



The Economy of Iceland

# ECONOMY OF ICELAND

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**Icelandic letters:**

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

**Symbols:**

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

## Republic of Iceland

### People

|                 |  |
|-----------------|--|
| Population      | 293,577 (December 31, 2004)                                  |
| Capital         | Reykjavík, population 113,848 (December 31, 2004)            |
| Language        | Icelandic; belongs to the Nordic group of Germanic languages |
| Main religion   | Evangelical Lutheran (85.5%)                                 |
| Life expectancy | Females: 83 years, Males: 79 years                           |

### Governmental system

|               |  |
|---------------|--|
| Government    | Constitutional republic                                      |
| Suffrage      | Universal, over 18 years of age; proportional representation |
| Legislature   | Althingi with 63 members                                     |
| Election term | Four years, last election May 10, 2004                       |

### Economy

|                        |  |
|------------------------|--|
| Monetary unit          | Króna (plural: krónur); currency code: ISK   |
| Gross domestic product | €10.2 billion (885.0 billion krónur, USD 12.6 billion) in 2004                         |
| International trade    | Exports of goods and services 36% and imports of goods and services 41% of GDP in 2004 |
| Per capita GDP         | €34.7 thousand in 2004 (3.0 million krónur, USD 33.6 thousand in terms of PPP)         |

### Land

|                         |   |
|-------------------------|---|
| Geographic size         | 103,000 km <sup>2</sup> (39,768 sq.m.)  |
| Highest point           | 2,110 m (6,923 ft)  |
| Exclusive economic zone | 200 nautical miles (758,000 km <sup>2</sup> / 292,680 sq.m.)                                      |
| Climate                 | Cool temperate oceanic; highly changeable, influenced by the warm Gulf Stream and Arctic currents |

## Republic of Iceland credit ratings

|                   | <i>Affirmed</i> | <i>Foreign currency</i> |                   | <i>Domestic currency</i> |                   | <i>Outlook</i> |
|-------------------|-----------------|-------------------------|-------------------|--------------------------|-------------------|----------------|
|                   |                 | <i>Long-term</i>        | <i>Short-term</i> | <i>Long-term</i>         | <i>Short-term</i> |                |
| Moody's           | July 2005       | Aaa                     | P-1               | Aaa                      | P-1               | Stable         |
| Standard & Poor's | October 2005    | AA-                     | A-1+              | AA+                      | A-1+              | Stable         |
| Fitch             | August 2005     | AA-                     | F1+               | AAA                      | Stable            |                |

## Central Bank of Iceland publications in English

Annual Report  
Monetary Bulletin  
Financial Stability  
The Economy of Iceland  
Central Bank of Iceland Working Papers

These publications are available on the Central Bank website. Also available on the website are Central Bank statistics (updated weekly) and Economic Indicators, a monthly snapshot of the Icelandic economy in charts and tables.

### Useful websites

|   |  |
|---|--|
| Central Bank of Iceland                                   | <a href="http://www.sedlabanki.is">www.sedlabanki.is</a> |
| Parliament of Iceland (Althingi)                          | <a href="http://www.althingi.is">www.althingi.is</a>     |
| Government of Iceland                                     | <a href="http://www.government.is">www.government.is</a> |
| Statistics Iceland  | <a href="http://www.statice.is">www.statice.is</a>       |
| National Economic Institute of Iceland (NEI) <sup>1</sup> | <a href="http://www.ths.is">www.ths.is</a>               |
| Iceland Stock Exchange                                    | <a href="http://www.icex.is">www.icex.is</a>             |
| National Debt Management Agency                           | <a href="http://www.bonds.is">www.bonds.is</a>           |
| Trade Council of Iceland                                  | <a href="http://www.icetrade.is">www.icetrade.is</a>     |
| National Association of Pension Funds                     | <a href="http://www.ll.is">www.ll.is</a>                 |
| Invest in Iceland Agency                                  | <a href="http://www.invest.is">www.invest.is</a>         |
| The National Power Company                                | <a href="http://www.lv.is">www.lv.is</a>                 |
| Financial Supervisory Authority                           | <a href="http://www.fme.is">www.fme.is</a>               |
| Icelandic New Energy                                      | <a href="http://www.newenergy.is">www.newenergy.is</a>   |



1. The National Economic Institute (NEI) was closed down on July 1, 2002. This website contains material produced by the NEI up to that date and directs visitors to the appropriate locations of the institutions that have taken over the tasks that it previously performed.

# Introduction

The Economy of Iceland has been published by the Central Bank of Iceland since 1987. It is mainly intended for an international readership. This includes international institutions which deal with Icelandic economic matters on a regular basis, rating agencies, financial institutions, foreign investors, embassies and more generally everyone who is interested to find out more about the Icelandic economy. We also hope that Icelandic readers will find this survey useful. It is published annually.

This publication focuses on the structure of the Icelandic economy. It is intended to serve as background material for understanding the evolution of the economy, but does not provide a detailed account of recent developments. A more up-to-date analysis of recent developments, particularly from a monetary policy point of view, is provided in the Central Bank's *Monetary Bulletin*. The Bank's Annual Report also gives an overview of economic developments each year.

The outline of this booklet is as follows: Chapter 1 provides a short summary of recent economic developments. Chapter 2 presents basic facts about Icelandic geography, population and society. Chapter 3 describes how Iceland evolved from one of the poorest economies in Europe in the beginning of the 20th century to become one of the more affluent in the 21st. It explains sources of volatility and growth and how, over the past two decades, the emergence of a modern market economy has served to overcome the legacy of high inflation. Recent overseas expansion by Icelandic businesses is covered as well. Chapter 4 deals with the structure of the economy. It discusses size and income levels, the composition of GDP, foreign trade, main industries and the labour market. It also describes the three pillars of the Icelandic pension system. Chapter 5 provides an account of the financial system, asset markets, institutions and supervision. Chapter 6 surveys the public sector, including its size, division of tasks, expenditure structure and the tax system. It also describes the structure and management of the foreign debt of the Republic of Iceland, and sovereign credit ratings. Chapter 7 addresses monetary policy. It covers the framework of monetary policy, its instruments and the role of the Central Bank. Chapter 8 discusses foreign debt, foreign exchange reserves and credit ratings of financial institutions. A number of tables are provided in an appendix.

We are constantly making efforts to improve this publication. Hence, we would be grateful for any comments and suggestions that might increase the usefulness of this booklet. If you feel that important information is missing and should be added, or see other scope for improving this publication, please e-mail your suggestions to: [publish@centbk.is](mailto:publish@centbk.is)



# 1 Economic developments and prospects

Policies of market liberalisation, fiscal consolidation, privatisation and other structural reforms were implemented in the late 1980s and 1990s, including membership in 1994 of the European Economic Area (EEA) by which Iceland was integrated into the internal market of the European Union (EU). In this period the Icelandic economy was characterised by slow or negative output growth. This was mainly due to a decline in fish catches, in conjunction with a downturn in the global economy and restrictive economic policies aimed at curbing inflation and restoring the fiscal balance to a more sustainable long-term position.

Economic growth started to gain momentum by the middle of the 1990s, rekindled by replenishing fish stocks, a global economic recovery, a rise in exports and a new wave of investment in the aluminium sector. During the second half of the 1990s, the liberalisation process continued, competition increased, the Icelandic financial markets and financial institutions were restructured and the exchange rate policy became more flexible. Iceland experienced one of the highest growth rates of GDP among OECD countries. While initially the upswing was led by rising exports and foreign investment in the export sector, it became increasingly characterised by booming consumption and investment in the non-traded goods sector, which was to a large extent financed by foreign credit.

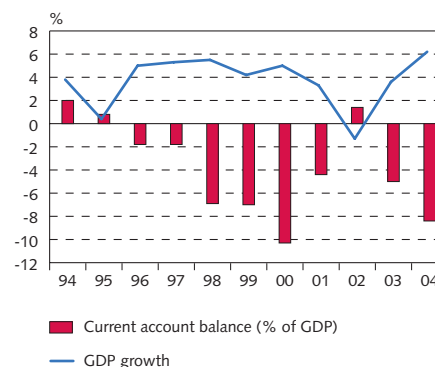
In 1998 signs of overheating became increasingly visible. Inflation took off and reached 6% in the spring of 2000. These imbalances were the underlying reason for a sharp depreciation of the króna in the latter half of 2000 and in 2001, with inflation rising to above 9% in January 2002. The economy then underwent rapid adjustment, the current account deficit disappeared in the space of two years and inflation fell rapidly.

In 2003 economic recovery began and gained momentum in 2004 with robust GDP growth of 6.2%. Initially fed by investments in the aluminium and power sectors, macroeconomic imbalances resurfaced that year and became increasingly pronounced in 2005. As growth outstrips the increase in potential output, it contributes to substantial and mounting pressures in the domestic goods and labour markets. A surge in mortgage credit has fuelled housing investment and private consumption.

## The most extensive investments in Icelandic history

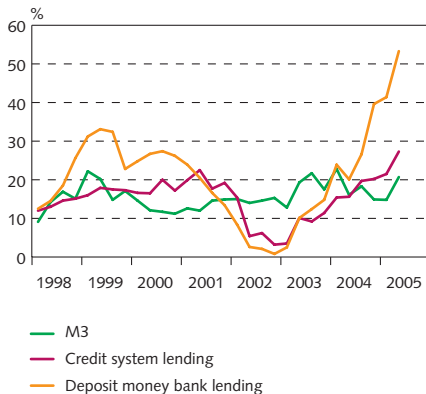
The large-scale investment projects in the aluminium and power sectors which commenced in 2003 are now well under way. When these projects are completed in late 2008, the total production capacity of aluminium smelters in Iceland will be 765,000 tonnes per year (tpy), up from 270,000 tpy in 2005 and 90 thousand in 1995. Power capacity needs to be stepped up by 130% to accommodate the increase. The long-term impact of these investments will strengthen the export base, increasing the share of aluminium in total merchandise exports from 18% in 2004 to 35% in 2009.

Chart 1.1  
Economic growth and current account balance 1994-2004



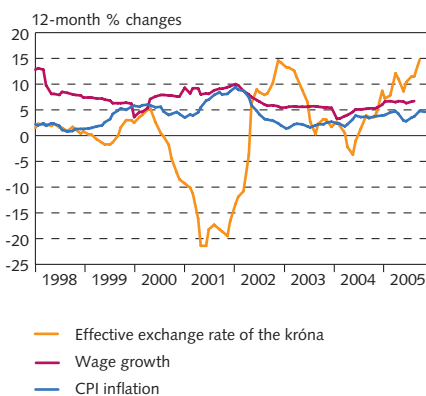
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 1.2  
Growth of credit and monetary  
aggregates Q1/1998 - Q3/2005



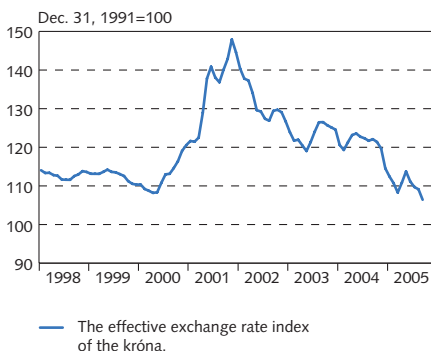
Source: Central Bank of Iceland.

Chart 1.3  
CPI inflation, wage growth and  
exchange rate of the króna,  
January 1998 - October 2005



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 1.4  
Effective exchange rate of the króna,  
January 1998 - September 2005



Source: Central Bank of Iceland.

Relative to the size of the Icelandic economy these investment projects are very large. In economic terms the total investment will amount to little over a quarter of 2005 GDP, or €3.5 billion. Projects of such scope are accompanied by a considerable widening of the current account deficit, mostly due to imports of capital equipment but also through induced general demand. The scale of the investments has considerably exceeded what was originally planned, especially in 2005, and the timeframe for completion has narrowed.

### Increased mortgage loan competition

The second driver of macroeconomic imbalances has been the sweeping change that took place in the mortgage market in the second half of 2004. In late summer 2004 the banks raised their profile in the mortgage market by engaging in head-on competition with the state-run Housing Financing Fund (HFF). The banks began to offer mortgage loans with lower interest rates, longer maturities and unprecedented high mortgage amounts, and unlike the HFF, they did not require a housing purchase as a precondition for a loan, which facilitated refinancing and mortgage equity withdrawal.

This massive increase in credit supply led to a surge in housing prices that has been the root of CPI inflation since 2004 and is also the main driver of private consumption growth.

### Widening current account deficit

The economy began to respond to the large projects in 2003 and the exchange rate appreciated by almost 20% from the end of 2003 to the end of October 2005. The strong króna, buoyant private consumption and growing pace of aluminium-related investments have been reflected in substantial import growth. Exports, after remaining virtually unchanged in 2003, rallied in 2004 and are expected to grow further in 2005.

The current account deficit has worsened markedly and is estimated to reach 14% in 2005. Imports in connection with investments in the aluminium and power sectors are estimated to account for half of the deficit this year and next year, then subside once the investment period is over and plants come on stream.

### Increased import of labour

Recent developments in the labour market have to some extent been an enigma. Notwithstanding a vigorous recovery of GDP growth, employment contracted over an extended period. Moreover, wage drift has been muted in historical terms, even in sectors that have experienced labour shortages. Stronger competition in the product markets seems to have added a new dimension to the flexibility of the Icelandic labour market, as employers have chosen to import labour on a large scale rather than bid up wages as in previous periods of labour shortages.

### The fiscal stance

In the last twelve years or so, the fiscal balance has followed the domestic cycle quite closely. A thirteen-year string of general govern-



ment deficits came to an end in 1997 after economic growth picked up. During 1997-2001 there was a return to surplus. As the economy cooled down in 2002-2003 the surplus turned into deficit.

Renewed growth brought back a surplus in 2004, which seems certain to strengthen in 2005 in spite of a cut in personal income taxes. In 2006, further cuts in income and property taxes will bite into revenues, reducing the surplus to roughly 1% according to budget projections.

### Inflation

A new monetary policy framework of inflation targeting was adopted in March 2001. The target was defined as a twelve-month rate of change in the CPI of 2.5%. After a spike in inflation caused by a substantial depreciation of the króna, as imbalances built up during the preceding fixed exchange-rate regime were corrected, the inflation target was reached in November 2003. Subsequently, inflation was at or below the target until spring 2004. Since then inflation has been above the target and had, at the time of writing in October 2005, twice moved beyond the tolerance limit of 1½% above target.

The recent rise in inflation has been the result of rapid expansion of domestic demand brought about by the combined effect of the investment projects and enhanced access to credit at lower interest rates. The demand-driven nature of inflation is most evident in rising prices of non-traded goods and services and housing, where foreign competition is minimal, while other goods prices with the exception of fuel prices have fallen year-on-year, mainly due to a appreciation of the króna.

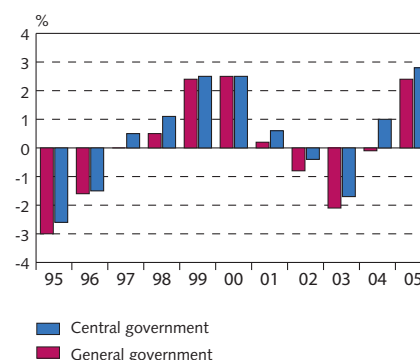
Measured by the European Harmonised Index of Consumer Prices (HICP) which excludes housing prices, inflation in Iceland has been noticeably lower for most of 2005 and among the lowest in Europe.

### Monetary policy

Although the current imbalances in the economy have posed great challenges, the new monetary policy framework has enabled the Central Bank to react more promptly than in previous episodes of imbalances. In light of rising demand and the inflation outlook, the Central Bank began to raise its policy interest rate as early as May 2004. By October 2005 it had been raised by almost 5 percentage points to 10.25%.

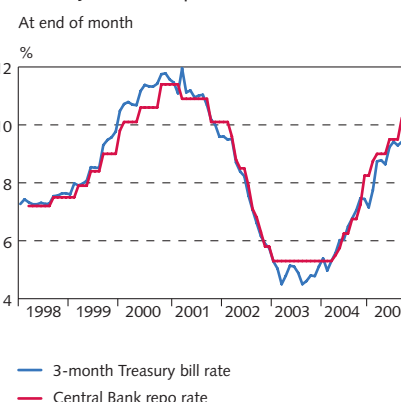
In September 2005 the Central Bank reiterated its ongoing commitment to bring inflation back to target, by pursuing a tight monetary policy and maintaining it for longer than previously has been expected.

Chart 1.5  
Treasury and public sector financial balance  
as % of GDP 1995-2005



Sources: Statistics Iceland 1990-2004, Treasury forecast for 2005.

Chart 1.6  
Central Bank repo rate and Treasury  
bill interest rate  
January 1998 - September 2005



Source: Central Bank of Iceland.



## 2 Country and people

### Geography

Iceland is located in the North Atlantic between Norway, Scotland and Greenland. It is the second-largest island in Europe and the third largest in the Atlantic Ocean, with a land area of some 103 thousand square kilometres, a coastline of 4,970 kilometres and a 200-nautical-mile exclusive economic zone (EEZ) extending over 758 thousand square kilometres in the surrounding waters.

Iceland enjoys a warmer climate than its northerly location would indicate because a part of the Gulf Stream flows around the southern and western coasts of the country. In Reykjavík, the capital, the average temperature is nearly 11°C in July and just below zero in January.

Iceland is mostly mountainous and of volcanic origin, with the highest peak reaching 2,110 metres. Lowlands stretch from the coast towards the interior, mainly in the south and the west. Several glaciers, one of them the largest in Europe, distinguish the landscape. The coasts are rocky and of irregular outline, with numerous fjords and inlets, except for the south where there are sandy beaches with no natural harbours. Only around 20% of the total land area is classified as arable land, most of it located in the southern and western part of the country and several fertile valleys stretching from the coast.

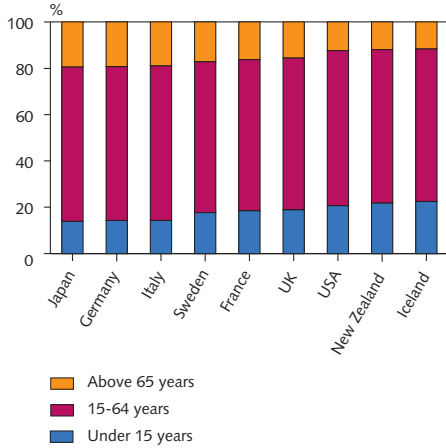
Iceland is endowed with abundant natural resources. These include the fishing grounds around the island, within and outside the country's 200-mile EEZ. Furthermore, Iceland has abundant hydroelectric and geothermal energy resources, which are still a long way from being fully harnessed.

With only 2.9 inhabitants per square kilometre, Iceland is one of the least densely populated countries in Europe. On December 31, 2004, the population of Iceland was 293,577. The annual rate of population growth 1994-2004 was 1.0%. Around 63% of the population (roughly 180 thousand) live in the capital city of Reykjavík and its surrounding municipalities. The largest town outside the capital area is Akureyri, in the north, with a population of 16,450. Most of the remainder live in small towns along the coast.

### People

Iceland was settled in the ninth century. The majority of the settlers were of Norse origin, with a smaller Celtic element. A general legislative and judicial assembly, the Althingi, was established in 930 and a uniform code of laws for the country was established at the same time. In 1262, Iceland entered into a union with the Norwegian monarchy. When the Danish and Norwegian monarchies were united in 1380, Iceland came under Danish rule, which lasted for more than five hundred years. Iceland was granted a new constitution in 1874 and obtained home rule in 1904. With the Act of Union in 1918, Iceland became a sovereign state in a monarchical union with Denmark. In 1944, Iceland terminated this union with Denmark and founded a Republic. The native language, Icelandic, belongs to the Nordic group of the Germanic languages.

Chart 2.1  
Age structure of the population  
in selected countries 2004<sup>1</sup>



1. Ranked by share of population 65 and over.  
Source: OECD (OECD in figures, 2005).

Iceland has experienced substantial net immigration in recent years, causing the share of citizens of foreign origin to rise to 3.6% of the total population at the end of 2004. Compared to most other developed countries this ratio still remains low.

As in other advanced countries the population of Iceland is ageing, but at a relatively slower pace than in most OECD countries. In 2003, notwithstanding high life expectancy, the ratio of the total population aged over 65 to the population of working age was lower in only six OECD countries: Ireland, Korea, Mexico, New Zealand, the Slovak Republic and Turkey.

### Society and the welfare state

Iceland is a modern welfare state, which guarantees access for its citizens to universal health care, education and a high degree of social security. Spending on health, education, social security, welfare and other social affairs amounted to just over a quarter of GDP in 2003.

Life expectancy which is among the highest in the world and one of the lowest infant mortality rates (3.5 per 1000 live births in 2004) testify to the advanced status of health care in Iceland, both primary health care and hospitals. The Icelandic health care system is a tax-financed universal system for all persons who have had legal residence in Iceland for more than 6 months. Health care services are provided mostly free of charge, although user charges have been on the rise. The main exception is dental health care, where adult patients are charged the full cost of service, but children under 17 years of age have most of the cost refunded. In 2004, 15% of total employment was in health care and social work, and expenditures on health care amounted to 10.1% of GDP.

The standard of education is high and public education is compulsory between the ages of six and sixteen. A good command of English and the Scandinavian languages is widespread. Education is offered free of charge or at a low fee at three levels. First, there are ten years of compulsory education at the primary level (age 6-16). Second, there are four years at the upper secondary level, which provides general education and vocational training in a wide range of fields. Finally, higher education is offered at several universities. In 2003, 20.5% of the employed labour force held a university degree. Roughly one out of every four university degrees held by Icelanders is obtained in other countries. As in most OECD countries, university enrolment has increased substantially in recent years, to 72% of those completing secondary education in 2002, compared to 51% in OECD countries on average. The ratio of pre-school enrolment is also one of the highest among OECD countries.

### Political structure

The present constitution was adopted on June 17, 1944 when the Republic was established. Iceland has a parliamentary system of government. Legislative power is vested in the parliament (Althingi), and executive power in a cabinet headed by the Prime Minister. The government has to be supported by a majority of parliament in order to remain in power. The 63 members of the Althingi are elected from six

constituencies on the basis of proportional representation, for a term of four years. A parliamentary bill becomes law when it is passed by the Althingi and signed by the President. The President is the head of state and is elected for a term of four years by a direct vote of the electorate.

Iceland has a tradition of political stability. Since Iceland gained autonomy from Denmark in 1918, governments have normally been formed by a coalition of two or more political parties that have held a majority in parliament. Since 1995 there have been successive coalition governments of the Independence Party and the Progressive Party.

The results of the 2003 elections were as follows: The Independence Party obtained 33.7% of votes and 22 seats, the Social Alliance 31.0% and 20 seats, the Progressive Party 17.7% and 12 seats, the Left-Green Movement 8.8% and 5 seats, and the Liberal Party 7.4% and 4 seats. Others obtained 1.5% and no seats with 1.2% of ballots void or blank. The next general election is to be held in 2007.

