Economic and monetary developments and prospects:[1]

Wage agreements are compatible with lower inflation, but an excessive current account deficit poses a long-term threat to exchange rate stability

Inflation in recent months has been at its highest level for a long time and far in excess of what is acceptable in the long term. The roots of inflation lie in general demand expansion in the Icelandic economy and tension in the real estate market, while the rise in petrol prices in international markets also plays a major part. Recent wage agreements imply a much greater rise in wages than among Iceland's trading countries, and other things being equal this will lead to a further real appreciation of the króna. However, these wage agreements can be compatible with a reduction in inflation from its present rate, if the exchange rate remains high and economic policy is kept tight. The Central Bank now forecasts 5% inflation from the beginning to the end of this year and 4% next year, assuming an unchanged exchange rate.[2] *However, the current account deficit, which is virtually unparalleled among developed nations and on the basis of present assumptions looks set to persist for the next few years, represents a major threat to economic stability. Further measures therefore need to be taken.*

Housing and petrol prices continue to rise

Price developments over the past three months have been similar to those in the past year. Over the period from January to April, the CPI rose by 1.1%, which is equivalent to a 4.4% annual inflation rate. The twelve-month rise in the CPI reached its highest level since April 1992, at 6%. As in recent years, the increase in consumer prices was to a large extent caused by housing price rises. Excluding housing, the CPI went up by 4.5%. Rising prices accounted for around half of the January-April index increase, private services for a quarter and petrol for a fifth. Domestic goods excluding food, imported food and beverages and motoring costs, however, have fallen. The impact of seasonal fluctuations on these inflation figures should be negligible. Clothing prices should have stabilized after the seasonal drop, although they are still somewhat lower than in December. Prices of clothing and shoes in April were higher than in January, and the difference from the December price level may be explained by exchange rate developments. Some change appears to have taken place in price trends for imported food and beverages. From January to April the price of imported food fell by 3.8%. The twelve-month increase in these items is now at its lowest level for eight months, or 4%. Although such short-term changes need to be treated with some caution, a certain change may conceivably be taking place and it will be interesting to monitor developments in the next few months. The price of agricultural products and other domestic food and beverages, however, rose by 1.5% and 1.3% respectively during the period, or more than the general price level.

In January the Central Bank forecast an inflation rate of 0.9% between the last quarter of 1999 and first quarter of 2000. In the event, the index rose by 1.1%. This is a small deviation and less than in recent Central Bank forecasts. However, this is the fourth time in a row that the Central Bank underforecasts inflation for the coming quarter, following a period

1. This article uses data available on April 25, 2000.
2. It should be pointed out that the new Central Bank inflation forecast is now published in the Monetary Bulletin, for the first time. The inflation forecast is discussed on p. 7.

of overforecasting. The Bank's new inflation forecasts will be discussed on page 7.

Table I Analysis of CPI inflation by origin in 1999

%	Change in index in previous 3 mo.[1]	12 mo.	Contribution to CPI growth in previous 3 mo.	12 mo.
(1) Domestic agricultural products less vegetables..	6.1	4.2	8.8	4.3
(2) Vegetables	8.9	4.4	1.8	0.6
(3) Other domestic food and beverages	5.4	7.1	7.8	7.4
(4) Other domestic goods	-2.6	1.8	-2.7	1.3
(5) Imported food and bev.	-14.2	4.0	-10.3	1.9
(6) Cars and spare parts	-1.2	0.6	-2.8	1.0
(7) Petrol	21.4	27.5	21.2	20.5
(8) Other imported goods	0.5	0.0	1.5	-0.1
(9) Alcohol and tobacco	1.5	1.7	1.1	0.9
(10) Housing	17.3	15.9	50.3	34.4
(11) Public services	-0.9	4.8	-2.5	9.6
(12) Other services	6.0	5.8	25.8	18.1
Total	4.4	6.0	100.0	100.0
Domestic goods (1-4)	3.7	4.6	15.6	13.7
Agricultural products and vegetables (1-2)	6.4	4.2	10.6	5.0
Domestic goods less agricultural products & vegetables (3-4)	2.0	4.8	5.1	8.7
Imported goods, total (5-9)	1.1	3.7	10.8	24.3

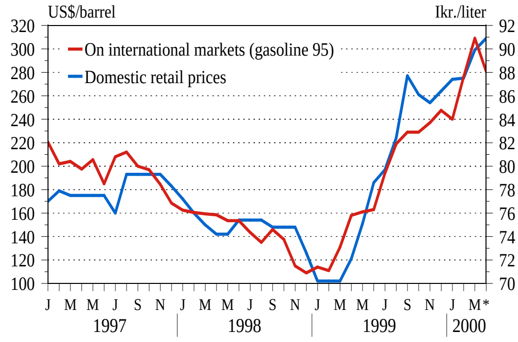
1. Changes at annual rate. *Source: Statistics Iceland.*

The housing market in the Greater Reykjavík Area apparently is still very tense. The Real Estate Evaluation Agency's index of real estate prices in the capital area, which shows a moving three-month average, rose by 1% in January and 1.5% in February. By then, it had gone up 22.5% over the past twelve months. Furthermore, prices rose faster during the first months of the year than the same period in 1999. Due to the fact that excess demand in the housing market has been concentrated in the Greater Reykjavík Area and as the CPI measured until April only housing prices there it caused some distortion in the CPI. The index was adjusted in April to incorporate information about regional housing prices for the first time. However, the impact of the adjustment was offset by an upward revision of the housing rent component.[3]

At its meeting in March, OPEC agreed to increase oil production. The price of crude oil fell considerably at once and petrol prices in international markets fell in April. The drop in world markets exceeded expectations.

