundance index for cod has gone down by 16% since the measurement taken in 2004.

Final recommendations for the total allowable catch (TAC) of demersal fish for the coming fishing season have not yet been announced by the MRI, however. The survey findings may signal a reduction in the TAC for cod in coming fishing seasons, although it is not certain that this will be made for the next season, which commences on September 1. Offsetting this, the haddock and saithe stocks are in fine condition and TACs for them are likely to be increased for the coming season. TACs for other major species are unlikely to change much between fishing seasons, apart from uncertainties surrounding Greenland halibut.

Chart II-5
Fish catch in January-April 2001-2005



Source: Directorate of Fisheries.

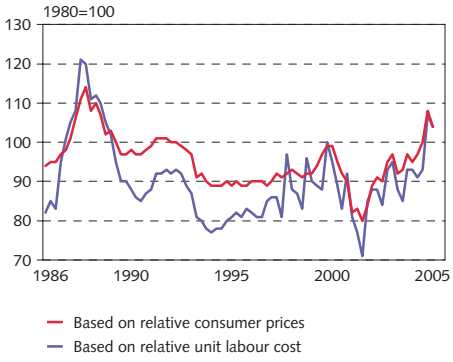
Less growth in catch value than forecast in March

The fish catch in the first four months of 2005 was considerably larger than over the corresponding period the year before and a somewhat larger total demersal harvest can be expected this year than in 2004, in terms of both volume and value. The annual pelagic catch is more difficult to predict, since the total capelin harvest tends to be highly uncertain with wide fluctuations in the summer and autumn fisheries in recent years. Nonetheless, a larger total pelagic catch can be expected this year than in 2004, with the capelin catch over the first four months already outstripping the figure for the whole of last year. The herring catch will probably also be up after the recent increase in the TAC from the Icelandic-Norwegian herring stock, but a slight contraction in blue whiting is likely.

A rather larger total fish catch can be expected this year compared with 2004, and it will also increase next year. Nonetheless, the volume increase has been revised downwards since the forecast in March, as a result of the poorer condition of stocks than assumed then.

The outlook for prices of fish products is unchanged from the March forecast. Prices are expected to rise next year by more than previously forecast, but not sufficiently to offset lower catch growth. Catch value and marine export production will therefore increase rather more slowly over the forecast horizon than was assumed in March.

Chart II-6
Real effective exchange rate of the króna
Q1/1986 - Q2/2005



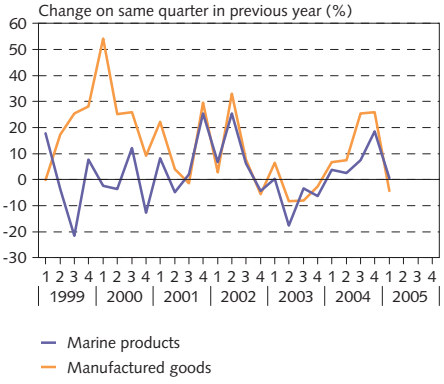
Source: Central Bank of Iceland.

Real exchange rate reached a seventeen-year high in Q1 but has fallen in Q2

The króna has depreciated since peaking on March 21, thereby reversing the appreciation that took place during Q1. The current forecast assumes an unchanged exchange rate from May 17, implying that the króna will be 5.7% stronger on average this year than in 2004.

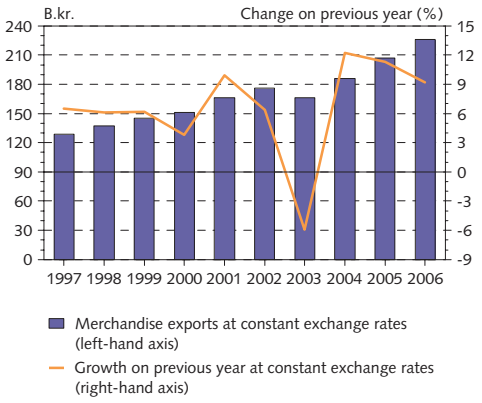
The real exchange rate peaked in Q1 when it reached its highest level for 17 years, but has decreased so far in Q2, especially as a result of a lower nominal exchange rate and lower inflation. Since the outlook is that domestic inflation and unit labour cost will rise faster than among trading partner countries, the real exchange rate will increase by more than the nominal rate year-on-year. Assuming an

Chart II-7
Merchandise export growth 1999-2005[1]



1. At constant exchange rates based on the export-weighted currency basket.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart II-8
Merchandise export real growth 1997-2006[1]



1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

unchanged nominal exchange rate from May 17, the average real exchange rate defined in terms of relative consumer prices will increase by roughly 8% this year, then remain virtually unchanged in 2006. In terms of relative unit labour cost the increase will be even sharper, at 10% this year and 2% next year.

Total exports likely to grow this year in spite of a drop in merchandise exports in Q1

Exports are expected to grow at a somewhat slower rate this year and in 2006 than was forecast in March. The reason is a downward revision in the growth forecast for marine exports in both years, and for exports of services and other goods than aluminium. Total exports of goods and services are expected to rise by 4% this year and 7½% next year.

The outlook is for some increase in total merchandise exports this year, even though they have only grown by 2% over the first four months. Exports of marine products increased by only 0.5% and manufactured goods by 1.5%. There was a contraction in exports of pharmaceuticals and medical equipment in the first four months, while exports of both aluminium and ferrosilicon were up. The downturn in pharmaceuticals exports is presumably temporary and they are expected to increase this year. Near-stagnation in marine exports cannot be attributed to lower catch volume or value, since both were up year-on-year. A probable explanation is inventory movements or factors such as the timing of sales and dispatch of orders, which would make the contraction temporary.

Table II-1 Main assumptions for developments in external conditions

	Current forecast[1]			*Change from previous forecast*[2]		
	2004	*2005*	*2006*	*2004*	*2005*	*2006*
Marine production for export	8.1	3.0	2.0	-	-1.0	-2.5
Export prices of marine products	-0.9	6.0	3.0	-	0.0	1.0
Aluminium export prices	9.6	2.9	-3.4	-	-1.3	4.8
Prices of exported goods and services	-3.5	7.7	0.6	-	-2.0	0.3
General import prices in foreign currency	2.5	2.5	2.3	-	0.2	0.1
Of which fuel prices	35.9	27.9	9.7	-	-6.1	12.9
Terms of trade for goods and services	-2.6	3.4	-2.1	-	1.5	-1.1
Foreign short-term interest rates	2.3	2.6	3.0	-	0.0	0.0

1. Percentage-point change year-on-year, except for interest rates. 2. Change since *Monetary Bulletin* 2005/1.
Source: Central Bank of Iceland.

III Financial conditions

Foreign long-term interest rates have gone down since March

After tightening over the period from November to March, as described in *Monetary Bulletin* 2005/1, financial conditions have not changed much overall. International financial conditions have eased and the króna has depreciated, but domestic short-term interest rates have edged up.

The economic recovery in Europe is still sluggish and is generally not expected to speed up in the near future. Improved business profitability has not been matched by greater investment. These conditions, a favourable inflation outlook and the low key rates of the European Central Bank (ECB) have contributed to low bond rates in the euro area which appear unlikely to change substantially this year. In fact, interest rates on 10-year German Treasury bonds were at a historical low in mid-May. US long-term interest rates have also inched downwards despite rising short-term rates and large fiscal and current account deficits. However, risk premia on corporate and emerging market economy bonds have risen somewhat after falling sharply over the past year, but remain relatively low.

Domestic short-term interest rates have inched up in real terms

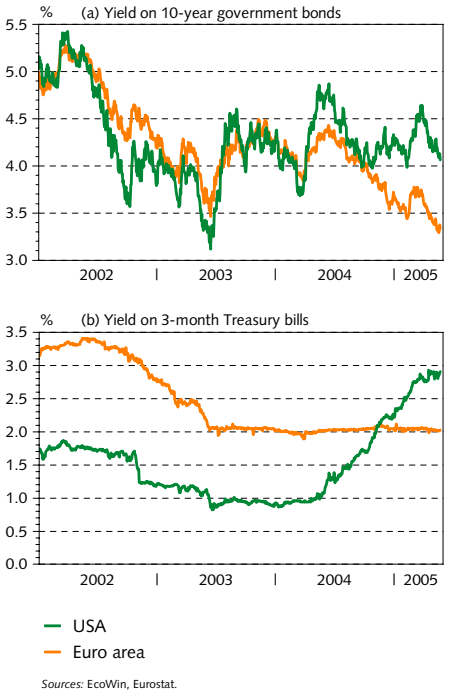
The Central Bank of Iceland raised its policy interest rate by 0.25 percentage points in March to the current rate of 9%. Since an increase on this scale or even more was expected beforehand, money market interest rates had already accommodated the hike before it was announced, and have changed little since then. Estimation of the Central Bank's policy rate in real terms has been complicated by the fact that the indexed bond which has been used as a benchmark matured in April. No new information is available on business and household inflation expectations since March, but on the basis of a survey conducted in February, expected real interest rates are around 5% among households and marginally higher among businesses. Given the tendency of household expectations to track historical inflation and the slowdown in inflation since March, real interest rates are likely to have risen by more than the policy rate hike in March. Based on the twelve-month rate of inflation, the policy rate has gone up significantly in recent months to beyond 6% in the past few weeks. Chart III-3 shows different measures of the Central Bank's policy rate in real terms. On the whole, it can be inferred that the Central Bank's policy rate has inched upwards in real terms since March.

Yields have risen on Treasury notes with a maturity of roughly two years, but have fallen on longer maturities

The transmission of policy rates through the non-indexed interest rate spectrum is mainly restricted to a sizeable rise in yields on Treasury notes with a maturity of roughly two years. However, they were approaching 9% some time before the policy rate hike in March and have changed little since. Yields on Treasury notes with a lifetime of 5-8 years have been on a downward trend since before the policy

Chart III-1

Foreign interest rate developments
January 2, 2002 - May 23, 2005 (daily data)

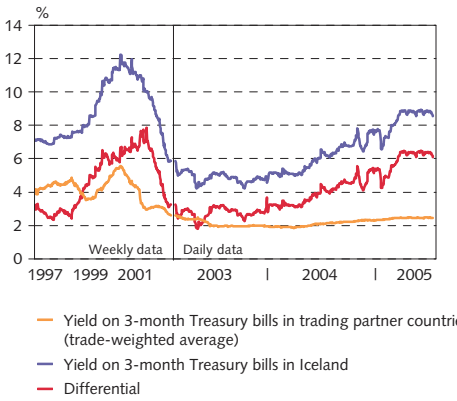


Sources: EcoWin, Eurostat.

Chart III-2

Domestic and foreign short-term interest rates and the interest-rate differential with abroad

3-mo. Treasury bills. Weekly data January 1997 - January 2003, daily data February 3, 2003 - May 23, 2005

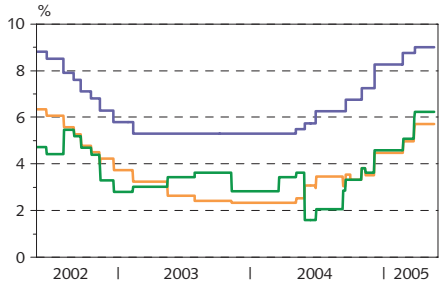


Source: Central Bank of Iceland.

Chart III-3

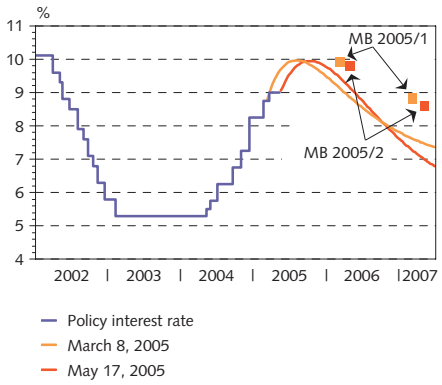
Central Bank policy interest rate in real terms

Daily data May 22, 2002 - May 20, 2005



Source: Central Bank of Iceland.

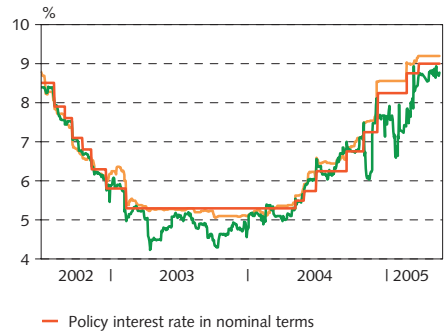
Chart III-4
Central Bank policy interest rate 2002-2007



Curves indicate forward interest rates. Boxes indicate interest rate forecasts by financial analysts before publication of *Monetary Bulletin* (MB) 2005/1 and 2005/2.
Source: Central Bank of Iceland.

Chart III-5
Policy interest rate and other short-term market rates: Treasury notes and REIBOR

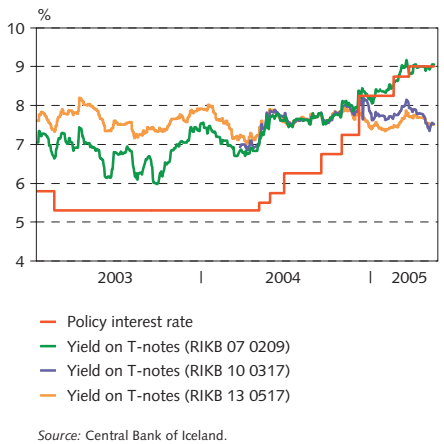
Daily data July 1, 2002 - May 23, 2005



Source: Central Bank of Iceland.

Chart III-6
The Central Bank policy interest rate and yield on Treasury notes

Daily data January 3, 2003 - May 23, 2005



Source: Central Bank of Iceland.

rate hike. As before, the policy rate pass-through to the non-indexed term structure appears to indicate that market agents expect the policy rate to peak soon and head back down relatively rapidly afterwards.

Non-indexed bank lending rates have risen broadly in pace with the policy rate. Indexed lending rates have remained more or less unchanged in recent months, in line with developments in the mortgage loan market. However, there are indications of some reduction in average premia on the banks' prime rates.

Market agents expect policy rate hikes to continue

The Central Bank's policy rate hike on March 22 was roughly in line with market agents' expectations, as can be read from the yield curve for non-indexed market interest rates. Likewise, the market appears to have expected interest rates to be raised by 0.25 percentage points with the publication of this edition of *Monetary Bulletin*.

As in March, implied forward rates indicate that the policy rate will peak in the second half of this year at around 10%, although somewhat later than was previously expected. Likewise, they imply that a fairly rapid reduction in the policy rate is expected in 2006, falling below 7% two years hence, which is somewhat lower than forecast in March.

Financial analysts still expect the policy rate to head downwards at a later time and slower pace than is implied by forward rates (see further Box 4). If the term structure provides a reliable indication of market agents' expectations, it can be inferred that they are rather more optimistic than financial analysts about when the Central Bank can lower its policy rate again.

Lending growth still gaining momentum

In recent months, the domestic money banks' (DMBs') lending growth has been gaining even more momentum. After adjustment for the effect of the currency appreciation and price indexation, twelve-month growth in domestic lending by DMBs was just over 47%. This was offset by a decrease in lending by the Housing Financing Fund (HFF) and pension funds. At the end of March, total lending by all these institutions had increased by just under 21% year-on-year. This surge reflects relatively favourable financial conditions and the removal of restrictions on household borrowing. By the end of April, commercial banks and savings banks had provided households with mortgage loans worth roughly 200 b.kr. since entering this market at the end of August 2004. Monthly lending has been fairly stable at close to 20 b.kr., apart from the period October-December, when it exceeded 30 b.kr.. Pension funds' lending to members appears to have picked up in Q1/2005 after a sharp contraction in the autumn following the banks' entry into the mortgage loan market.

Foreign currency-denominated securities issues and foreign borrowing by DMBs are still growing apace. The twelve-month increase this March was just over 64%, while in March 2004 it was just over 69%.

The annual growth rate of broad money (M3) has been in the region of 15% in recent months. While down from the peak recorded in 2003, growth on such a scale is clearly incompatible with price stability in the long term.

The króna is considerably weaker now than in the forecast published in *Monetary Bulletin* 2005/1 in March, having slid by 6% between forecast dates. Its depreciation is possibly the most important change in financial conditions since March and represents some easing. However, the current outlook for exchange rate developments may be more uncertain, which could subdue demand for foreign borrowing, even though the króna is weaker than before.

Little change in financial conditions of households, despite higher short-term interest rates

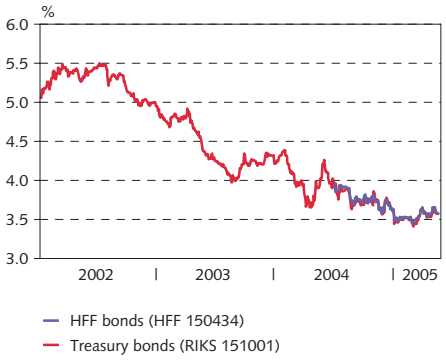
The main determinant of financial conditions of households is the development of indexed lending rates, in particular on the mortgage loans that they have taken on a large scale recently. These rates have shown little change since autumn 2004. Relatively minor changes have taken place in interest rates on foreign currency-denominated loans available to households, while overdraft rates have increased in pace with Central Bank's policy rate. Households have continued to refinance their debt by taking mortgage loans to prepay existing loans that are on less favourable terms. The benefits of loan conversion are still likely to outweigh the increased debt service caused by higher interest on overdrafts. So far, households have apparently not made much use of this new borrowing to reduce their overdrafts.[3]

Weaker króna improves financial conditions for some sectors

The depreciation of the króna since March affects the financial conditions of businesses much more than households, but as discussed in *Monetary Bulletin* 2005/1 the sectoral impact may vary. On the whole, a weaker currency ought to imply easier financial conditions, i.e. it should boost their profits and make foreign currency-denominated borrowing more favourable by reducing the subsequent expected volatility of their exposures. However, a depreciation of the currency also increases debt service on existing foreign currency-denominated loans, which in recent years have accounted for more than half of outstanding corporate debt. If the bulk of a company's income is not also denominated in foreign currency, this may imply a tightening of financial conditions. High equity prices, as well as the weaker króna, also represent favourable financial conditions for listed companies.

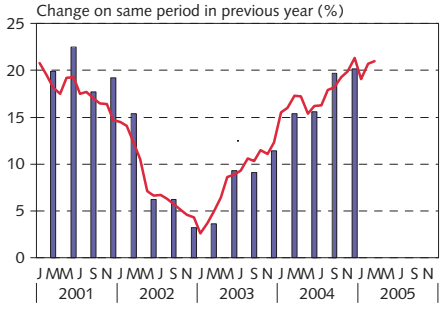
In the opposite direction, short-term interest rates have been moving upwards, although they have not changed much since March. On the whole, therefore, the financial conditions of businesses are probably broadly the same as in March, or possibly marginally better.

Chart III-7
Yields on indexed long-term bonds
Daily data January 3, 2002 - May 23, 2005



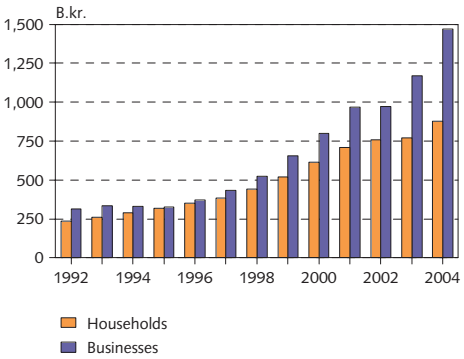
Source: Central Bank of Iceland.

Chart III-8
Credit growth January 2001 - March 2005
Quarterly credit system lending and monthly lending by DMBs, Housing Financing Fund (HFF) and pension funds
Change on same period in previous year (%)



Source: Central Bank of Iceland.

Chart III-9
Credit by sector 1992-2004
Outstanding credit system lending to households and businesses at end of year[1]



1. Lending was reclassified in 2003.
Source: Central Bank of Iceland.

3. See *Financial Stability* 2005, published by the Central Bank of Iceland in April.

IV Domestic demand and output

No new national accounts data have become available since the Central Bank's last forecast in March. Changes in the outlook since then primarily reflect the depreciation of the króna and movements in a number of economic indicators that were considered to warrant inclusion when the forecast was revised.

GDP growth ran at 5.2% last year, and is expected to climb even higher this year and in 2006. The general outlook is broadly the same as in March but with slightly greater GDP growth, partly because the króna will be weaker. Higher housing prices should also drive private consumption and residential investment. As in the March forecast, private consumption is expected to soar this year and next year. Private consumption appears to have gained pace in Q1/2005 and the forecast for next year has been revised slightly upwards. The weaker króna will increasingly channel demand directly towards the domestic economy, resulting in a wider positive output gap than was forecast in March.

Private consumption

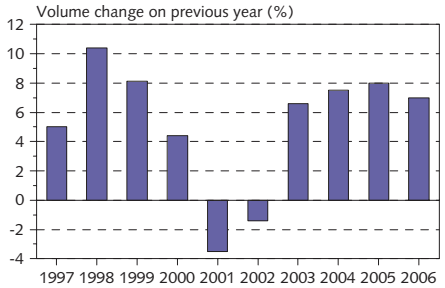
In March, the Central Bank forecast private consumption growth of 8% this year and just over 6½% in 2006. Private consumption grew by 9.2% in the last quarter of 2004, which was considerably faster than earlier that year. Indicators of private consumption growth so far this year suggest that it will be at least as robust in Q1/2005 as in the preceding quarter. The same forces are still at work as at the end of last year: more easily available credit at low interest rates, enhanced scope for mortgage equity withdrawal, robust growth of real disposable income and ongoing rises in asset prices. Housing wealth is now expected to grow more rapidly than in the March forecast, driven by greater rises in housing prices and investment. This should boost private consumption further, other things being equal. Hence, the Bank's forecast for private consumption next year has been revised upwards since March. The forecast for the current year remains unchanged, however.

As pointed out above, financial conditions of households have not changed much since the last *Monetary Bulletin* was published in March. Interest rates on indexed bank lending have changed little but overdraft rates have gone up in step with the Central Bank's policy rate. However, only a small proportion of household credit carries interest rates that are affected relatively quickly by changes in the policy rate.

Household expectations so far this year are broadly the same as one year before, according to Gallup's consumer confidence survey. As in recent years, households are less upbeat about the future than the present, probably in part because their current position is very favourable. Also, discussions of rising inflation and other signs of macroeconomic imbalances have an adverse effect on their expectations for the future.

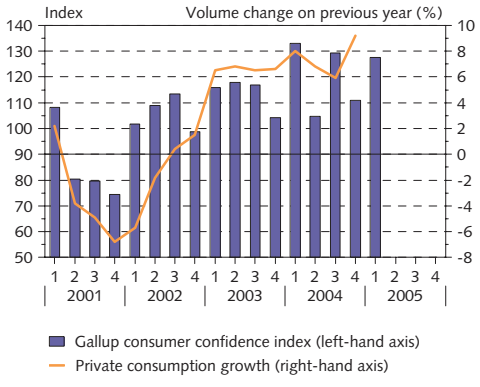
As noted above, the rise in asset prices so far this year continues to bolster private consumption. On May 19, equity prices had risen

Chart IV-1
Private consumption growth 1997-2006[1]



1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-2
Private consumption and consumer confidence[1]
Q1/2001 - Q1/2005



1. Confidence index at end of each quarter.
Sources: IMG Gallup and Statistics Iceland.

Table IV-1 Indicators of private consumption in 2004 and in the first four months of 2005

	Quarterly figures					Most recent period		
							Change based on	
% year-on-year change unless otherwise stated	Q1/2004	Q2/2004	Q3/2004	Q4/2004	Q1/2005	Month	1 month	year-to-date figures
Grocery turnover (in real terms)	3.8	3.4	4.3	3.3	7.2	April 2005	7.2	14.3
Payment card turnover (in real terms)[1]	9.7	9.7	4.9	11.2	11.2	April 2005	12.0	35.3
of which domestic	8.9	8.6	4.0	9.8	9.8	April 2005	11.9	7.1
of which abroad	27.3	29.1	18.4	34.0	35.6	April 2005	35.0	35.3
Car registrations (increase in number)	35.8	28.4	19.5	44.3	61.4	April 2005	66.8	64.4
General imports (volume change)[2]	23.7	18.7	13.6	16.0	15.1	April 2005	.	13.8
Imports of consumer goods (volume change)[2]	14.5	15.3	14.5	15.7	22.1	April 2005	.	23.3
Private motor vehicles[2]	24.4	24.2	24.6	35.0	56.7	April 2005	.	57.5
Consumer durables. e.g. household appliances[2]	21.7	19.4	16.3	17.1	36.3	April 2005	.	36.5
Consumer semi-durables. e.g. clothing[2]	10.7	9.9	8.8	7.5	16.9	April 2005	.	17.2
Food and beverages[2]	13.8	11.8	10.5	10.2	6.8	April 2005	.	6.8
Imports of investment goods excluding ships and aircraft (volume change)[2]	36.9	38.3	23.8	19.3	36.9	April 2005	.	26.8
Gallup confidence index	18.0	-11.7	5.5	-3.2	-1.7	April 2005	4.0	-1.8
Current situation	66.1	13.8	23.1	19.8	21.2	April 2005	31.0	24.6
Expectations six months ahead	2.4	-22.3	-3.5	-14.7	-13.7	April 2005	-10.1	-15.4

1. Payment card turnover for both households and businesses; the bulk of payment card turnover comes from households. 2. Quarterly figures are year-to-date figures.

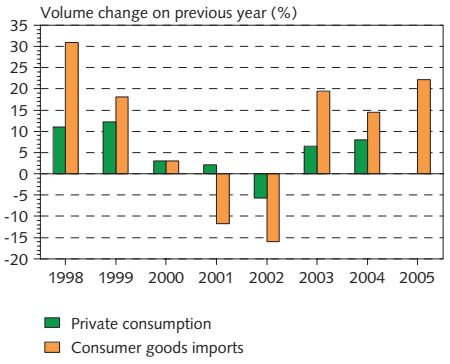
Sources: Federation of Trade and Services, Housing Financing Fund, Land Registry of Iceland, Motor Dealers' and Services Federation, Statistics Iceland and Central Bank of Iceland.

by 22% since the beginning of the year and by almost 27% year-on-year. Real estate prices, which surged when credit supply was stepped up at the end of last summer, continue to rise. Housing prices in the Greater Reykjavík Area over the first four months of 2005 were up 18% year-on-year. According to the Central Bank's forecast for residential investment, housing supply in and around the capital could outstrip demand later next year. Slower housing inflation can then be expected.

At the end of April, the commercial banks and savings banks had provided households with mortgage loans to the tune of roughly 200 b.kr. since they entered the mortgage loan market last August, and no sign of a slowdown in lending growth appears in sight. Although lending by the Housing Financing Fund (HFF) and pension funds has contracted over the first half of this year, total lending to households by the credit system has still soared.

The strong króna has fuelled demand for imported goods and services. Imports of private motor vehicles and other consumer durables, and credit card use abroad, grew faster in Q1/2005 than in any quarter of last year. Imports of food and beverages, however, grew at a slower rate. While the króna remains strong, it has depreciated somewhat from the exchange rate on which the March forecast was based, which may subdue consumption of imported goods and services.

Chart IV-3
Consumer goods imports and private consumption in Q1 1998-2005



Source: Statistics Iceland.

Public consumption

Apart from monthly summaries of Treasury finances, no new data on public consumption have been published since the Central Bank's last forecast in March. According to the budget for 2005, central

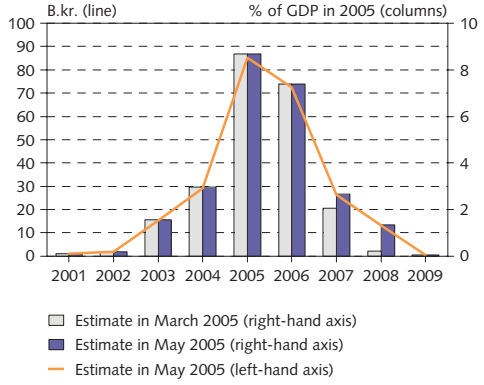
Box 2

The status of aluminium and hydropower sector investments

Chart 1

Aluminium and power sector investments: total investment cost 2001-2009

Construction of Fjarðaál smelter, expansion of Norðurál smelter and related power facilities

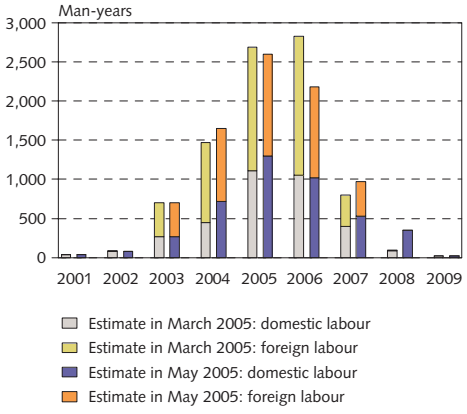


Source: Central Bank of Iceland.

Chart 2

Aluminium and power sector investments: labour use 2001-2009

Construction of Fjarðaál smelter, expansion of Norðurál smelter and related power facilities



Source: Central Bank of Iceland.

In April, Norðurál signed an agreement with Reykjavík Energy (Orkuveita Reykjavíkur) and Suðurnes Heating (Hitaveita Suðurnesja) to purchase approximately 70 MW of additional electric power for its smelter at Grundartangi, west Iceland. The agreement enables Norðurál to expand the plant's capacity to 260,000 tonnes per year (tpy). Current capacity is 90,000 tpy and an expansion now in progress will increase this to 212,000 tpy in the second half of 2006 and to 220,000 tpy by early 2007. A further expansion phase will be launched after mid-2007, adding 40,000 tpy of extra capacity when it is completed in the second half of 2008. Estimated cost of this final investment phase including power facilities to supply it is roughly 17 b.kr. Around one-third of the additional investment will be made in 2007 and two-thirds in 2008. If these plans materialise, total production capacity of the three aluminium smelters in Iceland – Ísal (Alcan), Norðurál (Century Aluminium) and Fjarðaál (Alcoa) – will be 765 thousand tpy in 2008, compared with Iceland's current capacity of roughly 270 thousand tpy. Capacity will therefore be boosted by more than 180% over the ensuing period.

government and welfare system expenditures will increase by 1½% year-on-year. So far in 2005, these expenditures have risen by 2% in real terms year-on-year, which is a negligible discrepancy given the short-term volatility of expenditure. These figures do not warrant a change in the assumptions underlying the forecast from March. Public consumption is still expected to grow by 2½% this year and next year. Central government spending growth is expected to be somewhat lower, while municipalities and the welfare system will increase theirs in the range 3-4%.

Gross fixed capital formation

The outlook for gross fixed capital formation has hardly changed since March, when the Central Bank forecast growth of just under 34% this year and a contraction of just under 8% next year. Data that have subsequently been released do not alter this conclusion substantially.

Business investment growth broadly the same as forecast in March

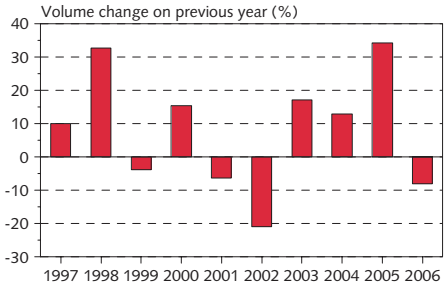
The Central Bank's March forecast took into account the rescheduling of investments in the aluminium and hydropower sector to this year not only from 2004 but also from 2006 and 2007. Business investment is now forecast to grow by 53% this year, which is broadly the same as was forecast in March. Next year will see aluminium and hydropower investments contract by almost 14%, a rather sharper decrease than in the March forecast. Additional investments by Norðurál aluminium smelter, Reykjavík Energy and Suðurnes Heating, which were agreed in April, will be made in 2007 and 2008 and therefore fall outside the forecast horizon (see Box 2). Excluding the aluminium and energy sectors, the forecast for business investment is broadly unchanged since March, and a contraction is still expected in 2006.

Results of companies listed on Iceland Stock Exchange (ICEX) could possibly justify revising the growth forecast upwards. Their turnover increased by 27% in 2004 and EBITDA and profits were very strong. On the basis of interim statements for the first quarter, their position is still strong although profitability is marginally down compared with Q1/2004. These companies would therefore appear well placed for continued growth. However, they accounted for only a small share of total gross fixed capital formation by businesses in 2004 and less than 17% of business investment excluding the aluminium and energy sectors and purchases of ships and aircraft. Furthermore, some of their expansion has taken place outside Iceland. Around four-fifths of these companies' increased turnover last year was foreign in origin, either in the form of export income or due to operations abroad.

One of the most important aggregates from the perspective of investment is cash flow from operating activities, which can then be deployed on investments and amortisation of loans. Cash flow from operating activities of listed companies increased by nearly one-third last year and amounted to almost 10% of turnover. A rather larger proportion of cash was used for net investment in 2004 than the preceding year, but since some of this was deployed on foreign investment it did not have a corresponding effect on domestic gross fixed capital formation. After adjustment for foreign investments, listed companies' total domestic investment can be estimated at 12 b.kr. last year.

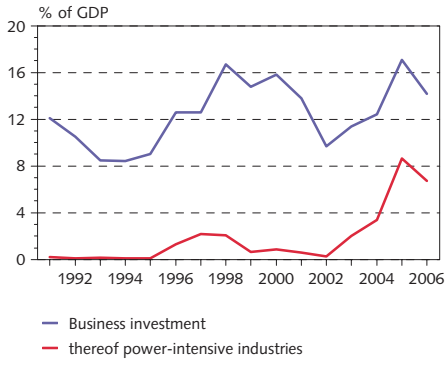
On the whole, the financial conditions of companies are broadly the same as when *Monetary Bulletin* was published in March, but the changes that have occurred have varying sectoral impacts (see the discussion of financial conditions of businesses in Chapter III). The less overvalued króna since March implies that foreign currency-denominated borrowing has become slightly more favourable, provided that expectations of a future depreciation have adjusted

Chart IV-4
Gross fixed capital formation growth 1997-2006[1]



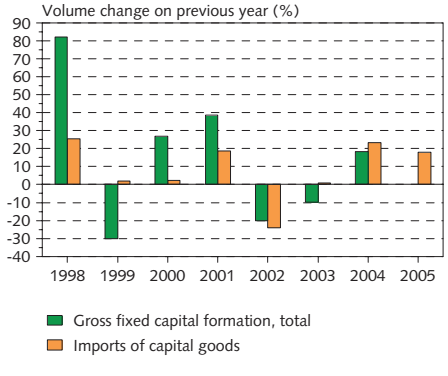
1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-5
Gross fixed capital formation: businesses and power-intensive industries 1991-2006



1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-6
Gross fixed capital formation and imports of capital goods in Q1 1998-2005



Source: Statistics Iceland.