### External relations

Iceland has participated actively in international cooperation. Iceland belongs to a group of Nordic countries that includes Denmark, Sweden, Norway and Finland – as well as Greenland and the Faroe Islands. The Nordic countries have established wide-ranging cooperation in a variety of fields, including economic affairs and international representation in which the Baltic States have increasingly been taking an active part. Iceland is a member of the Nordic Council and specialised institutions such as the Nordic Investment Bank.

Iceland became a member of the United Nations in 1946 and is an active participant in most of its affiliated agencies. Iceland is a founding member of the Bretton Woods institutions that were established in 1945, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). Iceland is one of the original members of the Organisation for Economic Cooperation and Development (OECD) and of the European Bank for Reconstruction and Development (EBRD). It joined the Council of Europe in 1950 and has participated in the Organisation for Security and Cooperation in Europe since it was initiated in 1975.

In 1964, Iceland became a party to the General Agreement on Tariffs and Trade (GATT), the predecessor to the World Trade Organisation (WTO). Iceland joined the European Free Trade Association (EFTA) in 1970 and entered into a free-trade agreement with the European Economic Community in 1972. In May 1992, the member countries of EFTA and the European Union signed an agreement to establish a zone for the free movement of goods, services, capital and persons, the European Economic Area (EEA), which took effect on January 1, 1994. Iceland participates in numerous Free Trade Agreements (FTAs) through its EFTA membership with countries including Bulgaria, Chile, Israel, Jordan, Croatia, Macedonia, Morocco, Mexico, Palestine, Romania, Turkey and Singapore. Agreements have also been made with Tunisia and Lebanon but await implementation. Negotiations on FTAs with South Korea and the South African Customs Union have been finalised but await confirmation. Work is in progress on FTAs

with Canada, Egypt and Thailand. There is also work in preparation on making FTAs with Albania, Algeria, the Gulf Cooperation Council, MERCOSUR, Serbia and Montenegro, the Ukraine and Indonesia. Iceland has enacted bilateral Free Trade Agreements with Greenland and the Faroe Islands.

Iceland is a founding member of the North Atlantic Treaty Organisation (NATO), established in 1949. A defence treaty with the United States was concluded in 1951. A NATO military base, staffed by United States military personnel, is operated at Keflavík in the southwest of Iceland.

Table 2.1 Iceland's membership of international organisations

|  | <i>Year of association</i> |
|--|----------------------------|
| International Monetary Fund (IMF)                                  | 1945                       |
| International Bank for Reconstruction and Development (World Bank) | 1945                       |
| United Nations (UN)  | 1946                       |
| North Atlantic Treaty Organisation (NATO)                          | 1949                       |
| Organisation for Economic Cooperation and Development (OECD)       | 1949                       |
| Council of Europe  | 1950                       |
| Nordic Council   | 1952                       |
| International Finance Corporation (IFC)                            | 1956                       |
| International Development Association (IDA)                        | 1961                       |
| General Agreement on Tariffs and Trade (GATT)                      | 1964                       |
| European Free Trade Association (EFTA)                             | 1970                       |
| Organisation for Security and Cooperation in Europe (OSCE)         | 1975                       |
| European Bank for Reconstruction and Development (EBRD)            | 1990                       |
| Western European Union (WEU)                                       | 1992                       |
| European Economic Area (EEA)                                       | 1994                       |
| World Trade Organisation (WTO)                                     | 1995                       |

### 3 Economic history

#### A century of high but volatile growth

In the course of the 20th century Iceland was transformed from one of Europe's poorest economies, with almost 2/3 of the labour force employed in agriculture, to a prosperous modern economy employing 2/3 of its labour force in services. For most of the century economic growth was led by the fisheries. Consequently, swings in the fish catch and export prices of marine products were the leading source of fluctuations in output growth.

By international comparison, post-WWII economic growth has been both significantly higher and more volatile than in other OECD countries. The average annual growth rate of GDP from 1945 to 2004 was about 4%. Studies have shown that the Icelandic business cycle has been largely independent of the business cycle in other industrialised countries. This can be explained by the natural resource-based export sector and external supply shocks. However, the volatility of growth declined markedly towards the end of the century, which may be attributed to the rising share of the services sector, diversification of exports and more solid economic policies.

Volatility may also be attributed to deficient economic policies and structural rigidities. Like most other advanced economies, Iceland became highly regulated towards the middle of the 20th century and only started to liberalise markedly in the 1960s. Gradual deregulation culminated in membership of the European Economic Area (EEA) in 1994 and liberalisation of the bulk of cross-border capital flows by 1995. It was only during the final decade of the 20th century that all the main pillars of a modern market economy were essentially in place.

#### From liberal trade to a controlled economy and on to European integration

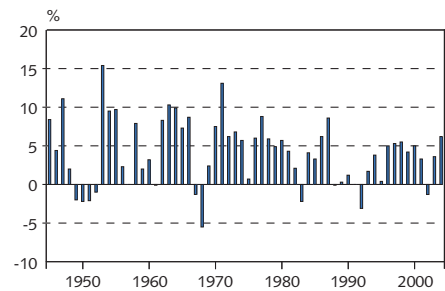
The first three decades of the last century were characterised by rapid growth, interrupted only by WWI. This growth occurred in the context of fairly liberal economic policies. In the wake of the Depression and WWII, however, Iceland, like many other countries, became entangled in a web of trade barriers, capital controls and a complex system of multiple exchange rates which led to serious distortion of the price mechanism and misalignment of real exchange rates.

A radical departure from these policies occurred in 1960, when barriers to trade were lowered considerably in conjunction with a large devaluation of the króna, leading to more efficient allocation of resources. Trade barriers were further lowered when Iceland became a member of the European Free Trade Association (EFTA) in 1971 and further still when it became a founding member of the EEA in 1994, which integrated Iceland and other EFTA member countries (except Switzerland) into the internal market of the European Union (EU).

#### Episodes of inflation and disinflation

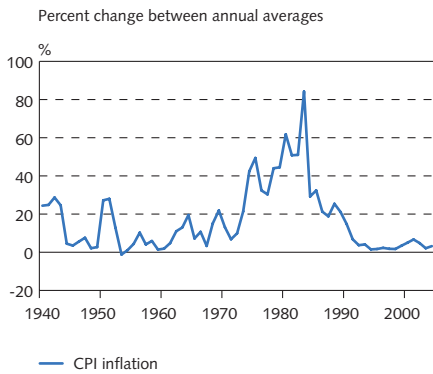
A distinguishing feature of Iceland's economic development in the post-WWII era was the high and variable rate of inflation. Inflation

Chart 3.1  
Growth of GDP 1945-2004  
Annual percent changes



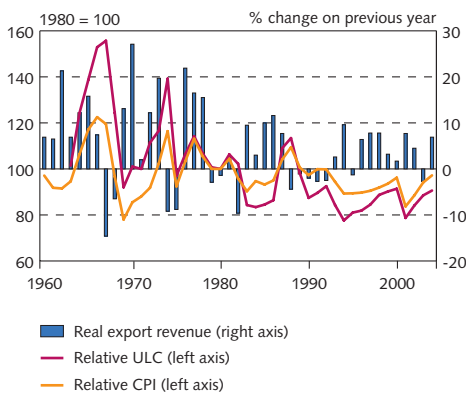
Source: Statistics Iceland.

Chart 3.2  
CPI inflation 1940-2004



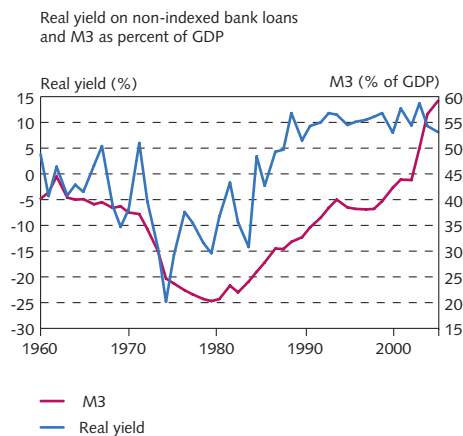
Source: Central Bank of Iceland.

Chart 3.3  
Real effective exchange rate of the króna<sup>1</sup> and real export revenue 1960-2004



1. Based on relative consumer prices (CPI) or relative unit labour cost (ULC).  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 3.4  
Real yield and broad money 1960-2004



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

surged in the 1970s, reaching a peak in 1983, when the 12-month rate briefly exceeded 100%. The inflationary tendencies were explained by the combination of structural features of the economy, which generally made attaining price stability a difficult task, and excessively accommodative policies.

While Iceland for a while had one of the highest inflation rates among OECD countries, it also provides one of the more remarkable examples of a successful disinflation strategy. Through a combination of tighter monetary and exchange rate policies, incomes policies that managed to reach a wide-ranging consensus on the need to reduce inflation, and broad-based structural reforms, inflation was brought down in the early 1990s to broadly the rate prevailing in major trading partner countries.

### A market-based economy

Over the past two decades, significant structural reforms have taken place in the Icelandic economy and financial markets. These reforms have aimed to enhance allocative efficiency by increasing the role of market forces through deregulation and integration into the world economy. Policies of market liberalisation, fiscal consolidation, privatisation and other structural reforms were implemented in the late 1980s and early 1990s. This process was accelerated by the need to align the Icelandic legislative and regulatory framework to that prevailing in the European Union when Iceland became one of the founding members of the EEA in 1994.

Government interference with the allocation of credit was gradually reduced following the deregulation of interest rates. A legacy of the regulated economy of the post-WWII years was that substantial segments of the economy became owned by either central or local governments. Most of these have been privatised in recent years, the most notable recent addition being Iceland Telecom. The commercial banks have now begun competing with the state Housing Financing Fund, which had totally dominated the mortgage market. The energy sector is still publicly owned. An exception to the trend towards liberalisation has been agriculture, which is still widely supported by government subsidies, price intervention, import protection and a system of production quotas.

The emergence of a money market in the early 1990s and the establishment of an interbank market for foreign exchange in 1993 laid the foundation for modern monetary policy implementation. Liberalisation of capital movements also made monetary and exchange rate policies in some respects more challenging. In order to cope with those challenges, exchange rate policy became gradually more flexible, until the króna was officially floated in March 2001, under a new framework of monetary policy based on inflation targeting. By the turn of the century Iceland had become an advanced economy, thoroughly integrated into the European market, with most of the features of a modern market economy.



### Increased participation in a global economy

In recent years, many Icelandic companies have expanded their operations abroad. The total stock of foreign direct investment by Icelandic residents grew by 96% year-on-year in 2004, to €2.8 b. (241 b.kr.), and has grown by over 40% per year on average over the past ten years.

The most common means of expanding abroad has been acquisitions of foreign companies. The Icelandic market is small and companies in markets such as pharmaceuticals, financial services, food production, retail commerce, aviation and shipping have bought subsidiaries abroad in similar sectors to broaden their base and increase their revenues and profit. Foreign investments have mostly been focused on the UK and Scandinavia but to a lesser extent continental Europe and elsewhere.

Investment in foreign equities has also grown substantially over the past decade. Before full liberalisation of cross-border capital movements in 1995, residents owned only approximately €74.8 million (6.5 b.kr.) in foreign capital equities. Over the ten years to 2004 the stock had risen forty-seven-fold to €3.8 billion (317 b.kr.).

Foreign direct investment in Iceland has also been growing over the past few years. The most substantial investment has been from US companies, mainly in the aluminium sector. Over the past few years non-resident funds have been investing in companies which are listed on Iceland Stock Exchange (ICEX). Also, franchising has been increasing in Iceland, especially in retail, consulting and auditing and accounting.

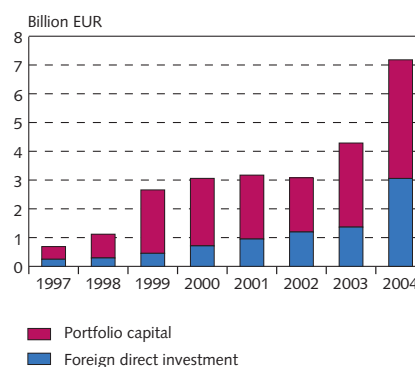
### Inward and outward investment

Since 1995, the only restrictions on investment by non-residents in Iceland apply to foreign direct investments in fisheries and fish processing, energy production and distribution, and aviation companies. Restrictions on investment in the fisheries sector are the only ones that apply to EEA residents and have the purpose of protecting the nation's exclusive rights to the fishing grounds around Iceland. Direct foreign ownership in fisheries companies is prohibited but companies that are up to 25% foreign-owned (33% in certain circumstances) may own fisheries companies. Combined direct and indirect ownership up to 49% is possible, however. Energy harnessing rights and production and distribution of energy are restricted to EEA entities. Entities domiciled outside the EEA must not own more than 49% of the shares in Icelandic aviation companies.

Liberalisation of cross-border capital movements has led to a profound change in the composition of residents' financial asset portfolios. Before full liberalisation in 1995 residents owned only approximately €145 million (13 b.kr.) in foreign securities. Over the ten years to the end of 2004, foreign asset portfolios rose twenty-seven-fold to €3.9 billion (344 b.kr.), the equivalent of 39% of GDP.

Chart 3.5

Foreign direct investment and portfolio capital owned abroad by residents (at year-end) 1997-2004



Source: Central Bank of Iceland.



## 4 Structure of the economy

### Size and income level

The Icelandic economy is the smallest within the OECD, generating GDP of €10.2 billion in 2004. This was less than 1/1000 of the US economy, 1/20 of the Danish economy and 1/3 of the economy of Luxembourg but ten times larger than the economy of Malta. The small size of the Icelandic economy mainly reflects the small size of the population, which was only 294 thousand at the end of 2004.

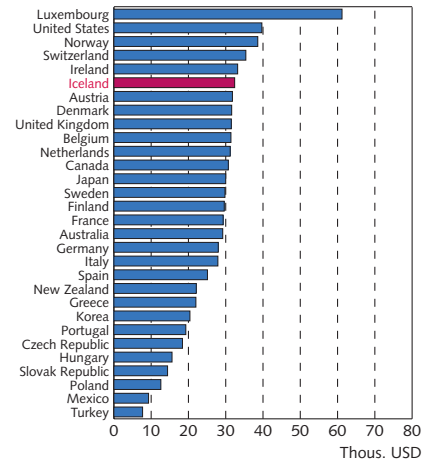
Iceland's small population has not inhibited economic growth and prosperity. The country has all the characteristics of a modern welfare state. GNI per capita measured in terms of Purchasing Power Parities (PPP) amounted to 32.4 thousand USD in 2004, the ninth highest in the world and the sixth highest among the OECD countries. In comparison to the Nordic countries, Iceland's GNI per capita is lower than in Norway, but higher than in Denmark, Finland and Sweden, and somewhat above the EU average.

This prosperity has largely been built on Iceland's comparative advantages in abundant marine and land-based natural resources, as well as human capital. The location and geology of Iceland determine its main resources which are fish from some of the richest and cleanest waters in the world, and hydro and geothermal energy. Both these resources are essentially renewable and non-polluting and are self-sustainable for the long term under scientific management. Iceland is the 12th largest fishing nation in the world, exporting nearly all its catch as domestic demand is relatively small. Even when the ongoing phase of investment in power-intensive industry is completed in 2008, only around 25% of economically harnessable hydro and geothermal power will have been harnessed. Iceland's unspoiled natural environment represents a third major resource, reflected in a large and growing tourist industry. High labour force participation by women and the young and elderly – with 81% of the population aged 16 to 74 employed – as well as long working hours by international comparison, also contribute to Iceland's robust growth.

### Composition of output and expenditures

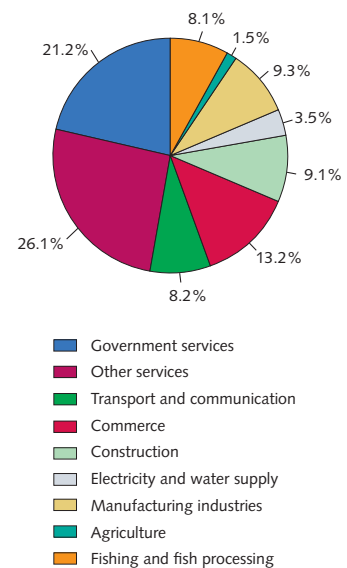
As in other developed economies, largely non-tradable services form the bulk of economic activity, accounting for 67.7% of GDP in 2004. While the marine sector is the most important source of export revenue, its share of GDP has declined considerably in recent years, from 16% in 1980 to around 9% in 2004. Agriculture contributes only 1.4% of the country's GDP.<sup>1</sup>

Chart 4.1  
Gross national income per capita  
in OECD countries 2004<sup>1</sup>



1. Based on PPP.  
Source: World Bank.

Chart 4.2  
Breakdown of GDP by sector 2004



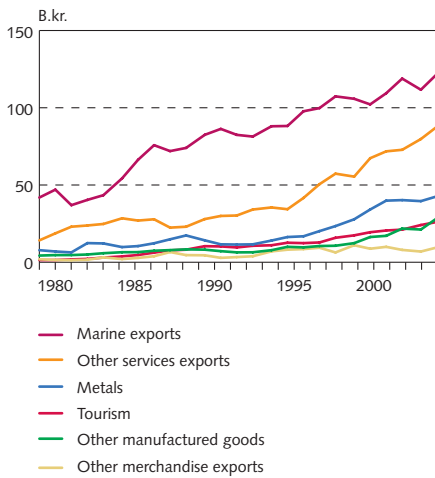
Source: Statistics Iceland.

1. Agriculture and fisheries are treated as separate sectors in Iceland, although they are often bracketed together in international statistics.

Chart 4.3

## Exports of goods and services 1980-2004

At constant average exchange rates, based on a trade-weighted basket of currencies

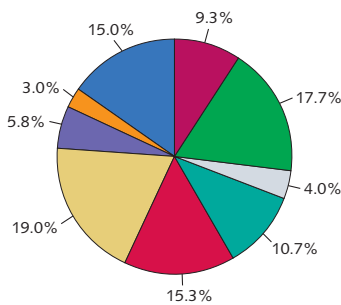


Sources: Statistics Iceland, Central Bank of Iceland.

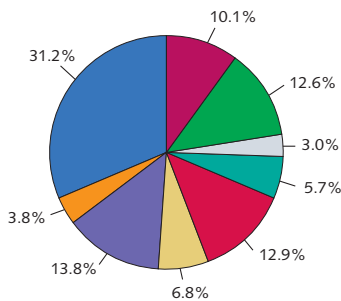
Chart 4.4

## Geographical division of merchandise trade 2004

Percentage of total exports



Percentage of total imports



Source: Statistics Iceland.

Table 4.1 Output and expenditure

| Percentage distribution (period average) |           |           |
|--|-----------|-----------|
| % of GDP                                 | 1970-1974 | 2000-2004 |
| Private consumption                      | 58.3      | 56.7      |
| Public consumption                       | 14.0      | 25.3      |
| Gross fixed investment                   | 30.4      | 21.2      |
| Changes in stock                         | 0.4       | -0.1      |
| National expenditure                     | 103.1     | 103.1     |
| Exports of goods and services            | 38.1      | 37.6      |
| Goods, fob                               | 24.7      | 24.4      |
| Services                                 | 13.4      | 13.2      |
| Less: Imports of goods and services      | 41.1      | 40.7      |
| Goods, fob                               | 29.3      | 26.6      |
| Services                                 | 11.8      | 14.1      |
| GDP                                      | 100.0     | 100.0     |
| Current account balance                  | -4.2      | -5.5      |

These developments reflect a transformation in the utilisation of natural and human resources. Scope for expanding marine harvesting has been limited in recent years, while the utilisation of hydroelectric and geothermal power potential has intensified. At the same time, the growth of service industries such as tourism and knowledge-based activities such as information technology and communications (ITC) and financial services has continued unabated. Significant advances have been made in technology niches such as medical equipment, technical solutions for food processing, fisheries equipment, biotechnology and pharmaceutical products.

Private consumption contributed on average to about 57% of GDP in 2000-2004 and public consumption and gross fixed investment 25% and 21% respectively. The investment-to-GDP ratio has risen substantially in recent years on average, after falling below 1/5 in the mid-1990s. The ratio of public consumption has also risen somewhat over the past five years, after remaining broadly stable through most of the 1990s.

### Foreign trade

Icelandic trade has many of the characteristics of small resource-based open economies, such as a high degree of openness, a large share of primary products and commodities and a small share of intra-industry trade. Nevertheless, the diversity of exports has increased significantly in recent years. In 2004, imports and exports of goods and services amounted to 41% and 36% of GDP respectively. Although Iceland can be seen as a fairly open economy, reflecting the small size of GDP, many larger economies have a considerably higher ratio. To some extent Iceland's lower ratio than many larger economies can be explained by geographic distance from major population centres, but other factors may also be at work, such as limited intra-industry and transit trade, a natural resource-based export sector with high value added, and extensive protection of domestic agriculture.

The mainstay of merchandise exports is still fish and other marine products although, as a share of total export, this category has been declining over the past 12 years. In 2004, fish and other marine products accounted for 60% of merchandise exports and 39% of total exports, down from 82% and 60% respectively in 1991. Exports of manufactured products have been growing rapidly in importance, and accounted for 35% of merchandise exports in 2004. This is mainly the result of growth in aluminium smelting and in medical and pharmaceutical products. Export of services grew rapidly over the past decade, as the economy became more service-oriented. Services now account for 36% of total export revenues while in 1990 the share was 26%.

Iceland imports a wide range of manufactured goods and commodities, reflecting both the small size of the economy and the limited range of natural resources. Imports of capital goods accounted for 28% of total merchandise imports in 2004. Industrial supplies and consumer goods are around one-third of imports each.

Iceland is the westernmost outpost of Europe and therefore strategically located for business between Europe and North America, enhanced by membership of EFTA (the European Free Trade Association) since 1970 and the European Economic Area (EEA), which has integrated Iceland into the internal market of the EU since it went into effect on January 1, 1994. The EEA constitutes the world's largest market, with GDP of €9.6 trillion. EEA membership implies that business legislation has been adapted to that of the EU, guaranteeing the free flow of goods, services, capital and labour.

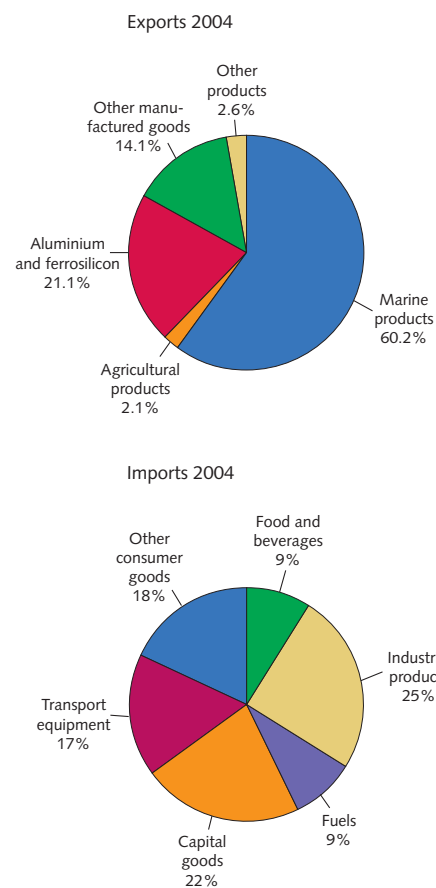
Free trade arrangements with Europe have stimulated Iceland's trade with the region, causing the share of North America to fall. In 2004, four-fifths of merchandise exports went to the member countries of the EEA, which also were the source of almost three-quarters of imports. Currently, the largest trading partner countries are Germany, the UK, the Netherlands and the Nordic countries. In terms of currency, the euro area constitutes the largest trading area, accounting for 40% of imports and 48% of exports. Iceland has in recent years generally had a trade surplus with the UK, Germany, the Netherlands and the Iberian countries, but a deficit with the USA, Japan and its Nordic neighbours.