Chart 1

Petrol prices



* Latest: April 25.

Wage agreements stretched to the limit ...

The wage agreement signed between the Confederation of Icelandic Employers (SA) and an alliance of labour unions in the southwest on March 13, and corresponding agreements with the Federation of Electrical Workers and the Icelandic General and Transportation Workers' Union (VMSÍ), lay down clear outlines for the content of those which are still pending. In addition, the Federation of Icelandic Trade (SV) and the Reykjavik Commercial and Office Workers Union (VR) agreed on a framework for so-called market-based determination of wages, but it is difficult to assess at this stage what this involves. Although the outlines of contractual wage developments for the next three years are known, it is unlikely, under prevailing conditions in the labour market, that contractual wage rises will be the only factor at work.

Agreements made so far cover 60% of the private sector labour market and 27% of the labour market as

3. Other changes made to the CPI in April included a new method for calculating the weights for insurance, in line with the harmonized European Economic Area index of consumer prices. Statistics Iceland is currently conducting a consumption survey, the results of which will be incorporated into the CPI as of April next year. It is planned to conduct such surveys every year to enable the results to be used for the annual review of the index base.

a whole. The strength of the agreements that have been signed lies in their duration, until the autumn or end of 2003, but the increase in wages is clearly close to the upper limit which is compatible with price stability. The agreements are revocable if the assumptions on which they are based do not hold good, for example if significantly greater wage rises are negotiated in other agreements or if the assumed drop in the inflation rate fails to materialize. A special committee appointed by the Federation of Labour and the SA will issue a ruling in the event of the assumptions being questioned. If they are deemed no longer valid, the wage clauses will either be renegotiated or revoked with three months' notice.

Assuming that the agreements that have been reached so far on the private market will broadly speaking apply to the labour market as a whole, the impact of wage changes will be as follows:

- During the contract period, a total of 230 m.kr. from the payroll tax will be allocated towards job training.

An important aspect of the recent agreement is that the lowest wages rise by considerably more than wages in general. This greatly increases the risk of wage drift in the near future, since there may be a tendency to re-establish earlier differentials. However, large contractual wage rises may deter employers and wage earners alike from wage drift. Whether the structure of the agreement will contribute to extensive wage drift may depend on the tightness of the labour market, on the one hand, which affects the bargaining position of employees, and the capacity of businesses to accede to wage demands, on the other hand.

Timing	*Wage increases*	*Estimated cost effect*[1]
March 1 2000	Wages below 70,000 krónur increase by 8.9%. The increase is proportionally smaller for higher wages, and wages above 90,000 krónur increase by 3.9%.	5%
January 1 2001	The lowest wages increase by 6.5%, but higher wages by gradually less up to 85,000 or 91,000 kr. (depending on contract). Higher wages increase by 3%.	3¾%
January 1 2002	The lowest wages increase by 6.5%, but higher wages by gradually less up to 90,000 or 96,000 krónur. Higher wages increase by 3%.	3¾%
January 1 2003	The lowest wages increase by 5.25% or 5.75%, but higher wages by gradually less up to 93,000 or 100,000 krónur. Higher wages increase by 2.25%.	3%

1. On the whole private sector

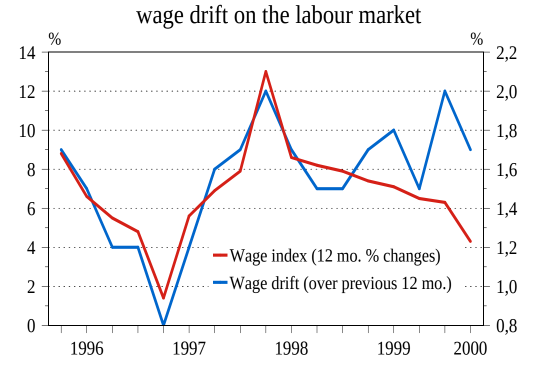
In addition to the wage rises outlined above, the estimated cost to employers includes costs resulting from various other clauses in the agreements. The main ones are:

- The employers' contribution to match the 2% voluntary supplementary pension fund premium payable by employees will rise from 0.2% to 2.2% during the term of the agreement.
- The right to sickness pay has been reviewed with the aim of clarifying it. These changes should not have any impact on total cost.
- Parents will be entitled to take leave to look after their sick children for ten days a year at basic pay rates after one year's employment, instead of seven days at present. It was roughly estimated that this would raise wage costs by 0.1%.