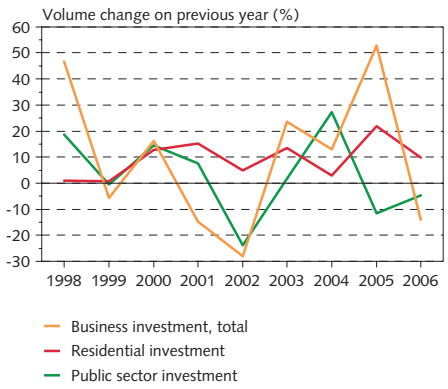
Table IV-2 Listed non-financial companies' cash flow from operating activities and investment in 2003 and 2004

All listed non-financial companies	*2003*	*2004*
Cash flow from operating activities	32,412	40,310
Net investment in fixed assets (m.kr.)	12,123	16,836
as % of turnover	37	42
Fisheries		
Net investment in fixed assets (m.kr.)	2,018	3,283
as % of turnover	31	39
Manufacturing		
Net investment in fixed assets (m.kr.)	3,580	3,911
as % of turnover	35	27
ICT		
Net investment in fixed assets (m.kr.)	3,333	3,305
as % of turnover	42	34
Transport		
Net investment in fixed assets (m.kr.)	2,347	4,451
as % of turnover	41	61

commensurably, and profits in the traded goods sector should be boosted as well. Both these factors stimulate investment. Higher equity prices also represent more favourable financial conditions which could spur gross fixed capital formation.

The short-term impact of exchange rate developments over the past year on business investment has probably varied as well. The high real exchange rate has squeezed profits and thereby investment plans for companies with a substantial share of operating expenses in domestic currency but income in foreign currency, such as the fisheries and travel and tourism sectors. A high real exchange rate may also deter investment by companies in direct competition with foreign producers in the domestic market. Offsetting this, the strong króna has made it economical to import capital goods, which is clearly reflected in import statistics. Imports of capital goods increased by 22% year-on-year in Q1/2005. The growth rate for imports of commercial transport equipment (excluding aircraft and ships) was most pronounced at 74%. Imports of machinery also showed a sizeable rise of 42%, which is largely accounted for by aluminium-related investments.

Chart IV-7
Growth in business, residential and public sector investment 1998-2006[1]



1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

Table IV-3 Profitability of listed companies 2003-2004 and in the first quarter of 2004 and 2005

	EBITDA		*Net earnings*		*EBITDA*		*Net earnings*	
% of turnover	*2003*	*2004*	*2003*	*2004*	*Q1/2004*	*Q1/2005*	*Q1/2004*	*Q1/2005*
Fisheries	21.3	18.1	8.7	11.7	19.7	14.6	12.4	15.8
Manufacturing	16.3	18.1	7.5	11.2	17.4	15.2	11.6	9.2
Marine exports	1.5	3.1	0.3	0.6	2.1	3.0	1.2	1.3
Transport	10.7	7.0	2.3	4.1	-0.5	1.7	-0.8	1.2
ICT	17.6	20.2	3.6	8.9	9.2	7.8	5.1	8.2
Other	17.6	27.5	5.4	15.5	12.7	12.8	7.0	11.1
Total	12.1	12.1	6.6	4.3	9.4	8.3	5.9	6.6

Source: Central Bank of Iceland.

Public sector investment

According to the Central Bank's forecast in March, public sector investment was expected to shrink by 11% this year and 8% next year. The outlook for this year remains virtually unchanged. Investment outlays contracted by 20-25% according to Treasury payment figures for Q1/2005, but sweeping conclusions should not be drawn from interim figures. On the other hand, the contraction in 2006 is smaller than forecast in March, at just over 4½%. If the forecast holds, central government investment as a proportion of GDP will drop to its lowest level for twenty years, at around 2¾%.

Residential investment

In March, the Central Bank forecast an increase in residential investment by just under 20% this year, significantly up from its forecast in December 2004. National accounts data suggest that residential construction grew by only 3% last year, which is a lower rate than in 2003 and far below the growth rate forecast by the Central Bank and others. Lower-than-expected growth last year will probably imply a correspondingly greater increase in 2005, when part of the previously estimated investment will be recorded. Accordingly, the forecast for residential investment was revised upwards in March. An even greater increase is expected this year, at almost 22%, and 10% in 2006. Stronger residential investment growth is explained by unexpectedly high housing inflation. The twelve-month increase in housing prices for all of Iceland is now 27.8% at the same time as the construction cost index has risen by only 6.7%. Housing prices are expected to rise by nearly 30% over the whole of this year, which is 5 percentage points above the March forecast.

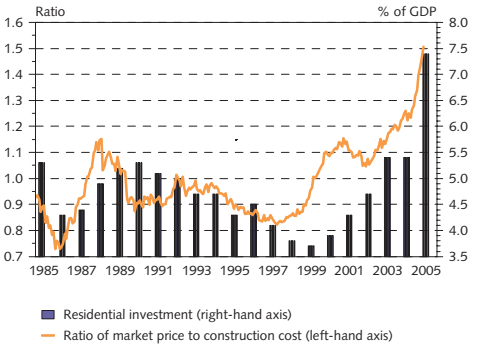
The housing market is still characterised by excess demand and the recent forces driving it are still at work and possibly even stronger than last year. It is estimated that real disposable income per capita will rise by twice as much this year as in 2004 – by around 4% – and by almost 6% next year. Unemployment is falling rapidly and credit terms are still favourable. Certain types of housing are in short supply. The twelve-month rise in the price of detached housing in the Greater Reykjavík Area, for example, was 43% in May. In the long run, it can be expected that the decreasing size of family units will drive up per capita demand for housing and people will move onto the housing ladder at an earlier age. Recent developments in real disposable income and favourable credit terms are likely to fuel this trend. All these factors should stimulate demand and contribute to rising housing prices for as long as supply remains short of demand.

Issued building permits provide an indication of the outlook for residential investment, because in the overwhelming majority of cases construction begins shortly after permits are issued. Estimates by municipal construction officials for the number of issued building permits in 2004 and this year signal rapid growth in housing investment this year.[4]

4. Some 20% more building permits were issued in 2004 than the previous year, and the increase so far this year is 10%. If some of last year's increase in permits is reflected in greater construction volume this year, and if building permit issuance increases further this year, the pending growth is quite likely to be in the region of one-fifth.

Chart IV-8

Housing market prices, construction cost and residential investment 1985-2006[1]

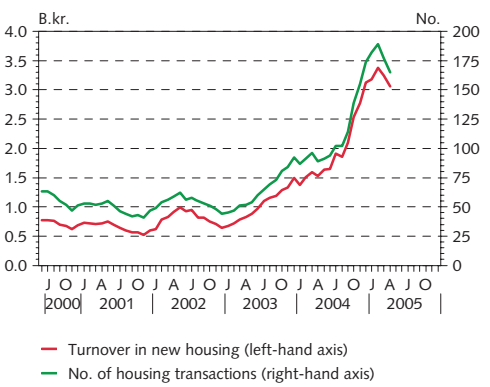


1. The yellow line indicates the ratio of market prices of apartments in the Greater Reykjavík Area to construction cost. Both indices are normalised to the average for 1985-2004. Central Bank forecast for residential investment 2005.
Sources: Land Registry of Iceland, Central Bank of Iceland.

Chart IV-9

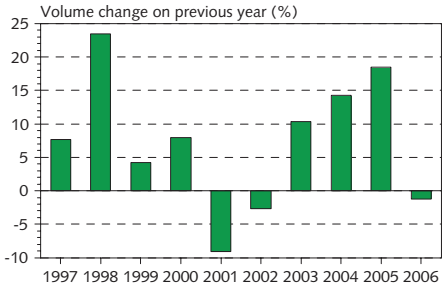
New housing: turnover and number of transactions June 2000 - April 2005

Six-month moving averages



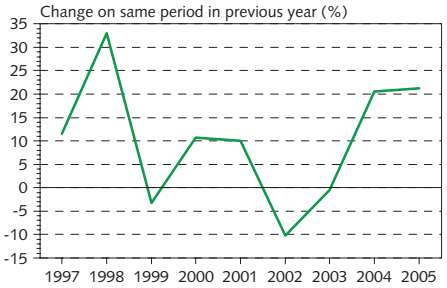
1. New housing is defined as constructed over the preceding twelve months.
Source: Land Registry of Iceland.

Chart IV-10
Import growth 1997-2006 [1]



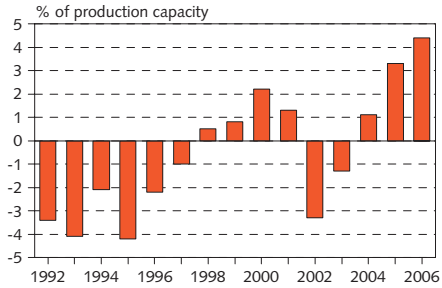
1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart IV-11
Goods imports in January-April 1997-2005
At constant exchange rates



Source: Statistics Iceland.

Chart IV-12
The output gap 1992-2006[1]



1. Central Bank forecast for 2005-2006.
Source: Central Bank of Iceland.

Over the period 2000-2002, turnover in the market for new housing[5] and the number of housing transactions remained fairly stable. Both figures jumped after mid-2003, and with the entrance of commercial banks and savings banks into the mortgage loan market last August, the real estate market surged. Housing transactions and turnover are down marginally so far this year, but the year-on-year growth rate is still high. Over the first four months of 2005, turnover in the market for new housing had increased by 83% year-on-year and the number of housing transactions by 63%.

Imports

The March forecast for import growth this year has been revised slightly downwards. The depreciation of the króna since March more than offsets a slight rise in imports resulting from marginally faster growth of domestic demand. Import growth this year is forecast at 18½%, roughly one percentage point down from the March forecast. Investments in the aluminium and hydropower sectors call for large-scale imports and private consumption is expected to continue to increase. In 2006, imports are forecast to shrink by just over one percentage point, with a drop in imports for aluminium-related investments and slower growth of private consumption as well.

Merchandise imports soared over the first four months of 2005, by 21% year-on-year measured at constant exchange rates. The surge in imports of transportation equipment, both private cars and commercial vehicles, was particularly pronounced. Imports of fuel, consumer durables and other capital goods also increased substantially. The high real exchange rate and, presumably, soaring private consumption have boosted imports so far this year, but the króna has slid recently. Nonetheless, the króna is forecast to appreciate on average by almost 6% year-on-year in 2005.

GDP growth and the output gap

GDP growth last year was just over 5%, according to an estimate by Statistics Iceland. Assuming an unchanged policy interest rate and exchange rate, the prospects are for buoyant GDP growth this year and in 2006. GDP is forecast to grow by just over 6½% this year and just over 6% next year. This is broadly in tune with the March forecast. The main difference lies in the higher growth rate of gross fixed capital formation this year, especially housing investment. The forecast for private consumption growth in 2006 has been revised marginally upwards, and so has public sector investment. For both years, imports will be subdued by the depreciation of the króna, but this is offset by slower export growth than was forecast in March. The revised outlook for GDP growth will produce a somewhat wider output gap over the coming two years than was forecast in March.

5. New housing is defined here as constructed over the past twelve months.

V Public sector finances

A large increase in Treasury revenues due to the present upswing will probably cause the public sector balance to improve more than assumed in Ministry of Finance estimates. The public sector surplus could increase from half a percentage point of GDP in 2004 to over 1½% in 2005 and more than 2% in 2006. Prepayment of debt could soften the slowdown in the economy when the cyclical effect unwinds. The cyclically adjusted public sector surplus is estimated to be broadly the same as in the March forecast.

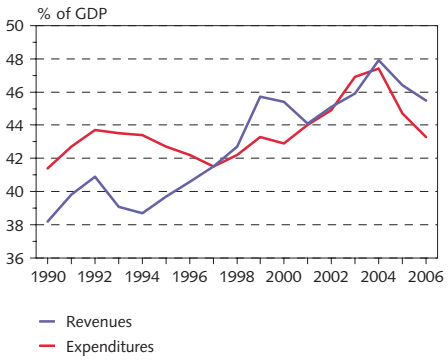
This year's fiscal balance could be stronger than in the Ministry of Finance's latest forecast, if expenditures stay under control

The fiscal balance in 2004 appears to have been marginally stronger than expected, with a surplus of 9 b.kr. compared with the 6 b.kr. target in the supplementary budget. Growth in tax revenues explains this improvement. The budget for 2005 assumed a surplus of 10 b.kr. with no proceeds from the privatisation of Iceland Telecom. In its most recent estimates from April 2005, the Ministry of Finance forecasts that Treasury revenues will rise by 6½% year-on-year in 2005 and tax income by more than 7½%. Expenditure growth is estimated at 5%. This corresponds to a ½% real contraction, which is largely driven by contracting investment outlays. Public consumption and transfers are expected to increase by just over 1% in real terms (relative to prices). The combined fiscal and welfare system surplus is estimated at 14 b.kr. In 2006, the estimated fiscal surplus is broadly the same.

However, the Treasury result this year could turn out even larger than in the Ministry of Finance's forecast. Wages are likely to rise faster than the tax-free limit for personal income, and revenues from consumption taxes and import duties will probably grow by more than demand and imports. Signs of such a trend can be seen in monthly reports on the Treasury's finances. In Q1/2005, total tax revenues grew 23% year-on-year. Personal income tax revenues were up by 13%, indirect tax revenues by 23% and other taxes by even more. The budget assumed year-on-year tax revenue growth of 6% on a cash basis. Buoyant revenues in the opening months of the year are clearly the product of exceptional circumstances, in particular the strong króna, which has stimulated imports. Central government expenditures on a cash basis were 8% higher year-on-year in Q1/2005, which is a negligible deviation from the budget targets bearing in mind volatility over the year as a whole. In light of this strong position, the Treasury decided to prepay 6 b.kr. of foreign debt over and above earlier plans.

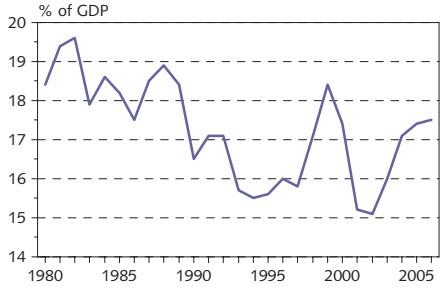
On the basis of the Central Bank's forecast, Treasury revenues can be expected to increase by more than 10% year-on-year in 2005 and yield up to 10 b.kr. in excess of the most recent estimates. However, there is no particular reason to expect expenditures to exceed estimates significantly. Given the ambitious budget target of a ½% reduction in expenditures in real terms, however, an overshoot could nevertheless be hard to avoid. If expenditures remain close to target, the fiscal surplus including the welfare system could approach 20 b.kr. this year. And if

Chart V-1
General government revenues and expenditures 1990-2006[1]



1. Central Bank estimate for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart V-2
Treasury indirect tax revenues 1980-2006[1]



1. Central Bank estimate for 2004-2006.
Sources: Treasury Accounts (consumption taxes and stamp tax), Central Bank of Iceland (estimate for 2004-2006).

they stay in line with the ministry's medium-term programme, a reasonable surplus could be shown next year as well. Nonetheless, expenditures could be more difficult to control in the run-up to the general election in spring 2007.

Local government deficit should narrow next year, but municipal elections could cause expenditures to overshoot

According to estimates by the Ministry of Finance, local government revenues will increase by just over 8% this year, and expenditures by broadly the same. The Central Bank forecasts higher wage rises and therefore higher municipal tax revenues than the Ministry of Finance. Some local authorities have also raised their municipal tax rate. Real estate tax revenues are driven up by higher housing prices, although some municipalities have waived part of these increases. Revenues for the year could be boosted by as much as 12%, which would improve the local government balance by 2-3 b.kr., assuming that expenditures remain according to plan.

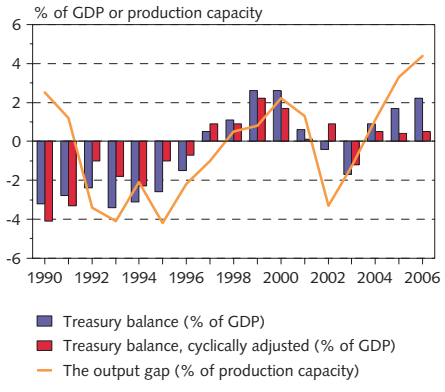
In 2006, local government revenues can be expected to go on rising in pace with housing prices this year and wages next year. An additional 1% in revenues is likely to be generated if recent proposals made by a joint central and local government committee on the latter's tax base are accepted. The latest estimates forecast that expenditures will increase by just over 4% in real terms, which is somewhat lower than the average growth since 1998, when municipalities took over the primary school system. Projected from the assumptions behind the Central Bank forecast, revenues will increase by almost 10%, or 5% in real terms. If expenditures increase by 4% in real terms as assumed above, this could shrink the local government deficit to around 1 b.kr. next year. However, experience shows that the municipal elections in spring 2006 could affect this year's and next year's outcome.

Larger general government surplus in 2005 and 2006 is mainly driven by growth in tax revenues

According to the above, estimated general government revenues[6] will increase by more than 3% in real terms this year and by more than 4% in 2006, while real expenditures will rise by almost 1% and roughly 3% respectively. According to the Central Bank forecast, general government revenues as a proportion of GDP will decrease from 48% of GDP in 2004 to 46½% this year and 45½% in 2006, and expenditures from 47½% in 2004 to 45% this year and to 43½% next year. The general government surplus could amount to more than 1½% of GDP this year and up to 2½% in 2006.

Part of this improvement is explained by the smaller increase in central government expenditures than in GDP, but it is mostly the result of growing tax revenues. Chart V-3 shows that the cyclically adjusted Treasury balance is considerably weaker than the headline figure would imply, and the surplus is smaller than during the last upswing.

Chart V-3
Cyclically adjusted Treasury balance 1990-2006[1]



1. Central Bank estimate 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

6. General government comprises the operations of central government, local government and also the social security system, which in Iceland is virtually a sub-department of the state.

VI Labour market and wage developments

Labour market pressures ahead

Pressures can be expected to build up in the labour market if excess demand for labour is not met with imported labour. Unemployment has dropped substantially and labour use has increased steadily since the beginning of autumn. Wage drift has been muted in historical terms, but began to register at the end of last year, mainly in sectors where there has been excess demand for labour.

Labour use still increasing but the participation rate is below average

Labour use increased further year-on-year in Q1/2005, according to Statistics Iceland's labour market survey. Signs of a turnaround emerged in Q4/2004 with a rise in the number of employed. However, neither total hours worked nor the participation rate increased until Q1/2005. The employment situation in regional Iceland – especially for women – also appears to be on the mend, contrary to the trend in 2004.

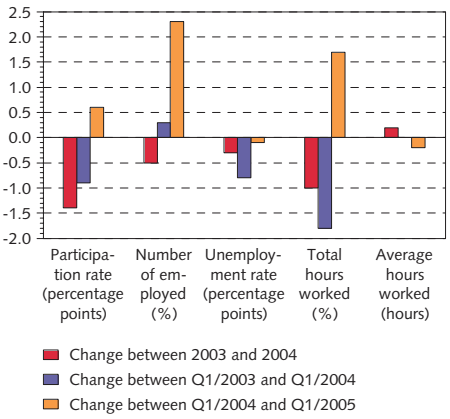
Virtually the entire increase in the number of employed lies with the youngest (age 16-24) and oldest (55-74) age groups. The participation rate is still some way below the average for the past thirteen years, and even lower than in Q1/2003 when the labour market was weakest. Domestic labour use could therefore grow still further, assuming that supply induces higher participation.

Based on the number of vacancies registered at employment agencies, however, this does not appear to be the case. So far this year, there have been around 60% more vacancies at employment agencies than at their peak in the last upswing, in autumn 2000.[7] Issuance of work permits has increased for most sectors. Only just over one out of four new work permits last year was in connection with investments in the aluminium and hydropower sectors, despite heavier use of foreign labour on those projects than originally assumed. The Directorate of Labour expects only a small share (10-30%) of the manpower requirement for aluminium and hydropower projects until 2007 to be met domestically.

Sizeable drop in unemployment this year

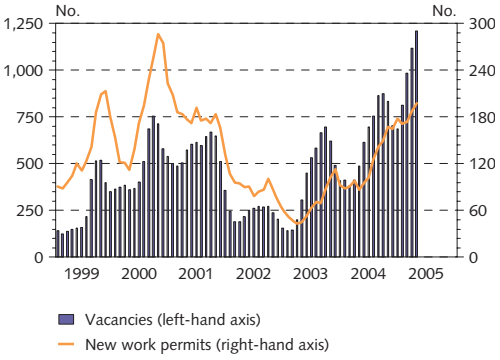
Unemployment has fallen rapidly this year. Seasonally adjusted unemployment was 2.1% in April, down by 0.6 percentage points since December and by 1.3 percentage points since summer 2004. So far this year seasonally adjusted unemployment has been 2.3%, the same figure that the Central Bank forecast in March for the whole year. According to the current forecast, unemployment is expected to be somewhat less than was forecast in March, at 2.1%. However, some rise in seasonally adjusted unemployment cannot be ruled out over the next few months, as was the case over the same period in

Chart VI-1
Changes in labour market 2003-2005



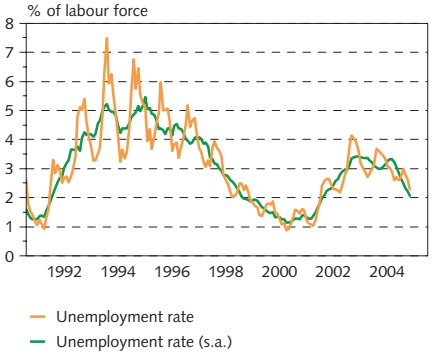
Source: Statistics Iceland.

Chart VI-2
Vacancies registered at employment agencies and issuance of new work permits 1999-2005[1]



1. Monthly data, shown as three-month moving averages.
Source: Directorate of Labour.

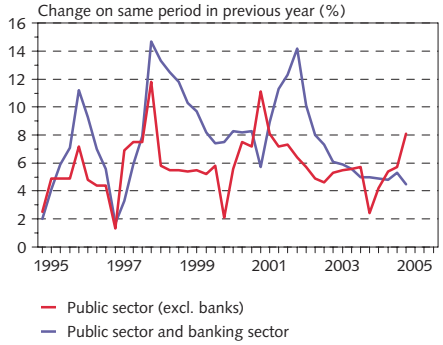
Chart VI-3
Unemployment rate January 1991 - April 2005



Sources: Directorate of Labour and Central Bank of Iceland.

7. See, however, the discussion on vacancies in Rannveig Sigurdardóttir (2005), The enigma of the Icelandic labour market, *Monetary Bulletin* 2005/1, pp. 93-103.

Chart VI-4
Wages in the private sector (excl. banks) and public and banking sectors
Quarterly data Q1/1995 - Q1/2005
Change on same period in previous year (%)



Source: Statistics Iceland.

2004. Unemployment is expected to shrink further in 2006 and measure 1.9% over the whole of next year.

Wage developments in line with the March forecast

Wages had increased year-on-year by 8.1% in the private sector in the first quarter of 2005, but by only 4.5% in the public sector. Timing of new wage settlements explains the sizeable lead in private sector increases over the past year. The full impact of recently agreed wage settlements for the majority of civil servants will be reflected in Statistics Iceland's wage index over the next few months.

In historical terms, wage drift has been modest in the sectors where excess demand for labour has been strongest. Indications that have emerged since the Central Bank's last assessment of wage trends in March do not suggest that wage drift has been greater than assumed then. Wage developments are therefore still expected to be broadly the same as in March.

However, the outlook is ambiguous due to this autumn's review of whether inflation benchmarks in private sector wage settlements have held. The costs entailed by changes in civil service pay scales next year could also turn out higher than currently expected.

VII External balance

The sharp deterioration in the external balance of the economy last year, which was described in *Monetary Bulletin* 2005/1, has continued so far this year. A record current account deficit therefore still looks likely this year, while the overall outlook for the external balance is broadly unchanged from the March forecast.

Largest merchandise account deficit in Q1 since 1998

Although developments in the early months of a year do not always provide reliable indications, the development of the merchandise account over the first months of 2005 firmly suggests that the forecast for the current account deficit this year could hold. Soaring imports and a contraction in exports resulted in a deficit of 11.6 b.kr. on the merchandise account in Q1/2005. The deficit was 5.9 b.kr. in March and has only been that high during a single month three times over the past 10 years, calculated at constant prices. As a proportion of GDP as roughly estimated for Q1/2005, the merchandise account deficit is the largest in the first quarter since 1998 (see Chart VII-1) and wider than in 2000, which turned out to be a record year. Imports in Q1/2005 increased 22.4% year-on-year, based on a constant exchange rate.

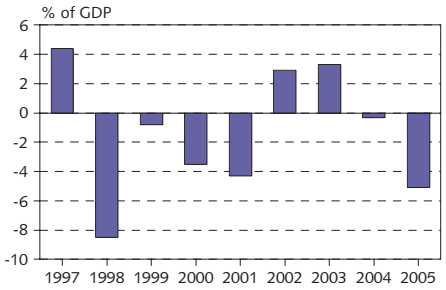
Current account deficit still heading for a record this year

The current account deficit in 2004 was almost 70 b.kr., equivalent to roughly 8% of GDP. More than half the deficit was registered on the merchandise account, but the service account worsened too, in particular due to increased expenditure on tourism and travel. The balance on income was negative by 17.7 b.kr., with interest payments rising strongly towards the end of the year. Foreign debt increased by 40% over the year. While this explains a large part of additional debt service, rising foreign short-term interest rates also contributed. These developments underline how sensitive the current account is to changes in foreign interest rates.

This year's current account deficit is expected to set another record at the equivalent of 12% of GDP, which is broadly in line with the March forecast. Although import growth, because of the depreciation of the króna, is expected to grow at a slightly slower pace than forecast in March, imports as a proportion of GDP are still forecast to peak this year, driven by investments in the aluminium and hydropower sectors (see Chart VII-3). The slower pace of import growth will not narrow the current account deficit, however, because the forecast for export growth has also been revised downwards since March, in step with slower growth of marine exports. Moreover, debt service will increase because of the lower exchange rate of the króna than was assumed in the March forecast. Thus the forecast current account deficit in 2005 is broadly unchanged from March.

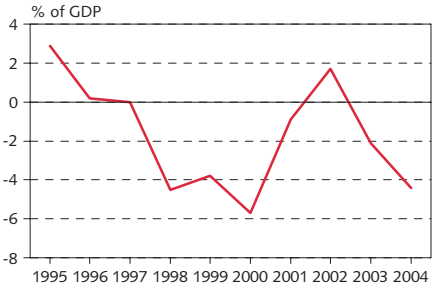
In 2006, the current account deficit will be marginally wider than was forecast in March, at 10% of GDP. The main force at work is a downward revision of export growth, on the back of a smaller fish catch. More growth is now forecast for national expenditure,

Chart VII-1
Merchandise account balance
January-March 1997-2005[1]



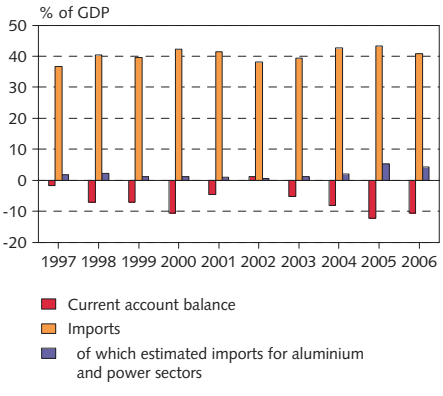
1. For 2005, the ratio is based on the Central Bank's estimate of gross domestic product in the first quarter.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart VII-2
Merchandise account balance
as a percentage of GDP 1995-2004



Sources: Statistics Iceland, Central Bank of Iceland.

Chart VII-3
Current account balance and imports
1997-2006[1]



1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland, Central Bank of Iceland.

especially private consumption. Although the weaker króna reduces imports and the current account deficit, rising national expenditure and debt service have the opposite effect.

As described in *Monetary Bulletin* 2005/1, the present deficit on the current account occurs under quite different economic conditions from those prevailing in 2000. The real exchange rate is much higher than then and global interest rates have been at a historical low. Thus the deficit on income has not grown in pace with foreign debt, which has quadrupled over the past seven years while interest payments have little more than doubled over the same period. Foreign interest rates look likely to rise in the near future, but the recovery is forecast to be slow. A little less than 15% of Iceland's external debt is denominated in US dollars. The Federal Reserve has raised the federal funds rate target by 2 percentage points since June 2004, so debt service on short-term dollar-denominated borrowing can be expected to have increased somewhat. However, long-term rates remain low and have even been falling in recent months. Short-term interest rates have remained virtually unchanged in the euro area and long-term rates have gone down, as in the US. Apart from some increase in risk premia, Iceland's interest rate terms have probably not changed significantly since March. For every percentage point that interest rates and premia on Iceland's external debt might rise, its debt service and current account deficit will increase by roughly 1⅓ percentage points of GDP.[8] This could have a substantial impact if interest rate developments deviate from the assumptions in the forecast.

8. Net external debt (excluding equity capital) was equivalent to just over 129% of GDP at the end of 2004.

VIII Price developments and inflation forecast

Price developments

Inflation has slowed down since the Central Bank's last forecast was published in March. Lower inflation can be attributed to the impact of the stronger króna on prices of imported goods and fiercer competition in the groceries market. A change in Statistics Iceland's method of calculating the housing component of the CPI also caused a drop in the index in May.

Change in calculation method produces a drop in the housing component of the CPI

Inflation breached the upper tolerance limit of the target in February and rose even further in March when the twelve-month increase in the CPI measured 4.7%. In April and May inflation slowed down, primarily due to the impact of the stronger króna and fiercer competition in the groceries market. Statistics Iceland's new method for calculating the housing component of the CPI also caused a 0.45% drop in the index in May. This change entailed shortening the horizon for calculating average real mortgage interest rates in the housing component of the CPI from five years to twelve months (as discussed in more detail in Box 3). The new calculation method will reflect the impact of interest rate changes earlier and more strongly than before. Twelve-month inflation measured 2.9% in May but would have been about 3.4% had the index calculation method been left unchanged.

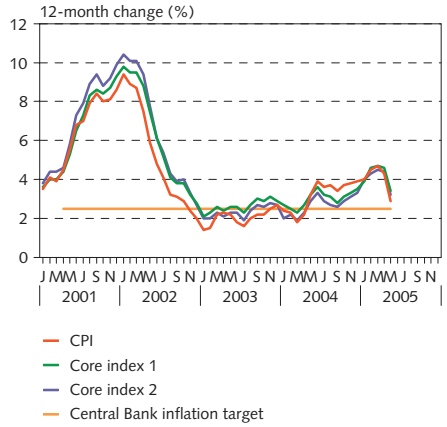
Changes in the two core indices published by Statistics Iceland provide an indication of underlying inflation. They have risen by rather more than the headline CPI so far this year, primarily because they do not reflect the reduction in agricultural prices. Thus the gap that developed between the CPI and the core indices in the middle of last year has virtually closed. In May the twelve-month average rise in Core index 1 was 3.4% and Core index 2 went up by 3.2%. Average inflation in Q1/2005 was in line with the Central Bank's March forecast at 4.4%.

Appreciation of the króna brings down imported goods prices ...

The appreciation of the króna has had a considerable effect on the CPI components which are most sensitive to exchange rate movements. In March the króna was 11% stronger year-on-year on average but it began to weaken towards the end of that month. The appreciation for most of March has had some effect on imported goods prices, but this had presumably not been transmitted in full when the króna began to weaken again.

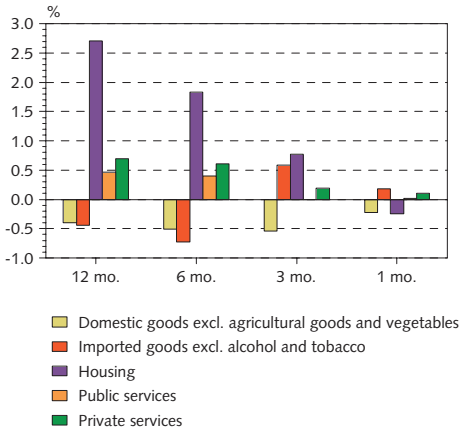
Imports of food and beverages are among the components of the CPI that are most sensitive to the exchange rate. In May this component had fallen by more than 12% in the space of a year. The currency appreciation of 7½% is not the sole explanation, however, because price competition among discount supermarkets also

Chart VIII-1
Inflation January 2001 - May 2005[1]



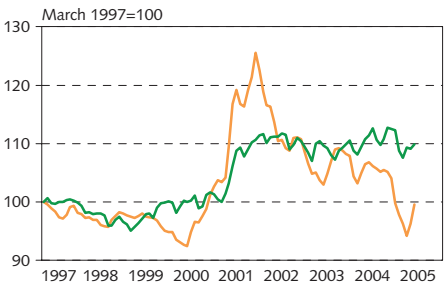
1. The core indices are compiled on the same basis as the CPI, with core index 1 excluding prices of vegetables, fruit, agricultural products and petrol, and core index 2 also excluding prices of public services.
Source: Statistics Iceland.

Chart VIII-2
Components of the CPI in May 2005
Contribution to CPI inflation
in past 1, 3, 6 and 12 months



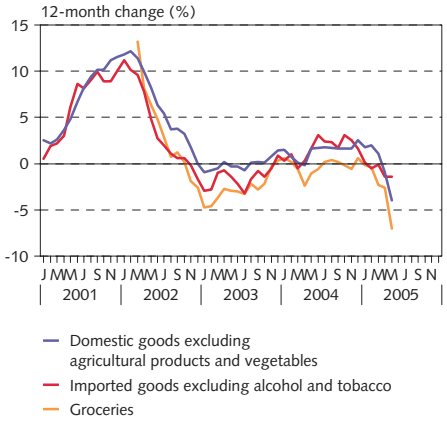
Source: Statistics Iceland.