Iceland's ratio of services to total trade is one of the highest among OECD countries. In 2003, Iceland ranked third with a share of services to total trade of one-third. Data on the direction of services trade are not as reliable as merchandise trade data. However, just over 1/5 of Iceland's services exports in 2004 used the euro and 2/5 used the USD as the vehicle currency.

### Marine sector

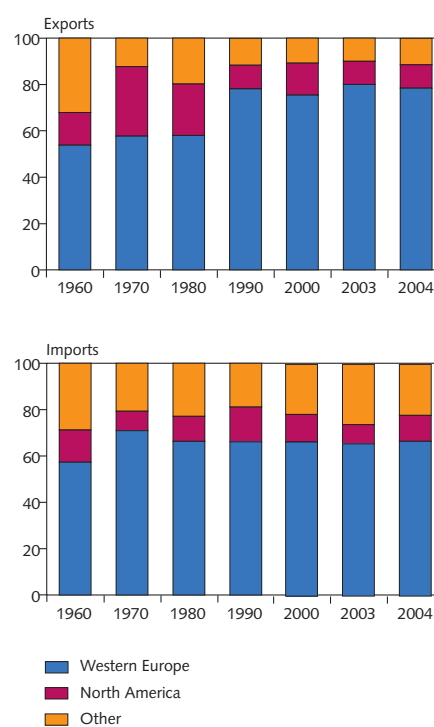
The marine sector is still one of the main economic sectors and the backbone of export activities in Iceland although its importance has diminished over the past four decades. In 2004, fishing and fish processing contributed 60% of total merchandise exports, compared with around 90% in the early 1960s. Likewise, the sector's contribution to GDP has fallen from 13-17% in the 1960s to 8.7% over the same period. The marine sector is highly diversified in terms of species, modes of processing and markets.

Chart 4.5  
Merchandise trade by category 2004



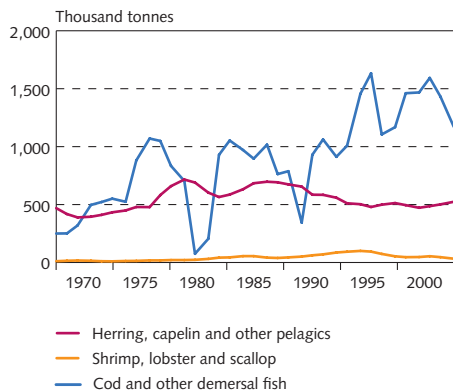
Source: Statistics Iceland.

Chart 4.6  
Regional division of trade 1960-2004



Source: Statistics Iceland.

Chart 4.7  
Fish catch by Icelandic vessels 1970-2004



Source: Statistics Iceland.

Fishing and processing of groundfish, mainly cod but also haddock, saithe and redfish, are the principal part of the Icelandic marine sector. The catch of these and other demersals accounted for 73% of landed value of fish in 2004. Conservation measures led to substantial cuts in total allowable catch (TAC) in the 1990s, mainly in cod quotas. Cod is the most valuable species in Icelandic waters in terms of total value of the catch, accounting for 41%. The decline in the cod catch has been offset by increased harvesting of other species such as capelin, haddock, saithe, redfish, flatfish, blue whiting and herring, inside and outside Iceland's exclusive 200-mile fishing zone.

Efforts to enhance value added in processing, e.g. by product development, have to a large degree succeeded in offsetting lower total catch volumes in recent years. Efficiency in the fishing and fish processing industry has increased substantially. The industry is increasingly relying on ITC, automation and modern management techniques to increase productivity and value. A growing emphasis on processing of fresh fish products instead of frozen or salted products from groundfish species has considerably increased the value of fish and seafood products. The most important step in the value-added strategy has been in processing of pelagics, mainly herring and capelin over the past 2-3 years. The mode of processing has undergone a radical change from relatively low-value fish oil and meal for animal feed and aquaculture towards salted, filleted and frozen seafood products for

## The ITQ system

All commercially important species are regulated within the individual transferable quota (ITQ) system. Quotas represent shares in the annual TAC and are allocated to individual fishing vessels. The present quota system is built on the following factors:

- Each year a TAC is set by the Minister of Fisheries on the basis of a biological assessment of the fish stocks and forecasts for their development in the near future.
- Fishing vessels are allocated a fixed quota share of each species subject to a TAC.
- The individual quota share is multiplied by the TAC to give the quantity which each vessel is authorised to catch during the fishing year.
- Permanent quota shares and annual quotas are transferable and can be traded on the quota market.

The law prescribes maximum holdings of quotas by individual fishing companies. Regulations cover both holdings of quotas for individual species and aggregate holdings of quotas.

In 1995 a refinement to the management system introduced a "catch rule" setting the TAC for the next consecutive quota year at 25% of the mean of the fishable biomass in the assessment year and the year after. Annual fishing quotas are allocated against an annual fee for fisheries inspection and enforcement purposes. Owners of fishing vessels holding harvesting rights now also pay a fishing fee to the state. The fee is calculated as a percentage of the aggregated value of the total catch of the fishing fleet minus operating expenses, divided by the catch quantity. In a transition period the percentage will increase from 6.5% in 2004 to 9.5% in 2009. This fee will still remain well below the market price of annual quotas.

human consumption. This has led to a large increase in value by moving these products up the value chain. In 2000, only 20% of the export value of herring and capelin was accounted for by food products, but in 2004 this ratio had risen to two-thirds.

A comprehensive fisheries management system based on individual transferable quotas (the ITQ system) has been developed to manage fish stocks and promote conservation and efficient utilisation of the marine resources.

In addition to the fisheries management system there are a number of other explicit and direct measures to support its aims and reinforce the conservation measures. Direct measures consist of rules on permitted fishing gear, closure of areas for bottom trawls, obligatory small fish grids to prevent juvenile fish catches and temporary closures of fishing grounds to protect spawning fish and limit by-catch of undersized fish.

In the last 5-7 years most of the larger fisheries companies have actively been seeking to enhance efficiency and benefit from economies of scale through mergers and acquisitions. Consequently, the largest companies have increased in size and the concentration of quota holdings has risen. The 10 largest fisheries companies in terms of quota holdings own a little under half of the total at the beginning of the fishing year commencing September 1, 2005.

Fisheries companies were among the first to be listed on Iceland Stock Exchange (ICEX) in the 1990s. At one time there were 25 listed fisheries companies on ICEX, but due to mergers and acquisitions and management buy-outs, only two companies are left.

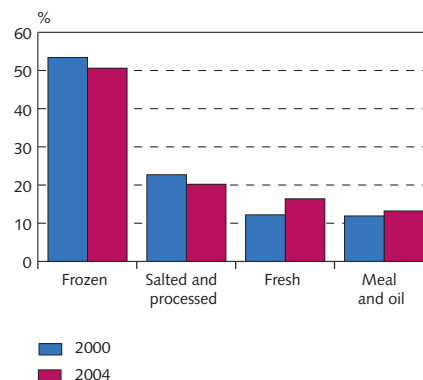
### Manufacturing and power-intensive industries

The largest manufacturing industries in Iceland are power-intensive industries which produce almost exclusively for export. There has been a considerable increase in manufacturing exports in recent years. In 2004, manufactured products accounted for 36% of total merchandise exports, up from 22% in 1997. Power-intensive products (mainly aluminium) amounted to 21% of total merchandise exports in 2004 but 12% in 1997.

A number of small and medium-size enterprises (SMEs) have emerged in export-oriented manufacturing in recent years, in areas such as medical equipment, pharmaceuticals, capital goods for fisheries and food processing. Most of these companies are founded on product innovation, R&D, strategic marketing and ITC. These emerging industries now account for approximately 2/5 of manufactured goods exports.

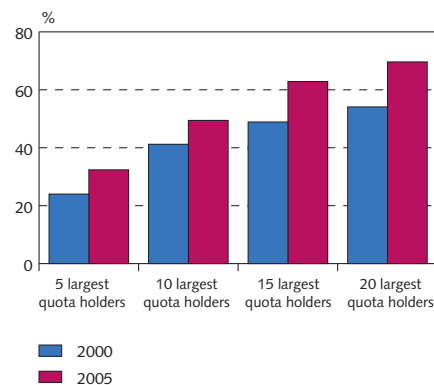
The largest manufacturing industries in Iceland, the aluminium smelters, are mainly based on competitive energy costs and a highly educated and skilled labour force. The government has actively encouraged foreign direct investment in power-intensive industries. The largest manufacturing facility at present is the Alcan Iceland Ltd. aluminium smelter located near Reykjavik, owned and operated by Alcan Inc. Its total capacity is now 178 thousand tonnes per year (tpy). Another aluminium smelter is operated by Norðurál at Grundartangi (Century Aluminum Ltd.) with a capacity of 92 thousand tpy. Icelandic

Chart 4.8  
Value of marine products for export, percentage breakdown 2000 and 2004



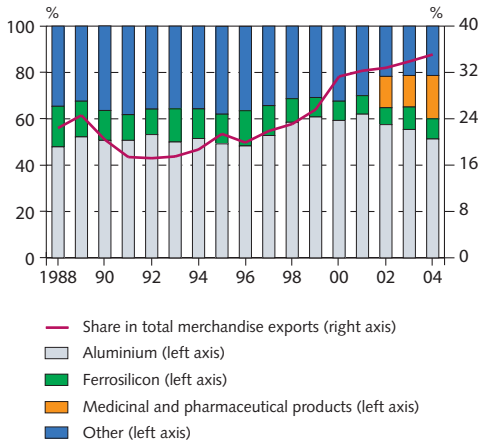
Source: Statistics Iceland.

Chart 4.9  
Concentration of quota holdings by number of companies as share of total quota



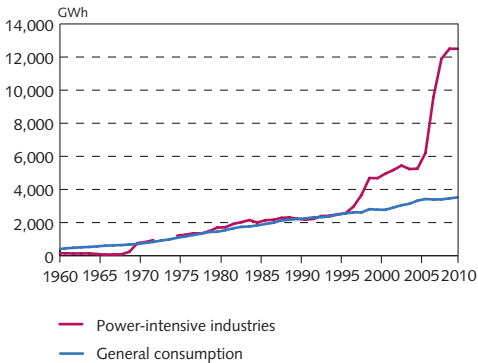
Source: Directorate of Fisheries.

Chart 4.10  
Composition of manufacturing exports and share in total merchandise exports 1988-2004



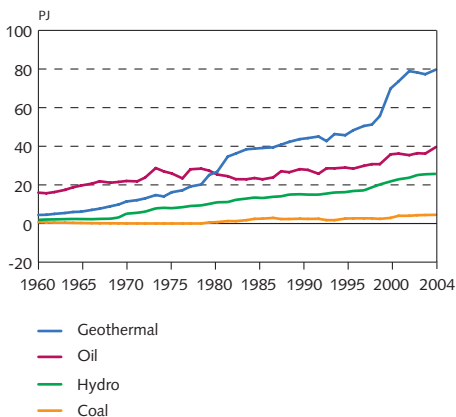
Source: Statistics Iceland.

Chart 4.11  
Electricity production in Iceland 1960-2010<sup>1</sup>



1. Estimates for 2005-2010  
Source: National Energy Authority.

Chart 4.12  
Primary energy consumption in Iceland 1960-2004



Source: National Energy Authority.

Alloys Ltd. (Elkem ASA) is a ferrosilicon plant with an annual capacity of 120 thousand tpy.

A new aluminium smelter, owned by Alcoa, is being built on the east coast of Iceland. It is due to go on stream in late 2007, producing 346 thousand tpy at full capacity. The Norðurál plant is also being expanded from 92 thousand tpy to 260 thousand tpy by late 2008. When both these projects materialise, the total production capacity of the aluminium industry in Iceland will be 785 thousand tpy, or nearly three times the present level. This will make Iceland one of the ten largest aluminium producers in the world.

### Energy

Iceland has extensive hydro and geothermal resources and is the only country in Western Europe that still has large-scale, competitively priced power remaining to be harnessed from such sources. Electricity consumption per capita is the highest in the world at some 29,400 kWh per capita in 2004. The proportion of energy consumption provided by renewable energy sources is greater in Iceland than in any other country. Notwithstanding its large electricity consumption, only 17% of Iceland's energy potential for generating electricity has been tapped.

Electric power potential from hydro and geothermal sources is now estimated to be 50 thousand GWh/year (50 TWh per year), taking into account economic, technical, cost-efficiency and environmental considerations. The commonly quoted estimates are 30 TWh per year for hydropower potential and 20 TWh per year from geothermal resources. Only 8,600 GWh/year of this power had been harnessed in 2004.

In 2004, total installed hydropower was 1,154 MW in 31 power plants with a capacity of 7,130 GWh per year (4/5 of generated electricity). Installed geothermal power in six steam turbine plants now amounts to 202 MW or 1,483 GWh/year. The largest single hydropower plant has an installed power capacity of 270 MW and the largest geothermal plant 120 MW (late 2005).

Iceland is a world leader in the use of geothermal energy for domestic and industrial purposes other than generating electricity. Some 90% of all homes are heated by geothermal energy, at less than one-third of the comparable cost of fossil fuels or electrical heating. Current utilisation of geothermal energy for heating and other industrial and commercial uses is considered to be only a small fraction of what this resource can sustain.

Three large-scale power stations are now under construction. Landsvirkjun (the National Power Company) is building a hydropower plant at Kárahnjúkar in east Iceland with a capacity of 690 MW to supply energy to the new Alcoa aluminium smelter at Reyðarfjörður. Reykjavik Energy (Orkuveita Reykjavíkur) and Sudurnes Heating (Hitaveita Suðurnesja) have three geothermal power stations under construction and is expanding one plant in southwest Iceland, to give a total additional capacity of 360 MW. Landsvirkjun is jointly owned by the Icelandic state, the City of Reykjavik and the Town of Akureyri, while Reykjavik Energy and Sudurnes Heating are owned by City of Reykjavik and the Reykjanes municipalities respectively.



Iceland is phasing in deregulation under an EU directive relating to the separation of transmission, generation, distribution and sales of electricity. Landsnet hf. (IceGrid) was launched in 2005 with the main role of transmitting electricity from producers to consumers (municipal distribution utilities and end-users such as the aluminium smelters). Under the principal ownership of Landsvirkjun and Rarik (Iceland State Electricity), IceGrid is also responsible for network administration, supervision and operation. New legislation does not call for incorporation of the power companies or any changes with regard to the state and/or municipal guarantees they currently enjoy.

Iceland currently provides a testing ground for the feasibility of using hydrogen in transport systems. The idea is to take advantage of Iceland's ample geothermal and hydropower resources to produce hydrogen for powering cars and ships. The first project is called the Ecological City Transport System (ECTOS) and involves a fuel station for fuel-cell buses which will run on emission-free hydrogen for two years. These buses are already in operation in the City of Reykjavik. The project is run by Icelandic New Energy Ltd., which is owned by Icelandic energy companies, DaimlerChrysler, Norsk Hydro, Shell International Hydrogen and others.

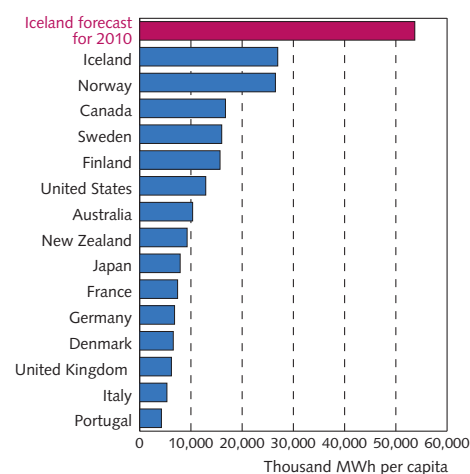
### Agriculture and farming

Approximately one-fifth of the total land area of Iceland is suitable for fodder production and the raising of livestock. Around 6% of this area is cultivated, with the remainder devoted to raising livestock or left undeveloped. Production of meat and dairy products is mainly for domestic consumption. The principal crops have been hay, potatoes and other root vegetables. Cultivation of other crops, such as barley and oats, has increased rapidly in the last 10 years and they are now becoming one of the staples. Vegetables and flowers are mainly cultivated in greenhouses heated with geothermal water and steam. An ambitious forestry programme is ongoing.

The agricultural sector has undergone structural changes in recent years. Demand for traditional products, especially lamb meat, beef and root vegetables, has declined or remained constant while consumption of white meat (pork and poultry) has risen in line with changes in taste and relative prices. Price support and export subsidies for the traditional products of sheep and dairy farming have been replaced with subsidies in the form of direct income payments to farmers in these segments.

Icelandic agriculture is the most heavily supported and subsidised in the world. However, the support is very uneven and nearly all goes to the dairy and sheep segments. In 2004, direct payments from the state amounted to an estimated 46% of farmers' income in lamb and mutton production and 46% of the producers' price for milk production. Total on-budget transfers to farmers amounted to about 1.9% of GDP in 2004 compared to 1.25% in the EU and 1.2% in the OECD. In terms of total agricultural support, Iceland outpaced Switzerland and Norway in 2004 to rank highest in the OECD, with a PSE (producers' support estimate) of 69; Switzerland and Norway had PSEs of 68. Producers' support in 2004 amounts to 33 on average in the EU and 30 in the OECD countries.

Chart 4. 13  
Electricity consumption per capita in selected countries 2001



Source: IEA 2003.

Imports of meat, dairy products and vegetables that compete with domestic production are subject to high tariffs, controls to prevent diseases, and quotas. Imports are likely to increase as tariffs go down in line with WTO agreements on trade in agricultural products.

### **Transport**

The domestic transportation network consists of roads, air transportation and coastal shipping. Car ownership is widespread. In 2004, Iceland had 612 passenger cars per 1,000 inhabitants and overtook the US and Australia, which hitherto have had the highest ratio within the OECD.

The road system totals 13,000 km, of which 4,300 km are primary roads. Some 4,500 km of the road network is paved and nearly 30 km of road tunnels have been built, with 11 km scheduled to be added in 2006.

Three international airlines operate in Iceland, all fully privately owned. Two of them offer direct passenger services to and from Iceland – both serve a number of cities in Europe and one has several gateways in the US as well. The third airline operates charter and air cargo services worldwide. Domestic air travel is an important mode of transport, with 750,000 passengers in 2004. The international airlines have been investing in foreign subsidiaries and other airlines in recent years, mainly in Scandinavia and in the UK.

Iceland has numerous harbours large enough to handle international ship traffic, which are without exception free of ice throughout the year. The two main shipping lines operate regular liner services to the major ports of Europe and the US. Both have been building transport networks on land and sea in Europe and North America by investing in foreign subsidiaries and other transport companies. A weekly ferry connection operates between two Nordic countries and east Iceland for passengers, cars and cargo.

### **Communications**

The telecom market in Iceland is characterised by one of the world's highest penetrations of broadband, Internet and mobile phones. Broadband penetration per 100 inhabitants was the fourth highest in the OECD in 2004, surpassed only by Denmark, Korea and the Netherlands. In 2004, Iceland had the second-highest mobile telephone penetration in the world, after Luxembourg, with 99 wireless subscribers per 100 inhabitants. In 2005, 89% of Icelandic households own a computer and 84% have access to the Internet. The percentage of households with an ADSL, SDSL or other xDSL connection has increased steadily in recent years to 54% in 2005.

Iceland's telecommunication infrastructure is both extensive and modern, with satellite earth stations, optical fibre cables, broadband networks and a wide-reaching cellular mobile phone system. There are two major players on the telecommunication market, Iceland Telecom (the former state-owned Landssíminn, privatised in July 2005) and Og Vodafone.

Three companies operate in the broadcasting market: two privately owned and the third under public ownership. Together, these

companies operate 8 radio channels and 7 TV channels. In addition, a large number of foreign TV channels are widely received via satellite, cable or UHF relay.

### Service industries

Iceland's financial services sector has experienced meteoric growth in recent years, catalysed by deregulation in the 1990s and, in particular, privatisation in 2002 of two commercial banks. International acquisitions have swollen the banks' combined balance sheets from €8.6 billion (102% of GDP) in 2000 to €35.1 billion (3.3 times GDP) in 2004 (see Chapter 5). The three commercial banks rank among the largest in the Nordic region with subsidiaries and affiliates in the UK, Scandinavia, Luxembourg and France.

Tourism has been one of the fastest-growing industries in recent years. The number of visitors from abroad in 2004 is estimated at 360 thousand, compared to 140 thousand in 1990. Foreign exchange revenues generated by tourism in 2004 amounted to approximately €460 million (39 b.kr.), equivalent to 12% of export revenues.

The technological sector of the services industry has also been rapidly diversifying. Iceland's software industry has extensive know-how and long practical experience in the design of software for sophisticated food and fish processing equipment. Icelandic software developers are also actively engaged in multimedia and Internet applications, e-commerce, real-time communication, medical software and general office and database systems. In 2004, exports of software products amounted to €45.4 million (3.9 b.kr), an increase of more than 50% since 2000.

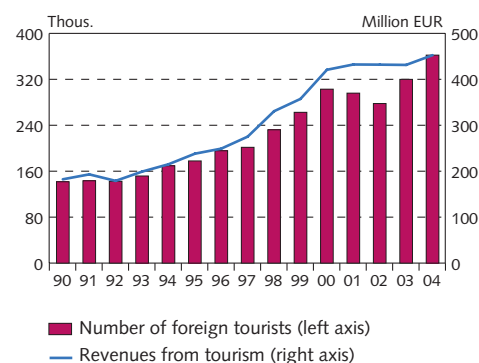
### The environment

Compared to other industrial countries, Iceland is relatively unpolluted and faces few immediate environmental problems. Soil erosion, however, has been a longstanding problem, as a result of the combined effects of climatic changes, volcanic activity and overgrazing. The intensity of grazing has fallen since the 1970s and considerable work is being carried out to reclaim eroded land.

Electricity and geothermal heating, Iceland's main energy sources, are generated by the use of renewable resources. Utilisation of hydroelectric power, however, requires the building of dams and large reservoirs that can affect the landscape.