In the present economic climate, conditions in the labour market may be expected to encourage wage drift. Whether business profitability is likely to contribute to wage drift is more uncertain. In some sectors last year's outcome was not particularly good, as is discussed in more detail in an article by Ólafur Örn Klemensson in this issue. Seasonally adjusted unemployment is now around 1½% and still falling. Such a low rate of unemployment causes bottlenecks in the labour market. Experience also suggests that the relationship between unemployment and labour market pressure is not a linear one. Wage pressure could increase very rapidly if unemployment drops below a specific threshold or rapidly approaches it. Where this threshold lies now is difficult to establish, but the accompanying chart, showing the relationship be-

Chart 2

The wage index and estimated wage drift on the labour market

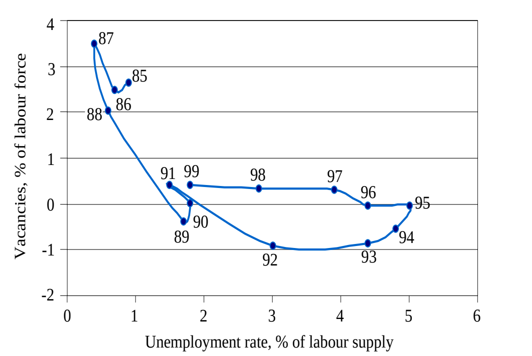


tween unemployment and vacancies (the Beveridge curve), suggests that labour market pressure, measured in terms of vacancies, intensifies once unemployment drops below 1-1½%. Thus unemployment may be very close to this threshold, especially since it still appears to be on the decrease.

It must be concluded that very little excess capacity is present in the labour market now, although participation is still somewhat lower than at its peak in the 1980s. Due to the fact that demand for extra labour is largely confined to the service sector in the Greater Reykjavik Area, bottlenecks may occur at an earlier stage. Furthermore, labour specialization may have increased and thereby raised the unemployment threshold beyond which wage pressure increases disproportionately. On the other hand, the labour market now is probably considerably more open, as illustrated by statistics for issued work permits and migration

Chart 3

Unemployment rate and job vacancies



to and from Iceland. Last year a record number of work permits were issued or renewed – more than 3,000. So far this year the number of work permits issued has surpassed last year's record and if the present trend continues, net migration to Iceland, which amounted to 1,100 individuals in 1999, will be even greater during the current year.

The wage index rose by 2.7% between the last quarter of 1999 and the first quarter of 2000. The lion's share of that figure is accounted for by pay rises among civil servants and bank workers at the beginning of the year. The negotiated wage rise in the private sector labour market will be recorded in the second quarter figures. In February the wage index went up by 1.3%, which cannot be explained by contractual rises. On the other hand, it rose by a modest 0.2% in March, and measured wage drift between the first quarter of 1999 and the first quarter of this year is running at a similar level to the past two years. Thus there are still no firm indications that a turning point has already been reached as far as wage drift is concerned.

Wage agreements not only have a direct impact on prices, but also affect prices indirectly via aggregate demand. The impact of the wage agreements on aggregate demand results from both the wage rises themselves and the measures which the government implemented in order to facilitate agreement, including a higher personal tax allowance. The government announced a rise in the personal allowance, which duly went up 2.5% on April 1 on top of the 2.5% rise this January. At the end of the year for the next three years the personal allowance will go up by the equivalent of the minimum wage rise under the SW labour alliance agreement, i.e. by considerably less than the average increase in wages. On average, the personal allowance will be 4.3% higher in 2000 compared with the previous year. Welfare payments will keep pace with the personal allowance until 2003. Reforms intended to reduce the marginal effects of child allowance benefits were announced too, and the right of parents to maternity or paternity leave was extended. The last-mentioned changes are in fact consistent with the coalition government's policy declaration and therefore do not entail a deviation from earlier plans. Such a large increase in the personal tax credit was not envisaged in the budget, so the government's measures involve some relaxation from its original stance, or by 1.3 b.kr. in 2000. However, the treasury's loss of revenue must be assessed in light of the fact that the personal tax credit rose by considerably less than consumer prices at the beginning of this year and it is doubtful whether the subsequent rises will keep pace with inflation either. On the whole, the government's contribution to the wage agreements is fairly moderate, and less than in the 1997 agreement. Moreover, the scope for using taxes as an instrument of economic management seems to be larger now.

... but could be compatible with falling inflation according to the new forecast

Although recent wage agreements may be testing the limits of price stability, the outlook is for somewhat declining inflation in the course of the year and even more so next year, provided that a major exchange rate reversal does not occur. However, inflation will probably come down much more slowly than is desirable. From January 1999 to January this year the CPI rose by 5.8%. The Central Bank now forecasts that prices will rise by 5% this year and 4% in 2001. This implies an average rise in prices of 5½% between 1999 and 2000, and 4½% between 2000 and 2001.