Chart VIII-3
Exchange rate and import prices
March 1997 - May 2005



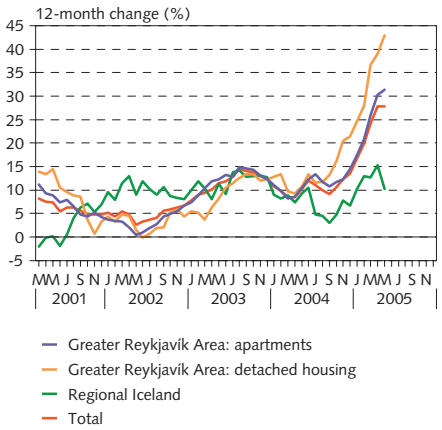
Source: Statistics Iceland.

Chart VIII-4
Goods prices January 2001 - May 2005



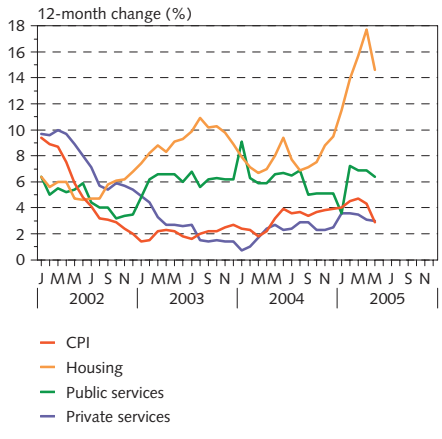
Source: Statistics Iceland.

Chart VIII-5
Market prices of housing
March 2001 - May 2005



Source: Statistics Iceland.

Chart VIII-6
Prices of housing and services
January 2002 - May 2005



Source: Statistics Iceland.

reduced the prices of these goods. Prices of imports that are less sensitive to short-term changes in the exchange rate, e.g. new motor vehicles and spare parts, have also fallen slightly over the past year, most markedly since the beginning of 2005.

Petrol prices are also sensitive to exchange rate changes and higher global fuel prices counteract the impact of the stronger króna. Since March, petrol prices have risen quite sharply and in May they were 6.2% higher year-on-year. Alcohol and tobacco have also risen, although these have slowed down in the spring. Thus the twelve-month decrease in imported goods prices measured only 0.9% in May, but excluding petrol, alcohol and tobacco the annualised decrease was 2.8%.

... and domestic goods prices have fallen rapidly in recent months

Fiercer competition among discount supermarkets is one of the main explanations for the recent fall in domestic goods prices. Domestic goods prices had decreased by 4.3% year-on-year in May and by almost 7% since February when a groceries price war began. Prices of domestic vegetables dropped most, down by almost 12% over the twelve months to May. Prices of agricultural goods excluding vegetables have also gone down after rising at the end of last year.

Market prices of housing continue to surge

Although the twelve-month rise in the housing component of the CPI was lower in May than in April, at 14.6%, due to the new method for calculating the index, the underlying annual rate of housing inflation gained momentum. Market prices of housing went up by 2.3% month-on-month and by almost 28% year-on-year. As before the increase was most pronounced in the Greater Reykjavík Area, although regional housing prices have also picked up.

There is no sign that housing price inflation is slowing significantly. It is mainly driven by increased availability of credit which has sent housing demand soaring, at a much faster pace than supply can meet. However, estimates by municipal construction officials in and around the capital indicate that supply may increase substantially later this year and in 2006.

Public services prices have risen by considerably more than the CPI over the past year, with a twelve-month increase of 6.4% in May. Prices of private sector services have also outpaced the inflation target and had risen by 3% year-on-year in May. This trend reinforces earlier observations that inflation mainly emerges in fields protected from international competition. An exception is the lower prices of agricultural products.

Inflation expectations

No reliable new information on inflation expectations has been available since March. In recent years the yield spread between non-indexed and indexed three- and five-year Treasury bonds has been used as a measure of market agents' inflation expectations. Due to the lack of an indexed bond to serve as a benchmark (after the class

Box 3

Changed method of calculating mortgage interest cost in the housing component of the CPI

Rises in the housing component of the CPI have been the main driver of inflation over the past year. Excluding this component, the CPI in May 2005 was unchanged year-on-year. This has prompted some debate about the methods used for calculating the housing component. They have been discussed in *Monetary Bulletin* and were also referred to by the Chairman of the Board of Governors of the Central Bank of Iceland in his address to the Bank's annual meeting on March 30 this year (see pp. 47-56). As of May 2005 Statistics Iceland changed the method of averaging real interest rates in the model which determines the user cost of owner-occupied housing in the CPI. This resulted in a CPI measurement that was 0.45% lower than would otherwise have been the case, while the headline CPI fell by 0.54% from April. The significance of this change from the perspective of monetary policy is discussed on p. 37. The following is Statistics Iceland's announcement of the change, published in its monthly statistics (*Hagtíðindi*) on May 3:

"In July 2004 the Housing Financing Fund (HFF) changed its long-term housing credit system with the introduction of cash mortgage loans (HFF mortgage bonds) carrying a lower real rate of interest than before. Shortly afterwards the banks began offering competitive mortgage loans, which greatly increased the supply of long-term credit to households. Housing transactions increased as a result and housing prices soared.

"Statistics Iceland took into account the fall in interest rates caused by this structural change in July 2004, since it reduced the level of real interest rates. In the new mortgage loan system, interest rates are determined on a monthly basis. Initially, mortgage rates were expected to change much more frequently than before, which might give rise to month-to-month volatility in the CPI. For this reason, it was decided in August 2004 to calculate real interest rates in the index as a five-year moving average, updated on a monthly basis. This would ensure that the impact of the interest rate reduction would be reflected in the calculation without interest rate changes causing short-term volatility in the index. Mortgage interest rates decreased from 5.1% to 4.8% in July 2004 and had gone down to 4.15% at the end of the year. They have remained unchanged since and are likely to have stabilised at a lower level in real terms.

"In light of this experience and perspectives that have been expressed, Statistics Iceland considers that the term of the moving average for interest rates should be shortened to twelve months, thus incorporating the effect of changes into the calculation more quickly. The new method will be applied until the CPI is rebased in March 2006, when it will be reconsidered. If interest rates remain stable over this period, the impact of the change in interest rates on inflation measurements will be neutralised.

"The composition of real interest rates used for the calculation has also been reviewed, as is done every March in the annual rebasing of the index. Interest rates on own financing of housing, which account for just over half the weight of interest rates in the housing component, are fixed. Other interest rates are variable, and cover HFF loans, mortgage loans from banks and pension funds, and mortgage loans taken over when housing is purchased. After these changes, average interest rates are 3.7%.

"The total reduction in the CPI on account of the fall in the twelve-month moving average of interest rates amounts to 0.9% from July 2004 to April 2005 and the impact of lower interest rates which lower the CPI by 0.45% has already been included in the measurement in May 2005."

Box 4

Financial market analysts' assessments of the economic outlook

The accompanying table shows the economic forecasts of financial market analysts at the beginning of May. Participants in the survey were the research departments of Íslandsbanki, Kaupthing Bank, Landsbanki, and Economic Consulting and Forecasting.

After disagreeing quite sharply in the February survey about probable economic developments, analysts are now in closer agreement on the scenario over the next two years. They are generally more upbeat, forecasting lower inflation and a higher rate of GDP growth.

Analysts expect average inflation of 3.8% over 2005, and a virtually identical rate year-on-year – i.e. just within the upper tolerance limit of the inflation target. The Central Bank forecasts a somewhat lower rate of inflation for the year, but it should be underlined that it assumes an unchanged policy interest rate and exchange rate over the forecast horizon. The Central Bank forecasts 3% inflation over 2005 and 3.6% year-on-year. Respondents differ markedly about the inflation outlook for 2006. On average they forecast a considerable rise over 2006, at 5.3%, and 4.9% year-on-year. In contrast, the Central Bank forecasts 3.6% over 2006 and an average of 3.2% year-on-year.

Respondents have revised their forecasts for GDP growth upwards since November 2004, with less difference between the highest and lowest forecast values. On average they expect 6.2% growth in 2005 and 5.3% next year. The Central Bank's GDP growth forecast is rather higher at 6.6% this year and 6.2% in 2006.

On average, respondents forecast an exchange rate index of 122 twelve months ahead, implying a sizeable depreciation of the króna from its value in recent weeks – the exchange rate index has risen somewhat (i.e. the króna has weakened) in recent weeks after dipping to just over 106 in the second half of March. Subsequently they forecast a further slide, bringing the exchange rate index down to just above 130 after two years. This is very close to their exchange rate forecasts in February.

The Central Bank raised its policy interest rate to 9% on March 29. Analysts expect further hikes in the coming months, forecasting a policy rate of almost 10% one year ahead and little change in the following year.

Asset prices have soared so far this year but forecasters expect the rises to slow down. Opinions are sharply divided, however, with one analyst forecasting a decrease one year ahead and a further decline two years ahead.

As in recent surveys, forecasters agree that real estate prices will rise both one year and two years ahead – but at a slower rate than recently, when housing prices have surged over a very short period.

Overview of forecasts by financial market analysts[1]

	2005			*2006*		
	Average	*Lowest*	*Highest*	*Average*	*Lowest*	*Highest*
Inflation (within year)	3.8	3.0	4.5	5.3	4.0	7.0
Inflation (year-on-year)	3.7	3.5	4.0	4.9	3.9	6.4
GDP growth	6.2	6.0	6.5	5.3	5.0	5.5
	One year ahead			*Two years ahead*		
Effective exchange rate index of foreign currencies vis-à-vis the króna (Dec. 31, 1991=100)	122.5	115.0	133.0	129.5	127.0	133.0
Central Bank policy interest rate	9.8	9.3	10.0	8.6	7.3	10.0
Nominal long-term interest rate[2]	7.6	7.5	7.6	7.2	7.0	7.4
Real long-term interest rate[3]	3.6	3.2	4.0	3.5	3.3	3.7
ICEX-15 share price index (12-month change)	6.8	-15.0	15.0	15.2	-19.3	35.0
Housing prices (12-month change)	10.9	7.5	15.0	14.6	7.5	20.8

1. The table shows percentage changes between periods, except for interest rates (percentages) and the exchange rate index for foreign currencies (index points). Participants in the survey were the research departments of Íslandsbanki, Kaupthing Bank and Landsbanki, and Economic Consulting and Forecasting. 2. Based on yield in market makers' bids on non-indexed T-notes (RIKB 13 0517). 3. Based on yield in market makers' bids on indexed HFF bonds (HFF 15 0644).

Source: Central Bank of Iceland.

that had been used matured in April), the breakeven rate of inflation can no longer be determined in this way. The most recent survey of household inflation expectations by IMG Gallup was produced at the end of February and beginning of March and showed that households forecast average inflation of around 4% over the following twelve months. Household inflation expectations appear to reflect measured rather than forecast inflation. Conceivably, expectations may have come down since the last survey, which was conducted when inflation was at a peak.

Inflation forecast

As pointed out earlier, the current Central Bank macroeconomic and inflation forecast is only an update of the March forecast. The next comprehensive forecast will be published in September.

The Central Bank has raised its policy interest rate by one-quarter of a percentage point since its last inflation forecast was published in March, and it stood at 9% on the day of the forecast. Over the same period, the króna has depreciated by 6%. The forecast is based on the technical assumption of an unchanged policy rate and the exchange rate index remaining at 116 over the forecast horizon.

Inflation outlook has worsened somewhat

Since the Central Bank published its last forecast in March, the inflation outlook has deteriorated somewhat. The exchange rate on which the current forecast is based is 6% lower than in March and demand is likely to grow faster. Other assumptions, such as the pass-through of exchange rate changes to prices, are barely changed.

The inflation outlook one year ahead is broadly the same as in the March forecast. The forecast for the next quarter has been revised downwards, as a result of Statistics Iceland's new method for calculating the housing component of the CPI, which is explained in Box 3. Inflation is forecast at 2.7% one year ahead, which is broadly the same as in the March forecast, whether estimated in the same quarter or over the same forecast horizon.

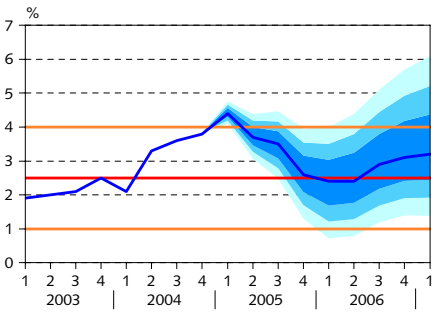
On a longer range, the inflation forecast has been revised upwards since March. This is particularly marked in Q2/2006, when the base effect of the change in the housing component of the CPI disappears. Inflation then is forecast almost 1 percentage point higher than in the March forecast. Two years ahead the discrepancy is smaller, with an expected rate of inflation of 3.7% compared with just over 3% in the March forecast.

As usual, the Bank's forecast is based on the technical assumption that both the policy rate and the exchange rate remain unchanged from the day of the forecast. An alternative inflation forecast based on variable interest rates and exchange rate is not published with the current forecast, but it presents broadly the same scenario two years ahead as the alternative forecast in March. This projects that the króna will depreciate relatively rapidly in the near term, producing a poorer inflation outlook than the main forecast despite a somewhat higher policy interest rate over most of the horizon. However, the divergence between the forecasts based on a

Chart VIII-7

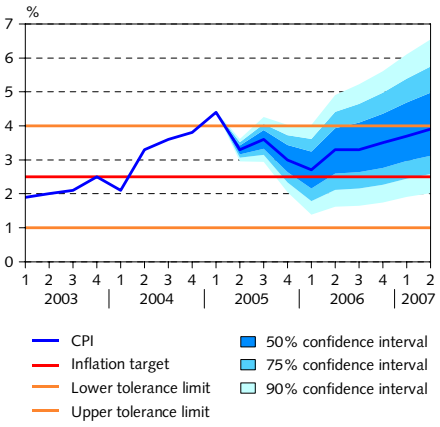
Previous Central Bank inflation forecast
(in *Monetary Bulletin* 2005/1)

Forecasting period: Q1/2005 - Q1/2007



Current Central Bank inflation forecast

Forecasting period: Q2/2005 - Q2/2007



The charts present the estimated confidence intervals of the forecast for the next two years. The entire shaded area shows the 90% confidence interval; the two darkest ranges show the corresponding 75% confidence interval and the darkest range shows the 50% confidence interval. The uncertainty increases over the horizon of the forecast, as reflected in the widening of the confidence intervals. Uncertainty in the forecast it is considered to be somewhat less than is shown by historical forecasting errors, which reflect volatile inflation in the period 2001-2002 immediately after Iceland moved on to an inflation target.

fixed and a variable policy rate should have narrowed since March, because part of the depreciation added to the alternative scenario in March has now been incorporated into the main forecast. Thus the exchange rate paths of the two forecasts should be in closer alignment now than in March.

Risk profile virtually unchanged from the March forecast

Inflation prospects are always fraught with uncertainty. The main forecast may be seen as the most probable outcome based on an unchanged policy rate and exchange rate, but it is vital to take into account the entire risk profile in monetary policy decision-making.

Table VIII-1 Main asymmetric uncertainties in the inflation forecast

Uncertainty	*Explanation*	*Inflationary impact*
Private consumption	The impact of lower long-term interest rates and easier credit access, and their potential wealth effect, on private consumption could be underestimated	Risk of underestimated demand and thereby of underestimating inflation
Exchange rate developments	The impact of currency appreciation on domestic prices could be underestimated	Risk of overforecasting short-term inflation
	Wide current account deficit and increasing inflation expectations for the coming years could create downward pressure on the króna	Risk of the króna depreciating and thereby of underforecasting inflation
Wage developments	Adverse inflation prospects and the outcome of specific wage agreements could lead to renegotiation of private sector wage agreements	Risk of underestimated wage rises and thereby of underforecasting inflation
Fiscal policy	The fiscal stance could be easier than assumed in forecasts, especially with a general election scheduled for 2007	Risk of underestimated positive output gap and thereby of underforecasting inflation
	The impact of planned tax cuts on future income expectations could be underestimated, so their demand impulse could be correspondingly greater	
Asset prices	Housing price rises over the coming months could be underestimated	Risk of underforecasting short-term inflation
	Asset prices could fall, reducing private consumption later in the forecast period	Risk of overestimated positive output gap and thereby of overforecasting inflation
Central Bank risk profile	*One year ahead*	*Two years ahead*
Monetary Bulletin 2004/2	Symmetric	Upward
Monetary Bulletin 2005/1	Symmetric	Upward
Monetary Bulletin 2005/2	Symmetric	Upward

The risk profile has not changed much since the March forecast, except that there is less probability of a sharp depreciation, since the króna is weaker now than in the previous forecast. Uncertainties therefore remain broadly symmetric one year ahead but are slightly more to the upside two years ahead. Table VIII-1 summarises the main asymmetric uncertainties in the forecast and their impact on its confidence intervals. Chart VIII-7 presents the estimated confidence intervals for the current forecast compared with the March forecast. A more detailed description of uncertainty assessments in the Central Bank's forecasts may be found in Appendix 3 in *Monetary Bulletin* 2005/1.

Table VIII-2 shows the Bank's assessments of the probability of inflation being in a given range, based on the confidence intervals. The probability that inflation will be within the tolerance limits of the target two years ahead has decreased, reflecting higher forecast inflation.

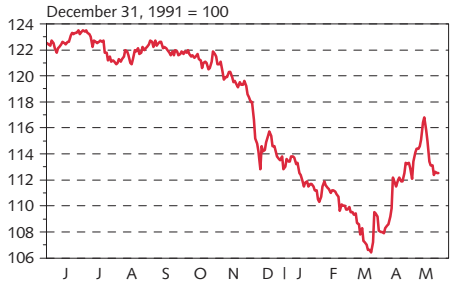
Table VIII-2 Probability ranges for inflation over the next two years

	Inflation				
Quarter	*Under 1%*	*In the range 1% - 2½%*	*Under 2½%*	*In the range 2½% - 4%*	*Over 4%*
Q2/2005	< 1	< 1	< 1	> 99	< 1
Q1/2006	< 1	39	40	55	5
Q1/2007	< 1	11	11	41	48

The table shows the Bank's assessments of the probability of inflation being in a given range, in percentages.

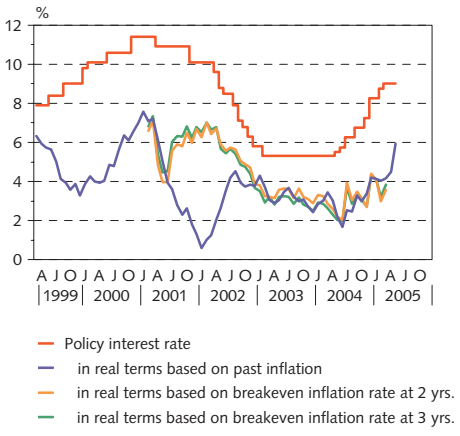
IX Monetary policy

Chart IX-1
Exchange rate index of the króna
May 27, 2004 - May 27, 2005



Source: Central Bank of Iceland.

Chart IX-2
Central Bank policy interest rate in nominal and real terms[1] March 1999 - May 2005



1. Due to the lack of an indexed bond to serve as a benchmark after the class that had been used matured in April 2005, the breakeven rate of inflation can no longer be determined by this criterion.
Source: Central Bank of Iceland.

Financial conditions broadly the same as in March

The Central Bank raised its policy interest rate by 0.25 percentage points at the same time as *Monetary Bulletin* was published in March. The rationale behind this decision was presented in the Introduction where it was stated that monetary policy decision-making should take into account the tighter stance implied by the appreciation of the króna. Since the forecast in March, some of the appreciation has unwound. The exchange rate on which the current forecast is based is 6% lower than in March. The weaker króna has resulted in a less favourable inflation outlook and also implies some easing of the monetary stance.

Apart from the depreciation of the króna, financial conditions have not changed much since March. The policy rate has inched up in real terms according to most available indicators, but is not very high in a historical context. On the other hand, foreign long-term interest rates have gone down, in spite of the Federal Reserve's hikes in its funds rate in March and May. Higher risk premia on interest rates could offset the effect to some extent.

Need for a tighter monetary stance despite a temporary slowdown in inflation

The current main task of monetary policy is to apply the necessary tightening to ensure price stability over the coming years in a climate of growing macroeconomic imbalances. In particular, imbalances take the form of soaring real estate prices and a widening current account deficit. Inflation has also exceeded the 2.5% target, although it has slowed down since March.

Excluding the housing component of the CPI, inflation is zero. Since the housing component reflects higher asset prices, which benefit most households and are also likely to unwind later, it is natural to ask whether it is necessary to tighten the monetary stance even further than has already been done.

To be effective, monetary policy must look forward rather than back. Although inflation has slowed down for the past two months and primarily takes the form of higher real estate prices, most economic indicators and the Central Bank's current forecast imply a substantial ongoing risk of excessive inflation over the next two years. Decision-makers must not be deceived by the decrease in inflation over the past two months which is above all due to the strengthening of the króna and a change in the method for calculating the housing component of the CPI. The price war in the groceries market may also prove short-lived. Signs of substantial imbalances can be seen throughout the economy. These include rapid growth of turnover, imports, deposit money bank lending and Treasury revenues, a widening current account deficit and surging real estate prices. Failure to take action to contain excessive growth of domestic demand would be a recipe for inflation later, even if the strong króna is softening the inflationary impact at present. Indeed, a strong currency is one of many manifestations of macroeconomic imbalances. Given

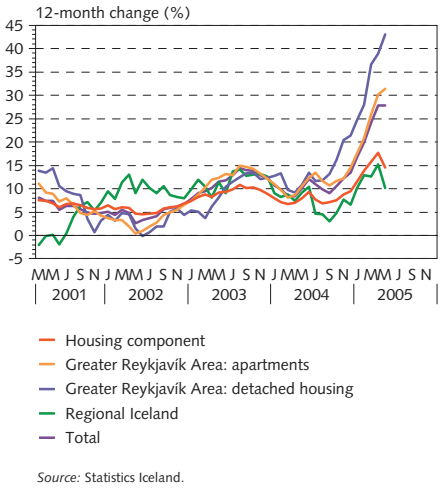
the very high probability that the currency will weaken in the long run, the arguments in favour of a tight monetary policy are obvious.

Change in method for estimating mortgage interest cost has no effect on monetary policy

A new method for estimating mortgage interest cost in the housing component of the CPI caused inflation to measure roughly half a percentage point lower than would otherwise have been the case (see Box 3). This reduction in measured inflation prompted some speculation that this would give the Central Bank room for manoeuvre to ease the monetary stance. This is a misunderstanding. First, it was already known that mortgage interest cost was overestimated in the index, provided that the lower interest rates on mortgage loans since summer 2004 were permanent. Monetary policy decisions have borne this in mind. It should be noted that although the twelve-month rise in the CPI is the formal benchmark for the inflation target, it is not a mechanical target for the Central Bank, which is also obliged to take into account other measures of underlying inflation in its monetary policy decisions. Second, it is important for monetary policy to be as forward-looking as possible. Two-year inflation forecasts therefore play a crucial role in monetary policy decision-making. Statistics Iceland's recent change in its method for estimating mortgage interest cost mainly affects its estimates of past inflation measured as the twelve-month change in the CPI. After just over a year the base effect of this structural change in the CPI will largely have disappeared. Thus the new method has no impact on the inflation outlook two years ahead. Moreover, it cannot be ruled out that the change will cause a higher inflation measurement two years hence, i.e. if interest rates on indexed mortgage loans go up. In the long run, this structural change in the CPI should not have any effect on measured inflation.

Chart IX-3

Increase in the CPI housing component and market prices of housing March 2001 - May 2005



Source: Statistics Iceland.

A shorter term for measuring mortgage interest cost could complicate monetary policy implementation

This prompts the question of whether Statistics Iceland's changeover from five-year to twelve-month averages for its calculations of mortgage interest costs for owner-occupied housing is entirely appropriate from the perspective of monetary policy. As a result of this shorter term, the policy rate could impact the CPI by changing the mortgage interest cost value, e.g. whereby a policy rate hike would produce a higher inflation measurement. This is unfortunate insofar as tightening the monetary stance can then call for even further tightening. The same type of spiral could operate in the opposite direction. To address this problem, when the UK moved on to an inflation target in the early 1990s it decided to calculate a separate benchmark index excluding mortgage interest payments. However, the situation in Iceland is not entirely comparable. Mortgage interest rates in Iceland are generally fixed, not variable as in the UK. The pass-through of the policy rate to mortgage rates is therefore much less immediate in Iceland, and sometimes does not register at all, as recent examples show. In addition, loans are

generally price-indexed in Iceland. Under normal circumstances, however, changes in the policy rate may be expected to exert some temporary effect on mortgage loan rates, and under certain conditions a fairly strong impact cannot be ruled out. Were this to happen, the Central Bank would also have the option of ignoring the effect of interest rate changes on the CPI in its monetary policy decisions, just as it can in the case of fluctuations in petrol prices or other factors beyond its sphere of influence. Another possibility would be to calculate a separate index excluding interest expense as a supporting reference, like the two core indices currently calculated by Statistics Iceland.

No conflict between the price stability objective and financial stability

The recent surges in equity prices and in real estate prices in the Greater Reykjavík Area are rather disconcerting. Higher asset prices fuel demand growth but may eventually unwind and amplify the resulting contraction. Real estate prices are buoyant at the same time as a firm tightening of the monetary policy stance is unavoidable for other reasons. Monetary policy measures, which aim to prevent the large-scale investments in the aluminium and hydropower sectors this year and in 2006 from disrupting price stability, will inevitably affect asset markets. It is fairly foreseeable when these investments will decline, i.e. assuming that no projects of similar scope are launched when the current ones come to an end in 2007. It can be concluded that a turnaround in the real estate market will become more likely towards or after the end of these investments. A cautious monetary approach may be justified at this juncture, to avoid a slump in asset prices, which could undermine financial stability. This does not conflict with monetary measures in the current climate, at least not so far. From the perspective of both the inflation target and financial stability, there are strong arguments in favour of a tight monetary stance now, to reduce foreseeable macroeconomic imbalances when investments tail off and to leave less need for an even tighter stance later, when a turnaround in the asset market might be close at hand. Also, it should be noted that, as a result of extensive indexation of financial liabilities, lower interest rates and higher inflation do not necessarily leave the financial system any less exposed to the risks that a slide in asset prices could cause. Thus there is no reason to flinch from the objective of price stability.

Appendix 1

Forecast errors in Central Bank of Iceland forecasts

The inflation forecast and analysis of economic prospects are one of the cornerstones of the Central Bank's monetary decision-making process. Due to the lags in the monetary policy transmission mechanism, it is vital for the Bank to have the clearest possible view of future inflation prospects and economic developments at any time.

Since the adoption of inflation targeting in March 2001, the Central Bank has published an inflation forecast two years ahead in its quarterly *Monetary Bulletin*. Confidence intervals have been included with the forecast, since the great uncertainty surrounding economic developments could make a simple point forecast misleading. Confidence intervals take into account various uncertainties that could lead to substantial deviations from the point forecast. Among them are changes in the global economic situation, exchange rate developments and various domestic factors. In evaluating inflation prospects two years ahead and possible monetary policy responses to them, the Central Bank also considers the risk profile of the forecast no less than the point forecast itself.

The Central Bank publishes a survey of its inflation forecasting errors once a year, most recently in *Monetary Bulletin* 2004/2. Evaluations of inflation forecasts focus on their bias and root mean square error (RMSE). The bias shows the forecasts' mean deviation from actual inflation and thus whether inflation is being systematically over- or under-forecast. The root mean square error measures how far on average the forecast value differs from the true value.

For many years, the Central Bank has published inflation forecasts with a horizon of up to one year. Table 1 shows the bias and RMSE in the Bank's forecasts since 1994. Both the bias and the RMSE increase as the forecast horizon lengthens, which is natural since the uncertainty increases further ahead. There are no indications of systematic under- or over-forecasting of inflation over this period.

Table 1 Central Bank inflation forecasting errors 1994:1-2005:1

	Forecast horizon			
%	*1 Q*	*2 Q*	*3 Q*	*4 Q*
Bias	0.0	-0.1	-0.2	-0.3
RMSE	0.4	0.8	1.3	1.6

Since moving on to an inflation target in March 2001, the Central Bank has also published an inflation forecast two years ahead. Table 2 presents the bias and RMSE since the adoption of inflation targeting. It shows that there is little discrepancy between the bias of the forecasts one and two years ahead, while the RMSE of the forecast two years ahead appears to be smaller. An explanation could

be that monetary policy is more capable of having an impact on inflation in the longer run due to the lags in the transmission mechanism. One should be careful, however, in interpreting these data due to the small number of data points available so far. Tables 1 and 2 show a similar RMSE one year ahead after the inflation target was adopted (1.5%) and over the whole period (1.6%). By comparison, the standard deviation of annual inflation over these periods is in the range 2-2½%.

Table 2 Central Bank inflation forecasting errors since 2001:2

	No. of measurements	*Bias (%)*	*RMSE (%)*
Four quarters ahead	13	-0.3	1.5
Eight quarters ahead	9	-0.4	1.2

Table 3 compares the estimated probability distribution of the inflation forecast with the distribution of actual inflation after targeting was adopted in 2001. Twelve forecasts four quarters ahead can now be compared with measured inflation over the same period. Of these, five fell within the 50% confidence interval (in 42% of cases), eight within the 75% interval (67% of cases) and eleven within the 90% interval (92% of cases). One forecast fell outside the 90% confidence interval, produced just before the beginning of the sharp depreciation of the króna in Q2/2001. Distribution of forecasting errors therefore closely matches the given probability distribution. Nine forecasts over a horizon of eight quarters can be tested. Five turned out to fall within the 50% confidence interval (56% of cases) and all nine within 75%. The confidence intervals two years ahead have therefore overestimated the measured distribution of inflation after two years.

Table 3 Distribution of measured inflation based on inflation forecast confidence intervals

	No. of measurements	*Within confidence interval*		
		50%	*75%*	*90%*
Four quarters ahead	12[1]	5	8	11
Eight quarters ahead	9	5	9	9

1. Only a point forecast was published in *Monetary Bulletin* 2004/1. Therefore, 12 measurements are given in Table 3 but 13 in Table 2.

Finally, when the forecast errors are examined in the context of exchange rate developments over the forecast period, a fairly clear relation can be seen between the deviations of the exchange rate from, first, the assumed rate in the forecast, and second, the one-year inflation forecast error. The relation is not so clear in forecasts two years ahead, which do not appear to be as sensitive to exchange rate changes as one-year forecasts. This implies that fluctuations in the exchange rate primarily affect the development of short-term inflation and have less impact on inflation in the long term. One explanation is that if the króna deviates significantly from an exchange rate that is compatible with the inflation target in the long run, this calls for a monetary policy response to correct the deviation.

Financial markets and Central Bank measures[1]

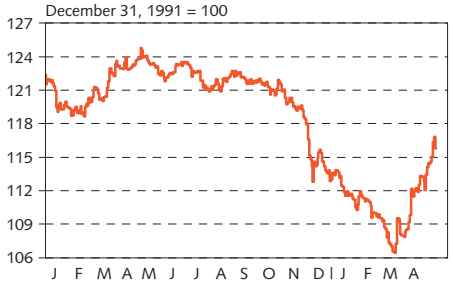
Lively foreign exchange market

The Central Bank of Iceland announced a 0.25 percentage-point rise in its policy interest rate on March 22, 2005, at the same time as the last Monetary Bulletin *was published. A sharp depreciation of the króna followed. In the beginning of May an announcement of a foreign currency purchase to pay down Treasury foreign debt led to a further weakening. In mid-May the trend was reversed, however. Yields on Housing Financing Fund bonds have inched upwards. Equity prices rose fairly decisively in March and April, but calmed down in May.*

Currency appreciation and reversal

The króna appreciated by almost 3% from March 1 to March 21, when the foreign exchange index reached its lowest value (106.42) since June 25, 1993. The Central Bank of Iceland announced a 0.25 percentage-point rise in its policy interest rate on March 22, 2005, at the same time as the last *Monetary Bulletin* was published. Judging from the market response, a hike of at least as much had apparently been widely expected, and some shifts took place in the foreign exchange and securities markets as a result. The exchange rate index rose by more than 2% from March 22 to 23 and the króna slid for the whole of April, i.e. the index value went up. At the end of April the index stood at 112.9, having risen by 6% since March 21. Chart 1 shows the development of the exchange rate index.

Chart 1
Exchange rate index of the króna
Daily data January 5, 2004 - May 17, 2005
December 31, 1991 = 100



Source: Central Bank of Iceland.

Currency purchase on behalf of the Treasury

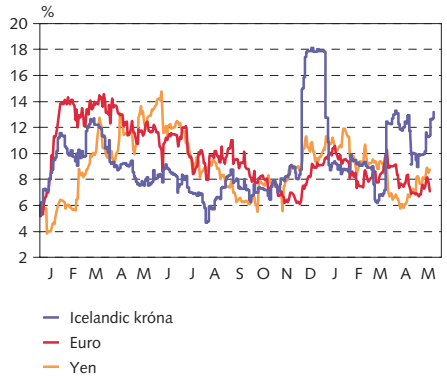
In the beginning of May the Central Bank announced plans to purchase foreign currency on account of the Treasury's discretionary amortisation of foreign debt, over and above its regular purchases during the year. The reason for the currency purchase was the Treasury's exceptionally ample liquidity, which it was considered appropriate to deploy on amortising short-term borrowing in May rather than rolling the debt over. At the same time, the Treasury announced that it had no plans for further discretionary purchases of currency for the rest of the year, but its regular purchases will continue under the format described in *Monetary Bulletin* in December 2004. The announcement caused a minor tremor which contributed to the weakening of the króna by more than 4% from May 2 to May 12, when the first tranche of the purchase took place that morning.