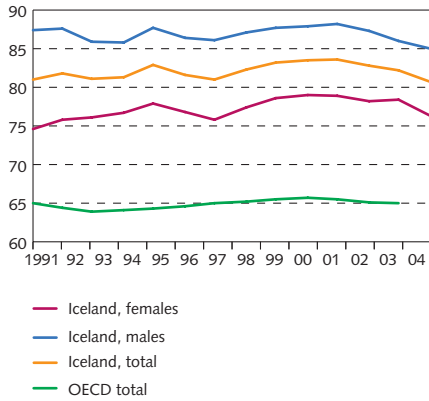
Acid disposition over Iceland is very low, due to its geographic location and limited emissions of pollutants. The emission limit set for Iceland in the Kyoto Protocol for the period 2008-2012 entails a 10% increase from the 1990 levels. In addition, emissions from single projects, which increase total emissions by more than 5%, can be reported separately but not included in the above set limit. Emission of greenhouse gases from Iceland in 2003 is estimated to have been 6% lower than in 1990. If emissions from new power-intensive industries are included, emissions in 2003 were 8% higher than the 1990 level. The largest source of emissions is the fishing fleet, followed by the transport sector, then by various industrial processes. The marine environment around Iceland is relatively unpolluted.

Chart 4.14  
Number of foreign tourists and  
revenues from tourism 1990-2004  
At current euro exchange rates



Sources: Central Bank of Iceland, Statistics Iceland.

Chart 4.15  
Labour force participation rate  
in Iceland and OECD countries 1991-2003



Sources: OECD, Statistics Iceland.

### The labour market

The Icelandic labour market has one of the highest participation rates among OECD countries. Over the past 10 years it has consistently been well above 80%. This is explained partly by the fact that the rate of unemployment has normally been one of the lowest among OECD countries. The participation rate of women has also been very high by international comparison. In 2004, female participation was in fact one of the highest in the OECD countries, with women accounting for 47% of the labour force. Participation rates among the young and the elderly have also been quite high. Furthermore, Icelanders tend to work long hours. The participation rate and number of hours worked are positively correlated with economic growth, dampening cyclical movements in unemployment.

Iceland's EEA membership facilitates movement of labour within the area. The Icelandic labour market tends to attract both foreign and Icelandic nationals during upswings and the opposite applies during downswings. Moreover, even in the case of significant shifts in sectoral or regional employment, a high degree of labour mobility between them prevents large differences in regional unemployment from emerging.

The influx of foreign labour has increased substantially in recent years, both from within and outside the EEA area. Nevertheless, as this is a rather recent phenomenon, the share of foreign nationals in the labour force remains at a modest level. In 2004 approximately 4.7% of the labour force was foreign.

The wage bargaining process in Iceland is highly centralised and usually leads to more or less nationwide settlements. Some 85% of the labour force is unionised and the employers are also highly organised. The government has frequently been involved in wage settlements, either through tax concessions and social transfers or with legislative acts aiming to accomplish moderate settlements. In addition, tailoring of national framework pay deals in sectoral and firm-level negotiations enables specific local conditions to be taken into account.

Notwithstanding its high degree of centralisation, the Icelandic labour market appears to be quite flexible compared to those within the rest of the EEA. Substantial and increasing labour mobility, flexible hours and variable participation rates serve to dampen the effects of external shocks. Furthermore, various studies indicate that real wages respond quickly to external shocks, which reduces their employment effect, although the measured flexibility may to some extent be the result of high historical inflation.

### The pension system

Iceland will face fewer problems due to the ageing of the population during the coming decades than most other developed nations. There are three main reasons for this. Firstly, the population is younger and will continue to be so during the coming decades. The old-age dependency ratio, i.e. over 64-year-olds as a ratio of 15- to 64-year-olds, was 18% in 2004, which is the same as in the US but lower than the average (23%) in the EU. Secondly, labour participation rates among the elderly are high and the pension system does not give spe-

cial incentives for early retirement. The official retirement age is 67 and 33% of 65- to 74-year-olds worked at least one hour a week in 2004. Thirdly, membership of a fully funded occupational pension fund is mandatory for all employees and self-employed. The Icelandic old age pension system is composed of a tax-financed public pension scheme, mandatory funded occupational pension schemes and voluntary pension saving with tax incentives.

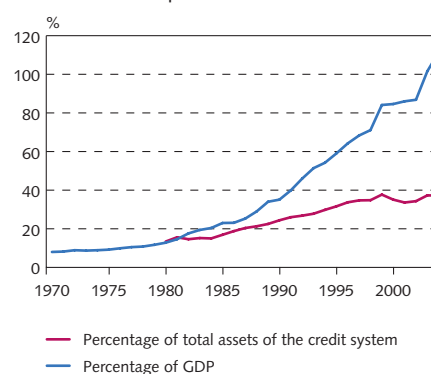
Public pensions are fully financed by taxes. The public pension system provides an old age pension, disability pension and survivors' pension. The old age pension is in most cases paid from the age of 67. It is divided into a basic pension and supplementary pension. Both are means-tested but pensions received from other sources are treated differently from other income. These do not affect the basic pension and the level at which they begin to reduce the supplementary pension is higher than for other income. The basic pension amounts to around 14% of the average earnings of unskilled workers but the maximum total old age pension to around 67% of the same earnings. Occupational pension funds have been increasing their share in pensions relative to the public system as they approach maturity and means testing reduces the public pension. In 2004 the pension funds and the public pension system had equal shares in payments totalling €693 million (58 b.kr.), or almost 7% of GDP.

It is mandatory to pay at least 11% of total wages and salaries to pension funds. Formally this 11% is split between a 4% contribution from the employee and a 7% contribution from the employer. Wage settlements made in 2004 raise the employer's mandatory fund contribution to 9% by 2007. Many of the funds were established through a collective labour agreement in the late 1960s. Most are managed jointly by representatives from the trade unions and employers. The funds have grown by leaps and bounds over the past two decades as their coverage has become almost total and the return on their assets was strong during the 1980s and the 1990s. Assets were equivalent to almost 115% of GDP at the end of 2004 and are predicted to reach at least 1½ times GDP around the middle of the twenty-first century. Pension funds in Iceland are large relative to GDP by international comparison as Iceland ranked third in 2003 among EU and EFTA countries on this criterion.

At the end of 2004 there were 38 fully operational pension funds in Iceland, thereof 11 with employer guarantees from the government, municipalities or banks. Funds without employer guarantee are required under current legislation to be fully funded. The ten largest pension funds held about 71% of the net assets of all pension funds in 2003, and the two largest ones accounted for 33%. The average fund had net assets of around €245 million (20.5 b.kr.), while the biggest had assets of a little over €2.1 billion (179.8 b.kr.).

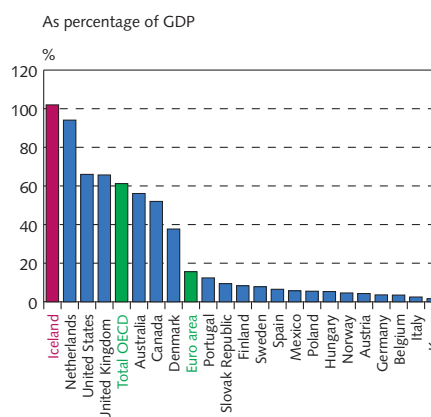
The benefits paid by occupational pension funds without employer guarantee will ultimately depend on their net return and will therefore vary from one fund to another. But the investment risk is born collectively by the members of each fund and there are no individual accounts as in pure defined contribution plans (DC plans). It has been estimated that a typical general occupational pension fund

Chart 4.16  
Net assets of pension funds 1970-2004



Source: Central Bank of Iceland.

Chart 4.17  
Size of pension funds in selected OECD countries 2003



Source: OECD.

will, at full maturity, be able to pay a pension amounting to 50-60% of full-time earnings, giving a total replacement ratio of 60-70% when the basic public pension is added.

In the third pillar of pension saving, employees are allowed to deduct from their taxable income a contribution to authorised individual pension schemes of up to 4% of wages. If employees contribute 2% of wages, employers have to contribute the same amount. The pension schemes have to be authorised by the Ministry of Finance. They are in most cases defined contribution individual accounts. The pension saving is not redeemable until the age of 60 and has to be paid in equal instalments over a period of at least seven years. It is estimated that 50% of wage earners were paying into such schemes in 2004.

Pension funds used to invest most of their assets in government-guaranteed bonds, housing finance and loans to members. During the last decade a significant shift took place in the asset allocation of pension funds, with the shares of equities and foreign assets increasing strongly. The proportion of equities was just over 1% of total assets in 1990 but had increased to 31% in 2004. The share of foreign assets went up from less than 2% in 1995 to almost 22% at the end of 2004. Current legislation sets upper limits on the share of equities in a pension fund's portfolio at 50% and restricts exposure to exchange rate risk to 50% of net assets.

The build-up of the pension funds has contributed a great deal to the development of financial markets in Iceland. It is estimated that their assets were equivalent to over 37% of the size of the credit system in 2004. The funds held 22% of the stock of marketable bonds in the same year and 38% of the stock of housing bonds. At the end of 2004 the funds owned domestic equities and shares in equity funds that amounted to around 12% of the size of the organised equity market. This figure really underestimates their scope, due to extensive cross-ownership of listed companies. Finally, foreign asset accumulation of the pension funds is very significant in terms of the national economy. Their foreign assets accounted for nearly 63% of all foreign portfolio assets of Icelandic residents at the end of 2004 and over 19% of total foreign assets as recorded in the international investment position.

## 5 The financial system

### Overview and recent developments

Structural and legislative reforms, along with the massive expansion in financial services and activity that they have engendered, have made Iceland's financial system more international in character and broadly on a par with European norms. Under its obligation to transpose into national law all existing and future EU legislation in the field of financial services, Iceland has implemented all the EC directives on banking, insurance and securities trading whose general objective is to accomplish an integrated European market for financial services, in particular with respect to the right of establishment, provision of services, prudential rules and capital movements. Furthermore, the Icelandic authorities, in close cooperation with market participants, have begun implementation of policy objectives and specific measures on the basis of the EU's Financial Services Action Plan from 1999 aimed at enhancing harmonisation, competition and effectiveness of financial services, payment systems and electronic commerce throughout Europe.

Table 5.1 Financial market liberalisation in Iceland: some important steps

| <i>Event</i>  | <i>Year</i> |
|---|-------------|
| Financial indexation permitted  | 1979        |
| Liberalisation of domestic bank rates   | 1984-86     |
| Iceland Stock Exchange established  | 1985        |
| Interest Rate Act – Interest rates fully liberalised  | 1987        |
| Stepwise liberalisation of capital movement begins  | 1990        |
| Treasury overdraft facility in the Central Bank closed  | 1992-93     |
| New foreign exchange regulation marks the beginning of liberalisation of cross-border capital movements | 1992        |
| Interbank market for foreign exchange established   | 1993        |
| Iceland becomes a founding member of the EEA  | 1994        |
| Long-term capital movements fully liberalised   | 1994        |
| Short-term capital movements fully liberalised  | 1995        |
| Foreign direct investment liberalised in accordance with EEA agreement                                  | 1995        |
| Interbank money market  | 1998        |
| Interbank FX swap market  | 2001        |
| Privatisation of state-owned banks completed  | 2003        |

A new Act on the Central Bank of Iceland entered into force in 2001 (see Chapter 7). It simplified and clarified the objectives of the Central Bank, provided full independence for applying its monetary instruments and increased its financial independence. The Central Bank of Iceland is committed to modern central banking principles such as transparency, accountability and independence. It pursues an inflation-targeting monetary policy and promotes financial stability.

Table 5.2 Selected legislation in the field of financial services

|  |
|--|
| Act on the Central Bank, No. 36/2001   |
| Act on Activities of Stock Exchanges and Regulated OTC markets, No. 34/1998  |
| Act on Electronic Registration of Title to Securities, No. 131/1997 (amended)  |
| Act on Official Supervision of Financial Operations, No. 87/1998 (amended)   |
| Act on Financial Undertakings, No. 161/2002  |
| Act on Securities Transactions, No. 33/2003  |
| Act on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds, No. 30/2003                     |
| Act on Insurance Activities, No. 60/1994 (amended)   |
| Act on Insurance Contracts, No. 20/1954 (amended). A new Act on Insurance Contracts will enter into force on January 1, 2006 (30/2004) |
| Act on the Mandatory Guarantee of Pension Rights and the Operation of Pension Funds, No. 129/1997                                      |
| Act on Deposit Guarantees and Investor-Compensation Scheme, No. 98/1999  |
| Act on Housing Affairs, No. 44/1998  |
| Act on the New Business Venture Fund, No. 61/1997  |
| Act on Measures to Counteract Money Laundering, No. 80/1993, as amended by Act No. 38/1999   |

### Iceland Stock Exchange and the Icelandic Securities Depository

There is currently one authorised stock exchange operating in Iceland where public listing of securities and securities trading are carried out, i.e. Iceland Stock Exchange (ICEX). ICEX is also licensed to operate a regulated OTC market. The Stock Exchange Act of 1998, modelled on EU legislation, furthermore regulates listing, takeover bids, disclosures and flagging in the event of the acquisition of major shareholdings and accompanying rights. Nordic stock exchanges have been cooperating for many years on various aspects of exchange operations, sharing their experience and addressing a variety of common interests together. This cooperation evolved into the Nordic Stock Exchanges (NOREX) alliance, which adopted a single trading system and a harmonised regulatory framework. Today, all the Nordic and Baltic exchanges (Copenhagen Stock Exchange, Oslo Børs, Stockholmsbörsen, HEX in Finland, the three stock exchanges in the Baltic countries and ICEX) are members of the NOREX alliance and share a joint trading system, SAXESS.

Electronic issue of securities and registration of titles to electronic securities can only be carried out by a licensed securities depository. The Icelandic Securities Depository is a registry, depository and clearing house for securities in dematerialised (electronic) form. Iceland Stock Exchange and the Icelandic Securities Depository are both owned by the same holding company as of June 2002. Settlement of securities and equities takes place on a T+1 basis.

### Bond market

The Icelandic bond market consists of a primary market which usually takes the form of bond auctions, and a secondary market which is mainly operated on ICEX. Icelandic bond issues can be broadly divided into four categories:

1. Government bonds, issued by the Treasury, are indexed against inflation and paid up with accrued interest at maturity date.



2. Treasury notes and Treasury bills, which are non-indexed, zero-coupon bonds.
3. Housing Financing Fund (HFF) bonds, housing authority bonds and housing bonds which are interest-bearing bonds in an annuity format. The annuity format of the last is realised by a lottery of all issued bonds at preset intervals. These bonds are indexed against inflation.
4. Bonds that are issued by government agencies, private firms or institutions such as banks.

An active market-making programme on the stock exchange ensures sufficient liquidity in the market for benchmark government bonds, HFF bonds, housing bonds and housing authority bonds. A primary dealer system is also in place for Treasury notes and bills. Most new issues are registered in the Icelandic Securities Depository and trading is conducted on a payment versus delivery basis. Several categories of bonds are registered in Clearstream. HFF bonds are registered in Euroclear, but a large share are sub-registered in the Icelandic Securities Depository.

The Icelandic bond market has several features which set it apart from those in other countries. First, indexed bonds dominate the market. The bulk of issues of maturity exceeding 5 years are linked to the CPI. Second, the majority of bonds carry a state guarantee, including HFF bonds, which are the market's most liquid issues. Third, yields on the Icelandic bond market have been high by international comparison. Over the past decade real yields of indexed housing and government bonds have fluctuated in the range 4% to 8%, and recently around 3.5%. At the end of September 2005, the market value of listed bonds amounted to €19.3 billion (1,540 b.kr.). Turnover on the bond market in 2004 was €15.7 billion (1,368 b.kr.) and from January to September 2005 €10.4 billion (830 b.kr.).

### Equity market

Market capitalisation of Icelandic equities has increased in recent years as equity prices have risen since October 2001. In September 2005, a total of 26 companies were listed on the ICEX main list and 4 companies on the alternative market which is an organised but not officially recognised market. Market capitalisation of listed companies at the end of September 2005 was €18.5 billion (1,471 b.kr.), or 170% of GDP of 2004.

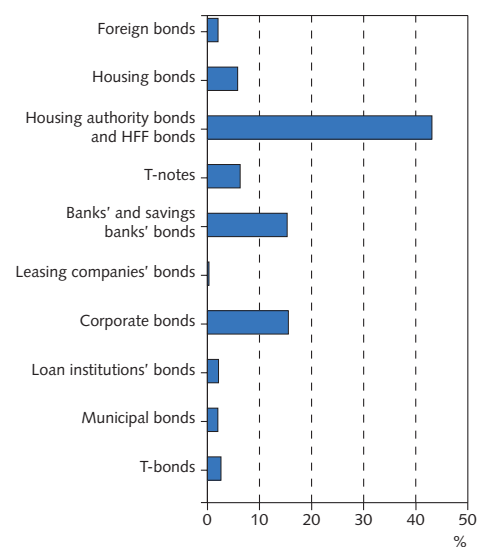
From 1998 to 2002, Icelandic share prices broadly followed a similar trend to that in foreign markets, reaching an all-time high in early 2000 and subsequently dropping considerably. In 2002, the trend was reversed and Icelandic share prices gained 56% in 2003 and 59% in 2004. From beginning of January until the end of September 2005 the ICEX-15 index has risen by 37%. Turnover in shares was €8.3 billion (721 b.kr.) in 2004 and €10.3 billion (817 b.kr.) over the first nine months of 2005.

### Money market

The money market consists of a secondary market in Treasury bills, bank bills and other short-term bonds on the Stock Exchange, and the

Chart 5.1

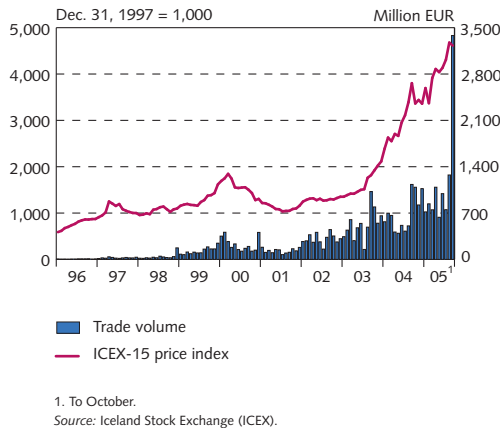
The Icelandic bond market at the end of 2004, percentage breakdown of market value



Source: Iceland Stock Exchange.

Chart 5.2

Equity market: Monthly trade volume and prices at month-end 1996-2005



interbank loan market. Turnover on the secondary market on ICEX in 2004 was €1.5 billion (128 b.kr.) and from January to September 2005 €1.3 billion. The interbank market is operated by the Central Bank of Iceland and trading involves unsecured loans between the members of the market. Members must display indicative bid and ask yields on various maturities, ranging from overnight to 12-month loans. Trades must be reported to the Central Bank. Once a day, the Central Bank fixes REIBID and REIBOR rates for the market. Turnover on the interbank market for domestic currency amounted to €12.3 billion (1,073 b.kr.) in 2004 and €15.1 billion (1,207 b.kr.) over January-September 2005.

### Foreign exchange market

The foreign exchange market is an interbank market run by the Central Bank of Iceland, operating since 1993. Market participants are the three largest commercial banks. The Central Bank of Iceland is the fourth participant but has not been an active market maker for a number of years. The Central Bank has purchased foreign exchange in the interbank market on behalf of the Treasury and to boost its own reserves for the past three years. Market makers are subject to rules issued by the Central Bank, which were last changed in the beginning of 2003.

Activity on the market is highly variable. Total turnover in 2004 was €10.8 billion (948 b.kr.) and in the first nine months of 2005 it had already reached €15.9 billion (1,271 b.kr.), surpassing the record annual turnover set in 2001. In November 2001 an informal FX swap interbank market was launched, for which the Central Bank of Iceland issued rules in March 2002. Turnover in the swap market was USD 1,282 billion in 2004 and USD 422 billion from January-September 2005. Other derivative instruments are used in Iceland but not in a formal market.

### Credit institutions

As in other areas of financial services, the legislative framework for credit institutions is comparable to other corresponding European legislation and international banking standards. Act No. 161/2002 on Financial Undertakings includes provisions on the establishment, authorised activities, management and holdings of banks, own funds requirements, annual accounts and mergers, as well as activities of foreign banks in Iceland. Regulations adopted on the basis of this Act cover areas such as annual accounts and capital adequacy requirements, which are consistent with European requirements.

There are currently four commercial banks in Iceland. The three largest – Íslandsbanki hf., Kaupthing Bank and Landsbanki Íslands hf. – provide all conventional banking and securities services. There are 24 savings banks in Iceland and the fourth commercial bank, Sparisjóðabanki Íslands hf. (Icebank), serves as a banking institution for most of them. Total assets of commercial and savings banks groups amounted to €38.4 billion (3,204 b.kr.) at the end of 2004, with the commercial banks accounting for approximately 93% of this figure.

Íslandsbanki, Kaupthing Bank and Landsbanki Íslands are private-held. In recent years they have expanded their operations abroad by

Chart 5.3

Volume traded in the interbank market for foreign exchange 1997-2005



acquiring subsidiaries in commercial banking and security brokerage. In mid-2005, around half of the assets of the Icelandic bank groups were held by foreign subsidiaries, most of them located in northern Europe. In 2005 it is estimated that as much as 50% of their overall income will be generated abroad. The three largest commercial banks are rated by international rating agencies.

Eleven other credit institutions currently operate in Iceland, comprising five investment banks, four investment funds and two leasing companies, plus the Housing Financing Fund.

The HFF is a state-owned investment fund with a considerable share in household mortgage lending in Iceland. Until mid-year 2004 it operated the housing bond system, which was not a traditional mortgage loan system, but a bond swap system. In mid-2004, the HFF discontinued the housing bond system and issued HFF bonds to finance its new cash loans to households. Swaps of several older classes of housing bonds and housing authority bonds were offered for HFF bonds. The new HFF bonds are linked to the CPI, have no call option and mature in 2014, 2024, 2034 and 2044 respectively. HFF bonds are listed on ICEX and registered with Euroclear. At the end of June 2005, bonds issued by the HFF represented 85% of the Icelandic government bond market.