In January the Central Bank forecast inflation of 3.8% in the course of 2000. In part the higher inflation forecast now reflect increases in the CPI during the first four months of the year, but inflation prospects until the end of the year have also worsened considerably. This bleaker scenario may be attributed to a change for the worse in various assumptions behind the forecast. Firstly, it is now apparent that wage rises will be considerably larger than assumed in the January forecast. In January, wage costs were expected to rise by 6½% in 2000, while the current forecast assumes an increase of almost 8% in 2000 and 5½% in 2001, based on an assessment of the cost effect of recent agreements , applied to the whole private sector. In addition, 2½% wage drift is expected in 2000 and 1½% in 2001. The assumption for productivity gains during the current year remains unchanged at 2%, so the higher wage cost will be passed on to prices. Productivity is expected to increase by 2½% next year. The other main change in the forecast assumptions is a deterioration in the outlook for import price developments. In January import prices were expected to rise by 2% in foreign currency terms, but the forecast now assumes an annualised rise of 3.5% during the first quarter of this year and an annualised rate of 2% after that. On the other hand, the exchange rate of the króna has appreciated by 2.1% since the January forecast. The new forecast assumes a constant rate of exchange from April 25. To summarise, the less favourable inflation outlook for 2000 is mainly the result of changes in the outlook for wages and import prices, accounting for almost 1 percentage point of a 1.2 percentage point difference between the January and the current forecast.

As always, foreign exchange developments during the forecast period are one of the main uncertainties. As usual in the Bank's inflation forecasts, the exchange rate is assumed to be constant from the day of the forecast. There are various indications that the króna will remain stable or even appreciate over the coming months on account of capital inflows, for reasons including the large interest rate differential. Later on in the forecast period, however, downward pressure on the króna cannot be ruled out, if eco-

Table II Inflation forecast of the Central Bank

Quarterly forecast

	Percentage change from previous quarter	*Index*	*Annualised quarterly change*	*Change from same quarter previous year*
1999:1	0.6	185.2	2.6	1.5
1999:2	1.5	188.0	6.3	2.4
1999:3	1.7	191.1	6.8	4.4
1999:4	1.4	193.9	5.9	5.4
2000:1	1.1	196.0	4.3	5.8
2000:2	1.4	198.7	5.7	5.7
2000:3	1.3	201.3	5.5	5.3
2000:4	1.3	203.8	5.1	5.1

Annual inflation rate (%)

Year	*Year on year*	*Within year*
1996	2.3	2.0
1997	1.8	2.2
1998	1.7	1.3
1999	3.4	5.8
2000	5.5	5.0
2001	4.5	4.0

Shaded area indicates forecast.

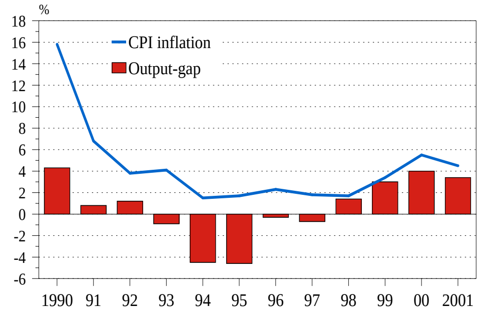
Box 1 The relationship between inflation and output-gap

Inflation forecasts by the Central Bank and others have been on the low side for the past year, reversing an opposite tendency in 1998. This prompts the question whether important parameters are lacking from the cost-push models which have been the principal forecasting tool, which could explain what is apparently a systemic deviation. Internationally, the utilization of domestic factors of production is often considered to be an important indicator of price developments. A higher utilization ratio of domestic factors of production increases the likelihood of price rises and vice versa. To quantify the relationsship between utilization of domestic factors of production and inflation, statistical methods are commonly applied in order to assess how much production is compatible with efficient utilization of the factors of production, i.e. leaves them neither underutilized nor overutilized. The outcome of such measurements is, however, subject to considerable uncertainty. The accompanying chart shows an assessment of the output-gap for Iceland along with inflation developments since 1990.[4]

4. This is a structural vector autoregressive assessment of systemic shocks having a permanent impact on real GDP. See Már Gudmundsson, Thórarinn G. Pétursson and Arnór Sighvatsson (2000), "Optimal Exchange Rate Policy: The Case of Iceland" in Macroeconomic Policy: Small Open Economies in an Era of Global Integration, eds. Már Gudmundsson, Tryggvi Th. Herbertson and Gylfi Zoëga. Reykjavík: Háskólaútgáfan (pending publication) and Thórarinn G. Pétursson (2000), "Wage and Price Formation in a Small Open Economy: Evidence from Iceland," Central Bank of Iceland Economics Department, unpublished manuscript.

Chart 4

Consumer price inflation and the output-gap



2000-2001: Projections.

The chart shows that the output-gap fell during the contraction in 1988-1995, and became negative in the second part of that period. These conditions contributed to a downturn in inflation until 1999. During the subsequent recovery, previously underutilized capacity was gradually employed and the factors of production appear to have become fully utilized in 1997 or 1998 and overutilized afterwards. Since then, demand has exceeded production capacity and fuelled growing inflation. According to this assessment, utilization of the factors of production this year will be 4% above the normal level, although the ouput-gap will narrow somewhat from next year onwards.

nomic imbalances continue. Another important uncertainty is the impact of economic overheating on wage drift and prices. The forecast model which incorporates these factors actually predicts a lower rate of inflation, but this is because it forecasts lower wage rises than assumed here. On the basis of the same wage rises, the model forecasts marginally higher inflation than here.