Króna climbs back

The króna began to rally on May 17 following news of possible plans by Norðurál to build an aluminium smelter on the southwest Suðurnes peninsula over the period 2010-2015. Reports were later received that Alcoa was interested in exploring the possibility of

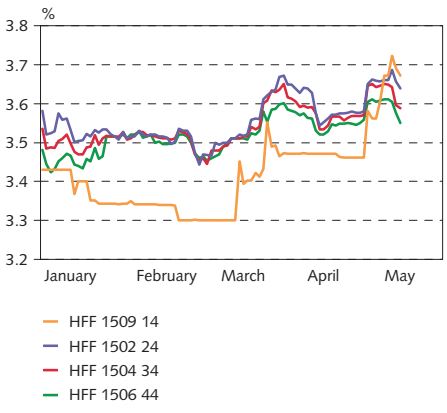
1. This article uses data available on May 17, 2005.

Chart 2
Exchange rate volatility of Icelandic króna, euro and yen against US dollar[1]
Daily data January 1, 2004 - May 17, 2005



1. One-month averages.
Source: Reuters.

Chart 3
HFF bond yields
Daily data January 4 - May 17, 2005



Source: Central Bank of Iceland.

building a smelter in north Iceland, which also appeared to bolster the króna. However, neither news report entailed more than an intention about or interest in exploring the possibility of building a smelter.

Increasing exchange rate volatility

Exchange rate volatility, i.e. short-term fluctuations in the exchange rate, is typically measured in terms of the standard deviation in day-on-day changes in the exchange rate index over a given period. This measure enables comparisons of the exchange rate volatility of different currencies and their trends. Chart 2 shows the increasing one-month volatility of the króna vis-à-vis the US dollar recently, together with the volatility of the euro and the yen against the dollar over the same period. The market is clearly more sensitive than before with a risk of investor flight. There is always a tendency to overshoot in FX markets, but the exchange rate volatility shows that investors respond more sharply now than often before.

Shifts in the bond market

The bond market has not escaped the unrest of recent weeks, which has partly been connected with shifts in the FX market but has also been driven by other events, such as Statistics Iceland's announcement of a changed method for calculating mortgage interest cost in the housing component of the CPI.

Are T-bonds on the way out?

In April, one of the last classes of Treasury bonds matured. A total of 18 b.kr. was redeemed, leaving only three issues listed on Iceland Stock Exchange (ICEX). The National Debt Management Agency (NDMA) has not announced whether this bond format will be maintained. While T-bonds clearly still interest investors, the Treasury's borrowing requirement is extremely low at present. Of the three T-bond issues now listed on ICEX, two have a nominal value of less than 500 m.kr., whereas the third amounts to more than 25 b.kr. and matures in 2015. It is not known whether the Treasury intends to maintain the indexed part of its debt instrument portfolio. The Treasury's position has been strong and its borrowing requirement negligible, but it is not certain that this will always be the case.

Yields on HFF bonds have edged upwards

Housing Financing Fund (HFF) bonds are the mainstay of the indexed end of the bond market and yields on the three longer classes have ranged from 3.42% to 3.69% since the beginning of the year. Sizeable day-to-day volatility has sometimes been noted, often coinciding with changes in the FX market. Yields on the shortest class, i.e. HFF bonds maturing in 2014, were for a long time lower than on the others, due to its small size and heavy demand for it. Demand has dwindled and yields now exceed those of other issues, as Chart 3 shows. For a while the interest rate spectrum of HFF bonds was unusual insofar as yields on the shortest issue, which was by far the smallest, were lower than on the others, even though there were no market makers for it. This situation changed in May, however, and the

interest rate spectrum is now more consistent. Since the beginning of March, yields on HFF bonds have edged upwards. Two auctions have been held so far this year, on March 14 when bids to the value 11 b.kr. were accepted, and on May 19 for 10 b.kr. The second was a closed auction. The HFF has had liquid funds available because of heavy prepayments of its loans last year and to some extent this year. Its responses have included arranging extra draws of bonds and prepayment of borrowing. From August 2004 to the end of April 2005, the deposit money banks lent 200 b.kr. in the form of new mortgage loans. It is clear that a significant share of this borrowing has been deployed on prepaying existing loans on less favourable terms, primarily earlier mortgage loans from the HFF and its predecessors.

Yields on Treasury notes rose and fell

Three Treasury note issues, maturing between 2007 and 2013, are in the market. Yields on them are sensitive to changes in inflation expectations. The shortest class is the most sensitive, because with less than two years remaining until it matures, it falls within the Central Bank's inflation forecast horizon and appears to mould expectations to some extent.

Growing turnover in the domestic currency market

So far this year, turnover in the market for loans in domestic currency (the króna market) has grown by 113%. Turnover has been greater in this market than in the FX market which for a long time far outstripped the other interbank markets. Interest rates in the króna market have provided good indications of market expectations, although overnight rates have been very volatile. Volatility at the shortest end partly reflects the impact of minimum reserve requirements, but fluctuations have also been caused by divergent expectations, unexpected events and position-taking. Chart 4 shows interest rates in the króna market for different maturities. It should be noted that various central banks are tackling the question of interest rate volatility on the final day of the maintenance period, and the Bank of England has aired ideas for a narrower rate corridor than on other days in order to reduce this problem. Because of the merger of credit institutions' reserve accounts and current accounts in the Central Bank of Iceland and enhanced liquidity management, the banks have had little need for Central Bank overnight lending facilities and their use has virtually disappeared. Nonetheless, overnight loans remain part of the Bank's instrument portfolio on account of their importance for payment systems and liquidity management. Since new rules on minimum reserve requirements entered force in January 2004, reserves have increased by 16%.

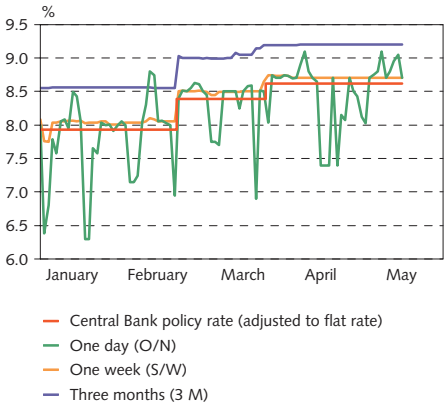
Time structure of interest rates is just beginning to flatten out

Interest rates in the króna market imply a market perception that the Central Bank's policy interest rate is approaching a peak, because the spread between the shortest and longest domestic currency market rates has been narrowing recently. The policy rate is now 9%, which

Chart 4

Interest rates in the interbank króna market and Central Bank policy interest rate

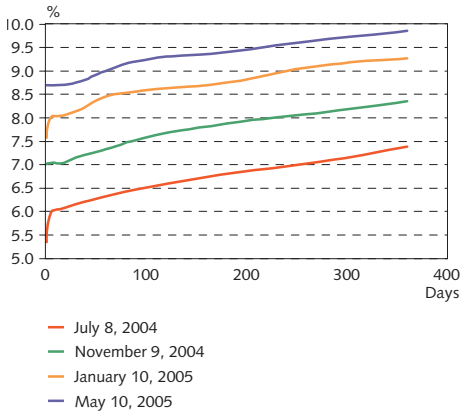
Daily data January 4 - May 17, 2005



Source: Central Bank of Iceland.

Chart 5

Time structure of interest rates in the interbank króna market (Reibor average rates)

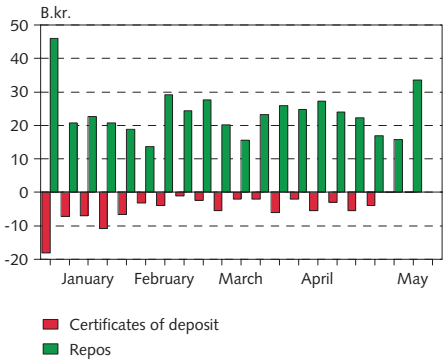


Source: Central Bank of Iceland.

Chart 6

Outstanding stock of Central Bank repos and CDs

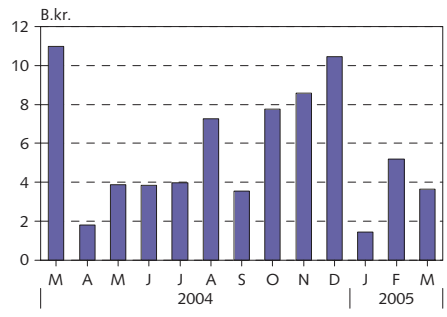
Weekly data January 4 - May 17, 2005



Source: Central Bank of Iceland.

Chart 7

Residents' net foreign portfolio purchases March 2004 - March 2005



Source: Central Bank of Iceland.

is the yield on one-week repos and corresponds to a flat interest rate of 8.62%. Since króna market rates are flat, it is misleading to compare them with the unadjusted policy rate. The fact that interest rates in the króna market always exceed the policy rate, coupled with a fair amount of demand for Central Bank facilities, implies that institutions subject to minimum reserve requirements face tighter liquidity than last year. Chart 5 shows the time structure of interest rates in the interbank króna market.

Repo transaction volume still quite large

One side-effect of Treasury liquidity has been to generate some demand for Central Bank lending facilities, and it has also dampened demand for certificates of deposit. Since the beginning of the year, the average volume of repo transactions in weekly auctions has been around 24 b.kr. The highest volume was 45.9 b.kr. on January 4, followed by 33 b.kr. on May 17. CDs reached a high of 18 b.kr. on January 4, but two auctions did not result in any sales. Net Central Bank facilities for credit institutions (repos less CDs) have averaged 19 b.kr. from the beginning of the year. The Board of Governors of the Central Bank has decided to abolish ceilings in auctions of seven-day CDs and the Bank will include their yields in its interest rate announcements. Chart 6 shows the development of repo and CD transactions so far this year.

Bank rates have tracked the policy rate more closely recently

Since the Central Bank began its cycle of policy interest rate rises in May 2004, the commercial banks and savings banks have raised their interest rates by varying amounts. Initially some banks hardly tracked the policy rate hikes, but subsequently they have followed suit quite closely. Average non-indexed lending rates are now 14.32%, as against 13.95% at the beginning of the year. Since deposit forms are very different and hardly comparable, it is difficult to estimate the banks' overall interest margin.

Changes in portfolio holdings of foreign and domestic investors

An interesting development has taken place in foreign investors' transactions with Icelandic securities. Since the beginning of the year they have been net sellers of securities, to the tune of 10.7 b.kr. over the period from January to March. Residents have continued to invest in foreign securities, however. Over the period from January to March their net purchases amounted to 10.3 b.kr. Some connection can be discerned between exchange rate movements and securities trading, as can be expected in an environment of free capital movements. Chart 7 shows residents' purchases of foreign securities.

Interest-rate differential with abroad widens in step with hikes in Iceland

In recent months the Central Bank of Iceland has raised its policy rate by more than most other central banks in major trading partner countries. This has naturally widened the interest rate differential with abroad. Among other central banks, the Federal Reserve has raised its

policy rate most frequently of late, hiking its funds rate in eight equal steps from 1% to 3% in the space of roughly a year.

Equity prices climb on Iceland Stock Exchange

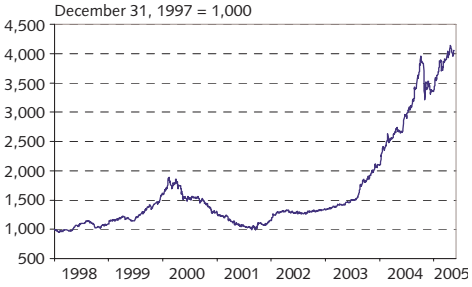
Iceland's equity market has been fairly lively and prices have continued to climb over the past few months. The ICEX-15 index passed the 4,000-mark on April 6, less than nine months after it moved above 3,000. In April and May it has hovered in the range 3,950 to 4,150 as shown on Chart 8. Four fewer companies are now listed than at the beginning of the year, but there are some hopes of an increase again – for example, one foreign company has announced plans to apply for a share listing.

Chart 8

The ICEX-15 equity price index

Daily data January 6, 1998 - May 17, 2005

December 31, 1997 = 1,000



Source: Iceland Stock Exchange (ICEX).

Birgir Ísl. Gunnarsson
Chairman of the Board of Governors, Central Bank of Iceland

Successful economic policies must not be abandoned for short-term fixes

Address to the Annual Meeting on March 30, 2005[1]

On behalf of the Board of Governors of the Central Bank of Iceland I welcome you all to the Bank's 44th annual meeting. The Bank's financial accounts for the year 2004 have been ratified today by the Prime Minister. The Bank's annual report has also been published. It includes a survey of the Bank's activities and operation, along with a report on the Bank's monetary policy and actions, the financial system, financial stability and the financial markets, and the main features of economic developments in the course of last year.

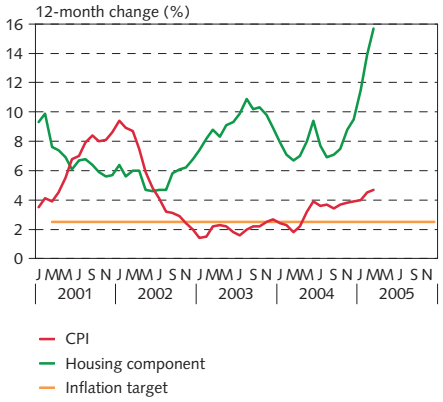
Price stability is the main objective of monetary policy

Under the Act on the Central Bank of Iceland that was passed by Parliament four years ago, the main objective of monetary policy is price stability. The joint declaration by the Government and the Central Bank from March 27, 2001 set a formal inflation target for the Central Bank, i.e. it is obliged to aim at a rate of inflation, measured as the annual twelve-month increase in the CPI, of as close to 2½% as possible. Since price stability is the Bank's main objective, monetary policy will not be applied to achieve other economic targets such as a balanced current account, high level of employment or specific exchange rate, except insofar as these are compatible with the Bank's inflation target.

Inflation beyond the tolerance limit in February 2005

Inflation rose in 2004 after being close to or marginally below the 2½% target since the end of 2002. The rate of inflation was 4% from the beginning to the end of the year. At the beginning of March this year, inflation measured 4.7%, having moved above the 4% tolerance limit defined in the joint declaration by the Government and the Central Bank from March 2001. When inflation moves beyond the tolerance limit, the Bank is obliged to submit a report to the Government explaining the reasons for the deviation, how the Bank intends to react and how long it will take to reach the inflation target again in the Bank's assessment. The report shall be made public. Such a report was sent to the Government on February 18 and published the same day.

Chart 1
The CPI and the housing component of the CPI
January 2001 - March 2005



Source: Central Bank of Iceland.

1. Translated from Icelandic.

Stepped-up aluminium investments and structural changes in the mortgage loan market drive domestic demand and inflation

There are a number of explanations for the recent rise in inflation. Large investments in aluminium smelters and power sectors have built up demand pressures in the economy. These investments will be stepped up this year, when they will peak instead of in 2006, as assumed under earlier plans. Investment cost this year is estimated at 85 b.kr., or almost 10% of GDP in 2004. New conditions in the credit market have also driven inflation. Plans by the Housing Financing Fund (HFF) to raise its loan-to-value ratio and maximum mortgage amounts prompted a response from the banks, which began offering mortgage loans on far easier terms than had been customary. So far the main impact of increased credit supply on the price level has been through the housing component of the Consumer Price Index (CPI). In the beginning of March the twelve-month rate of increase in housing prices was 24%. Excluding the housing component, the CPI had increased by 2% over the same period. Housing inflation has therefore clearly made a major contribution to total inflation in recent months. Another cause of concern is inflation in services. Over the past twelve months, prices of public services have risen by 6.9%, driving up the CPI by 0.5 percentage points, and private sector services by 3.5%, adding a further 0.8 percentage points. Rising prices of private sector services have often been an indication of mounting demand pressures.

Economic policy challenge is to prevent overheating

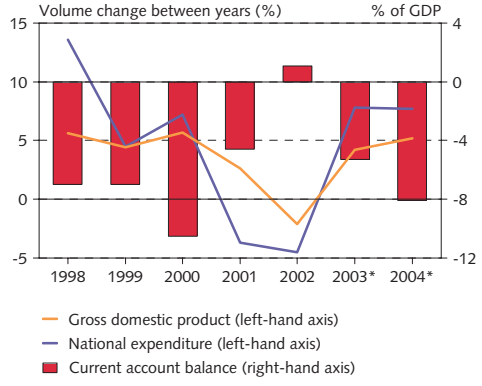
According to estimates by Statistics Iceland, GDP growth amounted to 5.2% in 2004, on the back of 4.2% growth in 2003. Faster GDP growth was largely the result of a continued surge in national expenditure, while exports also increased significantly after a low in 2003. Private consumption also continued to firm up during the year with an estimated growth rate of 7.5%, the fastest for five years. Real disposable income increased more slowly than in 2003, but private consumption was spurred by lower mortgage debt service and easier access to credit. Investment grew by an estimated 12.8%, somewhat less than in 2003. GDP growth in the euro area is estimated at 1.9% in 2004 and growth prospects are lean for the years to come. This shows yet again the difference in the economic challenges faced by Iceland and the rest of Europe, since policies there aim at stimulating the economy, whereas Iceland's problem is to try to prevent overheating.

Current account deficit a cause for concern

The widening current account deficit is also a cause for concern. Last year it is estimated at 70 b.kr., the equivalent of 8% of GDP. Exports increased by 12% in 2004 after being virtually stagnant in 2003. The strong value of the króna, robust private consumption and stepped-up investments in aluminium-related projects are reflected in substantial import growth during the year. Merchandise imports were up by 23% in real terms, the sharpest increase since 1998. Roughly one-third of the current account deficit may be attributed to invest-

Chart 2

Economic growth and the current account balance 1998-2004



Source: Statistics Iceland.

ments in the aluminium and power sectors. The current account deficit is forecast to widen even further in 2005, but will also peak this year instead of in 2006, as had been forecast earlier.

Imported labour has prevented pressures in the labour market

Unemployment declined slowly last year despite brisk economic activity. It was not until the closing months of the year that labour market statistics indicated mounting pressures. Seasonally adjusted unemployment measured 2.4% in February and vacancies have soared. To some extent, growing labour demand was met with imported labour; issues of new work permits almost doubled in 2004. However, the number of new work permits has not increased year-on-year over the past quarter. More labour has been imported to meet the labour requirement on aluminium and power sector projects, but it has increased in other sectors as well.

Lower inflation important to avoid triggering a wage review

Private sector wage settlements agreed in the first half of 2004 were broadly uniform and their cost effect more or less consistent with the inflation target. The settlements are in force for four years but may be renegotiated at the end of 2005 and 2006 if inflation moves out of line with the target and the increased wage costs that they imply are not adopted across the labour market in general. This is one example of the importance of keeping inflation as close to target as possible later this year.

Unrealistic to expect the Central Bank to fine-tune the exchange rate

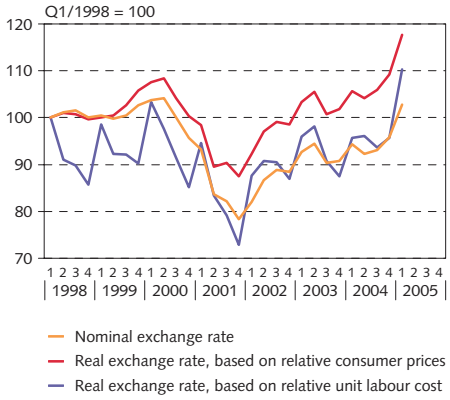
When Iceland moved onto an inflation target, this involved abandoning the fixed exchange-rate regime and allowing the króna to float in the market. Experience has shown that, in a climate of unrestricted cross-border capital movements, it is impossible for a central bank to control the exchange rate. Central Bank interest rate decisions admittedly affect the nominal exchange rate, but many other factors operate as well. Thus it is totally unrealistic to insist that the Central Bank should keep the exchange rate at a certain level and find the right combination of interest rates and exchange rate, whatever that may be. To do so, the Bank would either need to abandon its inflation target or impose foreign exchange restrictions, which of course is unrealistic. After depreciating at the beginning of 2004, the króna remained fairly stable until it appreciated noticeably towards the end of the year. It continued to appreciate in the New Year and is currently higher than it has been since early 2000.

The Central Bank had warned that aluminium industry investments would force up the real exchange rate ...

The exchange rate of the króna has a widespread impact on the Icelandic economy. It directly affects the prices of imports and exports of goods and services. The combined value of Iceland's imports and exports in recent years has been equivalent to 75-80% of GDP. The real exchange rate may be defined as the development of domestic

Chart 3

The nominal[1] and real exchange rate of the króna Q1/1998 - Q1/2005



1. An appreciation in the nominal exchange rate of the króna (decrease in the exchange rate index) is shown by an upward path.
Source: Central Bank of Iceland.

prices or unit labour costs relative to trading partner countries, based on a given reference year and measured in the same currency. A rise in the real exchange rate implies that prices or labour costs in Iceland have increased by more than among trading partner countries after adjustment for changes in the exchange rate, i.e. the competitive position of domestic sectors has deteriorated. When it was decided to launch the large-scale investment projects for the aluminium industry that are currently under way, it was perfectly clear that the real exchange rate of the króna would rise considerably, as the Central Bank repeatedly pointed out in its public statements. In particular, the real exchange rate would be driven up by a rise in the nominal exchange rate caused by heavy capital inflows. If inflation could not be kept under control, the real exchange rate would also increase as a result.

... so the increase should not have come as a surprise

Thus the task has primarily involved controlling the way that developments unfold, and in the Central Bank's view the worst path would have been if the real exchange rate had been driven up by domestic inflation. We are familiar with such cycles from historical experience and neither businesses nor households benefited from them. The Central Bank's approach was therefore to raise its policy interest rate, causing a corresponding increase in the nominal exchange rate, in an attempt to prevent the real exchange rate from rising in step with inflation. An easier monetary stance may lead to a lower nominal exchange rate in the short run, but not to a lower real exchange rate in the long run. Lower interest rates would eventually lead to more inflation and wage rises, which in the final analysis would probably move the real exchange rate to broadly the same level as if monetary policy had been kept tight from the outset. The chief difference would simply be a much higher rate of inflation when the inevitable exchange rate adjustment arrived as the aluminium-related investments came to an end. There is no question that the high real exchange rate has squeezed the export and traded goods sectors, but it was known that such difficulties would emerge when the investments peak, so it should not have come as a surprise. However, the sectors that have been affected would be in an even tougher position with a lax monetary stance at present, which would leave us facing a much higher rate of inflation and a strong real exchange rate at the end of this expansionary episode. Tightening the monetary stance under such conditions could also provoke problems and shocks for the financial system, with unforeseeable consequences.

Real exchange rate no more volatile than in other countries

The real exchange rate is heading for a historical high this year which is unlikely to be sustainable for very long. It is important to engineer as soft a landing as possible. In this context I want to mention the study in the latest *Monetary Bulletin* which shows that the real exchange rate is no more volatile in Iceland than in other countries, for example other inflation-targeting countries with which we often

compare our performance. On the other hand, the importance of foreign trade varies from one economy to the next, so exchange fluctuations have a different impact on households and businesses in different countries.

International expansion by commercial banks calls for review of working procedures

According to the Central Bank Act, one of the Bank's roles is to promote an efficient and safe financial system, including payment systems domestically and with foreign countries. I shall not dwell on financial stability issues on this occasion. The reason is that the Central Bank will be publishing a separate financial stability report in April which will include its assessment of the position of the financial system. However, I would like to mention two points which are closely related to financial stability. One is the noteworthy overseas expansion by Icelandic banks, which has major ramifications for the financial system. Among the changes that this entails is that the banks are now less exposed to volatility in the Icelandic economy, because of the large share of their activities that has been transferred abroad. At the same time, they are left more prone to shocks originating in foreign markets. This development calls for a review of the Central Bank's working procedures. I shall not go into details here of possible changes, which were discussed in *Monetary Bulletin* last autumn.

Review of the role of the Housing Financing Fund is necessary in light of unfolding events

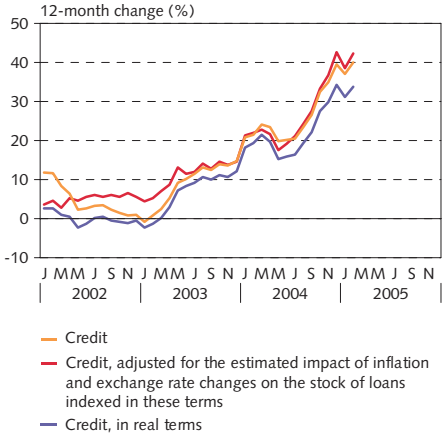
The other point is the growth in lending by the credit system, in particular by the banks. The surge in lending over the past two years is a cause of concern both for financial stability and the Central Bank's inflation target. Accounts of the credit system are published quarterly and the most recent statistics show that lending by the credit system as a whole increased by 16% in real terms last year. The credit system embraces all undertakings involved in lending activities, including the HFF and the pension funds. The latest figures for the largest credit institutions show that domestic lending by the deposit money banks (DMBs) grew by 40% over the twelve months to the end of February. By far the greatest increase has been in mortgage lending. From August to the end of February the DMBs had disbursed 14,500 mortgage loans, for a total of 158 b.kr. In the opposite direction, pension funds' loans to members contracted over the same period by 6 b.kr. and lending by the HFF by 59 b.kr. The transfer of mortgage lending to the banking system is beneficial and will strengthen it in the long run. However, the timing of this development during a strong expansionary phase is inappropriate. Given the way that events have unfolded, a review of the role of the Housing Financing Fund and the legislation governing it has become very necessary.

Banks responsible for national debt growth ...

Excluding their direct foreign operations, the DMBs' foreign debt amounted to 1,200 b.kr. at the end of January, and had grown by 561 b.kr. over the previous twelve months. The lion's share of this debt is

Chart 4

Growth in bank credit to domestic sector
January 2002 - February 2005



Source: Central Bank of Iceland.

long-term, which is a great improvement from the times when the banks were overdependent on short-term borrowing for their funding. Their foreign assets have grown as well, but not in pace with their debts. Foreign assets of DMBs amounted to 590 b.kr. at the end of January, having grown by 312 b.kr. over the previous twelve months. Iceland's external debt, which is largely comprised of the banks' foreign debts, is one of the weakest links in its economy. All the agencies that issue sovereign ratings for Iceland identify this as a risk and warn that increased indebtedness could lead to a down-grading of its credit ratings. The banks therefore bear a great responsibility in this respect.

... so they have to make similar demands towards themselves as towards the Central Bank and the Government

The only conclusion that can be drawn from the massive growth in lending by the banks is that they have overstepped the mark. There is no question that this surge in lending is a major contributor to the current expansionary forces in the economy, which have fuelled inflation and call for a higher policy interest rate than otherwise. The banks are a pillar of the Icelandic economy. They insist that the Central Bank and the Government should act with restraint and promote economic stability, so they also have to make comparable demands towards themselves. In the long run, no economy can sustain this huge expansion in credit that originates in the banking system.

Outlook for vigorous expansion into next year

Last week the Central Bank published its quarterly *Monetary Bulletin* in which it discusses economic and monetary developments and prospects and has published its new macroeconomic forecast. Without going into detail here, the broad finding is that robust private consumption will continue and investment will increase, especially business investment, for reasons including that aluminium-related projects have been stepped up for this year, as I mentioned earlier. Public consumption growth is expected to be modest, however. GDP growth will be 6.4% this year. It will be marginally less next year, when growth of private consumption and investment will also slow down. The positive output gap will widen considerably this year and in 2006. This year the current account deficit will peak at 12% of GDP, then shrink next year, contrary to previous forecasts. From all this it is clear that the economy will be characterised by vigorous expansion this year and into 2006.

Need for further tightening

According to the inflation forecast also published in *Monetary Bulletin*, the outlook for inflation has improved since the previous forecast in December but will remain above target two years ahead. The higher policy rate and a substantial appreciation of the króna will subdue domestic demand and dampen rises in import prices, especially in the short term. Inflation will therefore be somewhat lower over the forecast horizon than was forecast in December. The

Central Bank forecasts an inflation rate around the 2½% target one year ahead, which is lower than forecast in December. Two years ahead, inflation is forecast at just over 3%, which is also somewhat lower than the rate forecast in December, although still above target.

It is important to remember that an unchanged monetary policy stance and unchanged strong exchange rate are assumed over the forecast horizon. The forecast describes the way that the Bank considers developments are most likely to unfold if it takes no further measures than it had already taken. Obviously, uncertainty increases over the horizon of the forecast. A particular uncertainty is the exchange rate, which is at a historical high at present as I have discussed, posing a higher probability that it will give way over this period and inflation will increase. In light of this forecast, at the same time as *Monetary Bulletin* was published the Central Bank decided to raise its policy interest rate by 0.25 percentage points, which is a somewhat lower hike than market agents had predicted and also less than the Bank's other recent policy rate rises. The policy rate is therefore currently 9%. Among other things, the decision to take a relatively modest step now is based on the fact that the tightening implied by the recent policy rate hikes and the significant appreciation of the króna have yet to be transmitted in full. Nonetheless, further tightening may be necessary over the next few months.

Monetary policy debate bears witness to a deeper understanding of economic principles, but focuses unduly on short-term effects

Comparisons with previous forecasts and various indicators suggest that since December the Central Bank's policy rate hikes have by and large delivered a tighter stance. The Central Bank's monetary policy is very much debated in society at large at the moment, which is natural given the great interests at stake. Obviously I have closely followed discussions of monetary policy for a fairly long time and must admit that the debate in recent times has been more mature and bears witness to a deeper understanding of economic principles than before. It is normal for opinions to be divided over the Central Bank's measures during tight stances such as the present. The Central Bank welcomes public debate and is ready to take part in it. I would like to use this opportunity to address a few points that have been raised in this debate recently.

Effect of interest-rate decisions not transmitted in full until after 1-2 years

Sometimes it is alleged that monetary policy is impotent in a climate of heavy capital inflows. Claims are also heard that the Central Bank's monetary policy measures only exert an influence through the exchange rate and have no effect on long-term interest rates, and absolutely not on indexed interest rates. Certainly, a tight monetary stance does put significant upward pressure on the exchange rate, contributing to lower inflation in the short run. Central Bank policy rate hikes also have a very swift effect on the money markets, and interest rates on other instruments with maturities of a few months or years are soon influenced too. Central Bank policy rate decisions also

have an impact on long-term interest rates, both indexed and non-indexed. All research in Iceland and everywhere else confirms this, but because the effect is transmitted with a long lag, monetary policy must be forward-looking. Interest rate decisions made today are not transmitted in full to long-term interest rates until one or two years hence. Thus the debate often focuses on the short-term effects of monetary policy, but people need to be patient and bear in mind the impact which does not emerge until well into the future. The Central Bank does not have the slightest doubt that interest rate changes in Iceland ultimately have the same effect as those in other countries, in other words that general economic principles apply just as much in Iceland as anywhere else.

Changing the minimum reserve requirement is not a transparent measure and can affect individual credit institutions unequally

When monetary tightening is beginning to have an effect and specific sectors of the economy bear the brunt, it is normal to ask whether there are no softer alternatives, which preferably affect no one. In the search for such approaches, it is sometimes claimed to be preferable to target liquidity through minimum reserve requirements, rather than interest rates, or to change the composition of the CPI, for example by excluding housing costs, which in fact would leave the rate of inflation within the target at the moment. The Central Bank has explained its position towards both these ideas. Regarding minimum reserve requirements, the Bank has pointed out that strong domestic financial institutions have various possibilities for sidestepping the effects of tighter liquidity. Individual credit institutions would therefore be affected very unequally. Such a measure would doubtless hit the savings banks very hard, since they do not have the same scope as the commercial banks for sidestepping the effects. International experience also shows that the impact of changes in minimum reserve requirements is extremely difficult to predict. For individual institutions, the consequences could be very significant. This is the main reason that none of the world's main central banks use changes in minimum reserve requirements as a policy instrument any longer. However, even if liquidity controls worked, their impact on interest rates and the exchange rate would be broadly the same as raising the policy rate, although the transmission mechanism might be different, and they would affect individual segments of the credit system unevenly. In addition, changing the minimum reserve requirement is not a transparent measure and its impact on expectations is unpredictable.

Housing costs should remain part of the reference index for the inflation target

The Central Bank firmly advocates that housing costs should remain part of the reference index for the inflation target, and believes that by and large the best available methodology is being used by Statistics Iceland to evaluate them. This is because housing costs are a major item in household consumption in Iceland, where the level of owner-occupancy is 80%. Excluding changes in housing prices would

ignore a large proportion of household expenditures. Experience also shows that housing inflation has the advantage, from the perspective of central banks on an inflation target, of being a leading indicator of general inflation later on. Presumably this is because the housing market is independent from foreign markets. Increased housing demand cannot be channelled out of the economy, unlike various other goods and services, nor is foreign competition present to any significant extent. When demand surges, housing prices often rise sooner and by more than prices of goods and services in general. It may be added that if housing prices had not been included in the CPI, the rate of inflation would have exceeded 10% in the recessionary year of 2001, which would have demanded even tougher measures on the part of the Central Bank than were applied then.

More resilient and reformed economy reflected in upgraded credit rating ...

Standard & Poor's recently upgraded its credit rating for the Republic of Iceland, which now has very good ratings from the three main sovereign ratings agencies, i.e. Standard & Poor's, Moody's and Fitch. All the agencies keep a very close watch on economic developments in Iceland. Because Standard & Poor's has recently upgraded Iceland's sovereign rating, it is interesting to examine the main points in its rationale, both the positive factors that support the rating and others that are identified as potentially weakening it.

The agency says that its upgrade reflects significant and sustained improvements in the resilience and structure of the Icelandic banking sector. Improved regulation and supervision leave the financial sector much more resilient. The recent entry of the commercial banks into the Icelandic mortgage market provides the private financial sector with additional domestic stability and profitability. Public finances continue to be healthy and Iceland boasts stable and flexible political institutions.

... but it could be lowered again if net external leverage increases significantly

However, the agency also points to very high and rising levels of net external debt throughout the economy, high current account deficits and relatively poor external liquidity. Adherence to the government's medium-term fiscal framework is central to maintaining the ratings and further unforeseen adjustment would need to be accommodated through fiscal policy, not monetary policy. Any significant increase in net external leverage or a recurrence of entrenched macroeconomic imbalances on the back of the large investment projects could weaken Iceland's creditworthiness. These were the main points highlighted by Standard & Poor's and there is every reason to take them seriously. Of course it is crucial for the Republic to enjoy a good credit rating. It is important for the Treasury's access to markets and investors, and for its credit terms. Iceland's sovereign rating also represents the ceiling for ratings of Icelandic banks and other rated institutions. Favourable ratings are vital for the banks' expansion abroad and for their growing need for easy access to foreign credit.