Chart 5.4  
Market value and total assets of the three largest commercial banks as of June 2005

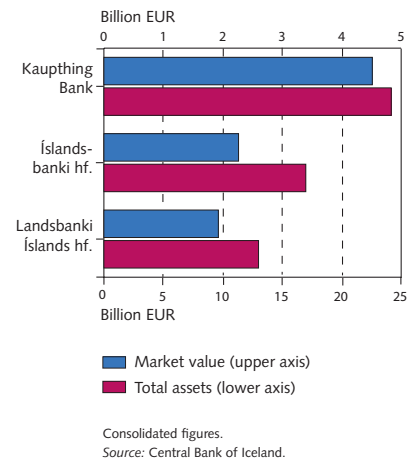


Chart 5.5  
Consolidation of the banking system

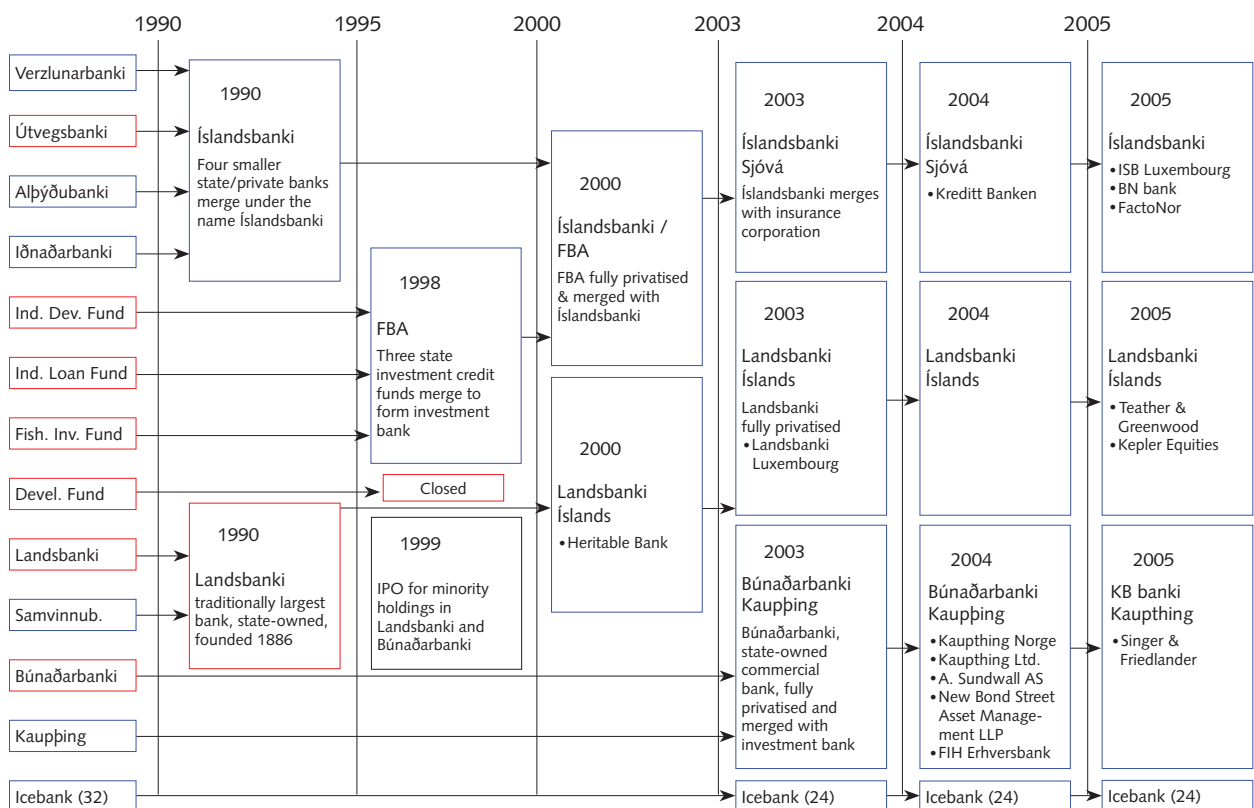


Table 5.3 Commercial banks' credit ratings

|                    | <i>Moody's ratings for foreign-currency obligations</i> |                  |                   |                           |                |
|--------------------|---|------------------|-------------------|---------------------------|----------------|
|                    | <i>Affirmed</i>   | <i>Long-term</i> | <i>Short-term</i> | <i>Financial strength</i> | <i>Outlook</i> |
| Kaupthing Bank     | May 2005  | A1               | P-1               | C+                        | Stable         |
| Íslandsbanki       | May 2005  | A1               | P-1               | C+                        | Stable         |
| Landsbanki Íslands | March 2005  | A2               | P-1               | C                         | Stable         |

Table 5.4 The Housing Financing Fund's credit ratings

|                           | <i>Affirmed</i> | <i>Foreign currency</i> |                   | <i>Domestic currency</i> |                   | <i>Outlook</i>               |
|---------------------------|-----------------|-------------------------|-------------------|--------------------------|-------------------|------------------------------|
|                           |                 | <i>Long-term</i>        | <i>Short-term</i> | <i>Long-term</i>         | <i>Short-term</i> |                              |
| Moody's Investors Service | March 2005      | Aaa                     |                   | Aaa                      |                   | Stable                       |
| Standard & Poor's         | Feb. 2005       | AA-                     | A-1+              | AA+                      | A-1+              | Stable/negative <sup>1</sup> |

1. The outlook for the domestic currency rating is negative.

### Securities firms and brokerages

Icelandic laws on securities firms and securities brokerages from 2003 are based on the corresponding European framework legislation. The Act on Securities Transactions covers fields including authorisation, public offerings, confidential information, insider trading, market manipulation, annual accounts and supervision. A number of regulations have been adopted on the basis of it. The Act on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds provides for rules on, among other things, authorisation, registration and articles of association of UCITS, management and depository companies, investment policy, management, annual accounts and supervision. At year-end 2004, seven securities firms and three securities brokerages had operating licences. Also, credit institutions are licensed to trade and provide services with financial instruments.

Five management companies of UCITS and investment funds had operating licences at year-end 2004. Between them they managed 10 UCITS and 12 investment funds. Four of the UCITS were umbrella funds in 34 individual funds and three of the investment funds were umbrella funds in five individual funds. UCITS are licensed to operate across the European Economic Area (EEA). At year-end 2004, total assets of management companies of UCITS and investment funds amounted to €22.4 billion (1,867 b.kr.).

### Insurance companies

Under Icelandic law, an insurance company must conduct only insurance activities and specifically defined ancillary activities. Life insurance activities must be separated from other types of insurance services. Icelandic insurance law is based on EU framework legislation.

There are 13 insurance companies authorised to operate in Iceland, with total assets of around €1.25 billion (104 b.kr.) at year-end 2004. Sjóvá-Almennar Tryggingar hf., Vátryggingafélag Íslands hf. and Tryggingamiðstöðin hf. are by far the largest. Life insurance companies represent only 8.4% of total assets of insurance companies. In addition, 225 foreign insurance companies have licences to provide

services in Iceland, but only one has established a branch in the country so far.

### **Financial stability and the Central Bank**

Article 4 of the Central Bank Act stipulates that it shall undertake such tasks as are consistent with its role as a central bank, such as to maintain external reserves and promote an efficient and safe financial system, including payment systems domestically and with foreign countries.

In performing its important role of promoting an efficient and safe financial system, the Central Bank of Iceland focuses on assessing the risk of liquidity problems among financial companies and problems in payment and securities settlement systems which could be systemically important. It also promotes efficiency and positive development of the financial system. Financial stability is an important precondition for economic stability, and vice versa. Central Bank activity in this field needs to be undertaken in such a way that markets and decision-makers take the Bank's views into account so as to contribute to an effective and safe financial system. One important way to achieve this is with the annual publication of an analysis of financial stability in the Central Bank's *Financial Stability Report*. The main findings of the Central Bank's analysis in the last *Financial Stability Report* published in April 2005 was that in spite of rapid expansion and the macroeconomic imbalances that need to be addressed in the coming years, the Icelandic financial system is broadly sound. It is sound in the sense of being equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to redistribute risks appropriately.

In its work on financial stability the Central Bank has taken into account international agreements and other standards for best practices along with the work of leading foreign central banks in this field. In light of the increasing prevalence of banks with cross-border establishments, in 2003 the central banks of the five Nordic countries signed a memorandum of understanding (MoU) on managing financial crises.

### **Supervision and deposit insurance**

The Financial Supervisory Authority (Fjármálaeftirlitið, FME) has since 1999 handled supervisory tasks formerly assigned to the now-disbanded Bank Inspectorate of the Central Bank and the Insurance Supervisory Authority. The Central Bank's role is in oversight and prudential regulation.

The FME has a Board of Directors appointed by the Minister of Commerce. The institution supervises commercial banks, savings banks and other credit institutions, insurance companies, companies and individuals acting as insurance brokers, undertakings engaged in securities services, UCITS, management companies, stock exchanges and other regulated markets, central securities depositories (CSD) and pension funds. The FME also supervises other activities as authorised in accordance with specific laws.

The main task of the FME is to ensure that the activities of the above institutions and firms are conducted in accordance with the

relevant laws and regulations and that they remain sound in other respects. These institutions and firms are obliged to provide all the information considered necessary by the FME to facilitate statutory supervision of their activities.

In 2003 the FME was given authority to raise the minimum capital adequacy ratio of an individual institution to a level in excess of 8% if its financial position is viewed as unsatisfactory with regard to its risk profile. In assessing the risk profile, the FME has developed a risk assessment system built on CAMELS and stress tests. The aim is to help to keep the current capital adequacy ratio close to its existing level and facilitate timely pre-emptive measures in the future.

By law, the Central Bank of Iceland sets rules for the liquidity ratio of credit institutions, i.e. the ratio of liquid claims to liquid liabilities, and for their foreign exchange balance. Other prudential regulations on financial markets are either sanctioned by law or adopted by government minister or the FME. The regulation on liquidity aims to ensure that credit institutions always have sufficient liquidity to meet foreseeable and conceivable payment liabilities over specific periods. For instance, the ratio of claims to liabilities which fall due or can be liquidated within 3 months must not be lower than 1. Limits are stipulated for the balance of foreign-denominated assets and liabilities. First, exposure in individual currencies is restricted to 15% of equity, except for the US dollar and the euro where the limit is 20%. Second, total foreign exchange exposure is limited to 30% of equity.

A Cooperation Agreement between the FME and Central Bank of Iceland is in place. The main aim of the Cooperation Agreement is to make clear the responsibility of each party and the division of tasks between them, both with respect to each other and vis-à-vis companies in financial markets and the general public. A specific agreement between the FME and the Central Bank applies to payment and settlement systems.

A deposit insurance scheme is in force in Iceland. The commercial and savings banks have annually contributed 0.15% of their deposits to this scheme (until the limit of 1% of total insured deposits is reached). Since the beginning of 2000, the Insurance Fund of the commercial banks and the savings banks has been a private institution. A separate department of the fund provides insurance for securities investors.

In June 2003 the IMF updated its financial stability assessment of 2001. The report assessed that most of the earlier problems – low capital adequacy, insufficient provisioning, high borrowing and lending in foreign exchange, and the understaffing of the FME – have been addressed and that the overall quality of supervision in Iceland has improved considerably. The assessment was published on the IMF's and the Central Bank's websites in August 2003.

## 6 The public sector

### The size of the government sector

Compared to its neighbours, Iceland has a relatively small public sector, with expenditures of around 47% of GDP in 2004. This is lower than in the Nordic countries (53%) and the mainland countries of the European Union (49%), but higher than for the US, Japan or South Korea. Despite balanced budgets, the expenditure ratio has risen significantly in the last few years. The rise from 42% in 1998 to 47½% in 2003 is mostly due to increased expenditures on health, education and social protection.

Several factors should allow Icelanders to get by with a relatively small government sector: the absence of defence expenditure, historically low unemployment and comparatively low spending on social affairs. Furthermore, occupational fully funded pension funds have become just as important as the public pay-as-you-go system, while the latter is the dominant pillar in many other OECD countries (see Chapter 4). The relatively young population and high retirement age also help to lower overall pension expenditures. Compared to either the EU (before the latest accessions) or the Nordic countries, the latest available figures from 2001 on government expenditures by function show that low expenditures are to a large degree counterbalanced by greater spending on general services, health care, education and economic affairs.

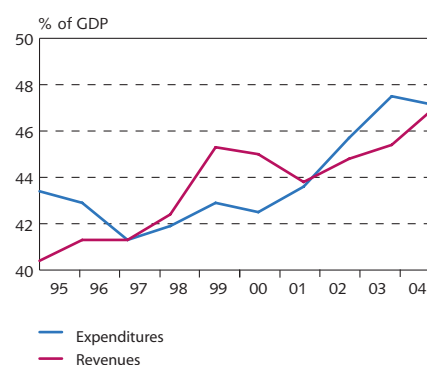
### General government finances

Iceland, like many other OECD countries, ran up a relatively large public sector deficit in the late 1980s and early 1990s, with deficits averaging 3% of GDP in 1985 to 1995. To some extent the early 1990s deficit was the result of a prolonged slowdown which depressed revenues and increased social spending.

General government finances consolidated after the mid-1990s and recorded surpluses by the end of last decade. Since the mid-1990s the public sector fiscal balance has been significantly above the OECD average. There was a brief return to slight deficits as spending rose and the economy cooled in 2002-2003, while 2004 saw a return to balance.

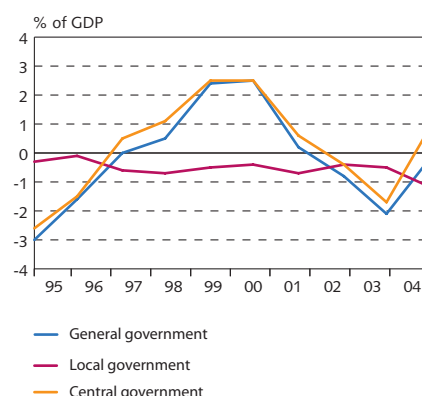
According to budget plans presented in October 2005, the general government is expected to show a surplus amounting to 2½% of GDP in 2005 and 1% in 2006, before weakening as the aluminium and hydropower sector investment projects now under way draw to a close in 2007. General government outlays are scheduled to fall from 47% in 2004 to 43½% of GDP in 2006. The Treasury has benefited indirectly from the import component of the expanding current account deficit as revenues from indirect taxes rise. As the boom peaks, tax cuts in 2006 and 2007 are expected to outweigh any revenue gains. According to the budget plans, revenues are expected to fall from 48% of GDP in 2005 to 43½% in 2007.

Chart 6.1  
General government revenues and expenditures 1995-2004



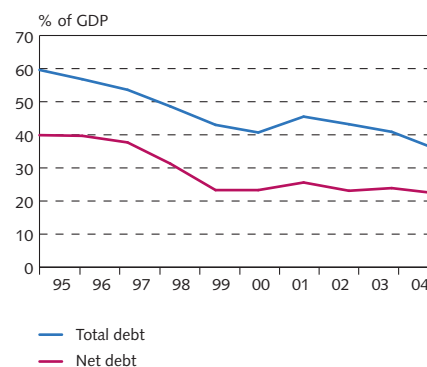
Sources: Statistics Iceland, Treasury projections.

Chart 6.2  
Government fiscal balance 1995-2004



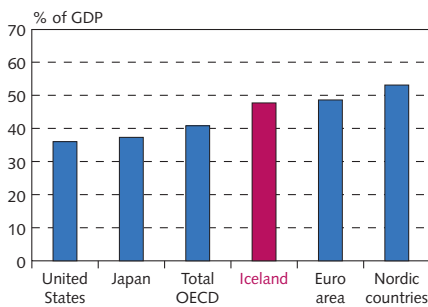
Sources: Statistics Iceland, Treasury projections.

Chart 6.3  
General government debt 1995-2004



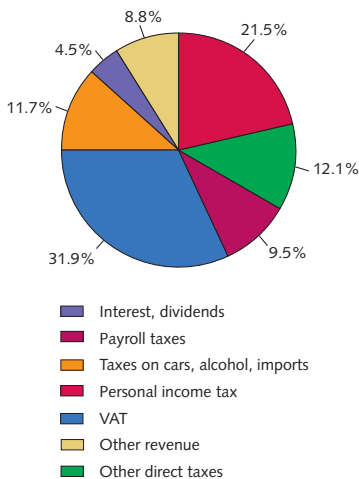
Sources: Treasury accounts, Treasury projections.

Chart 6.4  
General government expenditures 2004



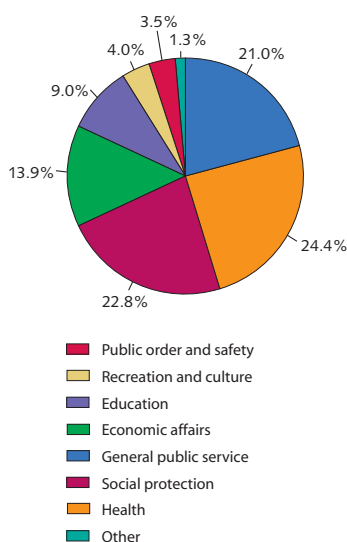
Sources: OECD Economic Outlook, Statistics Iceland.

Chart 6.5  
Treasury revenues by source 2004



Source: Treasury accounts.

Chart 6.6  
Treasury expenditures by function 2004



Source: Treasury accounts.

General government debt rose significantly during the recession from the late 1980s to mid-1990s. Net debt peaked in 1995 at 40% of GDP. With stronger growth and improving balance it fell to around 24% by the end of 2004 and is expected to fall to around 12% of GDP at the end of 2006.

### Division of responsibilities

The government sector in Iceland is organised on two levels, the central government as described in the Treasury accounts, and municipal or local governments. Separate sets of social security accounts are maintained, but their expenditures and revenues are authorised through the Treasury budget. Since the early 1990s local government expenditures have been climbing from around 10% of GDP to around 13% as against a central government budget of around 35% of GDP.

The central government regulates local governments, legislates their authority to collect revenue and actually collects more than 80% of local government tax revenues. It also administers and finances the social security sector of government.

The central government is responsible for the police, courts, foreign affairs, upper secondary and higher education, health services, institutional care for the disabled and elderly, general support and services for industry and most infrastructure construction and maintenance not obviously specific to individual municipalities. It administers basic benefit programmes for elderly and disabled persons and the bulk of supplementary old-age and disability pensions, unemployment benefits, rebates on mortgage interest payments for owner-occupied housing and benefits to families with dependent children. Most of these programmes are means-tested.

Local governments are responsible for local planning, most local infrastructure, day care and education from pre-school to the end of lower secondary level, and welfare services of various kinds, in particular services for the elderly except for health care. They are also responsible for solving the housing needs of low-income households. This is done via rent support, partially financed by the central government, and by providing rental housing for those who cannot find housing on their own. Local governments provide supplementary assistance to general programmes of pensions otherwise run by the central government.

### Central government finances

Central government revenues as presented in the Treasury's accounts amounted to 34% of GDP in 2004. The composition of Treasury revenues is shown in Chart 6.5. The noticeably large share of taxes on goods and services puts Iceland in third place among OECD countries on this measure and first in terms of such taxes as a percentage of GDP.

Discretionary expenditures of the central government are quite low and have been falling. In particular, expenditure on fixed capital and capital transfers has fallen considerably in recent years. The Government has outlined a medium-term programme where the aim is to keep growth in public consumption below 2% a year and income transfers below 2.5%.



Central government revenues respond quite strongly to swings in the economy for two main reasons. First, bracket creep occurs when personal income tax revenue increases disproportionately to incomes during an upswing, if legislated rises in deductions are less than rises in incomes. Second, the composition of consumption seems to tilt towards higher-taxed items during upswings, especially if the real exchange rate of the króna is high. These factors, along with a smaller boost from corporate income and payroll taxes and the introduction of a tax on personal capital income in 1997, helped transform the Treasury balance from  $-2\frac{1}{2}\%$  of GDP in 1995 to  $+2\frac{1}{2}\%$  at the height of the 1999-2000 upswing. With the boom turning into a mild contraction and the GDP share of Treasury expenditures rising from 32% in 2001 to  $35\frac{1}{2}\%$  in 2003, the surplus turned into a  $1\frac{1}{2}\%$  deficit. Many of these expenditure increases were temporary and the return to higher growth strengthened revenues, resulting in a surplus of 1% of GDP in 2004.

Treasury surpluses, privatisation revenues, reduced lending activity and strong economic growth contributed to a fall in gross Treasury debt from 51% of GDP in 1995 to 29% in 2004, while net debt fell from 34% to 18% of GDP. Besides, since 1999 the Treasury has made an effort to pre-fund civil service pension liabilities, which are not classified as debt in international comparisons. Accumulated pre-funding, along with accrued interest, now amount to around €1 billion (75 b.kr.), or around  $8\frac{1}{2}\%$  of GDP. By comparison, unfunded civil service pension liabilities were around €2.5 billion at the end of 2004.

### Local government finances

The local government sector has run deficits 14 years in a row, by 0.5% of GDP in 2003 and 1.2% in 2004. Local government budgets have run at around 13% of GDP in the past couple of years. They have grown from an average of 7% of GDP in the early 1980s, mainly because of new and expanded tasks in the area of primary education and day care.

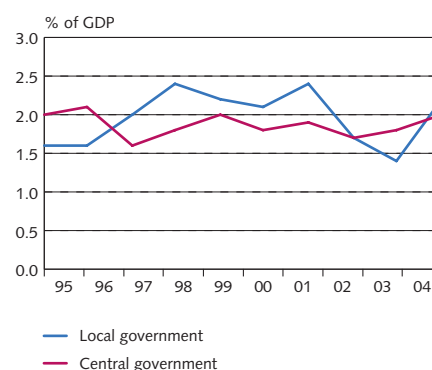
The latest available figures show that in 2003, education and day care accounted for 37% of local government expenditures, followed by 17% for social affairs, 15% for culture and recreation, 15% for general services and 8% for roadworks and traffic. On the revenue side, preliminary figures for 2003 show 59% of revenues coming from municipal income taxes, 12% from real estate taxes and other indirect taxes,  $6\frac{1}{2}\%$  from the Treasury-financed Municipal Equalisation Fund and 14% from the sale of services.

In spite of persistent deficits, gross local government debt hovered around 7% of GDP and net debt around 5% in the period 1994-2000. Asset sales, economic growth and a 10% appreciation of the króna in 2002-2004 helped municipalities hold ground on their net debt.

### The tax system

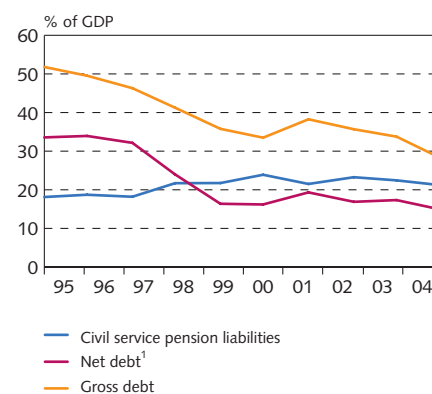
The central government or Treasury derived around 88% of its revenue from taxes in 2004, while at the local government level this tax-dependency ratio was 75%. Of Treasury revenue, 39% came from

Chart 6.7  
Government fixed investment 1995-2004



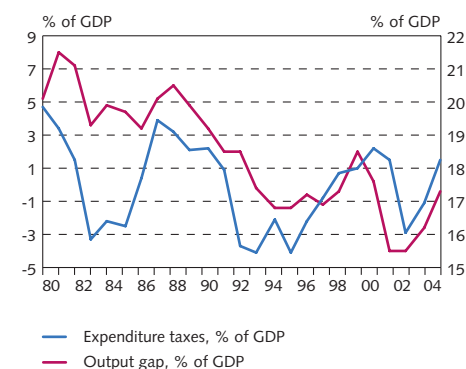
Sources: Statistics Iceland, Ministry of Finance projections.

Chart 6.8  
Central government debt 1995-2004



1. Including cash position but excluding pension liabilities.  
Sources: Ministry of Finance, Central Bank projections.

Chart 6.9  
Cyclicality of indirect taxes 1980-2004



Sources: Treasury accounts, Statistics Iceland.

direct taxes on income and wealth, 32% from value-added tax, 9½% from payroll taxes and 15% from various excise taxes on imports, production and consumption.