Uncertainties which could result in higher inflation include the following:

1. There is a risk of wage drift because the lowest wages rise by more than higher ones.
2. Housing price rises may continue to outstrip overall inflation, as there are few signs indicating that the overheated housing market will cool down in coming months.
3. International price developments could prove less favourable than is forecast now. Excluding rises in energy prices, international inflation has been very low over the past year.[5] In recent months, however, signs of emerging inflationary pressure have become visible in the USA. Commodity prices (other than fuel) which were on a declining trend until the middle of last year are also beginning to rise again.

Uncertainties which could cause less inflation than now forecast include:

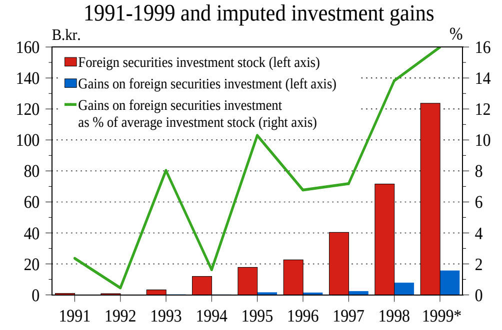
5. The harmonized CPI in the Euro countries went up by 2.1% from March 1999 to March 2000. This is marginally higher than the European Central Bank's inflation targets, while inflation excluding energy prices was only 0.9%.

Box 2 Revised compilation of current accounts

In recent years the imputed capital gains on foreign securities holding of residents has been entered as factor income in the current account, since information has been lacking about dividend payments from abroad. While this method is not in line with international standards for the compilation of national accounts, it had no significant impact on the calculation on the current account until 1998, since holdings of foreign securities and equities was very small. The stock of financial assets abroad owned by Icelandic residents has grown rapidly in recent years, particulary the stock of foreign equities. In 1994, i.e. before the final restrictions on capital movements were abolished at the beginning of 1995, Iceland's foreign equity stock amounted to 3½ b.kr. At the end of 1997 it amounted to 40 b.kr., and its value was estimated at 103 b.kr. at the end of last year. In part this rapid growth is the result of soaring share prices in foreign markets in recent years. As the stock of foreign equity multiplied the imputed gains had a progressively larger impact on the current account balance, especially as share prices rose quite rapidly over the past two years. The estimated capital gains amounted to 1.6 b.kr. in 1997 and 6.8 b.kr. in 1998, and would have been 14.8 b.kr. last year had the same method been employed as before. This would have distorted the international comparability of domestic balance of payments statistics. Although the change in methodology does not alter the underlying economic development, the less favourable outcome of the new method underlines the sensitivity of underlying economic trends. Recent upheavals in international equity markets confirm that unrealised capital gains cannot be taken for granted. In that sense the former method of calculation concealed an inherent risk in the current account balance. On the other hand, in the long run earnings from equity ownership are largely realized through buying and selling of shares rather than direct dividend payments. International standards therefore underestimate to some extent the long term benefit to the economy of foreign equity ownership.

Chart 5

Foreign security investment at year-end 1991-1999 and imputed investment gains



1. Petrol prices in international markets have declined considerably following OPEC's decision in March to step up production. In the absence of a reversal, or if prices drop even further, the petrol price rise in Iceland in the beginning of April might have been the last one for some time. Petrol prices came down marginally in the beginning of May and could conceivably fall even further.
2. Prices of imported food have decreased somewhat recently, as mentioned earlier, and further decline cannot be ruled out. However, this item only constitutes 3% of the CPI and thus has a minor impact.
3. The price impact of the lower excise taxes on larger motor vehicles will be felt in the next few months, and is expected to reduce the CPI by 0.2%. In light of the apparent slowing down of growth in motor vehicle imports, the effect is fairly likely to be transmitted to prices.

The scale of the current account deficit in 1998 and 1999 is almost unparalleled among advanced countries

In March the National Economic Institute (NEI) published revised figures for economic growth in 1999 and a forecast for 2000. The projected growth of national expenditure in 1999 is unchanged from the NEI's December forecast. A somewhat larger contraction in gross capital formation is projected, but this is offset by a faster growth in both private and public consumption. In addition, exports are now considered to have been 1% lower than assumed in December, and imports marginally greater (Table III shows deviations from the NEI October forecast). Consequently, the economic growth estimate has been revised downwards to 4.4%, from 5.8% in October. The most important turnaround in the economy since the publication of the October and December forecasts is a larger than forecast current account deficit. It is now estimated to have been 43 b.kr. last year, the equivalent of 6.7% of GDP, which is a 2.1% larger deficit relative to GDP than forecast in October and 0.7% larger than in December. Most of the deviation from the December forecast can be attributed to changed methods in calculating the current account balance, aimed at harmonizing it with international standards, which left the deficit for the year 14-15 b.kr. larger than would otherwise have been the case.[6]

Even though the new accounting methods largely explain the widening deficit since the December forecast, the position now is considerably worse than had been expected earlier. The deterioration from the October forecast was split fairly equally between the balance on goods, the balance on services and the balance on income. In addition, the composition of national expenditure is now less favourable from the viewpoint of stability, because investment appears to have been lower and private and public consumption greater than forecast. Iceland's current account deficit over the past two years is one of the largest recorded by any OECD country in recent years. Only New Zealand has sustained a comparable deficit recently.