Thus the Treasury and the banks share an interest in Iceland being able to maintain its good credit rating.

Short-term solutions could backfire

Ladies and Gentlemen: As I mentioned earlier, the Central Bank raised its policy interest rate by 0.25 percentage points last week. The Bank has thereby raised its policy rate by 3.7 percentage points since its first hike in May last year. These measures reflect the Central Bank's view that, given the current economic situation and the scenario two to three years ahead, it is much more effective to ensure a sufficiently tight stance in good time rather than to wait and take action later. Belated measures to tighten the monetary stance entail a risk of higher inflation afterwards, and thereby a far greater risk for the financial system, businesses and households. It is crucial to take immediate measures to tackle the inflation that we see on the horizon. This is the Central Bank's mandatory role and the Bank is determined to perform it. The more that other economic agents contribute towards containing expansionary trends, namely the central government, local government and credit institutions, the easier it will be to ensure long-term stability. The successful economic policies of past years must not be swept aside in favour of short-term solutions that would ultimately only backfire.

I would like to conclude by thanking the Office of the Prime Minister and other government authorities for their pleasant co-operation. Davíð Oddsson stepped down as Prime Minister on September 15 last year and he is thanked for his good cooperation with the Central Bank. At the same time I welcome Halldór Ásgrímsson to the Annual Meeting for the first time as Prime Minister, and look forward to good cooperation with him. Last but not least, I would like to thank the employees of the Central Bank for their fine work, without which the Bank could not have achieved such impressive results.

Gudmundur Gudmundsson[1]

Risks in higher loan-to-value ratios of housing

Considerable changes have taken place in housing finance arrangements in Iceland recently. Mortgage loan amounts have increased, interest rates have been reduced and the loans provided by banks are now similar to those from the Housing Financing Fund. The following article discusses the consequences of these changes for the finances of borrowers and deposit institutions, and their impact on financial stability.

The state Housing Financing Fund (HFF) has been the largest provider of mortgage loans to homebuyers after taking over from the old State Housing Authority. Other major lenders in this field have been the pension funds and deposit institutions. Until recently, HFF loans have carried a maximum loan-to-value ratio of 60-70% (relative to official valuations by the Land Registry of Iceland) as well as a cap on the loan amount. Since pension funds have imposed similarly strict rules on qualification for mortgage, homebuyers have not been able to borrow from them to top up their state loan to the full price of housing, except by securing the new loan with other collateral.

A major change took place in housing market arrangements in the second half of 2004. The banks began offering long-term mortgage loans and now lend up to 100% of market price. The HFF raised its loan-to-value ratio to 90%. Most Icelandic mortgage loans are in annuity format, indexed against the CPI. Each instalment is divided into interest since the preceding due date and a loan repayment. Thus the interest is loaded towards the front end of the loan and decreases proportionally as the residual balance goes down. There are minor differences in the conditions set by credit institutions.[2] All offer mortgages with a maturity of up to 40 years carrying a 4.15% interest rate with price indexation. Those offering a loan-to-value ratio of up to 100% of market price impose certain stricter conditions for the highest loans, but the following discussion will be restricted to a 90% ratio. With a real rate of interest of 4.15% and a maturity of 40 years, the combined real value of interest and repayments will be just over double the original loan amount.

Mortgage loans in other countries

Iceland's mortgage loan market has several quite different features from those in most other countries with comparable living standards. Real interest rates in Iceland are higher, maturities are longer and loans are price-indexed. Uncertainty about price developments decades ahead makes it virtually impossible to negotiate a satisfactory mortgage term for wage-earners which will give the borrower and lender a reasonable idea of the real repayment value, except either

1. The author is a statistician with the Marine Research Institute and the Central Bank of Iceland's Economics Department.
2. See Appendix 4, Economic and monetary developments and prospects, *Monetary Bulletin* 2005/1.

with price indexation or with variable interest rates of some kind, which is the norm in OECD countries. A common loan term there is 15-30 years.[3] In the euro area, average fixed interest rates for the first 5-10 years of a mortgage were just under 5% in 2004 (European Central Bank, 2005). Annual euro area inflation has been about 2%, so real interest rates are just under 3%. The loan-to-(market) value ratio in Iceland is somewhat higher than the OECD norm, although parallels are found.[4]

Table 1 shows annual debt service on a 10 m.kr. loan relative to interest rates, inflation and term in Iceland and the euro area.

Table 1 Annual instalments on a 10 m.kr. loan in Iceland and the euro area

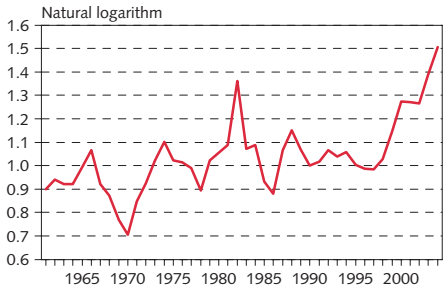
	Interest rate (%)	*Loan term (years)*	*Annual instalments (thousand kr.)*
Iceland, indexed	4.15	40	517
Iceland, non-indexed	8.32	40	867
Euro area, indexed	2.8	30	497
Euro area, non-indexed	4.8	30	636

Since indexed mortgage loans in Iceland carry 4.15% interest, the corresponding nominal rate in real terms with 4% inflation would be 8.32%. Nominal mortgage rates in the euro area averaged 4.8% in 2004 and inflation 2%, corresponding to a real interest rate of 2.8%. Annual instalments on indexed loans increase in pace with inflation, but remain unchanged in nominal terms for non-indexed loans. For a given real interest rate and inflation rate, annual instalments are therefore higher for non-indexed loans than for indexed loans at the front end, then reach a point where debt service on them is lower. Based on the above inflation assumptions, the annual instalment on an indexed loan will be broadly the same as on a non-indexed loan after 13 years in Iceland, but after 12 years in the euro area.

Real house prices in Iceland since 1960 are shown in Chart 1.[5] The data show an upward trend of around 0.7% annually. Various economic explanations for this trend can be proposed but their relevance is more difficult to ascertain and will not be examined here. An upward trend is common in OECD real house prices over this period.[6] However, this is not a universal rule, since some countries show no sign of it and in others it may depend on the choice of model used to assess whether the trend is statistically significant.

One technical reason for the upward trend should be mentioned. The housing price index measures price per square metre of sold housing. Part of the trend shown by the index is caused by gradually

Chart 1
Real house prices in condominiums in the Greater Reykjavík Area 1961-2004[1]



1. The scale on the Y-axis is a natural logarithm (1% change = approximately 0.01).
Sources: Land Registry of Iceland, Statistics Iceland, Central Bank of Iceland.

3. Catte et al. (2004), Table 3, shows typical loan terms in 20 OECD countries. Iceland is not included.
4. Catte et al. (2004), Table 3, shows the maximum loan-to-value ratio in 16 OECD countries. It is 80% in 9 countries and higher in the others.
5. Calculated as the ratio between the housing price index and CPI.
6. Girouard and Blöndal (2001), Figure 1, shows real house price developments 1970-2000 in 16 OECD countries. Iceland is not included.

increasing quality of the housing that it measures and therefore does not apply to price developments of individual properties.

The standard deviation for trend-adjusted data is around 11%. This is the average price in sales contracts for each year, so it is less volatile than the price of individual dwellings.

Iceland has experienced major changes in both the inflation rate and the credit market structure over the period covered by these data, which diminishes their predictive value. However, a similar degree of volatility to that shown in Chart 1 was common over the same period in countries where price developments and lending arrangements were completely different and closer in line with the current situation in Iceland.[7] This warrants an examination of the consequences that changed mortgage loan arrangements will have, assuming that real house prices continue to fluctuate on the scale experienced hitherto.

Changes in residual balance of loans and real house prices

Chart 2 shows the residual balance of indexed loans and interest due before payment of instalments for loans with an original value of 90% of market price. Two examples of loans are shown, with respective terms of 25 and 40 years and carrying 4.15% interest. The chart shows that the debt is still equivalent to 80% of the original market price 10 years after a 40-year loan is taken. Relative to the current value of the property bought for the loan, the ratio is even higher. Housing depreciates in value and the Land Registry[8] calculates a factor of 1% p.a. for the first ten years after construction and 0.3% for older housing. It takes 12 years until the residual balance on a 40-year loan has decreased to 80% of house value when an instalment is paid, assuming an 0.3% annual rate of depreciation. This calculation does not incorporate the real house price trend, which if it is positive lowers the ratio of residual balance to house value.

According to the Central Bank housing finance report (2004), simple time series models do not fit the series in Chart 1 perfectly and the characteristics of the series are unlikely to remain unchanged for the next 40 years. Nonetheless, the chart gives a fair idea of how the probability of house mortgage equity turning negative would be affected by raising the loan-to-value ratio from 70% to 90%.

Based on the series in Chart 1, only those who bought housing in 1966 and 1982 experienced a period of negative mortgage equity on a 70% loan. This happened in 1970 for those who bought housing in 1966, and in 1985 and 1986 for buyers in 1982. However, a large proportion of homebuyers with a 90% loan-to-value ratio would have seen their mortgage equity turn negative, sometimes for several years. Clearly, even if house price volatility diminishes in the coming years, a period is likely to occur when those who bought housing over the past decade or even earlier with a 90% loan-to-value ratio will experience negative equity. Such spells could last much longer than one or two years.

Chart 2
Indexed residual balance and interest due as a % of original purchase price

Based on a 90% loan-to-value ratio with a real interest rate of 4.15% and terms of 25 years and 40 years

7. Girouard and Blöndal (2001), Figure 1.
8. See the Land Registry website, www.fmr.is.

Judging from the description of the mortgage markets in OECD countries given in Catte et al. (2004) and Girouard and Blöndal (2001), the risk of negative equity appears to be considerably higher in Iceland than in most of the OECD, where the maximum loan-to-value ratio is commonly 80%. Furthermore, the proportion of residual balance to house price also falls more quickly in those countries than in Iceland, due to their shorter loan terms and the erosion of the real value of non-indexed loans by inflation.

Borrowers' debt burden

Even though the 90% loan-to-value ratio is a recent innovation in Icelandic housing finance, there is nothing new about some homebuyers being so highly mortgaged. It has naturally been quite common for first-time buyers not to have the balance between an HFF mortgage loan and the full house price. (From the trends in Chart 2 this can also be expected to have applied to some buyers who changed housing after 5-10 years). This gap has been bridged by loans secured with collateral in other properties or by third-party guarantees. Bridge loans have generally carried higher interest rates and been for shorter terms than state mortgage loans. Converting them to the same format as public lending system loans will ease debt service. Presumably, however, the availability of a loan-to-value ratio of 90-100% will lead to an increase in the amount of housing with zero or negative equity. Easier access to credit will encourage people to move on to the housing ladder earlier and buy more expensive housing. The changes have thus induced factors that ought to ease homebuyers' debt service capacity and others that squeeze it. Little is known about the scale of the impacts mentioned here and data are not available to assess them.

Even if mortgage equity turns negative for some while, it will not seriously affect an owner-occupier who plans to continue to own the housing and can afford to meet the repayments on it, although he will not be able to use it as collateral to secure more credit. However, borrowers in liquidity difficulties who owe more than their housing is worth are differently placed, depending upon whether the debt is secured entirely against the housing itself or whether part is secured with other collateral. If the loans secured against the housing are less than its market price, the owner can sell it and move to rented accommodation or buy somewhere cheaper and withdraw mortgage equity to restore his liquidity. Chart 1 indicates empirically that doing so would often have sufficed to bridge the gap until the next economic upswing. Such a recourse is not available to a homebuyer who is in liquidity difficulties and has negative mortgage equity. Labour mobility is also impaired if housing cannot be sold because it is overmortgaged.

Lender risk

Research by the University of Iceland Institute of Economic Studies (2003) and Central Bank of Iceland (2004) shows a strong correlation between general wage developments and housing prices. A relatively high proportion of homebuyers are therefore likely to encounter re-

payment problems when real house prices turn downwards. It is worth examining what effect a 90% loan-to-value ratio would have on the position of banks in such a scenario.

Iceland's credit market is in the process of major changes besides higher loan-to-value ratios. Household debt remained very low when lending was not price-indexed and amounted to 26% of disposable income in 1980. It had risen to 83% in 1990 and 89% in 2000, and the outlook is that household debt was equivalent to 188% of disposable income in 2004. Interest payments alone therefore consume a fairly large share of disposable income. There is every reason to assume that a substantial contraction in real income would drive debt delinquency by wage-earners to a level that is unparalleled in previous contractions. While it is uncertain how large a share of mortgage loans will ultimately shift from the state housing credit system to deposit institutions, their share in total household credit has already clearly soared.

In a reasonable or good economic climate, some households will still end up in liquidity difficulties and the most suitable action for a deposit institution may be to repossess. The situation is different in the case of economy-wide illiquidity. At such times, housing prices can be expected to drop and housing market activity to shrink. If deposit institutions then repossess and spur housing sales to any degree, this could bring down housing prices even further. The main recourse available to deposit institutions under such circumstances would be to extend the loan term. An obstacle to this option, however, is that the business sector, their other main customer group, would presumably be in difficulties at the same time.

As mentioned earlier, it is not certain that raising the loan-to-value ratio to 90% will increase mortgage delinquency. But a borrower facing tight liquidity is better placed with a lower loan-to-value ratio, and so is the lender. It is easier to defer payment or top up a loan for a borrower whose assets are not fully mortgaged. And when part of the debt is secured with a third-party guarantee or collateral, the owners of that asset are likely to help to ensure that debt service is met.

From a financial stability perspective, it is undesirable to provide mortgages with a loan-to-value ratio above 70-80%, due to the problems that may arise in the event of mass delinquency by owners of overmortgaged assets during an economic contraction. Third-party guarantees of loans are not an ideal solution, although they may have benefits for homebuyers and lenders. Preferably the principle ought to be for homebuyers to pay a rather higher proportion of housing transactions with own savings. For this to happen, interest terms and rental housing market conditions would be required that make it more economical to rent and save part of the cost of a dwelling than to take a higher loan to buy it. From the viewpoint of credit institutions it would be natural to add a risk premium to interest rates for the highest loan-to-value ratios. This would encourage prospective first-time buyers to save in advance, but would admittedly also increase the share of loans with third-party guarantees. The deposit institutions' scope for pricing their loans to match the risk is none-

theless restricted by the HFF's credit terms; the recent upheavals in the mortgage loan market are the result of competition to win borrowers. One productive measure might be to channel saving systematically into this area, e.g. with something akin to the old compulsory savings system or to the supplementary pension savings schemes that are now part of general wage terms. However, neither option would be suitable in unchanged form.

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Monetary policy and instruments

The target of monetary policy

The target of monetary policy is price stability. On March 27, 2001 a formal inflation target was adopted, as follows:

- The Central Bank aims for an annual rate of inflation, measured as the annual twelve-month increase in the CPI, which in general will be as close as possible to 2½%.
- If inflation deviates by more than ±1½% from the target, the Central Bank shall be obliged to submit a report to the government explaining the reason for the deviation, how it intends to respond and when it expects the inflation target to be reached once again. This report shall be made public.[1]
- The Central Bank publishes a quarterly inflation forecast, projecting two years into the future, and explains it in *Monetary Bulletin*.

Since monetary policy aims at maintaining price stability, it will not be applied in order to achieve other economic targets, such as a balance on the current account or a high level of employment, except insofar as this is consistent with the Bank's inflation target.

Main monetary policy instruments

In particular, the Central Bank implements its monetary policy by managing money market interest rates, primarily through interest rate decisions for its repurchase agreements with credit institutions. Yields in the money market have a strong impact on currency flows and thereby on the exchange rate, and in the long run on domestic demand. Broadly speaking, transactions with credit institutions can be classified into fixed trading instruments and market actions.

Fixed trading instruments:

- *Current accounts* are deposits of the credit institutions' undisposed assets. These are settlement accounts for netting between deposit institutions and for interbank market trading, including transactions

Overview of Central Bank interest rates May 17, 2005

	Current rate (%)	*Last change*		*Rate one year ago (%)*
		Date	*Percentage points*	
Current accounts	7.25	April 1, 2005	0.50	3.0
Overnight loans	10.75	February 21, 2005	0.50	7.9
Certificates of deposit (90 days)	8.50	April 1, 2005	0.25	5.0
Required reserves	8.00	April 1, 2005	0.25	4.3
Repos	9.00	March 29, 2005	0.25	5.5

1. The Central Bank was to attain the inflation target of 2½% no later than by the end of 2003. In the interim the upper limit for inflation was set at 3½% above the inflation target in 2001, and 2% in 2002.

with the Central Bank. Interest rates on these accounts set the floor for overnight interest rates in the interbank market.

- *Overnight loans* are provided on the request of credit institutions and secured with the same securities that qualify for repo transactions (see below). Overnight interest rates form the ceiling for overnight interest rates in the interbank market.
- *Certificates of deposit* are issued with a maturity of 90 days, on the request of credit institutions. Although they are unlisted, they qualify for repo transactions. Their role is to establish the floor for three-month yields in the money market.
- *Required reserves* are made with the Central Bank by credit institutions which are not dependent on Treasury budget allocations for their operations. The required reserve base comprises deposits, issued securities and money market instruments. The required reserve ratio is 2% for the part of the required reserve base which is tied for two years or longer. The maintenance period is based on the 21st day of each month until the 20th of the following month, and the two-month average reserve is required to reach the stipulated ratio during the period.

Market actions:

- *Repurchase agreements* are the Central Bank's main instrument. Auctions of 7-day agreements are held every week. Credit institutions need to put up securities that qualify as collateral. Fixed-price auctions have been used so far.
- *Certificates of deposit* with a maturity of 7 days are auctioned weekly. Their function is to counteract temporary surplus liquidity in the banking system. The Dutch auction format is used.
- *Securities market trading* is limited to Treasury-guaranteed paper and is rarely used.
- *Foreign exchange market intervention* is only employed if the Central Bank considers this necessary in order to promote its inflation target or sees exchange rate fluctuations as a potential threat to financial stability.

Economic and monetary chronicle

March 2005

On March 7, Moody's Investors Service upgraded the long-term deposit and senior debt ratings of Landsbanki Íslands hf. to A2 from A3. The outlook on these ratings is stable. At the same time, Moody's affirmed with a stable outlook its financial strength rating of C (outlook changed to stable from positive) and the P-1 short-term deposit and debt ratings.

On March 15, Íslandsbanki hf. increased its share capital by a nominal value of just over 134 m.kr. Shareholders were given the option of receiving part of their dividends in the form of these new shares at the price of 10.65 kr. per share. After the increase, Íslandsbanki's listed nominal share capital amounts to 13,134 m.kr.

On March 16, Landsbanki Íslands hf. announced its completion of a €350m (28 b.kr.) subordinated bond issue under its EMTN programme. It consisted of two tranches: €150m of Tier I capital and €200m of Tier II capital.

On March 18, Straumur Fjárfestingarbanki hf. investment bank announced an issue of subordinated bonds in the amount of 5 b.kr. This was Straumur's first subordinated debt issue and was classified as Tier II capital.

On March 22, the Governors of the Central Bank of Iceland announced that the Bank would raise its policy interest rate (i.e. its repo rate in transactions with credit institutions) by 0.25 percentage points to 9% as of March 29. Other interest rates were also raised as of April 1: on credit institutions' current accounts in the Bank by 0.5 percentage points and on their reserve accounts by 0.25 percentage points.

On March 31, Straumur Fjárfestingarbanki hf. investment bank increased its share capital by a nominal value of 700 m.kr. After the increase, Straumur's listed nominal share capital on Iceland Stock Exchange (ICEX) was 6.1 b.kr. Sale price of the new shares was 7 b.kr.

April 2005

On April 1, Bolig- og Næringsbanken ASA (BNbank) of Norway became part of the Íslandsbanki hf. consolidated accounts after all conditions for Íslandsbanki's acquisition of it had been fulfilled. Íslandsbanki originally bid for all the shares in BNbank on November 15, 2004. The offering price was NOK 3.3 b. (35 b.kr.) and the final condition for the acquisition was fulfilled on March 15.

On April 13, Íslandsbanki hf. announced that its subsidiary ISB Luxembourg S.A. had formally started operations and lending activities of Íslandsbanki's branch in Luxembourg would be transferred to it.

On April 18, Landsbanki Íslands hf. increased its share capital by a nominal value of 800 m.kr. After the increase, Landsbanki's listed

nominal share capital on ICEX was 8.9 b.kr. Sale price of the new shares was 11.4 b.kr.

On April 19, Íslandsbanki hf. sold 66.6% of shares in its insurance subsidiary Sjóvá to Þáttur eignarhaldsfélag ehf. holding company for 17.5 b.kr. Sjóvá thereby ceased to be part of the Íslandsbanki consolidated accounts. After the sale, Íslandsbanki holds 33.4% of shares in Sjóvá.

May 2005

On May 2, it was announced that the Central Bank would purchase foreign currency in the domestic interbank market on behalf of the Treasury, in connection with a discretionary prepayment of Treasury foreign debt. The purchase was made in tranches of 20 m. US dollars each, on May 12, 17, 19, 23 and 25.

On May 10, Moody's Investors Service affirmed Kaupthing Bank's A1 long-term and P-1 short-term debt and deposit ratings, and its C+ financial strength rating.

On May 10, Moody's Investors Service downgraded the financial strength rating of Íslandsbanki hf. to C+. Moody's affirmed Íslandsbanki's A1 long-term and P-1 short-term debt and deposit ratings, with a stable outlook.

Tables and charts

Based on statistical information available on May 17, 2005. A list of symbols is on p. 2.

A Tables

B Charts

Table 1 Main monthly indicators (continued on next page)

	Consumer prices		Exchange rate		Interest rates (end of period, %)						Money and credit[5]			
	% change in CPI[1] over the previous		% ch. in effective exchange rate [1,2]		Short-term rates			Long-term rates[4]			12-month % change			
	1 month	12 months	1 month	12 months	Central Bank repo yield	3-month REIBOR[3]	3-month Treasury bills	5-y. non-indexed T-notes	10-year Treasury bonds[4]	40-year HFF bonds[4]	Base money	M3	DMB lending[6]	DMB foreign liabilities
1999	.	3.4	.	0.2	9.0	11.7	9.8	9.6	4.7	4.8	75.9	16.9	22.8	15.2
2000	.	5.0	.	-0.1	11.4	12.0	11.5	11.7	5.5	6.3	-10.4	11.2	26.2	33.0
2001	.	6.7	.	-16.7	10.1	12.5	10.0	9.1	5.1	5.9	-14.2	14.9	13.4	-0.2
2002	.	4.8	.	3.0	5.8	6.2	5.8	6.9	4.9	5.2	17.2	15.3	0.9	-5.5
2003	.	2.1	.	6.4	5.3	5.1	4.8	7.5	4.3	4.6	-33.5	22.3	14.8	-5.6
2004	.	3.2	.	2.1	8.25	8.6	7.4	7.8	3.6	4.6	77.7	13.4	39.5	3.2
2003														
July	-0.1	1.6	-2.2	2.7	5.3	5.3	5.1	6.8	4.2	4.6	-2.5	14.8	11.5	12.0
August	-0.1	2.0	-1.9	0.3	5.3	5.2	4.9	6.5	4.0	4.4	5.6	19.6	13.1	1.9
September	0.7	2.2	0.0	2.3	5.3	5.2	4.5	6.3	4.3	4.6	-5.4	23.0	12.4	-9.0
October	0.5	2.2	0.6	3.2	5.3	5.1	4.6	6.9	4.2	4.6	-1.2	25.5	13.9	-16.9
November	0.1	2.5	0.5	3.1	5.3	5.1	4.8	7.1	4.3	4.6	-17.2	23.7	13.6	-7.1
December	0.3	2.7	0.5	1.7	5.3	5.1	4.8	7.5	4.3	4.6	-33.5	22.3	14.8	-5.6
2004														
January	0.0	2.4	3.3	2.7	5.3	5.3	5.1	7.3	4.4	4.7	-12.5	26.4	20.8	-19.1
February	-0.3	2.3	1.1	2.0	5.3	5.3	5.4	7.0	4.1	4.6	-30.0	22.5	21.4	-27.2
March	0.6	1.8	-1.7	0.5	5.3	5.4	5.0	7.0	3.9	4.4	-28.7	24.9	24.1	-25.8
April	0.6	2.2	-1.5	-2.2	5.3	5.4	5.3	7.0	3.7	4.1	-7.7	21.2	23.5	-7.9
May	0.8	3.2	-0.3	-3.7	5.50	5.8	5.6	7.7	4.0	4.3	-32.4	18.4	19.8	-19.1
June	0.8	3.9	0.7	-1.1	5.75	6.1	6.0	7.7	3.9	4.2	-11.7	19.0	20.1	-17.1
July	-0.5	3.6	0.3	1.4	6.25	6.5	6.0	7.6	3.9	3.8	23.8	24.7	20.5	-22.4
August	0.0	3.7	0.5	3.9	6.25	6.6	6.5	7.7	3.7	3.7	-15.8	15.2	23.4	-6.5
September	0.4	3.4	-0.3	3.6	6.75	6.9	6.8	7.5	3.7	3.7	-8.3	20.0	26.6	7.2
October	0.8	3.7	0.6	3.6	6.75	7.2	7.0	7.8	3.7	3.7	3.5	17.4	32.4	7.3
November	0.2	3.8	1.4	4.6	7.25	7.7	7.5	7.9	3.6	3.6	7.4	14.9	34.9	3.3
December	0.5	3.9	4.5	8.7	8.25	8.6	7.4	7.8	3.6	3.5	77.7	13.4	39.5	3.2
2005														
January	0.1	4.0	1.9	7.2	8.25	8.6	7.1	7.7	3.5	3.5	3.9	15.5	37.0	22.2
February	0.2	4.5	1.6	7.8	8.75	9.0	7.8	7.8	3.4	3.5	-13.1	16.4	40.0	40.8
March	0.8	4.7	2.2	12.1	9.00	9.2	8.7	7.9	3.6	3.6	14.7	15.7	41.3	25.1
April	0.2	4.3	-2.3	11.1	9.00	9.2	8.8	7.7	3.5	3.5	...	...	...	...
May†	-0.5	2.9	-3.4	7.7	9.00	9.2	8.8	7.5	3.6	3.6	...	...	...	...

† To May 17, 2005. 1. Percentage changes between period averages. 2. Based on the official effective exchange rate basket (trade-weighted). Positive sign indicates appreciation of the Icelandic króna. 3. Average yield on the interbank market in Icelandic króna. 4. For government bonds and HFF bonds, the quoted yield is in excess of changes in the CPI. Trading with HFF bonds began in July 2004; prior figures are for housing bonds. 5. Annual figures are changes over year. Latest figures are preliminary. 6. DMBs = deposit money banks = commercial and savings banks and other institutions permitted to accept deposits from the public. Foreign lending excluded from January 2002.

Table 1 (continued) Main monthly indicators

	Foreign exchange market and reserves				Foreign trade and external conditions					Labour market		Treasury financial balance, % of rev., from beg. of year[11]	Asset prices, 12-mo. % changes	
	Gross foreign currency reserves:			CB net purchases (b.kr.)	Trade balance (b.kr.)	Merchandise exports (b.kr.)	Merchandise imports (b.kr.)	Marine product prices 12-mo.% ch.[9]	Real exchange rate of króna[10]	Unemployment	Wages, 12-mo. % change		Equity prices[12]	Housing prices[13]
	in b.kr.	as ratio of: Merch. imports[7]	as ratio of: For. short-term liabil.[8]											
1999	35.8	2.6	0.91	12.0	-22.9	144.9	167.8	-4.8	93.6	1.9	6.8	8.7	47.4	22.2
2000	34.2	2.1	0.60	-13.9	-38.0	149.3	187.3	-3.0	96.3	1.3	6.6	5.9	-19.3	13.3
2001	36.6	2.1	0.40	-29.5	-6.7	196.4	203.1	1.6	83.7	1.4	8.8	-0.2	-11.2	3.1
2002	37.2	2.5	0.20	4.5	13.1	204.3	191.2	3.4	88.5	2.5	7.2	-5.6	16.7	7.5
2003	58.1	3.5	0.25	43.2	-16.9	182.6	199.5	0.4	94.2	3.4	5.6	-7.7	56.4	9.1
2004	65.6	3.6	0.24	27.2	-37.8	202.4	240.2	0.6	97.2	3.1	4.7	1.8	58.9	23.3
2003														
July	36.5	2.3	0.17	4.4	-5.0	15.0	20.0	-4.7	93.1	3.0	5.7	-11.4	19.4	13.9
August	41.0	2.5	0.20	4.0	-0.9	14.9	15.8	-1.2	91.4	2.9	5.7	-11.5	38.0	14.9
September	46.4	2.8	0.23	4.4	-4.7	14.6	19.2	0.0	91.5	2.7	5.6	-11.7	39.5	12.6
October	51.7	3.1	0.28	4.4	-2.8	15.8	18.6	0.3	92.4	2.8	5.5	-9.6	48.7	12.4
November	57.8	3.5	0.29	3.8	-0.3	16.0	16.2	1.1	93.1	3.0	5.5	-10.2	52.7	12.7
December	58.1	3.5	0.25	3.7	-2.5	13.7	16.2	-1.4	93.6	3.1	5.4	-7.7	56.4	9.1
2004														
January	56.4	3.4	0.28	7.0	0.3	16.7	16.4	-2.9	96.5	3.7	3.3	20.1	76.8	8.3
February	57.3	3.5	0.28	1.4	0.1	14.3	14.1	-2.3	97.3	3.6	3.3	18.4	89.3	9.2
March	66.7	3.8	0.33	1.8	-1.0	20.3	21.2	-2.7	95.8	3.5	3.8	7.2	79.8	9.7
April	65.6	3.7	0.31	1.5	-3.2	16.8	20.0	-5.1	94.8	3.5	4.0	6.4	91.1	13.4
May	65.8	3.8	0.31	1.5	-3.6	15.0	18.6	-3.1	94.9	3.3	4.6	2.4	82.7	11.4
June	68.5	3.8	0.29	1.8	-7.2	16.0	23.1	-1.8	95.6	3.1	5.1	1.2	96.9	9.9
July	68.1	3.8	0.34	1.4	-6.2	16.8	23.1	-0.1	95.8	3.0	5.1	-5.8	105.6	12.6
August	70.8	3.8	0.30	1.6	-6.5	14.1	20.6	3.3	96.4	2.9	5.2	-2.0	92.6	9.5
September	71.1	3.8	0.29	1.6	0.3	19.4	19.2	4.3	96.4	2.6	5.3	-3.4	109.3	14.3
October	66.1	3.5	0.27	1.4	-4.5	17.1	21.6	4.9	97.1	2.7	5.3	0.1	75.1	13.8
November	67.1	3.6	0.24	4.9	-2.3	18.9	21.2	5.3	98.8	2.6	5.4	-1.8	70.1	17.3
December	65.6	3.6	0.24	1.4	-4.0	16.9	20.9	9.2	103.4	2.7	6.0	1.8	58.9	23.3
2005														
January	65.0	3.5	0.26	0.8	-3.3	13.9	17.3	9.5	105.9	3.0	6.6	15.2	54.6	27.9
February	60.0	3.2	0.26	0.6	-2.3	16.4	18.7	7.9	107.6	2.8	6.7	21.1	43.3	32.2
March	59.5	3.2	0.26	0.6	-5.9	16.4	22.3	9.8	109.9	2.6	6.5	11.6	53.5	32.2
April	61.5	...	...	0.6	...	...	...	...	106.8	2.3	...	...	51.8	...
May[†]	...	...	...	4.4	...	...	...	...	103.4	...	...	...	...	...

7. Gross foreign exchange reserves at end of period as a ratio of the average monthly value of merchandise imports. Calculated at fixed exchange rates. 8. The denominator is foreign short-term liabilities of credit institutions (deposit money banks and investment banks). 9. Prices in SDR. Annual figures are % changes between annual averages. 10. Real effective exchange rate of the Icelandic króna based on relative consumer prices (a trade-weighted average of trading partners' consumer prices is used). 1980 = 100. 11. Cash basis. Without privatisation revenues. Adjusted for changed timing of expenditure charges in 2004. 12. The ICEX-15 index. Annual figures are % changes over year. 13. Residential housing in the Greater Reykjavík Area. Annual figures are % changes over year.

Sources: Statistics Iceland, Directorate of Labour, State Accounting Office, Iceland Stock Exchange (ICEX), The Land Registry of Iceland, Central Bank of Iceland.