A 24.75% tax is levied on personal income up to €57 thousand (4.2 m.kr.) for individuals, while an additional 2% is charged on higher income. In the autumn of 2004, the tax code was amended whereby the general rate would be lowered from 25.75% to 24.75% at the beginning of 2005, with an additional point in 2006 and, finally, two points in 2007, leaving the general rate at 21.75%. Similarly, the 2% surcharge will be abolished in 2006. In addition to the state income tax, a municipal income tax is levied on personal income. It ranges from 11.2% to 13% depending on locality. Income up to €12.2 thousand (901 thousand kr.) per person per year is exempt from the combined state and municipal income taxes, as are pension contributions.

Interest, dividends, rental income and personal capital gains are taxed at a lower rate of 10%.

The corporate income tax was lowered from 50% in 1991 to the current 18% in 2002. Capital income of corporations is treated like other revenue for tax purposes. A payroll tax of 5.73% is charged on wages.

Table 6.1 Main features of the tax system in Iceland

|  |                          |
|--|--------------------------|
| State income tax <sup>1</sup>              | 24.75%                   |
| on incomes > €57 thousand (4.2 m.kr.)      | 26.75%                   |
| Municipal income tax <sup>1</sup>          | 11.2% to 13% by locality |
| State tax on financial income <sup>2</sup> | 10%                      |
| Corporate income tax                       | 18%                      |
| Taxes on net worth <sup>3</sup>            |                          |
| Persons                                    | 0.6%                     |
| Corporations                               | 0.6%                     |
| Payroll taxes                              | 5.73%                    |
| Value-added tax                            |                          |
| General rate                               | 24.5%                    |
| Low rate <sup>4</sup>                      | 14.0%                    |

1. Incomes up to €12.2 thousand per person are exempt from income taxes. The exemption falls entirely on the Treasury. Pension fund contributions are exempt up to a point. The 2% surcharge expires in 2006. The rate is set to fall to 21.75% in 2007. 2. Interest, dividends, realised capital gains and rental income of persons. 3. Collected for the last time in 2005. 4. Food, hotel rooms, heating, books, newsprint, television and radio subscriptions.

Sources: Internal Revenue Directorate, Association of Local Authorities.

A net wealth tax of 0.6% is levied on net assets exceeding €67 thousand (4.8 m.kr.) for individuals and on the net value of corporations. This tax will expire as of 2006. The marginal rate has come down since 1989 from 2.95% for individuals and 1.45% for corporations. There is a 1.5% stamp duty on most debt instruments, a 0.25% duty on bills of exchange and 0.5% on the issue of equity shares. Local governments collect real estate taxes at a maximum rate of 0.625% of assessed value for residential property and 1.65% for commercial property.

The largest single source of Treasury revenue is the value-added tax, which is levied at 24.5% on most goods and services. Food, heat-

ing fuel and some services are taxed at 14%, while a few specific categories are exempt, notably financial services, education, health services and passenger transportation. This tax is also targeted for cuts in the government's manifesto of 2003.

A general excise tax is levied on a range of goods at three rates of 15-25% while unit fees are charged on some goods. Customs duties range from 0 to 30% of c.i.f. value; most imports from EFTA and EU countries are exempt. Revenue from general excise taxes and import duties has fallen from around 2% and 3% of GDP respectively in the early 1980s to a total of less than 1% in 2004. Taxes on imports and ownership of motor vehicles, and excise taxes on motor fuel, made up 8% of Treasury revenues in 2004, while 3½% derived from charges on the sale of alcohol and tobacco.

In total, the Treasury and local government taxes described above accounted for 83% of general government revenues and 97% of tax revenues in 2004. Non-tax revenue accounted for 10% of general government revenue in 2004. Non-tax revenue consists mostly of service charges, interest income and dividends, as privatisation proceeds are not counted as revenue under national accounts definitions. The ratio of total general government tax collection to GDP jumped by 1½ percentage points in 2004 to 40%, compared to a weighted average of 31% for the OECD as a whole, 39½% for the EU 15 countries and 47% for the Nordic countries in 2003.

### Government holdings in the business sector

In Iceland, both central and local government were traditionally heavily involved in the business sector, notably in the operation of utilities and banking institutions.

Table 6.2 Highlights of recent privatisation

| Years     | Company sold                    | Million EUR |
|-----------|---------------------------------|-------------|
| 1998-2002 | Icelandic Alloys (ferrosilicon) | 14          |
| 1998-2003 | IAV (contractors)               | 28          |
| 1998-1999 | FBA (investment bank)           | 184         |
| 1999-2002 | Landsbanki (commercial bank)    | 251         |
| 1999-2003 | Búnaðarbanki (commercial bank)  | 199         |
| 2001-2005 | Iceland Telecom                 | 864         |
| 1998-2005 | Other                           | 28          |
|           | Total                           | 1,568       |
|           | Percentage of GDP               | 17          |

Sources: Executive Committee on Privatisation, Central Bank of Iceland.

Over the last 15 years the central government has pursued an extensive programme of privatisation. After the most recent sales, the state's most important business holdings are in the production and distribution of electricity, as well as the Housing Financing Fund, the Student Loan Fund and a few smaller financial institutions, altogether responsible for just under 20% of credit in the economy. Iceland Telecom has now been fully privatised and the government's monopoly on broadcasting has been abolished and its competitive advantage diluted with new entrants, as has the postal service, which still remains in government hands.

Local governments still own more than half of all electricity production capacity in Iceland, notably through holdings in the national power company, Landsvirkjun. They almost invariably own geothermal power companies responsible for central heating for most homes. Many own their local distributor of electricity and they generally own operating companies for the harbours.

### Government guarantees

Besides debt on the books of government entities, the state and local governments guarantee certain debts of various enterprises. State guarantees must now be authorised explicitly in budget legislation and in recent years have been confined to government enterprises and institutions related to government. Local governments are now legally prohibited from granting loan guarantees except to their own subsidiary institutions.

Table 6.3 Treasury guarantees at the end of 2004

|                           | <i>Million EUR</i> | <i>% of total</i> |
|---------------------------|--------------------|-------------------|
| Housing Financing Fund    | 5,544              | 81.9              |
| National Power Company    | 562                | 8.3               |
| Agricultural Loan Fund    | 191                | 2.8               |
| Regional Development Fund | 133                | 2.0               |
| Other                     | 336                | 5.0               |
| Total Treasury guarantees | 6,766              | 100               |

Source: Treasury Accounts 2004

The Treasury accounts for 2004 show that the government has outstanding guarantees of just under €6.8 billion (567 b.kr.), equivalent to 63% of GDP. Of these guarantees, 82% represents government backing of residential mortgages. Another 8% represents its guarantees for the debt of Landsvirkjun, in which the Treasury is a 50% partner and whose debt is guaranteed in solidum by the Treasury and the townships of Reykjavík and Akureyri. Landsvirkjun's total debt stood at around €1.2 billion (102 b.kr.) at the end of 2004, or 11% of GDP. Both the company's debt and the guarantees will rise significantly with the construction of a large new power plant in east Iceland at an estimated total cost of €1.1 billion (90 b.kr.).

### Treasury foreign debt

The Republic of Iceland has been a modest borrower in international markets. In recent years, the balance on government finances has led to reductions in total outstanding debt. The ratio of Treasury foreign debt to GDP fell from 28% in 2001 to 8.5% in 2005. The strengthening of the króna, in addition to the Treasury surplus and the use of proceeds from the privatisation of the banking system and of the state telecommunication company to pay down debt, have contributed to this significant reduction in debt in the past years.

Table 6.4 Republic of Iceland foreign bond issues 1995-2005

| Currency | Amount         | Issue date | Maturity   |
|----------|----------------|------------|------------|
| JPY      | 15,000,000,000 | 31.1.1995  | 31.1.2005  |
| DEM      | 250,000,000    | 11.4.1996  | 11.4.2001  |
| DEM      | 100,000,000    | 25.7.1996  | 11.4.2001  |
| DEM      | 150,000,000    | 18.3.1997  | 18.3.2000  |
| CHF      | 100,000,000    | 22.10.1999 | 22.10.2002 |
| EUR      | 200,000,000    | 14.3.2000  | 1.3.2007   |
| EUR      | 250,000,000    | 6.4.2001   | 6.4.2006   |
| USD      | 100,000,000    | 5.10.2001  | 5.4.2004   |
| EUR      | 90,000,000     | 5.10.2001  | 5.10.2005  |
| EUR      | 87,000,000     | 8.10.2001  | 10.10.2005 |
| EUR      | 250,000,000    | 10.4.2002  | 10.4.2012  |
| EUR      | 150,000,000    | 30.9.2002  | 30.9.2009  |
| EUR      | 150,000,000    | 12.5.2003  | 12.5.2008  |
| USD      | 200,000,000    | 10.3.2004  | 10.3.2004  |

A primary aim in debt management is to spread the amortisation of foreign debt evenly over coming years as well as to maintain a balanced composition in regard to interest rates, maturity and currency denomination. Interest rate and currency swaps are also used to achieve debt and risk management objectives. At the end of October 2005, the Treasury's long-term foreign debt amounted to USD 1.3 billion (80 b.kr.). Around 32% of the Treasury's foreign obligations were denominated in US dollars, 47% in euros, 3% in Japanese yen, 12% in sterling and 6% in Swiss francs.

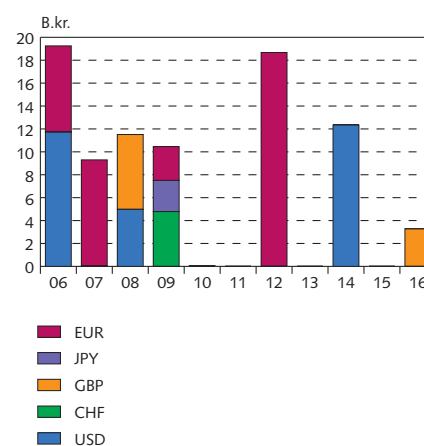
Currently, 46.2% of the Treasury's total foreign debt carries fixed interest rates. The average maturity of foreign long-term debt was approximately 4.1 years and the average duration 3.1 years at the end of October 2005.

The Republic of Iceland has established three financial programmes to facilitate its financing requirements. These are a Euro-Commercial Paper (ECP) programme amounting to USD 500 million, a United States Commercial Paper (USCP) programme amounting to USD 1 billion, and a Medium-Term Note (MTN) programme amounting to USD 1.5 billion. The ECP programme was originally established in 1985 and the MTN and USCP programmes were introduced in 2001. The Treasury also has a committed credit facility under a five-year agreement in the amount of USD 250 m. This is a syndicated bank facility from 2005.

The National Debt Management Agency (Lánasýsla ríkisins, NDMA) is assigned the borrowing and debt management functions of the Treasury, and the issue of government guarantees. Under a special agreement with the Minister of Finance, the Central Bank is responsible for the implementation of foreign borrowing for the Treasury.

The Republic of Iceland has never defaulted on its debt and always paid when due the full amount required in respect of principal, interest and sinking fund instalments for all internal and external obligations.

Chart 6.10  
Maturity profile of Treasury external long-term debt  
October, 2005



Source: Central Bank of Iceland.

### Credit rating history

In February 2005 Standard & Poor's Ratings Services raised its long-term foreign currency sovereign credit rating on the Republic of Iceland to AA- from A+, and affirmed the AA+ long-term local currency and the A-1+ short-term foreign and local ratings with a stable outlook. The main arguments for the upgrade were significant and sustained improvements in the resilience and structure of the Icelandic banking sector, as well as strong public finances. Moody's Investors Service and Fitch Ratings confirmed their previous ratings with a stable outlook. From the reports issued by the ratings agencies it can be inferred that Iceland's creditworthiness has strengthened significantly over the past decade, supported by a fiscal consolidation programme, achievements in structural reforms, a more diversified export base and the increased flexibility of the economy. The reports have cited robust GDP growth in recent years, but the rating agencies have expressed concerns about the imbalances in the economy, escalating asset prices and growing net external indebtedness. However, the rating firms have underlined the flexibility of the Icelandic economy and its proven capacity to sort out imbalances.

Table 6.5 Ratings for Icelandic Treasury bonds 2005

|                   | Affirmed  | Foreign currency |            | Domestic currency |            | Outlook |
|-------------------|-----------|------------------|------------|-------------------|------------|---------|
|                   |           | Long-term        | Short-term | Long-term         | Short-term |         |
| Moody's           | July 2005 | Aaa              | P-1        | Aaa               | P-1        | Stable  |
| Standard & Poor's | Oct. 2005 | AA-              | A-1+       | AA+               | A-1+       | Stable  |
| Fitch             | Aug. 2005 | AA-              | F1+        | AAA               |            | Stable  |

Iceland's relationship with the rating agencies started in 1986 when Standard & Poor's assigned an indicative rating for the Republic of Iceland. At first the rating was outside the traditional letter ratings structure until 1989, when an indicative Ai rating was assigned to the Republic. Moody's followed in 1989 by assigning an indicative A2 rating. These ratings actions were unsolicited. Iceland's formal ratings history began when the Republic requested a short-term rating from Standard & Poor's in 1989 and later from Moody's in 1990. The respective short-term ratings formally assigned to the Republic at the time were A-1 and P-1. In connection with preparations for the Republic's initial bond issue in the US public market in 1994, Moody's and Standard & Poor's were formally asked to provide long-term credit ratings for Iceland. Standard & Poor's awarded an A for long-term debt in January 1994. Moody's announced an A2 long-term rating for Iceland the same month. The agencies thereby affirmed earlier, informal ratings which they had issued for Iceland.

In 1996 and 1997 Moody's and Standard & Poor's upgraded Iceland's credit rating to reflect better the country's increased creditworthiness. Standard & Poor's announced in 1996 that it had upgraded the credit rating for the Republic of Iceland's long-term foreign currency-denominated debt from A to A+, and short-term debt from A-1 to A-1+. Furthermore, Standard & Poor's assigned a first-time rating of AA+ to Iceland's long-term local currency debt. In July 1997, Moody's

upgraded the Republic's foreign currency rating to Aa3 and assigned an Aaa rating to the Republic's long-term ISK bonds. In September 1998 Standard and Poor's changed the outlook of their rating from stable to positive. In February 2000 Fitch entered the field by assigning an AA- long-term foreign currency rating for Iceland. A short-term rating of F1+ and an AAA rating for long-term local currency were also assigned. In March 2001, Standard & Poor's amended its previous positive outlook to stable and in October the same year changed the outlook to negative. Fitch changed its outlook on the rating in February 2002 from stable to negative.

One of the most important rating actions for the Republic of Iceland occurred in October 2002 when Moody's upgraded the foreign currency rating to Aaa in connection with a revision of its ratings methodology. Shortly after this Standard & Poor's confirmed its A+ rating but moved the outlook back to stable in November 2002. In March 2003 Fitch changed the outlook for the rating from negative to stable. Standard & Poor's again revised its outlook on foreign long-term credit in December 2003 from stable to positive and in February 2005 raised its rating, as mentioned above.





## 7 Monetary policy

### **The Central Bank**

The Central Bank of Iceland was established as a separate institution in 1961. The current Central Bank Act entered into effect in May 2001 and involved substantial changes from the previous Act. In the new Act, ensuring price stability was defined as the Bank's single main objective. Furthermore, the Bank was granted instrument and financial independence, the transparency and accountability provisions were strengthened and provisions were included which serve to strengthen the capital position of the Bank.

The legislation granted the Central Bank of Iceland full independence to implement monetary policy in accordance with the inflation target, and formally closed any direct access by the government to Central Bank financing. At the same time it aimed to improve the transparency of monetary policy and make the Bank more accountable towards the government and the public at large. Monetary policy decision-making authority continued to be vested in the Board of Governors, consisting of three governors appointed by the Prime Minister to seven-year terms. The new Act specifically authorised the adoption of an inflation-targeting policy.

The activities of the Central Bank have evolved over the years. Foreign exchange controls, for example, were removed with the liberalisation of capital flows in the early 1990s and the supervisory responsibilities of the Bank were moved to a separate Financial Supervisory Authority (FME) at the beginning of 1999 (see Chapter 5). In recent years the Central Bank, like its counterparts in many other countries, has put increasing emphasis on monitoring financial stability.

### **Inflation targeting**

In 2001, Iceland joined a growing number of countries that have adopted a formal inflation target as a framework for monetary policy. The inflation target was specified in a joint declaration of the government and the Central Bank of Iceland on March 27, 2001 as inflation of 2½%, measured in terms of the twelve-month rate of change in the consumer price index (CPI). The aim is to keep the rate of inflation on average as close to the target as possible. If it deviates by more than 1½% in either direction, the Central Bank is obliged to submit a report to the government, explaining the causes for the deviation, how it intends to respond and when it expects the inflation target to be reached again. The report shall be made public. Three such reports have been compiled and published to date, in July 2001, February 2005 and September 2005.

By defining the role of the Central Bank in the formulation of monetary policy, the current legislation has brought the Bank into line with best practice around the world. It sets price stability, as defined by the inflation target, as the main goal of monetary policy. Hence, monetary policy may only be applied to achieve other economic goals insofar as the Central Bank deems this to be consistent with the inflation target.

Table 7.1 Monetary policy arrangements in Iceland since 1970

|           |  |
|-----------|--|
| 1970-1973 | After the collapse of the Bretton-Woods system the Icelandic króna followed an adjustable peg against the US dollar.   |
| 1974-1983 | Implementation of exchange rate policy became increasingly flexible and can be described as a managed float. The króna was first pegged against the US dollar and then against various baskets of trading partner countries' currencies.   |
| 1984-1989 | Exchange rate policy became more restrictive, with increasing emphasis on exchange rate stability. In 1989, however, the króna was devalued ten times in small steps.  |
| 1990-1995 | <p>More emphasis was again put on exchange rate stability as the anchor of monetary policy. Until 1992 the currency peg was specified against a basket of 17 currencies, weighted according to merchandise trading shares, with <math>\pm 2\frac{1}{4}\%</math> fluctuation bands. The basket was redefined in 1992, with the ECU given a 76% weight, the US dollar a 18% weight and the Japanese yen a 6% weight. The króna was devalued twice in this period, in November 1992 by 6% and in June 1993 by 7½%.</p> <p>In September 1995 the fluctuation band was widened to <math>\pm 6\%</math> in response to the abolition of capital controls. The currency basket was also changed. The new basket contained 16 currencies, weighted by their share in Iceland's trade in goods and non-factor services.</p> |
| 1996-2000 | Fluctuation of the króna within the bands increased as the foreign exchange market deepened and the emphasis on price stability relative to exchange rate stability increased. Reflecting this, the exchange rate band was widened to $\pm 9\%$ in February 2000.  |
| 2001-     | The exchange rate target was abolished in March 2001 and an inflation target adopted. The target requires approval by the Prime Minister but the Central Bank has full independence in setting monetary policy to attain this target without interference by the government. <sup>1</sup>  |

1. The current framework for monetary policy has been described in detail in the Central Bank's *Monetary Bulletin* 2001/2, available on its website ([www.sedlabanki.is](http://www.sedlabanki.is)).

To guide monetary policy, the Central Bank publishes regular inflation forecasts, projecting two years ahead. The Central Bank is constantly enhancing and evolving its forecasting tools. In addition to the conventional baseline inflation forecast assuming an unchanged policy interest rate and exchange rate across the forecast horizon, the Central Bank now publishes an alternative forecast based on variable interest rates and exchange rate, based on forward interest rates and an expected exchange-rate path based on uncovered interest-rate parity. These forecasts serve more or less as the intermediate target of monetary policy, instead of the previous currency peg. Inflation targeting therefore represents a significant departure from earlier policies, since Iceland had a long history of using the exchange rate as a monetary anchor, although with a varying degree of commitment, as can be inferred from the table on this page.

In practice, the króna floats freely without interventions by the Central Bank. Under provisions in the Act, the Central Bank may temporarily limit or halt trading in a foreign exchange market, and temporarily suspend its own quotation of the rate of exchange of the króna. However, these authorisations have not been exercised.

### Monetary instruments

The main monetary instrument of the Central Bank of Iceland is the interest rate in its weekly repurchase auction – the policy interest rate. Usually the Bank auctions one-week agreements. So far the auctions have been fixed-price, with unlimited access subject to collateral. No reverse repurchase agreements have been issued, although there is scope for them within the rules. Repurchase agreements are secured with collateral in the form of listed securities that the Bank approves. Since year-end 2003 the Central Bank has offered weekly certificates of deposit (CDs) with a maturity of one week.

The Central Bank offers an overnight loan facility to the banks, subject to collateral requirements. Central Bank CDs can be pledged as collateral against repurchase agreements and overnight loans. Banks are subject to reserve requirements and may deposit money at will on an interest-bearing account with the Central Bank. The required reserve base is the balance sheet total less equity and interbank liabilities at the end of the preceding month.

The required reserves ratios are in line with those of the European Central Bank, i.e. 2% of specific bank liabilities with a maturity of less than two years, and 0% of other liabilities.

The Central Bank of Iceland may also intervene in the interbank foreign exchange market and participate in the interbank FX swap market.

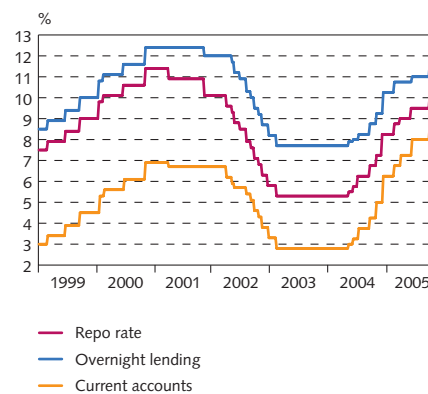
### Foreign exchange reserves

One of the functions of the Central Bank is to manage Iceland's foreign exchange reserves. Investment guidelines for the reserves are laid out in a resolution by the Board of Governors. The resolution prescribes the minimum amount of reserves, their currency composition and the investment categories of the portfolio. Currently the size of the reserves should not be smaller than the value of 3 months' merchandise imports. The portfolio consists mainly of deposits and investment grade bonds. The Central Bank holds a small position of gold reserves amounting to about 64 thousand ounces and Iceland has a quota of SDR 117.6 million at the International Monetary Fund.

In mid-October 2005 the foreign exchange reserves amounted to about 58 b.kr., the equivalent of 5.8% of 2005 GDP. The reserves are supplemented by committed credit lines amounting to USD 500 million. Thus, the reserves and committed credit lines will together equal roughly 8.9% of GDP in 2005. The Central Bank also has access to uncommitted interbank lines with a number of international banks.

Chart 7.1  
Central Bank of Iceland interest rate corridor,  
January 5, 1999 - November 1, 2005

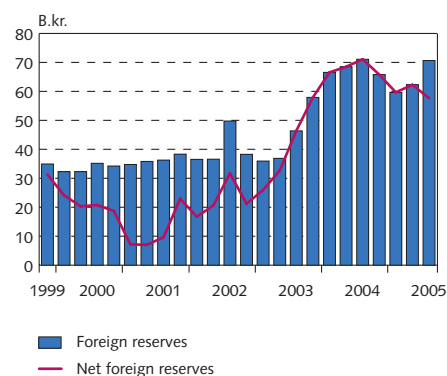
Weekly figures



Source: Central Bank of Iceland.

Chart 7.2  
The foreign exchange reserves of  
the Central Bank of Iceland

At end of quarter December 1999 - September 2005



Source: Central Bank of Iceland.