The NEI estimates that real disposable income per capita increased by 5% in 1999 but private consumption by 7.2%. Hence, some private consumption has been financed through household borrowing. Data from the credit system confirms this, since lending to households increased by 16% from the beginning to the end of the year and 15% in 1998, i.e. considerably faster than disposable income. The ratio of debt to disposable income has gone up steadily over the past 20 years, but the increase in 1999 was unusually rapid. At the end of the year, estimated household debt was equivalent to 147% of disposable income, rising almost 9% from the year before. This behaviour of households could be seen as somewhat puzzling. It would seem sensible for households to reduce their debt during an economic boom in order to level out consumption between good and bad years. In contrast, households have been increasing their debt during the present upswings.

Two conjectures can be put forward to explain this behaviour by households. The first is that they expect a substantial real increase in income over the next few years which will enable them to service larger debt. Thus the rise in the ratio of household debt to current disposable income may be explained by their optimism about the growth in disposable income over the coming years. The other explanation is that households now estimate their assets as being much more valuable and are therefore prepared to

Table III NEI's forecast in March 2000 and October 2000

	NEI's forecast in March 2000		*Difference from October forecast in 1999*	
Annual volume changes in % if not indicated otherwise	*Projection 1999*	*Forecast 2000*	*1999*	*2000*
Private consumption	7.2	4.0	1.2	1.5
Public consumption	4.7	3.5	1.3	1.0
Gross fixed investment	-2.0	8.4	-1.9	6.3
National expenditure	4.7	4.7	0.7	2.3
Exports of goods and services	5.8	1.8	-2.5	-0.8
Imports of goods and services	6.3	4.1	2.9	2.1
Gross domestic product	*4.4*	*3.9*	*-1.4*	*1.2*
National income	4.1	4.0	-0.7	1.3
Current account balance, % of GDP	-6.7	-7.2	-2.1	-3
Foreign trade				
Merchandise exports	7.4	1.5	-2.3	-0.7
exports production	5.3	4.2	-2.7	0.1
Merchandise imports	5.0	3.8	2.9	2.9
excluding volatile items	3.6	2.3	2.9	3.5
Export of services	2.6	2.4	-2.9	-1.1
Import of services	9.5	4.7	2.8	0.2
Merchandise trade balance	-22.4	-27.0	-4.4	-11.9
Balance of services	-5.5	-5.5	-4.5	-4.5
Net factor income from abroad	-14.2	-17.1	-4.3	-4.9
Current account balance	-42.8	-50.5	-13.5	-21.5

Source: National Economic Institute.

6. Current account balances for previous years were revised at the same time. The deficit for 1998 now measures just over 40 b.kr. instead of 33½ b.kr., increasing the ratio to GDP by just over 1%. There is less discrepancy in calculations for the preceding years.

incur more debt than before. Moreover, the recent surge in real estate prices allows housholds to mortgage their assets more heavily. Both explanations probably apply. However, this scenario involves a considerable risk for both households and the credit institutions from which they have borrowed. Expectations of continuing growth in disposable income may be unrealistic and asset prices higher than is sustainable in the long term.

Further measures are needed to ensure stability in the coming years

According to the NEI forecast, economic growth will slow down somewhat in 2000. GDP is forecast to grow by 3.9%, around 1 percentage point faster than in the NEI's previous forecast. The most important changes in the economic outlook for 2000 are considerably faster growth of gross capital formation, which is forecast to grow by 8½%. Business investment is forecast to increase by 11½%, in particular in vessels and aircraft. The growth rate of private and public consumption has also been revised upwards. Wage agreements that have been concluded since the NEI published its forecast should not change this scenario much, as the NEI's assumptions seem to have been fairly close to the outcome of wage settlements now envisioned.

Faster growth in national expenditure is accompanied by faster growth of imports, which are now expected to increase by 4.1% instead of 2%. Since very sluggish export growth is still forecast, or less than 2%, the current account deficit will widen still further. According to the forecast, the current account deficit in 2000 will be equivalent to 7.2% of GDP, which would be the largest deficit since 1982.