Table 2 Prices

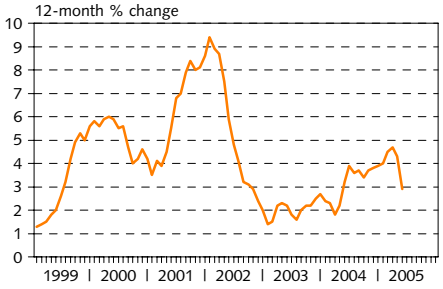
	2004					2005			
	Sept.	*Oct.*	*Nov.*	*Dec.*	*Jan.*	*Feb.*	*March*	*April*	*May*
Consumer price index, May 1988 = 100	235.6	237.4	237.9	239.0	239.2	239.7	241.5	242.0	240.7
1-month % changes									
Consumer price index	0.4	0.8	0.2	0.5	0.1	0.2	0.8	0.2	-0.5
Domestic goods excl. agric. products and vegetables	0.6	0.2	0.1	0.6	-0.2	-0.1	-1.4	-1.9	-2.4
Agricultural products and vegetables	-0.1	0.7	-0.7	1.3	1.1	-0.8	-2.0	-1.7	-5.3
Imported goods excl. alcohol and tobacco	0.9	1.8	-0.2	-0.2	-3.1	-1.1	1.6	-0.2	0.6
Petrol	-0.4	2.0	-2.2	-1.1	-5.7	0.1	2.7	0.2	3.8
Housing	0.7	0.9	1.1	1.1	1.9	2.4	2.2	2.7	-1.1
Public services	-0.6	0.3	0.1	-	4.4	1.0	-0.2	-	0.2
Other services	-0.1	-0.1	0.1	0.4	0.9	0.4	0.6	-0.1	0.4
Harmonised index of consumer prices (HICP)[1]	0.5	0.5	0.1	0.3	-0.4	-0.2	0.4	...	...
12-month % changes									
Consumer price index	3.4	3.7	3.8	3.9	4.0	4.5	4.7	4.3	2.9
Domestic goods excl. agric. products and vegetables	1.6	1.6	1.6	2.5	1.8	2.0	1.1	-0.9	-4.0
Agricultural products and vegetables	4.2	3.7	3.0	5.1	5.2	4.9	3.0	2.0	-4.8
Imported goods excl. alcohol and tobacco	1.7	3.1	2.5	1.6	0.1	-0.5	-0.1	-1.4	-1.4
Petrol	13.0	19.2	16.6	12.6	4.3	4.9	9.9	5.7	6.2
Housing	7.1	7.5	8.8	9.5	11.5	13.9	15.7	17.7	14.6
Public services	5.0	5.1	5.1	5.1	3.6	7.2	6.9	6.9	6.4
Other services	2.9	2.3	2.3	2.5	3.6	3.6	3.5	3.1	3.0
Harmonised index of consumer prices (HICP)[1]	2.8	2.9	2.9	2.9	2.7	2.9	2.5	...	...
Building cost index for residential buildings	5.2	5.6	6.1	5.9	8.6	8.1	7.0	6.6	...
Housing prices[2]	14.3	13.8	17.3	23.3	27.9	32.2	32.2	...	...
Foreign CPI and commodity prices, 12-mo. % changes									
Consumer price index in USA	2.5	3.2	3.5	3.3	3.0	3.0	3.1	...	...
Consumer price index in euro area[3]	2.1	2.4	2.2	2.4	1.9	2.1	2.1	2.1	...
Commodity prices ecxl. oil	17.3	12.8	10.8	9.0	9.1	9.2	10.5	...	...
Petrol prices[4]	59.8	68.5	49.3	32.2	42.0	46.3	56.8	53.3	...

1. Deviates from the CPI calculated by Statistics Iceland in that the latter includes own housing, education and health care. 2. Present value of price per m^2 in the Greater Reykjavík Area. Data for 2004 are preliminary. 3. Harmonised index of consumer prices (HICP). 1996=100. 4. Crude oil (Brent).

Sources: Statistics Iceland, The Land Registry of Iceland, EcoWin.

Chart 1

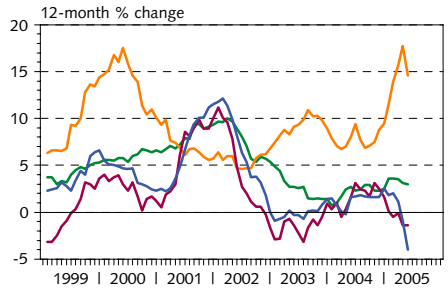
Consumer price index
January 1999 - May 2005



Source: Statistics Iceland.

Chart 2

Consumer price index by origin
January 1999 - May 2005



Domestic goods
Imported goods excluding alcohol & tobacco
Housing
Other services

Source: Statistics Iceland.

Table 3 Exchange rate of the Icelandic króna

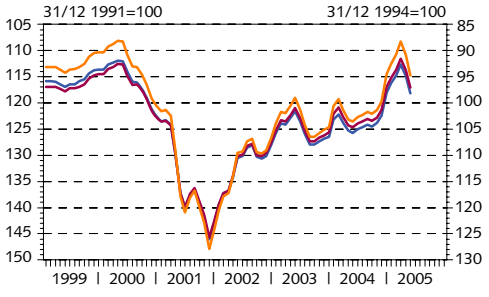
Monthly averages	2004 Sept.	Oct.	Nov.	Dec.	2005 Jan.	Feb.	March	Apr.	May†	3 mo. % change to May 17
Effective exchange rate indices[1]										
Official index (31/12 '91 = 100)	122.1	121.4	119.7	114.5	112.5	110.7	108.3	110.8	114.7	-4.2
Import-weighted index (31/12 '94)	103.4	102.8	101.3	97.0	95.2	93.7	91.6	93.8	97.1	-4.1
Export-weighted index (31/12 '94)	104.5	103.8	102.4	98.0	96.2	94.7	92.7	94.9	98.2	-4.2
Central Bank quotations[2]										
U.S. dollar	71.7	70.2	67.1	62.7	62.7	62.0	59.9	62.3	64.9	-6.3
Euro	87.6	87.6	87.1	84.1	82.1	80.7	79.2	80.6	83.1	-3.2
Yen	0.652	0.644	0.640	0.604	0.606	0.591	0.570	0.581	0.613	-4.6
Pound sterling	128.6	126.7	124.7	121.0	117.6	117.0	114.4	118.0	121.8	-3.8
Danish krone	11.78	11.78	11.72	11.31	11.04	10.85	10.64	10.82	11.17	-3.2
Norwegian krone	10.48	10.64	10.70	10.23	10.00	9.70	9.68	9.86	10.25	-6.4
Swedish krona	9.64	9.67	9.68	9.36	9.07	8.88	8.72	8.79	9.04	-2.0

	Between annual averages 2001	2002	2003	2004	From beginning of year May'03	May'04	May'05†	Previous 12 months May'03	May'04	May'05†
% changes[3]										
Official index (31/12 '91 = 100)	-16.7	3.0	6.4	2.1	5.5	0.8	-2.4	10.4	-3.3	5.8
Import-weighted index (31/12 '94 = 100)	-16.4	3.1	6.6	2.3	5.6	0.8	-2.3	10.6	-3.1	5.8
Export-weighted index (31/12 '94 = 100)	-17.0	3.0	6.2	1.8	5.4	0.8	-2.4	10.2	-3.5	5.7
Central Bank quotations[2]										
U.S. dollar	-19.3	6.8	19.2	9.5	12.9	-0.5	-7.6	27.7	-0.1	8.1
Euro (Deutschemark before 1999)	-17.0	1.5	-0.6	-0.5	0.1	2.4	-0.2	1.3	-3.4	4.7
Yen	-9.1	10.2	10.1	2.3	13.0	3.2	-3.3	22.3	-6.6	4.5
Pound sterling	-15.3	2.6	9.4	-2.4	10.4	-3.5	-3.0	13.7	-10.3	7.8
Danish krone	-17.0	1.2	-0.6	-0.4	0.0	2.3	-0.2	1.1	-3.2	4.8
Norwegian krone	-17.7	-5.2	5.9	4.1	8.4	0.2	-2.0	7.1	0.5	3.2
Swedish krona	-9.0	0.4	-1.0	-0.4	-0.4	2.8	1.9	1.4	-3.6	5.9

† To May 17, 2005. 1. Based on a trade-weighted (goods and services) basket of trading partners' currencies. 2. Exchange rate of respective currency against the Icelandic króna.
3. Positive sign indicates an appreciation of the Icelandic króna.

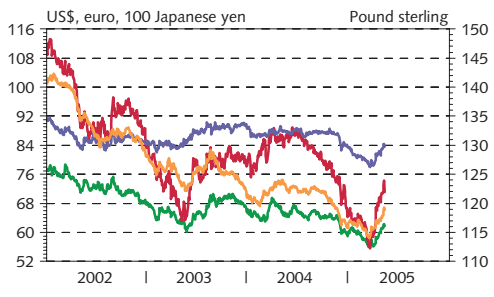
Source: Central Bank of Iceland.

Chart 3
Effective exchange rate indices
January 1999 - May 2005[1]



1. To May 17, 2005.
Source: Central Bank of Iceland.

Chart 4
Daily exchange rates of US dollar, euro, pound sterling and yen against the Icelandic króna
January 2002 - May 2005[1]



1. To May 17, 2005.
Source: Central Bank of Iceland.

Table 4 Interest rates

All figures are in %	Annual averages[1] 2002	2003	2004	At end of month 2004-2005 Nov.	Dec.	Jan.	Feb.	March	Apr.	May†
Central Bank rates										
Credit institutions' current accounts	5.5	2.9	3.7	5.0	6.25	6.25	6.75	6.75	7.25	7.25
Required deposits	7.1	4.2	4.9	6.0	7.25	7.25	7.75	7.75	8.00	8.00
Overnight loans (discount rates)	10.7	7.8	8.3	9.3	10.25	10.25	10.75	10.75	10.75	10.75
Repurchase agreements	8.4	5.4	6.1	7.3	8.25	8.25	8.75	9.00	9.00	9.00
Yields in the money market[2]										
REIBOR, O/N	9.3	5.1	6.1	7.1	8.0	8.0	8.6	8.7	8.1	8.7
REIBOR, 1-month	9.0	5.3	6.1	7.5	8.2	8.2	8.6	8.8	8.8	8.8
REIBOR, 3-month	8.9	5.3	6.3	7.7	8.6	8.6	9.0	9.2	9.2	9.2
REIBOR, 6-month	8.8	5.5	6.5	8.0	8.8	8.8	9.3	9.4	9.4	9.4
Treasury bills, 3-month	8.1	5.0	6.1	7.5	7.4	7.1	7.8	8.7	8.8	8.8
Treasury bills, 6-month[3]	7.9	5.0	...	...	...	...	...	...	...	...
Yields in the capital market [4]										
Treasury notes (RIKB 07 0209)	7.8	7.6	7.6	7.7	7.4	7.4	7.4	7.7	7.7	7.5
Treasury notes (RIKB 10 0317)	.	.	7.6	7.9	7.8	7.7	7.8	7.9	7.7	7.5
Treasury notes (RIKB 13 0517)	8.1	6.8	7.5	8.0	8.1	8.3	8.6	8.8	9.0	9.0
Treasury bonds (RIKS 15 1001)	5.2	4.4	3.9	3.6	3.6	3.5	3.4	3.6	3.5	3.6
Housing bonds (IBH 26 0315)[5]	5.7	4.7	4.5	4.6	4.6	4.7	4.7	.	.	.
Housing Financing Fund bonds (HFF 15 0914)[5]	.	.	3.5	3.5	3.4	3.3	3.3	3.5	3.5	3.7
Housing Financing Fund bonds (HFF 15 0924)[5]	.	.	3.8	3.7	3.6	3.5	3.4	3.7	3.6	3.6
Housing Financing Fund bonds (HFF 15 0934)[5]	.	.	3.8	3.6	3.6	3.5	3.5	3.6	3.6	3.6
Housing Financing Fund bonds (HFF 15 0944)[5]	.	.	3.7	3.6	3.5	3.5	3.5	3.6	3.5	3.6
Commercial banks' lending rates[6]										
Average rates on non-indexed securities	15.4	12.0	12.2	13.3	14.0	13.9	13.9	14.3	14.3	14.3
Average rates on indexed securities	10.1	9.1	8.0	7.7	7.6	7.6	7.6	7.4	7.4	7.4
Rates acc. to Interest Rate Act 38/2001[7]										
Penalty rates	21.3	17.3	17.3	17.5	17.5	20.0	20.0	20.0	20.0	20.0

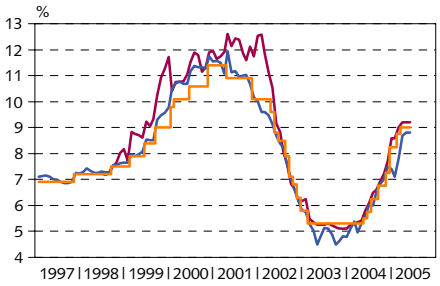
† May 17, 2005. 1. Arithmetic averages of end-of-month figures. Central Bank rates are time-weighted averages. 2. REIBOR are interest rates on the interbank market in Icelandic króna. For Treasury and bank bills, yields in trading on ICEX (Iceland Stock Exchange). 3. Treasury bills with the closest maturity to 6 months. 4. All bond yields are in real terms. 5. Housing bonds and Housing authority bonds were discontinued as of June 1, 2004. New bonds, Housing Financing Fund bonds (HFF), were issued instead and a majority of older issues were swapped into the new bonds. 6. From July 1, 2001, the Bank issues information on banks' average interest rates only as statistical information. 7. Interest rates that have legal status in the month shown. From July 1, 2001, penalty rates are revised at 6-month intervals.

Source: Central Bank of Iceland.

Chart 5

Short-term interest rates
January 1997 - May 2005

At end of month



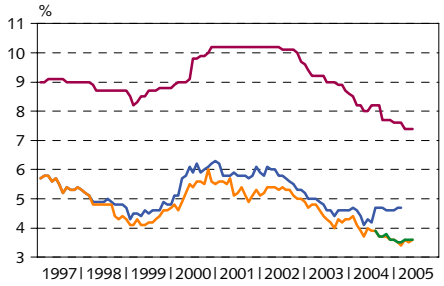
Central Bank repo rate
3-month Treasury bills
3-month REIBOR on the interbank market

1. To May 17, 2005.
Source: Central Bank of Iceland.

Chart 6

Long-term interest rates
January 1997 - May 2005

At end of month[1]



30-year HFF bonds
15-year Treasury bonds
Housing bonds
Secured bank loans

1. To May 17, 2005.
Source: Central Bank of Iceland

Table 5 Money and credit

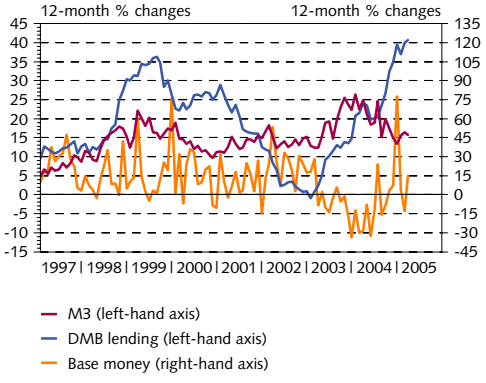
Selected items from the balance sheets of the Central Bank, deposit money banks and the banking system	*In b.kr.*	*% change over year*			*1-mo. change in b.kr.*			*12-mo. % change*		
	March'05	*2002*	*2003*	*2004*	*Jan.'05*	*Feb.'05*	*Mar.'05*	*Mar.'03*	*Mar.'04*	*Mar.'05*
Net foreign exchange reserves	59.4	.	.	.	-0.8	-4.9	-0.5	.	.	.
Claims on Treasury and gov. institutions, net	-23.2	.	.	.	-0.8	-6.4	1.8	.	.	.
Claims on deposit money banks	21.8	27.9	-65.2	32.2	-17.6	4.0	3.6	-18.3	-42.8	-48.5
Base money	30.3	17.2	-33.5	77.7	-4.9	-6.7	3.3	-8.5	-28.7	14.7
Notes and coins in circulation	8.4	3.4	9.4	9.1	-0.8	-0.1	0.2	-1.9	9.7	11.8
Reserves of deposit money banks	21.9	22.3	-46.7	121.0	-4.1	-6.6	3.1	-9.8	-37.5	15.9
Deposit money banks										
Central Bank items	-0.2	.	.	.	13.5	-10.6	-0.7	.	.	.
Short-term position, net	-8.1	.	.	.	5.2	-0.8	-5.7	.	.	.
Credit and listed securities[1]	1,908.8	3.1	28.2	40.2	50.7	105.5	89.6	4.8	35.2	46.3
Credit[2]	1,493.1	2.6	22.8	43.1	25.7	100.4	52.6	4.5	31.7	48.8
Treasury and government institutions	12.5	8.1	1.6	-16.1	-1.6	-1.6	0.0	-9.5	-10.5	-20.7
Non-bank financial institutions	13.7	-45.2	.	.	-3.4	3.1	-0.7	.	.	-40.7
Industries	848.8	15.5	2.1	24.8	1.4	36.7	28.5	3.4	39.8	30.9
Households	364.9	9.9	8.1	12.7	23.4	14.7	25.2	4.7	10.8	97.5
Foreign sector	241.9	.	63.1	117.9	5.4	48.6	-2.5	49.8	115.8	104.3
Listed securities	230.6	-3.4	38.3	22.6	6.7	-0.2	26.9	10.0	16.0	51.7
Domestic credit and listed securities	1,613.6	0.9	22.6	35.4	49.0	55.0	83.9	3.2	27.5	40.0
Domestic credit	1,251.2	0.9	14.8	39.5	20.3	51.8	55.1	2.3	24.1	41.3
Deposits	579.1	15.5	22.5	13.5	21.9	-8.2	26.3	12.7	25.2	15.8
Bonds	1,136.2	6.7	106.1	79.2	29.9	30.7	80.8	13.0	129.2	71.7
Foreign liabilities for on-lending	226.9	-5.5	-5.6	3.2	3.8	15.8	-18.5	2.9	-25.8	25.1
Banking system										
Foreign assets, net	373.9	-18.6	-223.4	190.0	-27.1	24.8	20.8	-26.3	-269.6	106.4
Domestic credit and marketable securities	1,597.2	-1.0	22.3	36.9	48.5	48.2	83.6	4.3	26.8	43.3
Money supply, M1 [3]	142.5	23.8	30.8	23.4	3.0	-2.8	0.7	12.7	44.8	19.2
M2 (M1 + demand savings deposits)	262.3	9.3	28.1	23.7	2.1	-6.5	13.6	10.7	31.7	23.9
M3 (M2 + time savings deposits)	587.5	15.3	22.3	13.4	21.1	-8.3	26.5	12.4	24.9	15.7
M4 (M3 + securities issues)	1,723.7	11.6	56.3	48.6	51.0	22.3	107.3	12.7	68.2	47.4

1. Treasury bills, equities and leasing contracts also included. 2. Lending series have been adjusted retroactively following reclassification under the ÍSAT standard. Data on lending to foreign entities available since January 2001. 3. Sum of notes and coins in circulation and DMBs' demand deposits.

Source: Central Bank of Iceland.

Chart 7

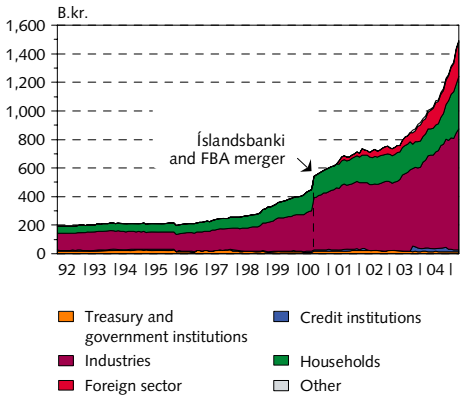
M3, DMB lending and base money
January 1997 - March 2005



Latest figures are preliminary.
Source: Central Bank of Iceland.

Chart 8

Deposit money bank lending by sector
January 1992 - March 2005[1]



1. Reclassification of lending in September 2003 based on the ÍSAT-95 standard led to a reduction in household debt figures and an increase in business and municipalities' debt figures. Latest figures are preliminary.
Source: Central Bank of Iceland.

Table 6 The credit system[1]

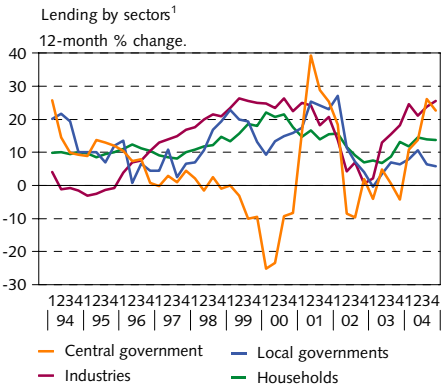
Assets	Dec.'04	% change over year						3-mo. % change		
		1999	2000	2001	2002	2003	2004	June'04	Sep.'04	Dec.'04
Domestic lending and securities	2,654.1	17.3	17.3	19.2	3.2	11.4	20.2	4.5	5.9	2.9
Banking system[2]	1,425.3	23.7	44.4	13.8	8.0	22.4	37.7	6.1	8.9	10.6
Miscellaneous credit undertakings	634.1	17.4	-3.8	20.8	-2.0	8.0	15.1	6.3	7.0	-4.5
Housing Financing Fund	447.0	13.9	12.0	18.1	11.5	14.1	0.3	4.2	0.9	-8.2
Credit undertakings subject to minimum reserve requirements[3]	145.2	.	.	30.3	-41.4	-19.0	133.6	21.0	41.2	9.0
Other credit undertakings[4]	42.0	9.2	17.2	16.1	9.0	0.8	-2.4	2.3	0.6	-4.3
Pension funds	720.7	17.9	4.6	16.4	12.2	13.4	14.6	4.7	6.4	-1.5
Insurance companies	66.9	10.1	24.1	12.2	6.3	14.8	4.1	0.6	2.9	-5.0
Mutual and investment funds[5]	256.5	24.1	-14.0	22.3	39.2	47.0	38.9	7.1	9.3	6.1
Foreign credit	1,612.0	24.0	39.6	30.0	-4.9	29.7	42.4	10.6	9.0	9.5
State lending funds	313.5	2.2	0.0	31.9	-3.0	-3.2	-4.4	-1.5	-0.8	-5.7
Total of above	5,029.0	18.3	18.4	21.7	3.0	18.8	28.2	6.5	7.5	4.8
Less inter-institutional transactions	-2,374.9	19.9	20.4	25.8	2.6	29.8	38.5	9.1	9.5	6.9
Assets = liabilities	2,654.1	17.3	17.3	19.2	3.2	11.4	20.2	4.5	5.9	2.9
Liabilities										
Domestic liabilities	1,891.4	21.0	7.2	14.2	7.1	18.9	15.3	2.9	2.8	3.5
Notes and deposits	469.0	16.6	11.1	14.9	13.4	21.9	9.8	0.9	10.3	-5.7
Securities	268.1	23.0	9.9	6.6	0.1	45.4	14.3	8.0	-3.6	5.8
Insurance companies' indemnity fund	50.7	9.1	11.5	15.6	4.4	4.7	2.3	-1.4	-2.2	-5.5
Pension funds	950.7	27.4	9.9	13.7	4.9	21.1	18.1	4.9	5.9	0.6
Capital of financial institutions	378.9	-1.9	14.3	26.0	19.4	19.7	71.0	7.7	25.9	20.4
Other items, net	-226.0	.	.	.	.	.	.	.	.	.
Foreign liabilities, net	762.7	6.6	50.3	30.6	-4.5	-5.8	34.2	9.0	14.2	1.3
Credit by sector[6]										
Central government	186.7	-9.5	-8.4	25.4	1.9	-4.2	0.0	2.0	15.4	-4.5
Municipalities[7]	119.7	13.1	15.9	23.0	4.1	6.3	6.3	4.0	-0.4	1.0
Industries[7]	1,469.0	24.9	22.5	20.7	0.6	18.2	18.2	5.4	7.2	2.6
Households[7]	878.7	18.0	17.6	15.5	7.0	13.2	14.7	3.6	2.5	5.3

1. Partly preliminary or estimated. 2. In May 2003, Glitnir leasing company merged into Íslandsbanki and was thereby reclassified to "Banking system". 3. Credit undertakings subject to minimum reserve requirements comprise: Frjálsi fjárfestingarbankinn hf., Framtak fjárfestingarbanki hf., Lýsing, SP-fjármögnun, Europay, Greiðslumiðlun hf., MP fjárfestingarbanki (since November 2003) and Straumur fjárfestingarbanki (since January 2004). 4. Other credit undertakings comprise: The Agricultural Loan Fund, the Agricultural Productivity Fund, the Municipal Loan Fund and the Regional Development Fund. 5. Since December 2003 investment funds are included. 6. Partly estimated. 7. Since September 2003, lending by sector has been reclassified according to the ÍSAT standard. This produces a lower figure than otherwise for lending to households, and a higher figure for lending to municipalities and industries.

Source: Central Bank of Iceland.

Chart 9

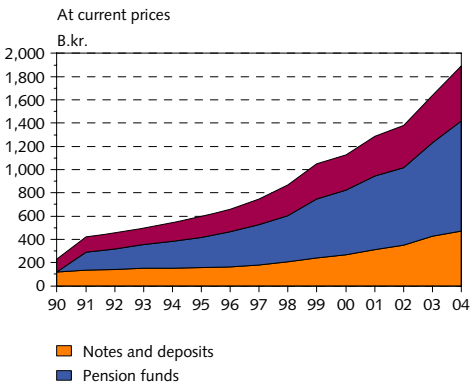
Growth of credit system lending 1994-2004



1. Reclassification of lending in September 2003 based on the ÍSAT-95 standard led to a reduction in household debt figures and an increase in business and municipalities' debt figures. Latest figures are preliminary.
Source: Central Bank of Iceland.

Chart 10

Credit system liabilities 1990-2004



Latest figures are preliminary.
Source: Central Bank of Iceland.

Table 7 Financial markets

At end of period	Outstanding in b.kr. 2003	2004	March'05	1-month % change Jan.'05	Feb.'05	March'05	12-month % change Jan.'05	Feb.'05	March'05
Money market[1]	36.9	39.4	32.5	15.1	-0.9	-17.6	-12.9	6.9	-19.7
Securities market[2]	1,187.6	1,736.0	1,758.6	5.5	5.8	1.3	47.1	46.2	44.4
thereof Treasury bonds	53.1	45.1	42.2	-3.6	0.1	-6.3	-14.1	-15.1	-14.5
thereof housing bonds	307.7	98.2	89.5	0.4	-5.3	-8.8	-66.0	-68.1	-71.2
hereof HFF bonds	.	340.3	341.8	3.5	-0.9	0.4	.	.	.
Market capitalisation of listed equities	658.8	1,083.7	1,089.1	1.9	-2.4	0.5	76.2	64.5	47.6
Mutual funds' units (open-end)	198.1	272.7	284.7	4.9	-4.1	4.4	49.1	37.7	39.3

1. Bills issued by Treasury, commercial banks, savings banks and investment credit funds. 2. Government bonds, government notes, housing bonds, housing authority bonds, HFF bonds and listed bond issues of banks, savings banks, investment credit funds, leasing companies, firms, municipalities and non-residents. Open-end mutual funds' units not included.

Source: Central Bank of Iceland

Table 8 Labour market

Changes in indices are in percent. Other changes indicate increase/decrease in jobs or permits	Averages 2003	2004	March'05	1-month change Jan.'05	Febr.'05	March'05	12-month change March'03	March'04	March'05
Wage index (1990=100)	205.9	215.6	226.4	2.2	0.3	0.4	5.7	3.8	6.5
Real wages (1990=100)[1]	131.8	133.7	136.0	2.1	0.1	-0.4	3.4	2.0	1.8
Number of issued work permits	3.299	3.750	378	-110	-61	155	-85	104	95
Job vacancies, total	459	668	1.128	325	126	-50	71	186	646
thereof Greater Reykjavík Area	104	204	321	158	38	22	35	40	174

Period averages	2002	2003	2004	Feb.'05	March'05	Apr.'05	Apr.'03	Apr.'04	Apr.'05
Number of unemployed	3.631	4.893	4.564	4.155	3.799	3.542	5.509	4.904	3.542
Measured unemployment rate (% of labour force)	2.5	3.4	3.1	2.8	2.6	2.3	3.9	3.5	2.3
Seasonally adjusted unemployment rate)	.	.	.	2.3	2.2	2.1	3.4	3.1	2.1

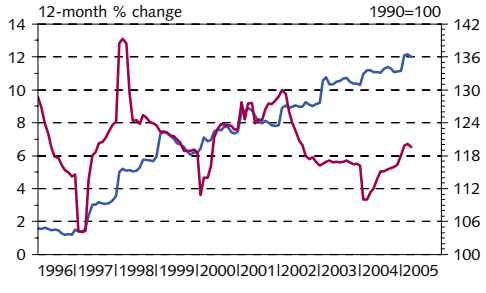
Quarterly measurements	Averages 2003	2004	Q1'05	3-month change Q3'04	Q4'04	Q1'05	12-month change Q1'03	Q1'04	Q1'05
Wage index (1990 = 100)	205.8	215.5	225.6	1.0	0.9	3.1	5.6	3.5	6.7
Wages in the private sector	188.5	196.9	207.3	1.5	0.8	3.4	5.3	2.4	8.1
Wages in the public sector and banks	234.5	246.3	255.5	0.4	1.0	2.7	6.2	5.0	4.5

1. Deflated by consumer prices.

Sources: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.

Chart 11

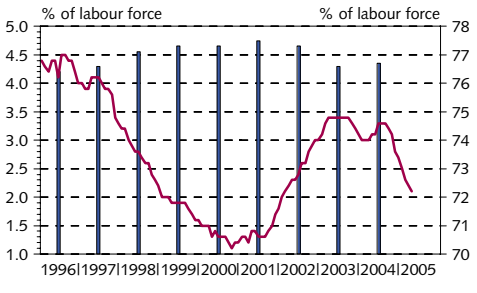
Nominal and real wages
January 1996 - March 2005



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 12

Unemployment and labour participation[1]
January 1996 - April 2005



1. Central Bank estimate for labour force participation in 2003-2004.
Sources: National Economic Institute, Directorate of Labour, Central Bank of Iceland.

Table 9 National accounts – annual data (continued on next page)

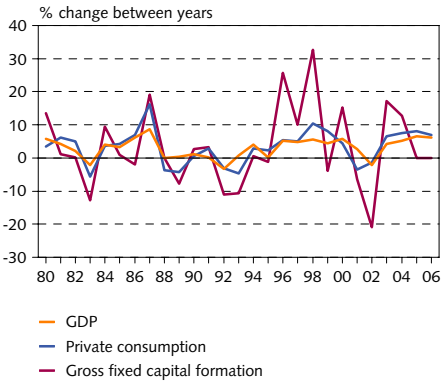
						Prel.	Estimate	Forecast[1]	
In b.kr.	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Gross domestic product (GDP), current prices	567.3	608.4	661.0	740.6	766.2	797.5	858.9	985.9	1,080.6
Current account balance, current prices	-39.5	-42.6	-69.3	-33.7	8.7	-42.4	-69.9	-118.0	-109.4
GDP at 1990 fixed prices	427.2	446.0	471.4	483.6	473.5	493.5	519.1	553.5	587.8
GNP at 1990 fixed prices	420.0	437.8	458.3	469.0	470.9	491.8	517.6	...	...
Volume changes between years, percent									
Private consumption	10.4	8.1	4.4	-3.5	-1.4	6.6	7.5	8.0	7.0
Public consumption	3.4	4.9	4.3	3.2	3.2	3.5	3.6	2.5	2.6
Gross fixed capital formation	32.6	-3.9	15.3	-6.4	-20.9	17.1	12.8	34.2	-8.0
Industries	46.7	-5.7	16.1	-14.8	-28.0	23.6	12.9	52.8	-13.9
Housing	1.0	0.7	12.8	15.3	5.0	13.4	3.0	21.9	9.9
Public works and buildings	18.6	-0.5	14.5	7.6	-23.8	1.8	27.3	-11.6	-4.7
National expenditure	13.6	4.5	7.2	-3.7	-4.5	7.8	7.7	12.4	2.4
Exports of goods and services	2.1	4.0	4.0	7.4	3.9	1.5	8.3	4.0	7.6
Exports of goods	-2.6	7.1	-1.3	7.3	6.6	-1.2	9.2	...	...
Exports of services	13.9	-2.5	16.3	7.7	-1.4	6.8	6.5	...	...
Imports of goods and services	23.5	4.2	8.0	-9.1	-2.7	10.4	14.3	18.5	-1.2
Imports of goods	24.3	3.2	2.7	-10.0	-3.4	7.3	15.8	...	...
Imports of services	21.2	6.9	21.5	-7.2	-1.2	16.9	11.6	...	...
Gross domestic product (GDP)	5.6	4.4	5.7	2.6	-2.1	4.2	5.2	6.6	6.2
Gross national product (GNP)	5.6	4.2	4.7	2.3	0.4	4.4	5.2	...	...
Gross national income (GNI)	8.0	4.3	3.7	2.2	0.8	1.2	4.6	...	...
Terms of trade (goods and services)	5.6	-0.8	-2.7	0.2	0.6	-4.3	-1.2	3.5	-2.1
Percent of GDP									
Private consumption	57.3	59.1	59.3	55.1	54.8	56.6	57.8	56.3	56.7
Gross fixed capital formation	24.5	22.2	23.9	22.4	17.7	20.1	22.0	27.9	25.2
Current account balance	-7.0	-7.0	-10.5	-4.6	1.1	-5.3	-8.1	-12.0	-10.1
Gross national saving	17.7	15.3	13.8	17.5	18.8	14.6	13.4	...	...

1. Central Bank of Iceland forecast in June 2005.

Sources: Statistics Iceland and Central Bank of Iceland.