## 8 Domestic and foreign debt

### External debt

Iceland's external indebtedness is high by international comparison and has risen sharply since the mid-1990s. As can be seen from Chart 8.1, Iceland has the highest ratio of indebtedness of the OECD countries; only New Zealand and Hungary have a level of debt in the same range.

Total external debt of the Icelandic economy, private as well as public, amounted to €19.7 billion (1,651 b.kr), the equivalent of 186.6% of GDP, by end-2004 and net external debt amounted to 98.8% of GDP. The international investment position (net external position of the Icelandic economy) was negative by €8.1 billion (680.9 b.kr.), or -86.6% of GDP, at the end of 2004. In that year the debt service of long-term debt was equivalent to 64.5% of export revenue (debt service ratio).

Total general government debt is low compared to other OECD countries and thus can not explain Iceland's high external indebtedness (see Chapter 6). Explanations for indebtedness therefore need to be identified in the private sector.

### Private debt

Of total external debt, the private sector was responsible for some 88%, or 163% of GDP, by the end of 2004, having increased from 30% of GDP in 1995.

A significant part of the recent debt growth is due to increased lending by the banking sector, whose external debt rose from 6% of GDP in 1995 to 138% at the end of 2004.

Low private sector savings and the financial liberalisation of the mid-1990s account for the rapid increase in external debt in recent years. The robust economic expansion over the last ten years and strong demand for credit raised domestic interest rates, which induced companies, especially those with income in foreign currency, to borrow abroad. Over half of Icelandic corporate debt is external, either direct or intermediated by banks, but most of it is intrinsically hedged, namely, matched by export revenues.

High levels of external indebtedness by international comparison and its increase in recent years must be seen in the light of country-specific factors as well as changes in the balance sheets of households and companies over the past decade.

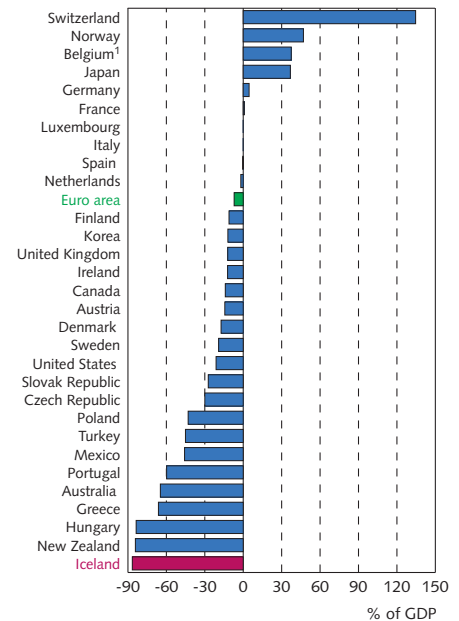
### The household balance sheet

Households in Iceland rank among the most indebted in the world. According to Eurostat figures (see Table 8.1), only Danish and Dutch households have higher ratios of indebtedness to GDP. According to OECD data the net worth of Icelandic households is broadly in line within the range of the G7 countries if pension fund assets are included, but lower if they are excluded.

A major reason for the rise in household debt over the past two decades is improved access to credit. It was not until the 1980s that

Chart 8.1

International investment position of OECD countries 2004

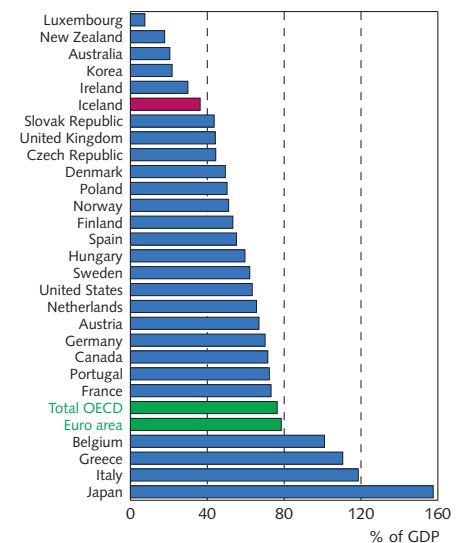


1. Figures for Belgium are for 2003.

Sources: IMF and various central bank and statistics office websites.

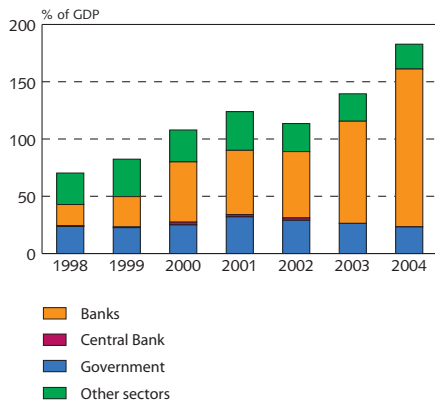
Chart 8.2

General government gross debt in OECD countries 2004



Source: OECD Economic Outlook No. 77 (June 2005).

Chart 8.3  
Estimated external debt by sector  
1998-2004



Source: Central Bank of Iceland.

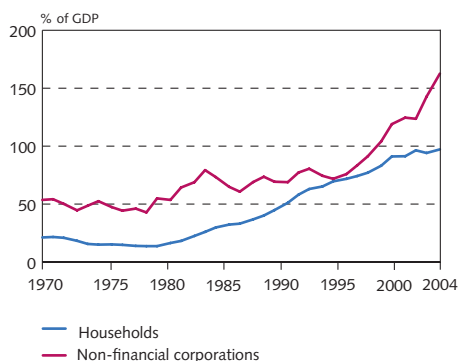
widespread credit rationing was lifted and interest rates became increasingly market-determined. When real interest rates turned positive with the widespread indexation of financial instruments in the 1980s, banks became more willing to lend. A major overhaul of the public housing fund in 1990 towards a market-based system greatly improved access to housing financing. At the end of summer 2004 the banks entered into competition with the Housing Financing Fund (HFF), offering mortgage loans and refinancing without limits on maximum loan and at lower interest rates than before – nor requiring a property transaction to take place when they grant mortgages, so some mortgage equity withdrawal for consumption has taken place. The long maturity and terms of preferential household credit imply that the debt service burden is lower than it would otherwise be.

Table 8.1 Household liabilities 2002

|                | Households liabilities as: |             |
|----------------|----------------------------|-------------|
|                | % of GDP                   | % of assets |
| Austria        | 41                         | 31          |
| Belgium        | 42                         | 16          |
| Denmark        | 116                        | 76          |
| Euro zone      | 58                         | 31          |
| Finland        | 37                         | 36          |
| France         | 51                         | 27          |
| Germany        | 73                         | 41          |
| Iceland        | 97                         | 48          |
| Italy          | 32                         | 16          |
| Netherlands    | 102                        | 41          |
| Norway         | 75                         | 77          |
| Portugal       | 85                         | 43          |
| Spain          | 64                         | 39          |
| Sweden         | 58                         | 38          |
| United Kingdom | 85                         | 35          |

Sources: Eurostat: *Households' financial assets and liabilities*, Central Bank of Iceland.

Chart 8.4  
Private sector debt 1970-2004



Source: Central Bank of Iceland.

At the beginning of the 1980s household debt was around 20% of disposable income and 14% of GDP, but by the end of 2004 debt to financial institutions had reached 102% of GDP and 192% of disposable income. In pace with its rising debt, the asset position of the household sector has strengthened and, if pension funds assets are included (see Chapter 4), so has its net worth. While debt rose from 80% of disposable income in 1990 to 192% in 2004, the value of the households' stake in pension funds showed similar growth, from 60% of disposable income to 203%. Increasing household debt is also to some extent a question of terminology, since it encompasses only debt for which bodies within the monetary system are creditors. Before the introduction of the housing bond system, some housing debt was between buyers and sellers, so that a lower level of debt to the monetary system was recorded. Furthermore, inflationary effects decreased the real value of household debt before general indexation of loans was introduced in 1979.

Data on financial assets are not as reliable as data on real assets but indicate that the value of shares owned by households has risen from 6% of disposable income to 103% over the 13 years to 2003. Holdings in firms that do not issue shares have not been estimated but should be included for international comparisons. Tangible assets show no clear trend relative to disposable income. Owner-occupied dwellings remain the largest chunk of household assets, representing 40% of total assets in 2004.

### Corporate balance sheets

Icelandic corporate debt is also high compared with other countries for which data are available. At the end of 2004, debt of non-financial corporations was equivalent to about 170% of GDP, the highest figure for the Nordic countries both throughout recent years and across industries.<sup>2</sup> The IMF identifies two factors explaining the relatively high debt leverage among Icelandic corporations. First, the tax regime has been more beneficial to debt issuance than to equity issuance, at least until recently. Second, the industry-wide degree of internationalisation, measured as the ratio of exports over production, seems to have an impact on leverage. In addition, the stock market is not as well developed as the banking sector, which causes firms more difficulties in raising funds by issuing equity than by issuing debt.<sup>3</sup>

Just like households, Icelandic corporations were relatively debt-free at the end of the negative real interest era in 1980. As real interest rates turned positive around that time, corporate debt rose relative to GDP, but then remained roughly stable for 15 years by this criterion. Liberalisation of the domestic financial markets in the late 1980s was followed by external liberalisation in the first half of the 1990s. With liberalisation of capital flows and the expansion of banking system balance sheets since 1997, the debt of Icelandic non-financial corporations has climbed from 80% of GDP to 170% in 2004. Some of the debt growth is traceable to the takeover and formation of foreign subsidiaries by Icelandic corporations and a significant part is the consequence of the government's privatisation programme in recent years.

However, corporate indebtedness has increased without a deterioration in net worth. The capital/asset ratio of publicly listed non-financial companies was about the same at the end of 2002 as at the onset of the debt increase in 1996, at around 36%, and the same general picture emerges through to 2004 in a larger sample of corporate accounts maintained by Statistics Iceland.

### Other explanatory factors

Important underlying factors need to be highlighted that explain Iceland's relatively high levels of indebtedness by international comparison. The IMF pointed out in a recent report on Iceland that its "cross-country analyses supported the view that the deviation of Iceland's

3. Based on information in IMF Country Report No. 05/367.

4. IMF Country Report No. 05/366: Iceland – selected issues: "Corporate leverage: How different is Iceland?"

international investment position with respect to comparable economies was largely explained by demographic factors." Furthermore, that "private sector borrowing appears rooted in demographic trends and the build-up of substantial private assets – rather than weak public finances or market distortions."<sup>4</sup>

The age structure of Iceland's comparatively young population, which reduces aggregate saving due to life-cycle behaviour, has been estimated to account alone for 60% of its higher external liabilities relative to other industrial countries.<sup>5</sup>

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5. IMF: Iceland – Staff Report for the 2003 Article IV Consultation, July 29 2003.

6. Ibid.



## 9 Appendix

Table A1 Economic development<sup>1</sup>

|  |       |   |       |
|--|-------|---|-------|
|  | 2004  |   | 2004  |
| Population size at year-end (thous.)         | 293.6 | Labour force participation rate, males (%)              | 89.1  |
| <i>Average annual population growth (%)</i>  |       | Labour force participation rate, females (%)            | 81.8  |
| in last 10 yrs.                              | 0.96  | Rate of unemployment (% of labour force)                | 3.1   |
| in last 20 yrs.                              | 1.01  | Infant mortality (% of 1,000 live births 2001-2004)     | 2.8   |
| in last 30 yrs.                              | 1.03  | Life expectancy (males) (2001-2003)                     | 78.8  |
| GDP in b.kr.                                 | 885.0 | Life expectancy (females) (2001-2003)                   | 82.6  |
| GDP in billion EUR                           | 10.2  | Live births per 1,000 inhabitants                       | 14.5  |
| GDP in billion USD                           | 12.6  | Energy consumption per 100,000 inhabitants (PJ)         | 146.9 |
| GDP/capita in thous. EUR                     | 37.7  | Physicians per 1,000 inhabitants (2003)                 | 3.6   |
| GDP/capita in thous. USD in terms of PPP     | 33.6  | Passenger cars per 1,000 inhabitants (2003)             | 574   |
| Rank among OECD countries                    | 6     | Access to Internet (% of population, 16-75 yrs.) (2005) | 86.0  |
| <i>Average annual growth rate of GDP (%)</i> |       | <i>Share of exports in GDP</i>                          | 35.7  |
| in last 10 yrs.                              | 3.5   | International investment position at year-end           | -86.6 |
| in last 20 yrs.                              | 2.8   | Share of government revenue in GDP                      | 47.1  |
| in last 30 yrs.                              | 3.2   | Share of government expenditures in GDP                 | 47.1  |
| <i>Average annual inflation rate (%)</i>     |       | General government gross debt as a share of GDP         | 37.5  |
| in last 10 yrs.                              | 3.3   |   |       |
| in last 20 yrs.                              | 8.8   |   |       |
| in last 30 yrs.                              | 20.2  |   |       |

1. Data refer to 2004 unless otherwise indicated.

Sources: Central Bank of Iceland, Ministry of Labour, OECD, Statistics Iceland.

Table A2 Structure of the economy

|                               | At current prices<br>(million EUR) |       |        | % of GDP |       |       | Average volume<br>change (%) |           |
|-------------------------------|------------------------------------|-------|--------|----------|-------|-------|------------------------------|-----------|
|                               | 1990                               | 2000  | 2004   | 1990     | 2000  | 2004  | 1964-2004                    | 1984-2004 |
| <i>A Components of GDP</i>    |                                    |       |        |          |       |       |                              |           |
| Private consumption           | 2,915                              | 5,508 | 5,808  | 59.3     | 59.8  | 57.2  | 3.9                          | 2.9       |
| Public consumption            | 983                                | 2,175 | 2,596  | 20.0     | 23.6  | 25.6  | 5.0                          | 3.6       |
| Gross capital formation       | 973                                | 2,175 | 2,377  | 19.8     | 23.6  | 23.4  | 3.3                          | 3.6       |
| National expenditure          | 4,847                              | 9,893 | 10,743 | 98.6     | 107.3 | 105.8 | 3.9                          | 3.2       |
| Exports of goods and services | 1,682                              | 3,161 | 3,627  | 34.2     | 34.3  | 35.7  | 4.0                          | 3.5       |
| Imports of goods and services | 1,615                              | 3,837 | 4,214  | 32.9     | 41.6  | 41.5  | 4.5                          | 4.2       |
| GDP                           | 4,914                              | 9,216 | 10,156 | 100.0    | 100.0 | 100.0 | 3.7                          | 2.9       |
| Current account balance       | -104                               | -951  | -848   | -2.1     | -10.3 | -8.4  | .                            | .         |

| <i>B GDP by sectors</i>                               | % of GDP |       |       |       |       |
|---|----------|-------|-------|-------|-------|
|   | 1973     | 1980  | 1990  | 2000  | 2004  |
| Agriculture   | 5.2      | 4.8   | 2.6   | 1.9   | 1.4   |
| Fishing   | 7.2      | 8.0   | 9.6   | 7.0   | 6.0   |
| Mining and quarrying                                  | 0.1      | 0.1   | 0.2   | 0.1   | 0.1   |
| Manufacturing   | 20.9     | 20.2  | 16.3  | 13.6  | 12.3  |
| Fish processing                                       | 8.2      | 7.8   | 4.7   | 2.8   | 2.7   |
| Electricity and water supply                          | 2.9      | 4.2   | 3.9   | 3.4   | 3.4   |
| Construction  | 12.0     | 8.7   | 8.4   | 8.3   | 8.7   |
| Wholesale and retail trade                            | 10.6     | 10.1  | 11.8  | 12.1  | 11.5  |
| Hotels and restaurants                                | 1.2      | 1.1   | 2.0   | 1.7   | 1.6   |
| Transport, storage and communication                  | 9.3      | 7.7   | 8.0   | 8.1   | 7.9   |
| Finance, insurance, real estate and business services | 15.2     | 17.9  | 17.7  | 19.8  | 21.9  |
| Other service activities                              | 15.2     | 17.1  | 19.6  | 24.0  | 25.0  |
| Total industries                                      | 100.0    | 100.0 | 100.0 | 100.0 | 100.0 |

| <i>C Employment by sectors</i>                     | Thous.<br>man-years<br>1997 | Percentage breakdown <sup>1</sup> |       |       |       |       |                   |                   |
|--|-----------------------------|-----------------------------------|-------|-------|-------|-------|-------------------|-------------------|
|  |                             | 1963                              | 1970  | 1980  | 1990  | 1997  | 2000 <sup>1</sup> | 2004 <sup>1</sup> |
| Agriculture  | 5,207                       | 13.4                              | 12.4  | 7.9   | 4.9   | 4.0   | 2.8               | 2.7               |
| Fishing  | 6,115                       | 6.6                               | 6.4   | 5.3   | 5.7   | 4.7   | 4.0               | 3.5               |
| Fish processing                                    | 7,598                       | 9.7                               | 7.8   | 9.1   | 6.1   | 5.9   | 4.3               | 4.1               |
| Manufacturing industry                             | 15,282                      | 15.6                              | 15.2  | 15.2  | 12.5  | 11.9  | 12.1              | 10.9              |
| Construction, electricity and water                | 11,638                      | 11.1                              | 11.4  | 11.0  | 10.8  | 9.0   | 8.0               | 7.8               |
| Wholesale & retail trade, restaurants & hotels     | 20,118                      | 13.7                              | 13.5  | 13.4  | 14.5  | 15.6  | 17.8              | 17.1              |
| Transport, storage and communication               | 8,817                       | 9.6                               | 8.5   | 7.3   | 6.7   | 6.8   | 7.3               | 6.8               |
| Finance, insurance, real estate, business services | 11,537                      | 2.7                               | 4.0   | 5.4   | 8.1   | 9.0   | 11.3              | 11.5              |
| Providers of government services                   | 25,300                      | 9.5                               | 12.4  | 15.7  | 18.2  | 19.6  | 6.7               | 6.8               |
| Other services                                     | 9,202                       | 7.0                               | 6.9   | 7.2   | 7.4   | 7.1   | 5.9               | 6.9               |
| Other  | 8,018                       | 1.0                               | 1.4   | 2.4   | 4.9   | 6.2   | 19.6              | 21.7              |
| Total employment <sup>2</sup>                      | 128,832                     | 100.0                             | 100.0 | 100.0 | 100.0 | 100.0 | 100.0             | 100.0             |

1. Figures for the period 1963-1997 show number of man-years by industry. Since 2000, data have been compiled from PAYE returns and show number of employed persons by industry. 2. Unemployed are not included.

Sources: Statistics Iceland, Central Bank of Iceland.

Table A3 Structure of foreign trade

## A Exports and imports by basic categories 1990-2004

|                                    | At current prices (million EUR) |       |       |       | % of total exports or imports |       |       |       |
|------------------------------------|---------------------------------|-------|-------|-------|-------------------------------|-------|-------|-------|
|                                    | 1990                            | 1995  | 2000  | 2004  | 1990                          | 1995  | 2000  | 2004  |
| Exports of goods and services      | 1,684                           | 1,925 | 3,161 | 3,627 | 100.0                         | 100.0 | 100.0 | 100.0 |
| Imports of goods and services      | 1,615                           | 1,728 | 3,837 | 4,214 | 100.0                         | 100.0 | 100.0 | 100.0 |
| Merchandise exports (f.o.b. value) | 1,247                           | 1,392 | 2,056 | 2,322 | 74.0                          | 72.3  | 65.0  | 64.0  |
| Marine products                    | 941                             | 1,001 | 1,301 | 1,397 | 55.9                          | 52.0  | 41.2  | 38.5  |
| Manufacturing goods                | 255                             | 298   | 643   | 816   | 15.1                          | 15.5  | 20.3  | 22.5  |
| Other goods                        | 51                              | 92    | 112   | 110   | 3.0                           | 4.8   | 3.5   | 3.0   |
| Merchandise imports (f.o.b. value) | 1,180                           | 1,233 | 2,572 | 2,742 | 73.1                          | 71.3  | 67.0  | 65.1  |
| Consumption goods                  | .                               | 418   | 817   | 886   | .                             | 24.2  | 21.3  | 21.0  |
| Capital goods                      | .                               | 321   | 795   | 764   | .                             | 18.6  | 20.7  | 18.1  |
| Industrial supplies                | .                               | 493   | 960   | 1,092 | .                             | 28.6  | 25.0  | 25.9  |
| Services exports                   | 437                             | 533   | 1,105 | 1,305 | 26.0                          | 27.7  | 35.0  | 36.0  |
| Transportation                     | 174                             | 207   | 533   | 726   | 10.3                          | 10.8  | 16.9  | 20.0  |
| Travel                             | 119                             | 143   | 247   | 299   | 7.0                           | 7.4   | 7.8   | 8.3   |
| Other services                     | 145                             | 183   | 324   | 280   | 8.6                           | 9.5   | 10.3  | 7.7   |
| Services imports                   | 435                             | 495   | 1,265 | 1,473 | 26.9                          | 28.7  | 33.0  | 34.9  |
| Transportation                     | 132                             | 160   | 450   | 560   | 8.2                           | 9.2   | 11.7  | 13.3  |
| Travel                             | 224                             | 217   | 511   | 557   | 13.9                          | 12.6  | 13.3  | 13.2  |
| Other services                     | 79                              | 118   | 304   | 356   | 4.9                           | 6.8   | 7.9   | 8.5   |

## B Merchandise exports by commodity groups (f.o.b. value) 1990-2004

|                              | At current prices (million EUR) |       |       |       | % of total merchandise exports |       |       |       |
|------------------------------|---------------------------------|-------|-------|-------|--------------------------------|-------|-------|-------|
|                              | 1990                            | 1995  | 2000  | 2004  | 1990                           | 1995  | 2000  | 2004  |
| Total merchandise exports    | 1,247                           | 1,392 | 2,056 | 2,322 | 100.0                          | 100.0 | 100.0 | 100.0 |
| Marine products              | 941                             | 1,001 | 1,301 | 1,397 | 75.5                           | 71.9  | 63.3  | 60.2  |
| Salted and/or dried fish     | 177                             | 161   | 280   | 261   | 14.2                           | 11.6  | 13.6  | 11.3  |
| Fresh fish                   | 161                             | 81    | 151   | 219   | 12.9                           | 5.9   | 7.3   | 9.4   |
| Whole-frozen fish            | 70                              | 149   | 130   | 112   | 5.6                            | 10.7  | 6.3   | 4.8   |
| Frozen fish fillets          | 349                             | 278   | 376   | 369   | 28.0                           | 20.0  | 18.3  | 15.9  |
| Frozen shrimp                | 60                              | 184   | 137   | 134   | 4.8                            | 13.2  | 6.7   | 5.8   |
| Fish meal                    | 42                              | 56    | 128   | 145   | 3.4                            | 4.0   | 6.2   | 6.2   |
| Fish oil                     | 14                              | 29    | 26    | 39    | 1.1                            | 2.1   | 1.3   | 1.7   |
| Other marine products        | 67                              | 63    | 73    | 117   | 5.4                            | 4.6   | 3.5   | 5.1   |
| Agricultural products        | 24                              | 25    | 35    | 49    | 1.9                            | 1.8   | 1.7   | 2.1   |
| Manufacturing products       | 255                             | 298   | 643   | 816   | 20.4                           | 21.4  | 31.3  | 35.1  |
| Aluminium                    | 129                             | 147   | 381   | 419   | 10.4                           | 10.6  | 18.6  | 18.0  |
| Ferrosilicon                 | 33                              | 38    | 53    | 71    | 2.6                            | 2.8   | 2.6   | 3.0   |
| Other manufacturing products | 93                              | 113   | 208   | 326   | 7.4                            | 8.1   | 10.1  | 14.1  |
| Other products               | 27                              | 68    | 76    | 61    | 2.2                            | 4.9   | 3.7   | 2.6   |
| Ships and aircraft           | 16                              | 49    | 43    | 9     | 1.3                            | 3.5   | 2.1   | 0.4   |
| Other products               | 11                              | 19    | 33    | 52    | 0.9                            | 1.3   | 1.6   | 2.2   |

Sources: Statistics Iceland, Central Bank of Iceland.