Exports at the beginning of a year are prone to fluctuations and hence provide only a weak indication about emerging trends, but the available statistics do not give any grounds for optimism about the development of the current account deficit this year. During the first three months of 2000 the merchandise trade deficit was 5.9 b.kr., compared to 1.1 b.kr. during the first quarter of last year. Excluding vessels and aircraft, however, the deficit was 5 b.kr. as against 3.5 b.kr. in 1999. The most gratifying aspect of these figures is the growth in exports of manufactured goods apart from aluminium and ferrosilicon. During the first quarter, exports in this category amounted to 3.2 b.kr., which is over 1 b.kr. more than at the same time last year. The value of aluminium and ferrosilicon exports also rose substantially, reflecting higher export prices as well as volume growth. Merchandise imports measured at a constantly exchange rate grew by 16% between the first quarters of 1999 and 2000. Around three-quarters of the increase may be attributed to more expensive fuel imports and by vessel imports in March. On the other hand, it is worth noting that the imports of motor vehicles have declined from the year before, and that imports of food and beverages remained steady. However, imports of other permanent consumer goods still appeared to be growing briskly.

The continued rapid growth in lending by DMBs does not point to a significant slowdown in demand. By the end of March, the twelve-month growth in lending by DMBs was 24%. Admittedly this is slower than around the middle of last year, but at that time lending figures for the DMBs were swollen for an exceptional reason.[7] So far this year, however, twelve-month credit growth has not slowed down to any extent, while growth in money supply (M3) has dropped marginally. It can only be concluded that considerable demand pressure still exists. The assessment of utilization of production capacity discussed above points in the same direction.

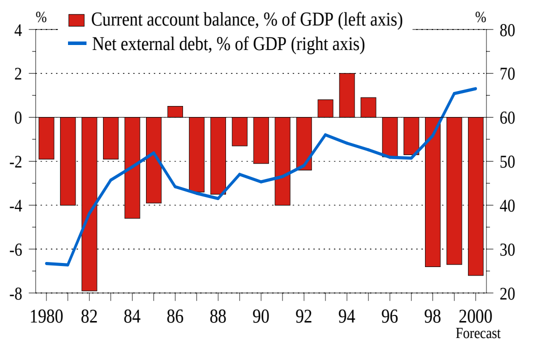
The forecast current account deficit in excess of 7% this year is a serious cause for concern. What is worse, however, is that there is no sign of an automatic reduction in the deficit over the coming years, given the NEI's long-term projection of underlying economic factors. The current account deficit, according to the long-term scenario, will persist or even widen to 8% in 2004. Such a large and persistent imbalance can test the confidence of market participants in economic policy. International experience suggests that such a large deficit poses a very high risk. Iceland's deficit is similar to that which preceded the currency prices in Mexico in 1994/1995 and in Thailand in 1997.

No developed OECD country has had to tackle a deficit on such a scale over the past decade, except when New Zealand's deficit reached 7% of GDP in

7. As already reported in earlier Central Bank publications, the reason is the incorporation of the Commercial Loan Fund's balance sheet into Íslandsbanki's accounts in October 1998.

Chart 6

Current account balance and external debt 1980-2000



1997, but subsequently declined. In that particular case, the deficit grew when exports stagnated or contracted following a strong real appreciation of the New Zealand dollar, wich strengthened by almost one-third from 1992 to 1997. The following year the dollar fell by an average of more than 10% and GDP contracted during the first part of the year. As in Iceland, the fiscal position was very strong, with a public sector surplus amounting to 2% of GDP in 1997 and an even larger one in the years before that. The monetary stance was also very tight. At the beginning of the 1980s, Portugal and Ireland also faced considerable economic difficulties, which resulted in a large current account deficit. Developing countries experiencing rapid growth and a high capital formation ratio have sometimes run up a current account deficit on Iceland's scale or more without a serious currency crisis ensuing. However, the scope for a developed welfare state such as Iceland to grow its way out of the problem is much more limited. What mainly distinguishes economic developments in Iceland from those in New Zealand several years ago is that it has run up a large deficit with much less appreciation in the real exchange rate. Inflation also increased significantly in Iceland last year while it remained low in New Zealand, as a result of stronger appreciation.[8] This invites the conclusion that Iceland's economic situation is more volatile insofar as the higher inflation does not leave any scope for the easing of monetary policy in the near future.

Projections of the type recently published by the NEI should be interpreted with caution. In view of the difficulty of foreseeing the development of many underlying economic factors so far into the future, projections of this type should rather be regarded as an instrument for revealing economic weaknesses than an actual forecast. The persistent current account deficit would push Iceland's foreign debt up to 85% of GDP in 2004, compared with 64½% at the end of 1999. The net external position would deteriorate less, since investment in foreign securities is assumed to continue.

It is unlikely that such a development will actually come about in this way. Although the models used in projections of this sort can at best provide a fairly reliable indication about short-term growth, the uncertainty increases exponentially for each extra year of the projection. One of the difficulties lies in foreseeing the relationship between private consumption and accumulation of household debt. Households have been steadily increasing their indebtedness for some twenty years now, but will obviously not do so indefinitely. During the past decade, households have been able to roll their debt repayment burden forward by taking longer loans, at a time when interest rates fell as well. Further loan extensions may be more difficult to arrange. Households will therefore have no other choice, if the economy suffers a considerable shock, than to cut consumption or sell assets, with the accompanying risk that this poses for the financial system. The current position is therefore clearly very sensitive. Although private consumption can continue to grow for some time by virtue of ongoing debt accumulation – and it is impossible to state for how long – there is a growing risk of a sudden reversal. To avoid a contraction in private consumption in order to meet growing debt repayment, real disposable income will have to keep on growing. If this fails to happen and household asset prices fall sharply at the same time, a sharp contraction in private consumption could follow.