Chart 13

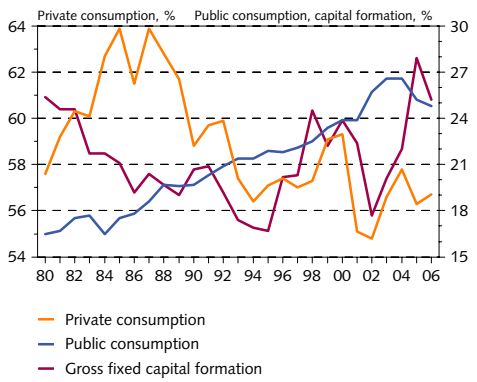
Growth of GDP, private consumption and gross fixed capital formation 1980-2006[1]



1. Preliminary 2003-2004. Forecast 2005-2006.
Sources: Statistics Iceland and Central Bank of Iceland.

Chart 14

Private consumption, public consumption and gross fixed capital formation 1980-2006[1]



1. Preliminary 2003-2004. Forecast 2005-2006.
Sources: Statistics Iceland and Central Bank of Iceland.

Table 9 (continued) National accounts – quarterly data

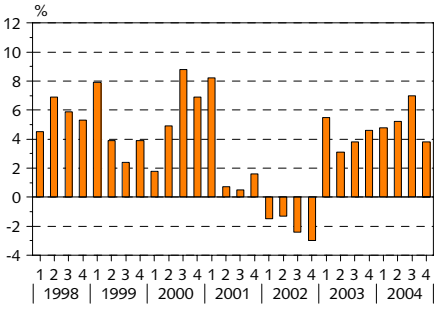
In b.kr.	Private consumption	Public consumption	Gross fixed cap. format.	Changes in stocks	National expenditure	Exports	Imports	GDP
2001: Q1	97,071	41,146	42,571	-2,739	178,049	63,867	-74,648	167,268
2001: Q2	102,091	43,990	38,107	53	184,241	70,824	-74,772	180,293
2001: Q3	101,193	44,372	44,980	622	191,166	83,189	-83,995	190,360
2001: Q4	107,631	47,148	39,906	-20	194,665	81,532	-73,482	202,715
2002: Q1	99,767	47,308	34,002	-339	180,737	75,691	-71,036	185,392
2002: Q2	105,605	48,869	33,608	-896	187,187	78,514	-75,162	190,539
2002: Q3	104,197	48,939	33,161	825	187,122	80,092	-75,079	192,135
2002: Q4	110,644	51,862	34,704	229	197,439	71,567	-70,833	198,173
2003: Q1	106,838	51,033	30,678	2,235	190,784	70,818	-67,353	194,249
2003: Q2	112,844	52,879	39,537	-369	204,892	67,827	-78,240	194,479
2003: Q3	111,866	52,522	43,911	27	208,327	80,223	-87,137	201,413
2003: Q4	119,688	55,363	46,552	-3,396	218,208	69,446	-80,307	207,347
2004: Q1	116,559	54,937	36,285	3,274	211,055	72,590	-78,108	205,537
2004: Q2	124,067	57,374	49,751	-1,936	229,257	75,017	-94,169	210,105
2004: Q3	121,792	57,049	50,706	-527	229,021	89,485	-96,307	222,199
2004: Q4	133,873	58,883	52,000	-4,194	240,562	79,047	-98,529	221,080
Volume change from same quarter in previous year (%)								
2001: Q1	2.2	6.7	31.2	-1.8	7.3	15.0	11.5	8.2
2001: Q2	-3.8	5.0	-22.2	-0.3	-7.1	2.4	-16.5	0.7
2001: Q3	-4.9	-1.5	-4.0	0.8	-3.3	0.8	-8.3	0.5
2001: Q4	-6.8	2.5	-20.1	-2.2	-10.0	13.5	-19.8	1.6
2002: Q1	-5.7	2.0	-28.4	1.7	-8.4	3.3	-14.2	-1.5
2002: Q2	-1.8	1.9	-15.7	-0.7	-4.7	12.1	2.3	-1.3
2002: Q3	0.4	3.9	-25.8	0.3	-4.9	2.7	-3.4	-2.4
2002: Q4	1.5	5.0	-11.2	0.2	-0.2	-1.8	6.4	-3.0
2003: Q1	6.5	3.5	-9.9	0.9	3.6	5.8	0.6	5.5
2003: Q2	6.8	4.1	18.9	0.6	9.1	-3.9	10.6	3.1
2003: Q3	6.5	3.4	27.3	-0.7	9.0	3.5	16.1	3.8
2003: Q4	6.6	3.0	31.6	-1.1	9.2	0.6	13.5	4.6
2004: Q1	8.0	4.0	16.0	0.3	8.8	4.8	15.7	4.8
2004: Q2	6.8	4.6	19.1	-0.4	8.5	5.9	13.7	5.2
2004: Q3	5.9	4.5	9.9	-0.2	6.3	9.1	7.4	7.0
2004: Q4	9.2	1.3	7.8	-0.1	7.2	13.2	21.3	3.8

Sources: Statistics Iceland.

Chart 15

Quarterly economic growth 1998-2004

Volume change in GDP over four quarters (%)

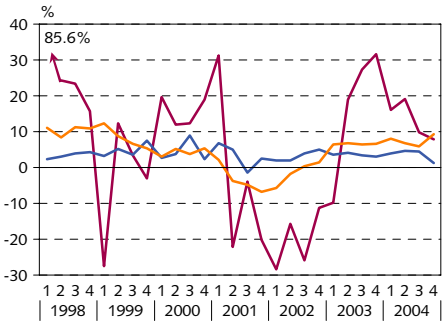


Preliminary 2003. Estimate 2004.
Source: Statistics Iceland.

Chart 16

Components of economic growth 1998-2004

Volume change over four quarters (%)



Private consumption
Public consumption
Gross fixed capital formation

Preliminary 2003. Estimate 2004.
Source: Statistics Iceland.

Table 10 Current account balance[1] (continued on next page)

	In b.kr.					% change from previous year[2]		
Trade in goods and services	*2001*	*2002*	*2003*	*2004*	*March'05*	*3-mo.*	*6-mo.*	*12-mo.*
Trade balance	-6.7	13.1	-16.9	-37.8	-11.6	.	.	.
Merchandise exports fob	196.4	204.3	182.6	202.4	46.7	-1.2	9.6	10.1
Excluding ships and aircraft	193.1	202.0	181.2	201.6	46.7	-0.8	9.6	10.2
Marine products	121.8	128.6	113.7	121.7	28.4	0.2	8.9	6.9
Aluminium and ferro-silicon	44.4	43.5	40.3	42.6	10.5	11.3	9.9	12.3
Other industrial products	19.0	14.5	21.6	28.4	5.7	-24.0	9.4	12.7
Merchandise imports fob	203.1	191.2	199.5	240.2	58.3	22.0	26.8	22.3
Excluding ships and aircraft	190.1	180.0	195.7	231.7	57.5	22.7	24.1	19.8
Consumption goods	60.8	59.5	66.3	77.2	19.6	23.9	23.4	19.3
Investment goods	44.4	38.6	46.1	52.8	13.0	28.1	17.3	17.7

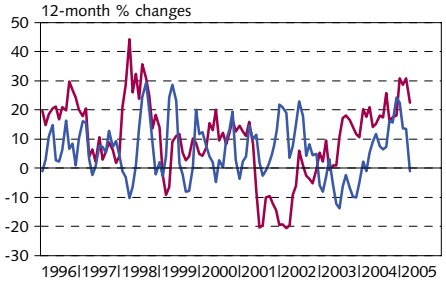
	In b.kr.					% change from previous year[2]		
Services and income balance	*2001*	*2002*	*2003*	*2004*	*2004/Q4*	*3-mo.*	*6-mo.*	*12-mo.*
Services balance	-1.5	-0.3	-8.8	-14.4	-8.6	.	.	.
Services exports	102.8	101.6	105.7	113.8	25.6	12.5	13.3	9.4
Transportation	47.0	48.5	50.2	63.2	15.5	38.4	39.0	28.1
Travel	22.9	22.8	24.5	26.1	4.6	1.0	7.9	8.1
Other receipts	33.0	30.2	31.0	24.5	5.6	-21.2	-25.0	-19.8
Services imports	-104.4	-101.9	-114.6	-128.2	-34.2	22.4	14.8	14.4
Transportation	-36.7	-38.6	-39.7	-48.8	-13.0	38.3	26.8	25.7
Travel	-36.4	-33.4	-39.8	-48.5	-13.3	32.8	23.9	24.5
Other expenditure	-31.3	-29.9	-35.1	-30.9	-7.9	-7.3	-10.8	-9.9
Balance on income	-25.3	-6.2	-16.5	-17.7	-9.8	.	.	.
Receipts	16.9	27.9	28.9	39.9	10.1	13.9	41.8	40.5
Compensation of employees	5.8	5.4	6.2	5.6	1.4	-4.9	-7.9	-8.3
Interest payments	3.4	4.9	4.4	8.8	2.6	134.7	135.7	106.6
Dividends and reinvested earnings[3]	7.8	17.6	18.3	25.5	6.1	-2.6	36.6	41.4
Expenditures	-42.2	-34.1	-45.4	-57.6	-19.9	30.9	30.5	29.8
Compensation of employees	-0.5	-0.7	-0.5	-0.8	-0.2	150.8	135.7	79.6
Interest payments	-41.3	-34.3	-31.3	-35.2	-9.6	41.2	29.6	14.9
Dividends and reinvested earnings[3]	-0.3	0.8	-13.6	-21.6	-10.1	21.1	29.8	62.4
Current transfer, net	-1.0	1.2	-1.2	-1.2	-0.3	-50.8	13.8	5.0
Current account balance	-33.7	8.7	-42.4	-69.9	-29.6	.	.	.

Chart 17

Merchandise trade
January 1996 - March 2005

3-month moving averages at fixed exchange rates

12-month % changes

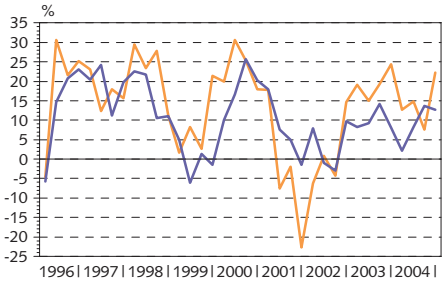


Latest data are preliminary.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 18

Exports and imports of services
1996/Q1- 2004/Q4

% change from same quarter in previous year at fixed exchange rates



Latest data are preliminary.
Source: Central Bank of Iceland.

Table 10 (continued) Current account balance[1]

	In b.kr.					Change from prev. year (b.kr.)[2]		
	2000	2001	2002	2003	Q2'04	3-mo.	6-mo.	12-mo.
Capital and financial account	19.3	-0.7	20.3	147.7	70.1	.	.	.
Capital transfer, net	0.4	-0.1	-0.4	-0.2	-0.0	0.1	0.3	0.2
Financial account[4]	18.9	-0.5	20.7	148.0	70.1	67.0	79.9	127.7
Financial account excl. reserves	14.1	5.1	44.1	162.2	70.8	54.7	61.6	119.0
Direct investment, net	-16.4	-21.2	-0.7	-146.7	-27.8	-36.9	-121.4	-146.0
Abroad	-33.7	-29.6	-26.9	-177.3	-42.0	-27.9	-116.6	-150.9
In Iceland	17.3	8.3	26.1	30.6	14.2	-9.0	-4.8	4.9
Portfolio investment, net	61.5	22.0	228.0	506.3	191.6	118.1	194.9	282.7
Assets	-5.6	-30.0	-45.3	-75.7	-26.8	-9.8	-11.6	-31.2
Equities	-5.8	-25.7	-40.6	-71.2	-25.3	-9.1	-11.8	-31.4
Debt securities	0.2	-4.3	-4.7	-4.4	-1.5	-0.7	0.2	0.2
Liabilities	67.2	52.0	273.3	582.0	218.3	127.9	206.5	313.9
Equities	9.8	4.5	-5.6	20.2	5.5	4.3	20.0	25.7
Debt securities	57.3	47.5	278.9	561.8	212.8	123.6	186.5	288.2
Other investment, net[4]	-30.9	4.4	-183.2	-197.4	-93.1	-26.5	-11.9	-17.7
Assets	-47.1	-30.4	-155.5	-237.5	-119.7	-29.6	-52.8	-84.9
Liabilities	16.2	34.8	-27.7	40.1	26.6	3.1	40.9	67.2
Reserve assets	4.8	-5.7	-23.4	-14.2	-0.6	12.3	18.4	8.7
Net errors and omissions	14.4	-8.0	22.1	-77.8	-40.5	.	.	.
Memorandum items								
Long-term borrowing, net	31.4	41.9	67.6	345.7	117.6	108.6	193.2	279.4
Assets	-42.1	-40.4	-183.7	-256.1	-121.8	-18.1	-34.2	-76.0
Monetary authorities	4.8	-5.7	-23.3	-14.2	-0.6	12.3	18.3	8.7
General government	-	-	-	-	-	-	-	-
Deposit money banks	-18.5	-33.3	-162.1	-220.8	-115.7	-19.0	-38.0	-61.8
Other sectors	-28.4	-1.4	1.7	-21.2	-5.5	-11.4	-14.5	-22.8
Liabilities	73.5	82.3	251.3	601.9	239.5	126.7	227.3	355.4
Monetary authorities	-5.8	4.8	-15.9	0.0	-0.3	-0.3	4.0	15.6
General government	42.3	17.5	-10.4	10.5	6.0	5.8	13.5	20.7
Deposit money banks	9.1	51.4	264.3	582.3	229.0	121.7	220.7	323.1
Other sectors	27.9	8.6	13.2	9.0	4.9	-0.6	-10.9	-3.9

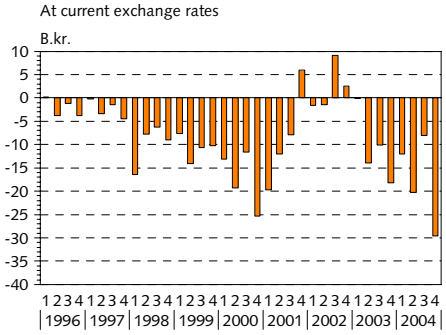
1. Latest figures are preliminary. 2. At constant exchange rates, based on the latest period indicated. 3. Dividend payments and reinvestment of earnings on direct investment. 4. Positive value represents inflow of capital due to foreign borrowing or decrease in assets. Negative value accounts for outflow of capital, debt repayments or increase in assets.

Source: Central Bank of Iceland.

Chart 19

Quarterly current account balance
1996/Q1- 2004/Q4

At current exchange rates

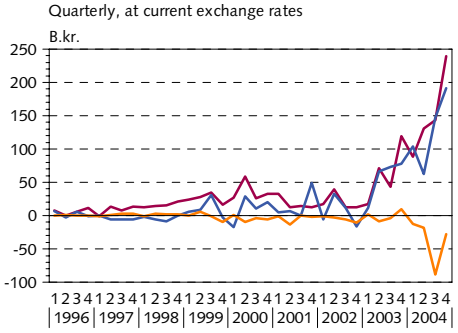


Latest data are preliminary.
Source: Central Bank of Iceland.

Chart 20

Selected financial account items
1996/Q1- 2004/Q4

Quarterly, at current exchange rates



Latest data are preliminary.
Source: Central Bank of Iceland.

Table 11 International investment position

In b.kr.	Position at end of period								
	2000	2001	2002	2003	2004	March'04	June'04	Sept.'04	Dec.'04
International investment position	-451.0	-590.8	-593.6	-553.4	-694.0	-577.6	-628.0	-680.4	-694.0
Total assets	314.4	421.5	395.6	707.0	1.116.8	776.2	867.0	984.0	1,116.8
Direct investment abroad	56.2	86.8	87.5	121.3	237.8	127.2	146.7	223.1	237.8
Equity capital	41.0	66.8	67.6	109.9	210.4	106.4	122.9	195.8	210.4
Other capital	15.2	19.9	19.9	11.5	27.4	20.8	23.8	27.2	27.4
Portfolio assets	185.0	202.9	159.7	262.3	345.5	289.6	303.4	311.8	345.5
Equity capital	178.4	188.4	149.3	239.2	317.6	265.9	278.1	285.7	317.6
Debt securities	6.6	14.6	10.4	23.1	27.9	23.7	25.3	26.2	27.9
Other investment assets	39.1	95.2	111.2	265.2	468.0	292.7	348.5	378.0	468.0
Reserves	34.2	36.6	37.2	58.1	65.6	66.7	68.5	71.1	65.6
Total liabilities	765.4	1,012.3	989.2	1,260.4	1,810.8	1,353.9	1,495.1	1,664.5	1,810.8
Direct investment in Iceland	41.5	70.8	64.3	86.0	112.1	80.7	85.9	99.9	112.1
Equity capital	33.1	63.4	56.1	61.8	88.1	56.2	61.0	75.6	88.1
Other capital	8.5	7.4	8.2	24.3	24.1	24.5	24.8	24.3	24.1
Portfolio liabilities	347.7	471.3	490.3	776.2	1,300.8	914.2	992.9	1,159.2	1,300.8
Equity capital	2.3	12.1	35.9	42.6	86.5	51.6	58.7	91.9	86.5
Debt securities	345.4	459.2	454.4	733.6	1,214.3	862.6	934.2	1,067.3	1,214.3
Other investment liabilities	376.2	470.2	434.6	398.3	397.8	358.9	416.3	405.4	397.8
Long-term debt	289.0	377.0	296.2	252.0	207.3	234.8	264.6	246.8	207.3
Short-term debt	87.2	93.2	138.4	146.3	190.5	124.2	151.7	158.7	190.5
Memorandum items									
Equity capital, net	190.7	192.2	136.6	231.9	356.8	260.7	280.2	317.0	356.8
Net external debt position	-641.7	-783.0	-730.2	-785.3	-1,050.8	-838.4	-908.3	-997.5	-1,050.8
Monetary authorities	18.6	21.7	20.8	58.1	65.5	66.5	68.3	70.7	65.5
General government	-167.2	-239.8	-227.2	-213.7	-206.3	-220.3	-211.7	-215.2	-206.3
Deposit money banks	-329.4	-373.7	-361.8	-471.1	-772.8	-528.2	-605.3	-709.0	-776.9
Other sectors	-163.7	-191.2	-162.0	-158.6	-137.1	-156.3	-159.5	-143.9	-133.0
Percent of gross domestic product[1]									
International investment position	-64.1	-76.2	-82.1	-69.6	-86.6	-65.1	-69.4	-77.4	-86.6
Net external debt[2]	91.2	101.0	101.0	98.8	131.1	94.4	100.4	113.4	131.1
External debt position[2]	102.5	119.8	123.0	142.4	201.1	137.6	149.3	167.4	201.1
Long-term debt	83.6	97.6	94.9	108.6	158.1	109.6	117.0	132.6	158.1
Short-term debt	18.9	22.2	28.1	33.8	43.0	28.0	32.3	34.8	43.0

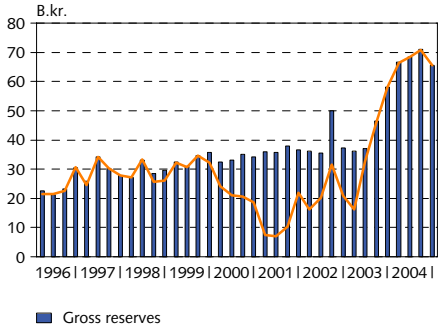
1. Foreign debt at year-end at annual average exchange rates (based on SDR). Quarterly ratios as percent of estimated annual GDP. 2. Direct investment capital and portfolio equities excluded.

Source: Central Bank of Iceland.

Chart 21

Reserve assets and Central Bank net foreign position, 1996/Q1- 2005/Q1

Quarterly, at current exchange rates

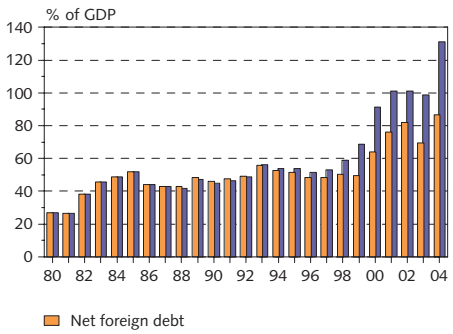


Latest data are preliminary.
Source: Central Bank of Iceland.

Chart 22

International investment position 1980-2004[1]

At end of year and latest quarter



1. IIP is shown here with positive sign but is actually negative (see Table 11).
Source: Central Bank of Iceland.

Table 12 Summary of Treasury finances[1]

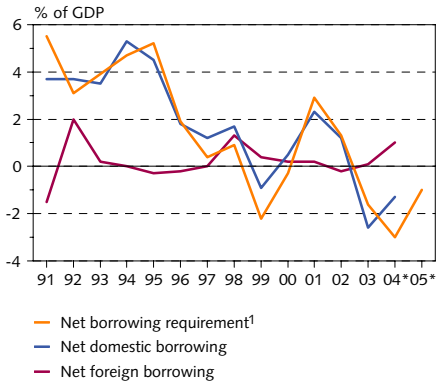
In b.kr.	Accruals basis 2001	2002	2003	Jan.-Dec. 2003	2004	% ch. from prev. year	Dec.-March 2003-2004	2004-2005	% ch. from prev. year
Revenues	237.4	237.4	237.4	259.8	280.7	8.1	95.0	112.4	18.3
Expenditures	228.7	228.7	228.7	268.7	280.4	4.3	93.4	93.7	0.3
Financial balance	8.6	8.6	8.6	-8.9	0.3	.	1.6	18.7	.
Miscell. short-term accounts	-6.5	-24.8	-6.1	9.8	-0.6	.	11.1	-1.5	.
Net lending	-12.6	-12.6	-12.6	6.5	26.4	.	4.3	11.4	.
Equity transactions	-11.3	-11.5	-11.5	4.5	-0.4	.	0.1	-0.2	.
Balance before financing	-21.8	-40.3	-21.5	11.8	25.7	.	17.1	28.4	.
Pension funds	-16.1	0.0	-18.8	-7.5	-10.8	.	-2.5	-1.5	.
Net borrowing	39.0	41.6	41.6	-6.0	-6.6	.	6.3	-12.2	.
Short-term domestic	6.0	6.0	6.0	8.5	-6.0	.	1.0	-8.1	.
Long-term domestic	-0.8	1.8	1.8	1.6	8.5	.	8.1	0.2	.
From abroad	33.9	33.9	33.9	-16.0	-9.1	.	-2.8	-4.3	.
Cash balance	1.2	1.4	1.4	-1.6	8.3	.	20.9	14.7	.
Revenues and expenditures									
Total revenue	237.4	259.2	274.6	259.8	280.7	8.1	89.1	99.7	11.8
Personal income taxes, gross	52.5	55.1	58.0	55.8	62.6	12.0	21.3	23.6	10.5
Other income and property taxes	27.0	27.5	30.8	28.1	32.8	16.8	12.9	12.1	-6.6
Value-added tax	72.1	76.3	80.9	80.3	91.1	13.5	27.5	31.2	13.5
Taxes on commodities & imports	15.9	15.4	17.6	17.5	20.8	18.7	6.2	6.9	11.4
Payroll taxes	21.9	23.4	26.3	25.2	27.8	10.3	8.7	9.7	11.8
Other taxes	22.3	22.9	25.2	23.7	25.7	8.7	7.1	8.0	12.1
Interest, dividends and rent	16.6	18.7	14.4	11.0	12.0	9.3	3.4	4.6	36.3
Profits from asset sales	1.1	11.7	12.0	11.6	0.2	-98.5	-0.7	0.1	-121.5
Other revenues	7.9	8.3	9.3	6.7	7.8	17.3	2.7	3.5	30.8
Total expenditures[2]	228.7	267.3	280.7	268.7	280.4	4.3	91.8	90.7	-1.2
Expenditure on goods and services	91.7	116.8	110.1	120.6	136.1	12.8	44.9	45.9	2.0
Current transfers	96.1	112.6	129.5	108.7	111.5	2.6	35.6	34.5	-3.2
Interest payments	17.9	16.0	15.3	14.9	13.1	-12.5	3.0	2.8	-8.1
Maintenance	5.7	6.1	6.3	5.0	3.7	-26.9	1.8	0.8	-54.3
Capital expenditures	17.3	15.8	19.6	19.4	16.1	-17.4	6.4	6.8	5.5

1. First three columns on accruals basis as in the Treasury accounts but latest figures on cash basis. 2. The most recent expenditure figures are not comparable with earlier data due to changes in the presentation of the accounts.

Source: State Accounting Office.

Chart 23

Treasury borrowing 1991-2005

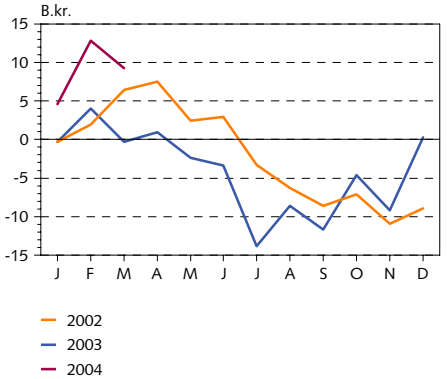


1. Including reduction in pension fund commitments and outstanding long-term interest. *Preliminary/forecast.
Sources: Treasury accounts, Ministry of Finance, Central Bank projections.

Chart 24

Monthly Treasury balance 2003-2005

Cumulative from beginning of year



Source: State Accounting Office.

Table 13 Public sector finances[1]

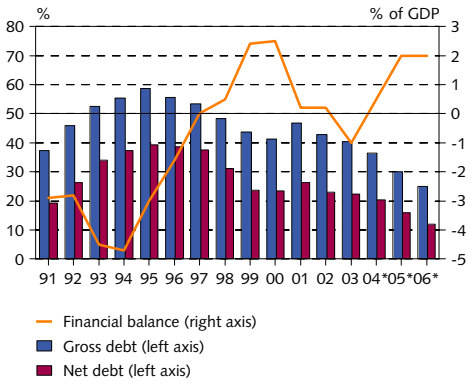
In b.kr.								*Estimate*[2]		
General government	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Revenues	213.2	242.9	278.6	301.1	328.5	351.2	372.4	411.4	454	490
Expenditures	213.3	240.0	264.0	284.6	327.2	349.7	380.7	406.8	437	465
Financial balance	-0.1	2.8	14.6	16.6	1.3	1.5	-8.3	4.6	17	25
Net debt	196.5	180.7	147.0	158.7	199.3	182.2	184.5	178.2	159	136
Gross debt	279.4	280.5	271.5	278.0	354.6	340.7	334.2	318.6	297	275
Central government										
Revenues	162.4	183.9	213.8	228.7	245.4	257.3	274.4	306.1	337	362
Expenditures	159.6	177.8	198.2	211.7	240.9	260.7	288.2	298.3	320	338
Financial balance	2.7	6.2	15.6	16.9	4.6	-3.4	-13.8	7.8	16	23
Net debt	172.3	151.3	118.8	127.4	168.8	149.5	158.0	148.5	132	109
Gross debt	241.6	237.8	226.0	228.5	298.3	281.1	277.2	254.9	238	215
Local government										
Revenues	55.5	62.9	69.9	77.7	89.5	100.4	107.2	113.5	127	139
Expenditures	58.5	67.2	72.8	80.3	94.8	97.1	102.8	118.3	129	140
Financial balance	-3.0	-4.3	-2.9	-2.6	-5.3	3.4	4.5	-4.8	-3	-1
Net debt	25.0	30.1	28.7	31.7	30.7	32.8	28.6	33.8	33	35
Gross debt	38.4	43.3	46.1	49.8	56.6	60.2	57.5	64.2	65	68
General government, % of GDP										
Revenues	41.5	42.7	45.7	45.4	44.1	45.1	45.9	47.9	46	45
Expenditures	41.5	42.2	43.3	42.9	44.0	44.9	46.9	47.4	44	43
Financial balance	0.0	0.5	2.4	2.5	0.2	0.2	-1.0	0.5	2	2
Net debt	37.5	31.2	23.7	23.5	26.3	22.9	22.3	20	16	12
Gross debt	53.3	48.4	43.7	41.2	46.8	42.9	40.5	36	30	25

1. The public sector includes the central and local governments and the social security system. Revenues and expenditures are as itemised by Statistics Iceland, according to the UN system of national accounts. The main differences from the Treasury accounts relate to the treatment of depreciation of tax claims, pension liability and profits from the sale of government assets. 2. Operating figures for 2004 are Statistics Iceland estimates. Other figures for 2004-2006 are Central Bank estimates.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 25

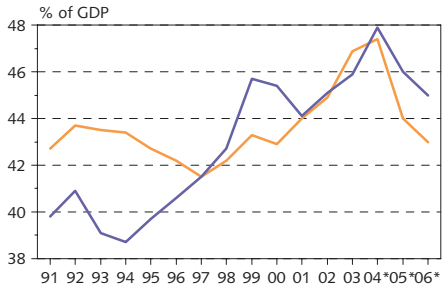
General government balance and debt 1991-2006



*Preliminary/forecast.
Sources: Statistics Iceland and Central Bank projections.

Chart 26

General government revenues and expenditures 1991-2006



Sources: Statistics Iceland and Central Bank projections.

Table 14 Turnover[1]

	January-December			% ch. in previous year, January-December[2]		
M.kr.	*2002*	*2003*	*2004*	*2002*	*2003*	*2004*
Industries, total	323.002	312.460	343.137	-1.1	-5.2	6.5
Industries, excluding fish processing	204.140	207.972	225.481	-1.9	-0.2	5.1
Industries, excl. fish processing and power-intensive	159.293	169.905	183.799	-3.2	4.5	4.9
Retail trade	181.307	187.202	203.093	-1.5	3.6	7.1
Wholesale trade	280.353	305.683	365.537	-5.2	8.3	17.1
Wholesale trade, excluding fuels	239.496	264.171	316.737	-5.1	10.6	18.4
Construction	74.423	92.918	116.408	-17.9	22.3	21.5
Total	1,293.327	1,340.481	1,537.926	-2.6	1.6	11.2
Total, excluding fuels	1,252.470	1,298.969	1,489.126	-1.5	4.0	13.2

1. Based on VAT reports. 2. Based on price-adjusted turnover, deflated by the consumer price index, in some cases excluding housing and petrol.

Sources: Statistics Iceland, Central Bank of Iceland.

Table 15 Real effective exchange rate of the Icelandic króna[1]

	Annual averages					Q1	% change in previous year		
	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*Q3 '04*	*Q6 '04*	*Q1 '04*
Real effective exchange rate (1980 = 100)									
based on relative consumer prices (CPI)	96.3	83.7	88.5	94.2	97.2	107.8	5.2	7.2	11.4
based on relative unit labour costs (ULC)	91.6	80.1	86.4	90.4	92.6	107.1	3.3	9.5	15.2

% change on previous year	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*Prel. 2004*	*Forecast 2005*
Nominal effective exchange rate	1.2	1.5	0.0	0.2	-16.6	2.5	6.2	1.8	6.3
Foreign consumer prices	2.1	1.6	1.6	2.3	2.1	1.7	2.0	1.8	1.8
Domestic consumer prices	1.8	1.7	3.4	5.1	6.6	4.8	2.1	3.2	3.4
Real exchange rate based on relative CPI	0.9	1.6	1.8	2.9	-13.0	5.7	6.3	3.2	8.0
Foreign productivity	1.5	1.2	1.2	1.8	1.3	1.2	1.3	1.4	1.5
Domestic productivity	2.0	1.8	1.4	3.4	1.0	-1.6	5.6	3.1	2.5
Foreign wages	3.2	3.0	3.3	3.2	3.3	3.1	2.9	2.0	1.8
Domestic wages	5.8	7.1	5.5	5.7	8.0	5.8	5.5	4.5	6.0
Real exchange rate based on relative ULC	3.3	5.3	1.7	1.2	-12.6	7.9	4.6	2.4	9.6

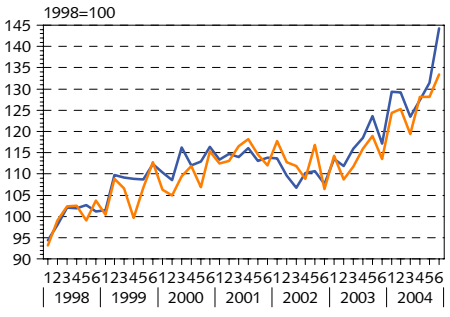
1. Latest values are preliminary.

Source: Central Bank of Iceland.

Chart 27

Turnover volume 1998/1 - 2004/6

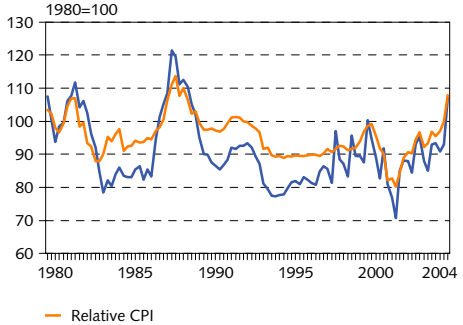
At constant prices, seasonally adjusted



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 28

Quarterly real effective exchange rate of the Icelandic króna 1980/Q1- 2005/Q1



Latest values are preliminary.
Source: Central Bank of Iceland.

Table 16 Real estate market and asset prices

Real estate market [1]	*2002*	*2003*	*2004*	*March'05*	*1-mo. % change Feb.'05*	*1-mo. % change March'05*	*12-mo. % change March'03*	*12-mo. % change March'04*	*12-mo. % change March'05*
Residential housing price index[2]	158.9	177.7	200.5	251.6	4.2	4.1	9.6	9.1	30.8
Apartment housing price index[2]	160.7	179.9	201.3	249.2	4.4	4.2	10.7	9.0	28.0
New housing loans at market prices (b.kr.)[3]	28.6	32.2	49.6	...	...	...	32.3	16.4	...
Number of Housing Fin. Fund loan applications[4]	2,846	2,535	3,271	...	...	...	2.9	13.4	...
Fish quota prices (period averages. kr./kilo)									
Price of long-term cod quota (kr./kilo)	709	930	1,223	1,170	-	-0.4	60.3	-7.2	0.9
Price of short-term cod quota (kr./kilo)	117	156	132	120	-	-4.0	-9.1	-23.3	4.3

Equity market / *Equity prices, Dec. 31, 1997 = 1,000*	*At end of year 2001*	*2002*	*2003*	*2004*	*May 17, 2005*	*% change to May 17, 2005 1 mo.*	*3 mo.*	*6 mo.*	*12 mo.*
ICEX-15	1,159.0	1,352.0	2,114.3	3,359.6	4,053.0	0.9	4.9	18.7	50.7
ICEX-MAIN (The Main List index)	1,180.8	1,436.2	2,075.2	3,167.4	3,796.0	1.3	4.7	18.2	46.4
ICEX industry indices, Dec. 31, 2004 = 100[5]									
Fisheries (ICEXFISH)	86.7	107.3	100.0	120.7	130.9	0.3	7.9	3.9	20.5
Finance and insurance (ICEX40)	.	.	.	.	121.2	1.2	4.7	.	.
Consumer staples (ICEX30)	.	.	.	.	118.5	1.5	14.0	.	.
Health care (ICEX35)	.	.	.	.	107.0	0.3	-2.1	.	.

1. Changes are based on 3-month moving averages. 2. Greater Reykjavík Area (GRA). January 1994=100. 3. Percentage changes are price-adjusted using the price index for residential housing in the GRA. 4. Housing Financing Fund applications for new and renovated housing. 5. New industry indices were introduced on April 1, 2005. Of the previous indices, only the fisheries index is still calculated, based on its initial value of 100 on December 31, 1997.

Sources: Land Registry of Iceland, Federation of Icelandic Fishing Vessel Owners, Housing Financing Fund, Icelandic Quota Exchange, Iceland Stock Exchange (ICEX), Central Bank of Iceland.