The accumulation of national foreign debt cannot be sustained indefinitely either, but a turnaround is just as difficult to predict as in the case of private consumption-household debt linkage. Technically speaking, the economy can continue to accumulate debt for as long as it enjoys the confidence of foreign

8. New Zealand uses inflation targeting in its fiscal measures and also has a very independent central bank.

creditors. However, there is a risk that before foreign creditors lose their confidence, the confidence of market participants in the stability of the króna will have vanished. On the assumptions made in the NEI projection, debt accumulation will not stop automatically. In the absence of any action this will gradually increase the risk of a loss of confidence in the stability of the króna. It is worth considering alternative adjustment scenarios, since it is clear that the NEI scenario is hardly tenable:

1. The turnabout may conceivably be a slow one, obliging the Central Bank to raise interest rates gradually over the next few years in order to maintain a strong exchange rate. High interest rates would eventually smother the economic growth which is now present, while the government would have the opportunity to take other measures to reduce demand and the current account deficit less painfully.
2. Experience shows, however, that reversals are often very sudden. When capital flight has started, the scope for defending the exchange rate may be quite limited. Were this to happen, the króna would inevitably depreciate sharply for a while. Experience also shows that balance is most often not restored until after a period of overshooting. This would be followed by a sharp contraction in private consumption and capital formation, and financial institutions would unavoidably suffer serious losses under such conditions.
3. The most preferable course of events would be for the government to adopt forward-looking restraint measures in order to contain domestic demand. Domestic interest rates would then not need to rise as much as would otherwise be the case. Fiscal measures would have a direct effect on demand, in particular in the area where it is most important to contain it, i.e. private consumption.
4. Despite the bleak outlook for long-term macroeconomic stability, it is impossible to rule out a scenario that would avoid serious contraction. Firstly, the NEI assumes fairly sluggish export growth during the period, or 2½% annually. This would certainly be a rather dismal result, given that annual global trade has been growing by 6% on average over the past decade. However, export growth cannot be taken for granted. Sharp price fluctuations can occur. The fisheries sector's growth potential is more limited than in the past, so growth will increasingly have to come from other sectors. Apart from the expansion of the Nordurál aluminium smelter at Grundartangi, the outlook is for a pause in export growth based on power-intensive industries, while the weight of other exported manufactured goods is still insufficient to affect the current account balance in a fundamental way, even if these exports have been growing quite briskly recently. Nonetheless, the prospects of export growth in various areas appear fairly good, and new export sectors can be hoped to have a significant impact in the course of time. In order to achieve a significant reduction in the current account deficit, exports need to grow considerably faster than imports. Secondly, households might increase their saving over the next few years while the NEI forecast assumes that private sector saving will remain at today's historical low. This is in fact rather unlikely, but it is impossible to predict when and how a reversal will take place.

Although an impressive surplus is projected in the budget for 2000, in the Central Bank's view it is inadequate considering the scale on which domestic demand growth has generated revenues for the treasury. In addition, various recent government measures have to some extent undermined the restraint implied in the budget. Besides measures intended to facilitate wage settlements, amended legislation on excise taxes on cars will cost the treasury 300-350 m.kr. in revenue, as well as stimulating imports and borrowing. Although a good case can be made for simplifying the excise tax structure, the Central Bank considers that these reforms should have been designed so as to leave fiscal restraint undiminished and have a minimal impact on imports.

The March national economic forecast implies there will be no scope for easing monetary policy in the near future. Although national expenditure growth has slowed down and is likely to continue to do so over in the medium term, this will in itself not bring inflation sufficently down or the current account balance to a sustainable level, unless further economic measures are taken. In the absence of tighter fiscal policy, monetary policy may need to be tightened even further. At the same time a very tight monetary stance will have various negative side-effects. High interest rates or a high rate of exchange could smother growth-edge industries in their infancy. Hence, it would be preferable to attack the problem revealed by the NEI's long-term scenario through greater fiscal restraint.

Conventional measures of fiscal restraint, i.e. cutbacks in expenditures or tax increases, are likely to be more effective in terms of their effect on national saving and domestic demand than various indirect measures such as tax incentives. Furthermore, privatisation by no means necessarily increases national saving. In general, spending cuts are more effective than tax increases, which may be regarded as temporary, for example if the long-term fiscal position is considered good. Iceland's position in this respect is not entirely clear, but conceivably the public could view the present strong fiscal position as a temporary phenomenon, in which case a tax rise could be considered permanent, and would probably dampen general optimism too. Both these factors would contribute to greater national saving. As far as spending cuts are concerned, it would seem viable to target labour-intensive investment expenditure under the tense climate now prevailing in the labour market. Finally, it is important to pay attention to reducing the special incentives for accumulating debt which are now present in the Icelandic tax system, such as interest rate rebates on mortgages.