Table 17 Households and firms: assets and debt

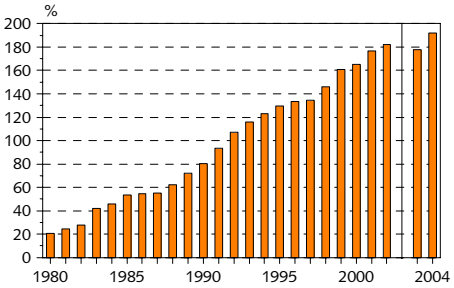
B.kr. unless otherwise stated	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*Preliminary 2003*	*Preliminary 2004*	*% change '03-'04*
Household assets in residential housing and cars [1]	676.0	724.1	842.6	953.2	1,043.9	1,108.3	1,235.8	1,342.4	8.6
Assets in pension funds	345.6	398.2	507.3	557.3	640.1	664.6	805.1	950.7	18.1
Household debt with the credit system[2]	386.2	442.6	522.0	613.8	710.4	758.6	772.1	878.7	13.8
Household debt as % of disposable income[2]	134.7	146.1	160.9	165.4	176.8	182.4	177.6	192.0	.
Firms' debt with the credit system[2]	420.7	509.4	668.8	801.1	962.3	972.5	1,171.0	1,469.0	25.4
Debt of firms in fisheries sector	123.5	139.7	160.3	165.2	195.5	191.9	185.5	208.4	12.3

1. National Economic Institute national wealth estimates. 2. Due to reclassification of lending within the credit system, household debt is 50.3 b.kr. lower than would otherwise have been the case at the end of 2003 and corporate debt 27.9 b.kr. lower, compared with the former classification. Year-on-year changes are based on the former classification.

Sources: National Economic Institute and Central Bank of Iceland.

Chart 29

Household debt as percentage of disposable income 1980-2004[1]



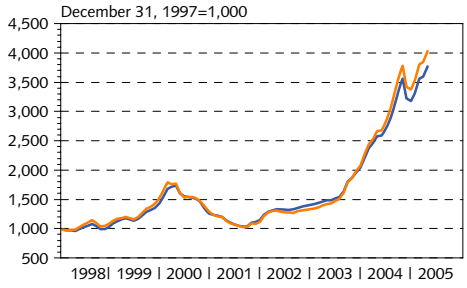
1. New classification from 2003.
See footnote 2 to table 17. Latest values are preliminary.
Source: Central Bank of Iceland.

Chart 30

Equity prices 1998-2005[1]

Monthly averages

December 31, 1997=1,000



ICEX-15
ICEX Main List Index

1. To May 17, 2005.
Source: Iceland Stock Exchange (ICEX).

Table 18 Icelandic firms' financial accounts

Accounts of publicly listed firms [1]	*Jan.-Dec.*		*Jan.-Dec.*		*Change*	*% of turnover*	
All amounts in b.kr.	*2002*	*2003*	*2003*	*2004*	*'03-'04*	*2003*	*2004*
Profit before financial expense & depreciation	33.4	34.8	32.5	40.0	7.5	12.2	11.7
Fisheries	10.8	8.4	7.4	7.9	0.5	20.8	17.7
Transport	2.6	3.2	1.6	2.6	1.0	7.0	10.7
ICT	8.1	9.8	8.2	10.2	2.0	19.2	19.6
Industry and manufacturing	8.7	9.9	11.8	16.4	4.6	16.7	18.7
Profit after taxes	16.7	16.1	12.2	20.7	8.5	4.6	6.1
Fisheries	8.7	3.5	3.1	5.4	2.3	8.5	12.1
Transport	2.3	4.4	0.5	1.0	0.5	2.3	4.1
ICT	1.2	1.6	1.9	4.2	2.3	4.5	8.2
Industry and manufacturing	5.3	5.8	5.8	9.2	3.4	8.2	10.4
Equity ratio	37.0	35.5	36.4	34.9	.	.	.
Return on equity	13.0	15.5	11.0	14.3	.	.	.
Sample size at end of period	24	24	24	24	.	.	.

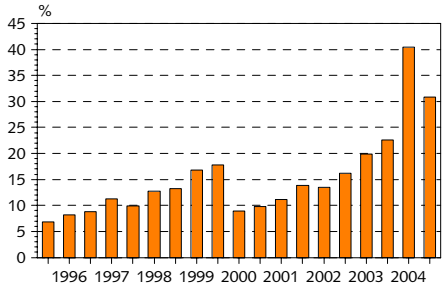
Accounts of commercial banks and savings banks [2]							*%-change*	
All amounts in b.kr.	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*'02-'03*	*'03-'04*
Net interest income	18.0	21.1	29.4	29.6	36.0	54.2	21.8	50.6
Other operating income	13.4	13.4	10.3	27.9	45.6	78.7	63.4	72.6
Net operating income	31.4	34.6	39.6	57.5	81.6	132.9	42.0	62.9
Operating expenses	19.6	22.7	25.4	34.1	44.9	60.2	31.6	34.1
Provisions for bad and doubtful debts	3.6	4.0	7.4	9.3	13.2	13.2	41.9	-
Value adjustments	-	1.7	-	-	-	-	.	.
Taxes	1.5	1.9	-0.1	1.2	2.9	8.9	145.8	206.9
Profit	6.7	4.4	6.9	12.5	18.6	43.1	48.4	131.7
Total assets at end of period	627.0	789.7	941.0	1,161.1	1,597.3	3,128.8	37.6	95.9
Stockholders' equity at end of period	44.2	49.1	60.8	84.5	113.5	256.6	34.4	126.1
% at end of period								
Return on equity	17.8	9.8	13.9	18.5	22.5	30.9	.	.
Cost ratio [3]	62.3	65.6	64.0	59.4	55.0	45.3	.	.
Capital ratio	10.3	9.7	11.3	12.2	12.3	12.8	.	.
Capital ratio excluding subordinated loans	7.9	6.6	8.0	9.1	9.2	9.5	.	.

1. Companies listed on Iceland Stock Exchange (ICEX), excluding the finance and insurance sector. Paired comparison. 2. The sample includes the commercial banks (excluding Sparisjóðabanki Íslands) and the six largest savings banks. 3. Operating expenses as a percentage of net operating income.

Sources: Financial Supervisory Authority (FME), Central Bank of Iceland.

Chart 31

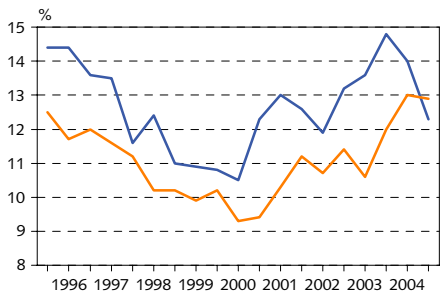
Commercial banks and savings banks: return on equity,[1] 1995/2 - 2004/2



1. The commercial banks and six largest savings banks. From 1998 FBA is included and before that the Fisheries Investment Fund and Industrial Loan Fund.
Sources: Financial Supervisory Authority (FME) and banks' and savings banks' annual/interim reports.

Mynd 32

Commercial banks and savings banks: capital ratio,[1] 1995/2 - 2004/2



1. The commercial banks and six largest savings banks.
Sources: Financial Supervisory Authority (FME) and banks' and savings banks' annual/interim reports.

Table 19 International comparison

Based on latest monthly data for each region:	*EU-25*	*EMU-12*	*USA*	*UK*	*Japan*	*Sweden*	*Norway*	*Finland*	*Denmark*	*Iceland*
Inflation in previous 12 months	2.1	2.1	3.5	3.2	-0.2	0.3	1.3	1.1	1.8	2.9
Unemployment [1]	8.9	8.9	5.2	4.7	4.5	5.5	4.5	8.3	5.9	2.3
Economic growth [2]	1.7	1.4	3.6	2.8	0.8	2.6	2.9	3.6	2.9	3.8
Long-term interest rates (nominal yield)[3]	.	2.7	3.8	4.3	0.5	2.7	3.1	2.9	2.6	7.5
Long-term interest rates (real yield)[3,4]	.	.	1.2	1.7	.	1.2	.	.	.	3.6
Short-term interest rates [5]	2.8	2.0	2.9	4.8	0.0	1.9	1.8	2.1	2.1	8.8
In 2004 (unless otherwise stated):										
GDP per capita based on PPP, in thous. US$[6]	.	25.6	36.1	27.9	26.9	27.3	35.5	26.5	29.2	28.4
Gross saving, % of GDP[7]	.	.	14.6	14.7	25.7	21.6	30.8	24.2	22.7	13.4
Gen. government fin. balance, % of GDP	.	-2.9	-4.4	-3.2	-6.5	0.5	8.2	2.3	0.9	0.5
Gen. government gross debt, % of GDP	.	78.3	63.5	43.4	163.5	61.2	34.9	51.8	48.4	36.0
Gen. government expenditure, % of GDP	.	48.6	35.6	44.4	36.7	57.5	46.7	50.5	55.6	47.4
Current account balance, % of GDP	0.1	0.7	-5.7	-2.2	3.5	7.4	14.2	4.9	3.1	-8.1

1. Seasonally adjusted. 2. Annual GDP growth based on latest quarterly figures. Seasonally adjusted except for Iceland. 3. Five-year Treasury bonds. 4. Figures are omitted where price indexation is not applied. 5. Three-month money market rates. 6. 2002. Converted to US dollars at an exchange rate that eliminates the difference in price levels between the countries. 7. 2002 for Japan and USA.

Sources: EcoWin, Eurostat, OECD.

Table 20 International economic developments

							Prelimary	*Forecast*	
Annual economic growth (%)[1]	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
World	2.8	3.7	4.6	2.5	3.0	4.0	5.1	4.3	4.4
Euro area	2.8	2.8	3.6	1.6	0.9	0.5	2.0	1.5	1.9
United Kingdom	3.1	2.9	3.9	2.3	1.8	2.2	3.1	2.5	2.3
United States	4.2	4.4	3.7	0.8	1.9	3.0	4.4	3.4	3.3
Japan	-1.1	0.0	2.4	0.2	-0.3	1.4	2.6	1.0	1.7
Other emerging market and developing countries[2]	3.0	4.0	5.8	4.2	4.7	6.4	7.2	6.3	6.0
Annual growth in world trade (%)	4.6	5.8	12.4	0.2	3.3	4.9	9.9	7.4	7.6
Consumer price inflation (%)									
Euro area	1.1	1.1	2.1	2.4	2.3	2.1	2.2	1.8	1.7
United Kingdom	1.6	1.4	0.8	1.2	1.3	1.4	1.3	1.8	1.9
United States	1.5	2.2	3.4	2.8	1.6	2.3	2.7	2.8	2.5
Japan	0.6	-0.3	-0.9	-0.7	-1.0	-0.2	0.0	-0.1	0.2
Unemployment, % of labour force									
Euro area	10.0	9.2	8.2	7.8	8.2	8.7	8.8	8.8	8.6
United Kingdom	6.3	6.0	5.5	5.1	5.2	5.0	4.8	4.7	4.7
United States	4.5	4.2	4.0	4.8	5.8	6.0	5.5	5.2	5.1
Japan	4.1	4.7	4.7	5.0	5.4	5.3	4.7	4.5	4.3
General government financial balance, % of GDP [3]									
Euro area	-2.3	-1.3	0.1	-1.7	-2.4	-2.8	-2.9	-2.6	-2.4
United Kingdom	0.1	1.1	3.8	0.7	-1.7	-3.5	-3.2	-3.2	-3.3
United States	0.4	0.9	1.6	-0.4	-3.8	-4.6	-4.4	-4.1	-4.2
Japan	-5.5	-7.2	-7.5	-6.1	-7.9	-7.7	-6.5	-6.4	-6.3
Long-term interest rates [4]									
Euro area	4.7	4.6	5.4	5.0	4.9	4.1	4.1	4.1	4.3
United Kingdom	5.5	5.1	5.3	4.9	4.9	4.5	5.0	5.2	5.2
United States	5.3	5.6	6.0	5.0	4.6	4.0	4.3	4.7	5.3
Japan	1.5	1.7	1.7	1.3	1.3	1.1	1.5	1.8	2.5

1. Real GDP percent change between years. 2. In May 2004, the IMF revised its world economic classifications into two categories of countries. The category 'Other emerging market and developing countries' comprises 146 countries. 3. General government, e.g. central government, local governments and social security transactions. 4. Yields on ten-year Treasury bonds.

Sources: Consensus Forecasts, International Monetary Fund, OECD.

Table 21 Historical economic indicators (continued on next page)

	Consumer prices [1]		Króna effective exchange rate[2]			Interest rates (%)			Money and credit % change over year			Ratio of gr. reserves to merch. imports [6]	External debt, % of GDP [7]	Growth of real GDP (%)
	Consumer price index	CPI inflation (%)	Nominal exchange rate[3]	Real exchange rate[4] Relative CPI	Real exchange rate[4] Relative ULC	Gov. bonds average yield[5]	Banks' secured lending (real yield) Non-indexed	Banks' secured lending (real yield) Indexed	M3	DMBs' lending	Credit system lending			
1976	1.8	32.4	8.5	103.3	106.4	5.8	-7.4	.	32.5	26.8	32.2	2.2	40.7	6.0
1977	2.4	30.3	9.7	113.1	114.2	3.5	-9.5	.	43.9	40.5	41.8	2.0	37.6	8.8
1978	3.5	44.0	13.9	105.3	106.6	3.3	-13.4	.	48.7	47.3	62.8	2.6	39.2	5.9
1979	5.0	44.5	18.7	100.0	100.7	3.5	-15.4	.	55.9	58.1	46.4	2.5	39.7	4.9
1980	8.1	61.8	25.9	100.0	100.0	3.5	-8.3	2.3	65.4	66.4	71.1	2.4	35.9	5.7
1981	12.2	50.8	34.7	104.4	106.3	3.2	-1.7	2.5	70.5	72.2	54.1	3.0	36.5	4.3
1982	18.4	51.0	54.5	95.8	102.2	3.5	-9.4	2.9	58.0	92.0	100.2	2.1	46.4	2.1
1983	33.9	84.2	100.0	90.3	84.3	3.8	-14.2	3.0	78.7	85.6	82.9	2.5	57.2	-2.2
1984	43.7	29.2	116.3	94.7	83.4	7.0	3.4	5.5	33.4	43.0	40.2	2.1	60.2	4.1
1985	57.9	32.4	148.7	93.2	84.5	6.9	-2.3	5.0	47.6	29.7	35.2	2.8	63.6	3.3
1986	70.2	21.3	171.0	95.0	86.4	8.5	4.3	5.2	35.0	19.1	20.1	3.6	56.5	6.2
1987	83.4	18.8	177.3	104.1	109.0	8.7	4.7	7.7	35.2	42.1	31.4	2.4	49.4	8.6
1988	104.6	25.4	202.6	109.4	113.4	8.7	11.8	9.2	24.0	37.2	34.0	2.4	51.3	-0.1
1989	126.7	21.1	254.7	100.6	98.1	7.4	6.5	7.8	27.2	25.2	33.8	3.0	56.8	0.3
1990	145.5	14.8	283.7	97.3	87.4	7.0	9.3	8.0	14.9	11.0	12.5	3.3	55.2	1.1
1991	155.4	6.8	283.6	99.9	89.6	8.1	10.0	9.2	14.4	11.6	15.4	3.2	56.0	0.1
1992	161.2	3.7	285.0	99.8	92.5	7.4	11.8	9.3	3.8	5.3	11.8	4.0	58.8	-3.3
1993	167.8	4.1	308.8	94.4	84.3	6.7	11.5	9.1	6.5	5.0	11.1	4.3	66.7	0.8
1994	170.3	1.5	324.8	89.3	77.6	5.0	9.5	7.9	2.3	-1.3	4.5	2.6	63.4	4.0
1995	173.2	1.7	322.3	89.4	81.0	5.6	10.1	8.7	2.2	0.0	5.9	2.4	63.4	0.1
1996	177.1	2.3	322.9	89.7	81.9	5.5	10.5	8.9	6.8	11.8	9.3	3.0	62.9	5.2
1997	180.3	1.8	318.7	90.5	84.5	5.3	11.1	9.0	8.7	16.8	11.8	2.6	64.8	4.7
1998	183.3	1.7	313.6	91.9	89.0	4.7	11.8	8.8	15.2	25.6	15.1	2.2	70.0	5.6
1999	189.6	3.4	313.1	93.6	90.5	4.4	8.0	8.6	16.9	22.8	17.3	2.6	82.5	4.4
2000	199.1	5.0	313.3	96.3	91.6	5.1	12.7	9.5	11.2	26.2	17.3	2.1	102.5	5.7
2001	212.4	6.7	376.3	83.7	80.1	5.1	9.4	10.2	14.9	13.4	19.2	2.1	119.8	2.6
2002	222.6	4.8	365.2	88.5	86.4	5.2	13.7	10.1	15.3	0.9	3.2	2.5	123.0	-2.1
2003	227.3	2.1	343.3	94.2	90.4	4.4	9.3	9.1	22.3	14.8	11.4	3.5	142.4	4.2
2004	234.6	3.2	336.3	97.2	92.6	3.9	8.1	8.0	13.4	39.5	20.2	3.6	198.3	5.2

1. Annual averages (May 1988=100) and changes between years. 2. Annual averages. Exchange rate of the króna against a trade-weighted average of foreign currencies. 3. 1983=100. 4. 1980=100. ULC=unit labour cost. 5. Annual average yield of indexed Treasury bonds of all maturities. Yields on Iceland Stock Exchange from 1987. Before that primary market yields. 6. Gross foreign exchange reserves at end of period as a ratio of the average monthly value of merchandise imports. Calculated at fixed exchange rates. 7. Gross debt. Direct investment capital excluded.

Table 21 (continued) Historical economic indicators

	Components of GDP (% change from previous year)			External trade (% change from previous year)				General government (% of GDP)[8]			Labour market (% of labour force)		Wages (% change from previous year)	
	Private consump-tion	Gross fixed cap. formation	National expendi-ture	Goods & services (volume changes) Exports	Goods & services (volume changes) Imports	Terms of trade	Curr. acc. balance (% of GDP)	Financial balance	Revenues	Expen-ditures	Unem-ployment	Labour particip.	Real wages[9]	Real disposable income
1976	5.4	-2.7	-3.5	13.1	-3.6	7.8	-1.5	1.1	32.1	31.1	0.5	73.4	.	2.3
1977	12.9	11.5	15.0	8.9	20.6	7.0	-2.3	-0.2	30.5	30.7	0.3	72.5	.	15.5
1978	9.0	-5.8	2.1	15.2	3.7	0.3	1.2	0.1	31.0	30.9	0.3	73.6	.	8.5
1979	2.8	-1.5	3.5	6.3	2.5	-8.6	-0.7	0.9	32.4	31.4	0.4	73.0	.	2.0
1980	3.4	13.5	5.7	2.7	3.0	-2.8	-1.9	1.3	33.8	32.5	0.3	74.1	.	1.1
1981	6.2	1.2	5.6	3.2	7.1	-0.5	-4.0	1.3	34.9	33.6	0.4	76.8	0.7	5.5
1982	5.0	0.1	5.0	-8.9	-0.6	-0.8	-7.9	1.7	36.0	34.3	0.8	77.6	1.7	2.2
1983	-5.6	-12.7	-8.6	11.0	-9.7	-1.3	-1.9	-2.0	34.0	36.1	1.0	77.4	-16.7	-12.5
1984	3.7	9.4	6.4	2.4	9.2	0.6	-4.6	2.2	35.4	33.1	1.3	77.6	-3.1	-2.5
1985	4.2	1.0	2.7	11.1	9.4	-0.9	-3.9	-1.7	34.0	35.7	0.9	79.3	1.2	10.8
1986	6.9	-1.9	4.5	5.9	0.9	5.4	0.5	-4.0	33.7	37.8	0.7	80.9	5.7	9.5
1987	16.2	19.1	15.7	3.3	23.3	4.3	-3.4	-0.9	33.9	34.7	0.4	84.1	9.0	25.8
1988	-3.8	-0.1	-0.6	-3.6	-4.6	-0.8	-3.5	-2.0	37.4	39.5	0.6	80.1	2.2	-2.7
1989	-4.2	-7.8	-4.4	2.9	-10.3	-3.9	-1.3	-4.6	37.5	42.0	1.7	78.7	-9.1	-9.4
1990	0.5	2.6	1.5	0.0	1.0	-2.0	-2.1	-3.3	38.2	41.4	1.8	77.5	-4.9	-4.6
1991	2.9	3.3	3.8	-5.9	5.3	3.5	-4.0	-2.9	39.8	42.7	1.5	76.2	1.4	2.1
1992	-3.1	-11.1	-4.5	-2.0	-6.0	-0.6	-2.4	-2.8	40.9	43.7	3.1	75.5	-0.8	-1.9
1993	-4.6	-10.7	-3.8	6.5	-7.8	-3.9	0.7	-4.5	39.1	43.5	4.4	75.3	-2.6	-7.6
1994	2.8	0.5	2.1	9.5	4.1	0.4	1.9	-4.7	38.7	43.4	4.8	75.4	-0.3	0.0
1995	2.2	-1.1	2.3	-2.2	3.9	1.3	0.7	-3.0	39.7	42.7	5.0	75.7	2.8	3.8
1996	5.4	25.6	7.1	9.8	16.5	-3.1	-1.8	-1.6	40.6	42.2	4.4	76.4	4.0	4.1
1997	5.0	10.0	5.5	5.3	7.7	2.1	-1.8	0.0	41.5	41.5	3.9	76.6	3.6	2.5
1998	10.4	32.6	13.6	2.1	23.5	5.6	-7.0	0.5	42.7	42.2	2.8	77.1	7.6	8.7
1999	8.1	-3.9	4.5	4.0	4.2	-0.8	-7.0	2.4	45.7	43.3	1.9	77.3	3.3	3.0
2000	4.4	15.3	7.2	4.0	8.0	-2.7	-10.5	2.5	45.4	42.9	1.3	77.3	1.6	1.3
2001	-3.5	-6.4	-3.7	7.4	-9.1	0.2	-4.6	0.2	44.1	44.0	1.4	77.5	2.0	1.6
2002	-1.4	-20.9	-4.5	3.9	-2.7	0.6	1.1	0.2	45.1	44.9	2.5	77.3	2.2	-0.1
2003	6.6	17.1	7.8	1.5	10.4	-4.3	-5.3	-1.0	45.9	46.9	3.4	76.6	3.4	5.3
2004	7.5	12.8	7.7	8.3	14.3	-1.2	-8.1	0.5	47.9	47.4	3.1	76.7	1.4	3.3

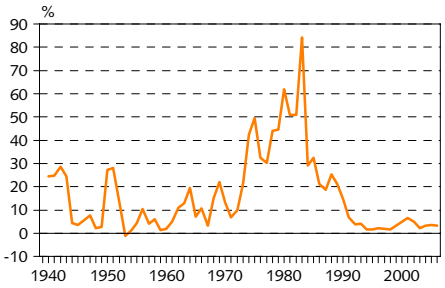
8. Central and local governments and the social security system. 9. Deflated by consumer prices.

Sources: Directorate of Labour, Iceland Stock Exchange, Ministry of Finance, Statistics Iceland, Central Bank of Iceland.

Chart 33

Consumer price inflation 1939-2006[1]

Change between annual averages

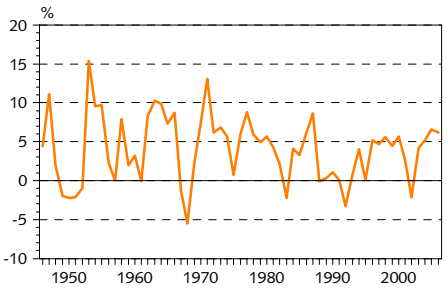


1. Central Bank forecast for 2005-2006.
Sources: Statistics Iceland and Central Bank of Iceland.

Chart 34

Economic growth 1945-2006[1]

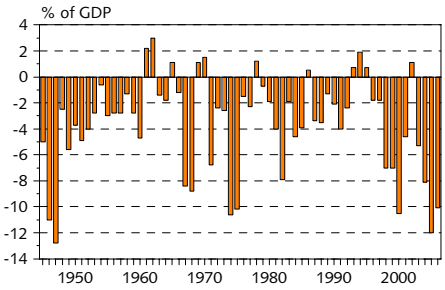
Change in real GDP between years



1. Preliminary 2003-2004. Forecast 2005-2006.
Sources: Statistics Iceland and Central Bank of Iceland.

Chart 35

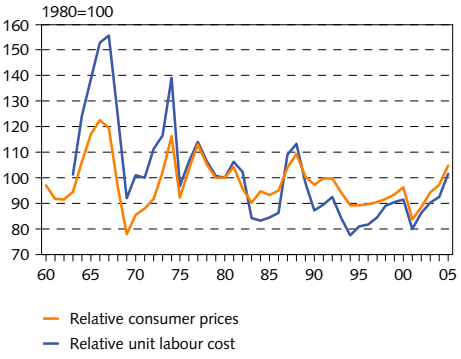
Current account balance 1945-2006[1]



1. Preliminary 2003-2004. Forecast 2005-2006.
Sources: Statistics Iceland and Central Bank of Iceland.

Chart 36

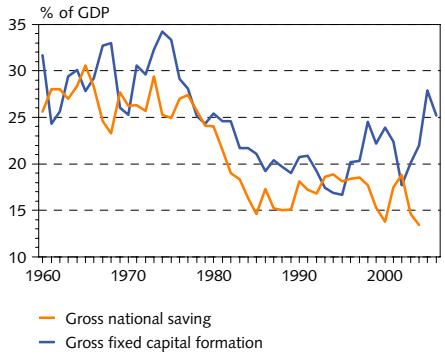
Real effective exchange rate of the Icelandic króna 1960-2005



Preliminary 2003-2004. Forecast 2005.
Source: Central Bank of Iceland.

Chart 37

Gross national saving and fixed capital formation 1960-2006[1]

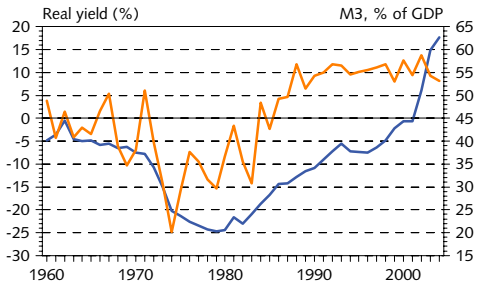


1. Preliminary 2003-2004. Forecast 2005-2006.
Sources: Statistics Iceland and Central Bank of Iceland.

Chart 38

Real yield and broad money 1960-2004

Real yield on non-indexed bank loans and M3 as percent of GDP



Latest data are preliminary.
Source: Central Bank of Iceland.

Table 22 Structural indicators for the Icelandic economy

I Population and labour force (thous.)	*1970*	*2004*
Population at end of year	204.8	293.6
under 16 years of age	70.6	70.1
16-74 years of age	127.3	207.2
above 74 years of age	7.0	16.3
Average population growth in previous 5 years (%)	1.1	1.0
Labour force (employed persons)	82.7	147.7
Males	54.7	84.9
Females	28.0	62.8

II Employment by industry (%)	*1970*	*2001*
Agriculture	12.4	3.3
Fisheries	6.6	3.9
Fish processing	7.8	5.1
Manufacturing industry	15.2	12.1
Construction, electricity and water supply	11.3	10.3
Wholesale and retail trade, restaurants & hotels	13.5	16.7
Transport, storage and communication	8.4	6.7
Financial, insurance, real estate, business services	4.0	9.5
Producers of government services	12.4	18.9
Other services	8.3	13.4

III Merchandise exports	*1970*	*2004*
Distribution by category (%)		
Marine products	77.1	60.2
Manufactures	18.4	35.1
thereof aluminium and ferro-silicon	13.2	21.1
Agricultural products	3.4	2.1
By regions (%)		
United States	30.0	9.3
European Union	52.8	75.2
Other	17.2	15.5

IV National income and output	*1970*	*2004[1]*
Gross domestic product (GDP), b.kr.	0.4	858.9
GDP, billion USD	0.5	12.2
National income per capita, thous. USD	2.0	41.0
GDP per capita (PPP) thous. USD[2]	2.7	32.6
Gross capital formation, % of GDP	25.3	22.0
Gross national saving, % of GDP	26.1	13.4
Net national saving, % of net national product	13.8	1.3
Export of goods and services, % of GDP	46.4	36.8
Public consumption, % of GDP	12.7	26.6
Gen. government total expenditures, % of GDP[3]	28.9	47.4
Total taxes, % of GDP[3]	28.9	41.1

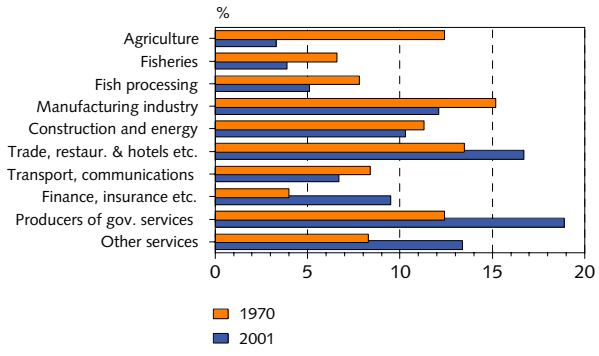
V Capital and debt	*1970*	*2004[1]*
% of GDP unless otherwise stated		
Fixed assets, % of GDP	3.4	3.0
Fixed assets, billion USD	1.8	43.5
Net external debt	20.1	129.3
Debt service, % of export revenue	11.3	56.9
General government total debt	13.0	36.0
General government net debt	-2.3	21.0
Broad money (M3)	37.5	62.6
Credit system total lending	484.8	303.1
to industries	53.6	167.7
to households	21.2	100.3
Market capitalisation of listed equities	.	123.7

1. Preliminary data. If preliminary data for 2004 are not available another year is stated. 2. Converted to US dollars at an exchange rate that eliminates the difference in price levels between the countries. 3. National accounts basis.

Sources: Iceland Stock Exchange, National Economic Institute, OECD, Statistics Iceland, Central Bank of Iceland.

Chart 39

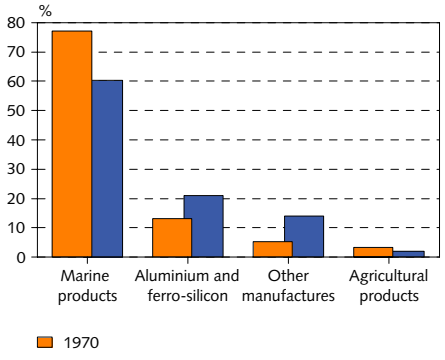
Employment by industry in 1970 and 2001



Source: Statistics Iceland.

Chart 40

Merchandise exports by category 1970 and 2004



Source: Statistics Iceland.

Table 23 Merchandise exports and imports by regions[1]

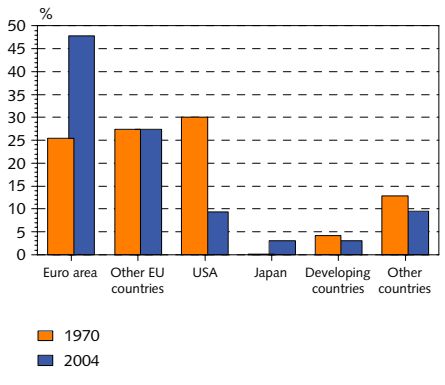
	Share of total (%)						B.kr.	
					Jan.-March		Jan.-March	
Merchandise exports, fob	*1970*	*1980*	*1990*	*2000*	*2004*	*2005*	*2004*	*2005*
European Union	52.8	52.3	70.7	67.4	75.2	75.8	152.2	35.4
Euro area	25.4	30.2	37.6	42.3	47.8	48.7	96.8	22.8
Other EU countries	27.4	22.0	33.1	25.1	27.4	27.0	55.4	12.6
United Kingdom	13.2	16.5	25.3	19.3	19.0	17.6	38.5	8.2
Other Western European countries	2.8	2.3	3.4	7.8	6.1	5.8	12.4	2.7
Eastern Europe and former Soviet Union	9.6	8.8	2.9	1.4	1.2	1.7	2.4	0.8
Russia	6.8	5.4	2.5	0.4	1.1	1.9	2.3	0.9
United States	30.0	21.6	9.9	12.2	9.3	8.9	18.8	4.2
Japan	0.1	1.5	6.0	5.2	3.0	3.5	6.1	1.6
Other OECD countries	0.5	0.6	0.5	2.0	1.5	1.1	3.0	0.5
Developing countries	4.2	12.9	5.5	3.0	3.0	2.9	6.1	1.3
Other countries	0.0	0.0	1.1	1.0	0.7	0.3	1.4	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	202.4	46.7
Merchandise imports, cif								
European Union	64.9	58.0	59.9	57.0	60.9	62.3	158.6	39.5
Euro area	32.0	33.2	35.5	33.5	34.2	32.9	89.2	20.8
Other EU countries	33.0	24.8	24.4	23.6	26.6	29.5	69.4	18.7
United Kingdom	14.3	9.5	8.1	9.0	6.8	6.1	17.8	3.9
Other Western European countries	5.4	8.1	5.2	9.7	12.3	10.2	32.1	6.5
Eastern Europe and former Soviet Union	10.4	10.9	6.5	5.7	1.2	0.5	3.2	0.3
Russia	7.2	9.7	5.0	1.8	1.0	0.7	2.7	0.4
United States	8.2	9.4	14.4	11.0	10.1	9.5	26.3	6.0
Japan	2.9	4.0	5.6	4.9	3.8	5.3	10.0	3.4
Other OECD countries	0.4	5.8	3.7	4.5	3.3	3.3	8.5	2.1
Developing countries	7.2	2.7	3.1	5.6	7.2	7.8	18.7	4.9
Other countries	0.6	1.1	1.4	1.5	1.2	1.1	3.1	0.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	260.4	63.4

1. In data prior to the year 2000, country groups are based on the year 2000.

Source: Statistics Iceland.

Chart 41

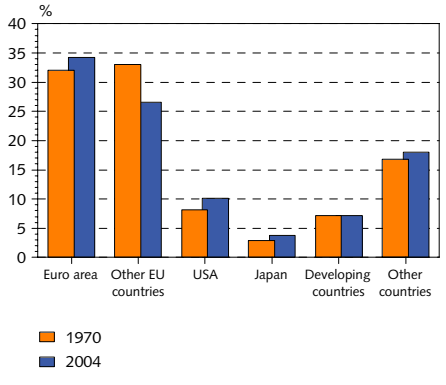
Merchandise exports by region 1970 and 2004



Source: Statistics Iceland.

Chart 42

Merchandise imports by region 1970 and 2004



Source: Statistics Iceland.