Table A3 (continued) Structure of foreign trade

C. Merchandise imports by economic category (f.o.b. value) 1990-2004

|   | At current prices (million EUR) |       |       |       | % of total merchandise exports |       |       |       |
|---|---------------------------------|-------|-------|-------|--------------------------------|-------|-------|-------|
|   | 1990                            | 1995  | 2000  | 2004  | 1990                           | 1995  | 2000  | 2004  |
| Total merchandise imports                               | 1,186                           | 1,236 | 2,579 | 2,756 | 100.0                          | 100.0 | 100.0 | 100.0 |
| Food and beverages                                      | 90                              | 123   | 207   | 239   | 7.6                            | 10.0  | 8.0   | 8.7   |
| Primary, mainly for industry                            | 4                               | 29    | 64    | 72    | 0.4                            | 2.4   | 2.5   | 2.6   |
| Primary, mainly for household consumption               | 25                              | 16    | 21    | 32    | 2.1                            | 1.3   | 0.8   | 1.2   |
| Processed, mainly for industry                          | 10                              | 11    | 12    | 13    | 0.8                            | 0.9   | 0.5   | 0.5   |
| Processed, mainly for household consumption             | 52                              | 67    | 110   | 122   | 4.4                            | 5.4   | 4.3   | 4.4   |
| Industrial supplies not elsewhere specified             | 311                             | 344   | 597   | 701   | 26.2                           | 27.9  | 23.2  | 25.4  |
| Primary   | 12                              | 14    | 28    | 33    | 1.0                            | 1.2   | 1.1   | 1.2   |
| Processed   | 299                             | 330   | 569   | 668   | 25.2                           | 26.7  | 22.1  | 24.2  |
| Fuels and lubricants                                    | 117                             | 87    | 238   | 251   | 9.9                            | 7.1   | 9.2   | 9.1   |
| Primary   | 3                               | 3     | 6     | 7     | 0.2                            | 0.3   | 0.3   | 0.3   |
| Motor fuel  | 25                              | 18    | 50    | 48    | 2.1                            | 1.4   | 1.9   | 1.8   |
| Other   | 89                              | 66    | 182   | 195   | 7.5                            | 5.4   | 7.1   | 7.1   |
| Capital goods (except transport), parts and accessories | 219                             | 264   | 611   | 606   | 18.5                           | 21.3  | 23.7  | 22.0  |
| Basic capital goods                                     | 136                             | 169   | 417   | 406   | 11.5                           | 13.7  | 16.2  | 14.7  |
| Parts and accessories                                   | 83                              | 94    | 193   | 200   | 7.0                            | 7.6   | 7.5   | 7.2   |
| Transport equipment                                     | 218                             | 154   | 440   | 459   | 18.4                           | 12.4  | 17.0  | 16.7  |
| Passenger motor cars (excl. buses)                      | 42                              | 55    | 168   | 195   | 3.5                            | 4.4   | 6.5   | 7.1   |
| Transport equipment (excl. ships, aircraft)             | 24                              | 17    | 67    | 85    | 2.1                            | 1.4   | 2.6   | 3.1   |
| Other, non-industrial                                   | 3                               | 3     | 6     | 10    | 0.3                            | 0.2   | 0.2   | 0.4   |
| Parts and accessories                                   | 36                              | 35    | 63    | 72    | 3.1                            | 2.8   | 2.5   | 2.6   |
| Ships   | 19                              | 35    | 80    | 38    | 1.6                            | 2.9   | 3.1   | 1.4   |
| Aircraft  | 94                              | 10    | 54    | 59    | 7.9                            | 0.8   | 2.1   | 2.2   |
| Consumer goods not elsewhere specified                  | 229                             | 261   | 484   | 497   | 19.3                           | 21.1  | 18.8  | 18.0  |
| Durable   | 51                              | 54    | 117   | 125   | 4.3                            | 4.3   | 4.5   | 4.6   |
| Semi-durable  | 92                              | 104   | 189   | 173   | 7.7                            | 8.4   | 7.3   | 6.3   |
| Non-durable   | 85                              | 103   | 178   | 199   | 7.2                            | 8.4   | 6.9   | 7.2   |
| Goods not elsewhere specified                           | 2                               | 3     | 3     | 3     | 0.2                            | 0.2   | 0.1   | 0.1   |

Sources: Statistics Iceland, Central Bank of Iceland.

Table A3 (continued) Structure of foreign trade

D Geographic distribution of foreign trade (f.o.b. value) 1970-2004<sup>1</sup>

|  | <i>Share of total</i> |              |              |              |              | <i>Million EUR</i> |
|--|-----------------------|--------------|--------------|--------------|--------------|--------------------|
|  | 1970                  | 1980         | 1990         | 2000         | 2004         | 2004               |
| <i>Merchandise exports</i>             |                       |              |              |              |              |                    |
| European Union                         | 52.8                  | 52.3         | 70.7         | 67.4         | 75.2         | 1,746.0            |
| Euro area                              | 25.4                  | 30.2         | 37.6         | 42.3         | 47.8         | 1,110.4            |
| Other EU countries                     | 27.4                  | 22.0         | 33.1         | 25.1         | 27.4         | 635.6              |
| United Kingdom                         | 13.2                  | 16.5         | 25.3         | 19.3         | 19.0         | 442.0              |
| Other Western European countries       | 2.8                   | 2.3          | 3.4          | 7.8          | 6.3          | 146.6              |
| Eastern Europe and former Soviet Union | 9.6                   | 8.8          | 2.9          | 1.4          | 1.2          | 28.0               |
| Russia                                 | 6.8                   | 5.4          | 2.5          | 0.4          | 1.1          | 26.5               |
| United States                          | 30.0                  | 21.6         | 9.9          | 12.2         | 9.3          | 215.4              |
| Japan                                  | 0.1                   | 1.5          | 6.0          | 5.2          | 3.0          | 69.7               |
| Other OECD countries                   | 0.5                   | 0.6          | 0.5          | 2.0          | 1.5          | 34.3               |
| Developing countries                   | 4.2                   | 12.9         | 5.5          | 3.0          | 2.8          | 65.7               |
| Other countries                        | 0.0                   | 0.0          | 1.1          | 1.0          | 0.7          | 16.6               |
| <b>Total</b>                           | <b>100.0</b>          | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>2,322.2</b>     |
| <i>Merchandise imports</i>             |                       |              |              |              |              |                    |
| European Union                         | 64.9                  | 58.0         | 59.9         | 57.0         | 60.9         | 1,819.5            |
| Euro area                              | 32.0                  | 33.2         | 35.5         | 33.5         | 34.2         | 1,023.4            |
| Other EU countries                     | 33.0                  | 24.8         | 24.4         | 23.6         | 26.6         | 796.1              |
| United Kingdom                         | 14.3                  | 9.5          | 8.1          | 9.0          | 6.8          | 204.1              |
| Other Western European countries       | 5.4                   | 8.1          | 5.2          | 9.7          | 12.3         | 368.1              |
| Eastern Europe and former Soviet Union | 10.4                  | 10.9         | 6.5          | 5.7          | 1.2          | 36.6               |
| Russia                                 | 7.2                   | 9.7          | 5.0          | 1.8          | 1.0          | 31.2               |
| United States                          | 8.2                   | 9.4          | 14.4         | 11.0         | 10.1         | 301.8              |
| Japan                                  | 2.9                   | 4.0          | 5.6          | 4.9          | 3.8          | 115.0              |
| Other OECD countries                   | 0.4                   | 5.8          | 3.7          | 4.5          | 3.3          | 97.6               |
| Developing countries                   | 7.2                   | 2.7          | 3.1          | 5.6          | 7.2          | 214.6              |
| Other countries                        | 0.6                   | 1.1          | 1.4          | 1.5          | 1.2          | 35.3               |
| <b>Total</b>                           | <b>100.0</b>          | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>100.0</b> | <b>2,988.5</b>     |

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

Sources: Statistics Iceland, Central Bank of Iceland.

Table A4 National accounts overview

|                                   | At current prices (million EUR) |       |       |       |        | Volume change on previous year (%) |       |       |      |      |
|-----------------------------------|---------------------------------|-------|-------|-------|--------|------------------------------------|-------|-------|------|------|
|                                   | 2000                            | 2001  | 2002  | 2003  | 2004   | 2000                               | 2001  | 2002  | 2003 | 2004 |
| Private consumption               | 5,508                           | 4,767 | 4,983 | 5,309 | 5,808  | 4.1                                | -3.2  | -1.8  | 5.8  | 7.0  |
| Public consumption                | 2,175                           | 2,019 | 2,325 | 2,439 | 2,596  | 4.4                                | 3.1   | 5.0   | 1.5  | 2.7  |
| Gross fixed capital formation     | 2,175                           | 1,895 | 1,609 | 1,914 | 2,377  | 14.7                               | -4.9  | -19.6 | 20.4 | 21.1 |
| Industries                        | 1,440                           | 1,169 | 893   | 1,105 | 1,422  | 15.1                               | -13.3 | -26.2 | 28.4 | 23.4 |
| Housing                           | 356                             | 362   | 414   | 493   | 541    | 12.9                               | 15.4  | 5.0   | 16.1 | 5.8  |
| Public works and buildings        | 379                             | 364   | 276   | 296   | 429    | 14.7                               | 8.0   | -23.1 | 3.0  | 26.9 |
| Changes in stock <sup>1</sup>     | 34                              | -24   | -2    | -17   | -38    | -1.8                               | -2.7  | -0.4  | -0.8 | -1.0 |
| National expenditure              | 9,893                           | 8,657 | 8,915 | 9,644 | 10,743 | 7.2                                | -3.7  | -4.5  | 7.8  | 7.7  |
| Exports of goods and services     | 3,161                           | 3,422 | 3,548 | 3,322 | 3,627  | 4.3                                | 7.4   | 3.9   | 1.3  | 8.3  |
| Exports of goods                  | 2,056                           | 2,247 | 2,370 | 2,105 | 2,322  | -1.3                               | 7.2   | 6.6   | -1.1 | 9.2  |
| Exports of services               | 1,105                           | 1,175 | 1,178 | 1,217 | 1,305  | 16.3                               | 7.7   | -1.4  | 6.6  | 6.7  |
| Imports of goods and services     | 3,837                           | 3,508 | 3,388 | 3,613 | 4,214  | 8.5                                | -9.1  | -2.6  | 10.7 | 14.3 |
| Imports of goods                  | 2,572                           | 2,315 | 2,206 | 2,289 | 2,742  | 2.8                                | -10.0 | -3.3  | 7.2  | 15.8 |
| Imports of services               | 1,265                           | 1,193 | 1,182 | 1,324 | 1,473  | 21.5                               | -7.2  | -1.2  | 17.1 | 11.5 |
| Gross domestic production (GDP)   | 9,216                           | 8,571 | 9,075 | 9,354 | 10,156 | 5.0                                | 3.3   | -1.3  | 3.6  | 6.1  |
| Current account balance           | -951                            | -378  | 125   | -464  | -848   | .                                  | .     | .     | .    | .    |
| Current account balance, % of GDP | .                               | .     | .     | .     | .      | -10.3                              | -4.4  | 1.4   | -5.0 | -8.4 |

1. Volume changes indicate percentages of GDP of the previous year at fixed prices.

Source: Statistics Iceland.

Table A5 Financial sector indicators

|  | 2000  | 2004               |
|--|-------|--------------------|
| <i>Financial institutions (number of, unless otherwise indicated)</i>                |       |                    |
| Commercial banks   | 4     | 4                  |
| Savings banks  | 25    | 24                 |
| Average number of employees in commercial and savings banks                          | 3,046 | 3,683 <sup>1</sup> |
| Total assets of commercial and savings banks (billion EUR)                           | 9.6   | 26.4               |
| Credit undertakings  | 12    | 9                  |
| Undertakings engaged in securities   | 11    | 10                 |
| Pension funds  | 56    | 48                 |
| Insurance companies  | 12    | 13                 |
| <i>Financial markets</i>   |       |                    |
| Listed companies on Iceland Stock Exchange (ICEX)                                    | 75    | 34                 |
| Market capitalisation of listed companies at end of period (billion EUR)             | 5.0   | 12.2               |
| Market capitalisation of listed companies at end of period (% of GDP)                | 59.0  | 115.1              |
| Annual turnover in listed equities (billion EUR)                                     | 2.7   | 8.3                |
| Annual turnover in listed bonds (billion EUR)  | 4.6   | 17.3               |
| Annual turnover on the Icelandic interbank market for foreign exchange (billion EUR) | 10.6  | 10.9               |
| Annual turnover on the interbank currency swap market <sup>2</sup> (billion EUR)     | .     | 1.1                |
| Annual turnover on the interbank market for krónur (billion EUR)                     | 7.2   | 12.4               |

1. Parent company basis. 2. Started November 26, 2001.

Sources: Financial Supervisory Authority, Iceland Stock Exchange (ICEX), Central Bank of Iceland.

Table A6 Government sector indicators

*General government revenues and expenditures % of GDP*

|                                   | 1960 | 1970 | 1980 | 1990 | 2000 | 2004 <sup>4</sup> |
|-----------------------------------|------|------|------|------|------|-------------------|
| Revenues <sup>1</sup>             | 35.5 | 30.1 | 33.9 | 36.1 | 41.2 | 42.7              |
| Taxes                             | 34.9 | 28.9 | 31.8 | 33.6 | 38.8 | 40.2              |
| on income and wealth              | 8.2  | 8.9  | 8.9  | 21.8 | 19.6 | 18.9              |
| on production/imports/consumption | 26.7 | 20.0 | 22.8 | 11.8 | 19.2 | 21.3              |
| Interest                          | 0.5  | 0.6  | 1.9  | 1.6  | 1.5  | 1.6               |
| Other                             | 0.2  | 0.6  | 0.3  | 0.9  | 0.9  | 0.9               |
| Expenditures <sup>2</sup>         | 33.2 | 29.8 | 33.1 | 39.4 | 38.7 | 42.7              |
| Public consumption                | 10.3 | 12.7 | 16.5 | 20.0 | 23.6 | 25.6              |
| Interest                          | 0.2  | 0.6  | 1.6  | 3.8  | 3.4  | 2.9               |
| Subsidies                         | 12.1 | 3.3  | 3.5  | 3.4  | 1.6  | 1.5               |
| Current transfers                 | 5.7  | 5.5  | 5.0  | 7.1  | 7.0  | 9.0               |
| Fixed investment                  | 3.0  | 4.6  | 3.6  | 4.3  | 3.9  | 4.2               |
| Capital transfers                 | 1.9  | 3.1  | 2.9  | 2.6  | 1.2  | 1.5               |
| Financial balance                 | 2.9  | 1.2  | 1.3  | -3.3 | 2.5  | -0,1              |

*Government expenditure by function*

| <i>Central government, % of GDP</i>      | 1960 | 1970 | 1980 | 1990 | 2000 | 2003 <sup>3</sup> |
|--|------|------|------|------|------|-------------------|
| Total expenditure <sup>3</sup>           | 33.2 | 29.8 | 33.1 | 39.4 | 38.7 | 42.9              |
| Including services cost and depreciation |      |      | 34.9 | 43.9 | 44.5 | 49.5              |
| Administration and safety                | 2.6  | 2.9  | 2.8  | 3.2  | 4.7  | 5.9               |
| Education                                | 2.8  | 4.2  | 4.3  | 4.9  | 7.2  | 8.5               |
| Health services                          | 2.1  | 3.2  | 5.5  | 6.9  | 8.1  | 9.1               |
| Social security                          | 5.6  | 6.2  | 5.6  | 7.8  | 8.5  | 10.4              |
| Other social affairs                     | 1.8  | 2.8  | 2.6  | 2.9  | 4.4  | 4.8               |
| Economic services                        | 17.5 | 9.0  | 9.3  | 8.6  | 6.9  | 7.2               |
| Other expenditure                        | 0.6  | 1.0  | 1.4  | 1.6  | ...  | ...               |
| Interest expenditure                     | 0.2  | 0.6  | 1.6  | 3.5  | 2.7  | 2.2               |
| Depreciation                             | ...  | ...  | 0.6  | 1.8  | 2.0  | 2.0               |
| Cost of service income                   | ...  | ...  | 1.2  | 2.7  | 3.8  | 4.5               |

| <i>Central government % of GDP</i>       | 1960 | 1970 | 1980 | 1990 | 2000 | 2003 <sup>3</sup> |
|--|------|------|------|------|------|-------------------|
| Total expenditure <sup>3</sup>           | 21.6 | 21.4 | 27.0 | 32.4 | 29.2 | 30.1              |
| Including services cost and depreciation | ...  | ...  | 28.8 | 35.4 | 33.1 | 33.9              |
| Administration and safety                | 2.1  | 2.3  | 2.2  | 2.5  | 4.8  | 4.9               |
| Education                                | 2.4  | 3.3  | 3.4  | 3.7  | 2.8  | 3.1               |
| Health services                          | 2.2  | 3.3  | 5.1  | 6.8  | 8.0  | 8.3               |
| Social security                          | 5.5  | 4.1  | 4.9  | 6.4  | 6.7  | 7.4               |
| Other social affairs                     | 0.8  | 1.4  | 1.1  | 1.2  | 1.8  | 1.7               |
| Economic services                        | 8.5  | 7.0  | 7.9  | 7.3  | 5.3  | 5.5               |
| Other expenditure                        | 0.0  | -0.3 | 1.1  | 1.2  | 0.0  | 0.0               |
| Interest expenditure                     | 0.1  | 0.4  | 1.3  | 3.4  | 2.3  | 1.7               |
| Depreciation                             | ...  | ...  | 0.6  | 1.3  | 1.5  | 1.3               |
| Cost of service income                   | ...  | ...  | 1.2  | 1.7  | 2.4  | 2.5               |

| <i>Local government, % of GDP</i>        | 1960 | 1970 | 1980 | 1990 | 2000 | 2003 <sup>3</sup> |
|--|------|------|------|------|------|-------------------|
| Total expenditure <sup>3</sup>           | 5.8  | 7.8  | 6.6  | 6.2  | 10.1 | 10.5              |
| Including services cost and depreciation |      |      | 6.9  | 7.1  | 12.0 | 12.7              |
| Administration and safety                | 0.6  | 0.6  | 0.5  | 0.7  | 1.0  | 1.7               |
| Education                                | 0.7  | 0.9  | 0.9  | 1.2  | 4.4  | 4.7               |
| Health services                          | 0.2  | 0.1  | 0.7  | 0.1  | 0.1  | 0.0               |
| Social security                          | 1.9  | 2.3  | 0.8  | 1.3  | 1.8  | 2.1               |
| Other social affairs                     | 1.0  | 1.4  | 1.5  | 1.8  | 2.6  | 2.7               |
| Economic services                        | 1.1  | 1.9  | 1.5  | 1.3  | 1.6  | 1.1               |
| Interest expenditure                     | 0.1  | 0.2  | 0.3  | 0.4  | 0.5  | 0.3               |
| Other expenditure                        | 0.2  | 0.3  | 0.3  | 0.5  | ...  | ...               |
| Depreciation                             | ...  | ...  | 0.1  | 0.5  | 0.6  | 0.5               |
| Cost of services sold                    | ...  | ...  | 0.1  | 0.5  | 1.4  | 1.7               |

1. Excl. sale of goods and services. 2. Excl. cost of goods and services sold. 3. Excl. depreciation and cost of goods and services sold. 4. Preliminary.

Source: Statistics Iceland.

Table A7 Balance of payments

| Million EUR                                  | 1990   | 1995   | 2000   | 2003   | 2004 <sup>1</sup> |
|--|--------|--------|--------|--------|-------------------|
| <i>Current account</i>                       | -104   | 41     | -957   | -466   | -847              |
| <i>Balance on goods, services and income</i> | -101   | 44     | -947   | -453   | -833              |
| Exports                                      | 1,749  | 1,992  | 3,331  | 3,661  | 4,149             |
| Imports                                      | -1,851 | -1,947 | -4,278 | -4,114 | -4,982            |
| <i>Balance on goods and services</i>         | 67     | 198    | -679   | -291   | -593              |
| Exports                                      | 1,684  | 1,928  | 3,171  | 3,332  | 3,663             |
| Imports                                      | -1,617 | -1,731 | -3,849 | -3,623 | -4,256            |
| <i>Balance on goods</i>                      | 65     | 160    | -518   | -184   | -423              |
| Merchandise exports f.o.b.                   | 1,246  | 1,395  | 2,062  | 2,111  | 2,345             |
| Marine products                              | 942    | 1,003  | 1,305  | 1,315  | 1,411             |
| Aluminium and ferrosilicon                   | 162    | 186    | 436    | 466    | 494               |
| Ships and aircraft                           | 14     | 49     | 43     | 16     | 9                 |
| Other goods                                  | 128    | 157    | 277    | 315    | 431               |
| Merchandise imports f.o.b.                   | -1,182 | -1,235 | -2,580 | -2,295 | -2,768            |
| Investment goods                             | -219   | -263   | -611   | -530   | -609              |
| Transport equipment                          | -215   | -154   | -440   | -311   | -461              |
| Fuels and lubricants                         | -117   | -87    | -238   | -177   | -252              |
| Industrial supplies                          | -310   | -344   | -597   | -610   | -704              |
| Consumer goods                               | -320   | -387   | -694   | -667   | -742              |
| <i>Balance on services</i>                   | 2      | 38     | -161   | -107   | -169              |
| Exports of services, total                   | 438    | 534    | 1,109  | 1,220  | 1,318             |
| Transportation                               | 174    | 207    | 535    | 580    | 733               |
| Air transport                                | 94     | 130    | 417    | 476    | 627               |
| Sea transport                                | 81     | 78     | 118    | 105    | 105               |
| Travel                                       | 119    | 144    | 248    | 284    | 302               |
| Other receipts                               | 145    | 183    | 325    | 356    | 283               |
| Communications services                      | 12     | 18     | 11     | 7      | 8                 |
| Insurance services                           | 5      | 4      | 6      | 6      | 7                 |
| Government services                          | 95     | 80     | 117    | 86     | 78                |
| Other services                               | 33     | 82     | 191    | 257    | 190               |
| Imports of services, total                   | -435   | -496   | -1,269 | -1,328 | -1,487            |
| Transportation                               | -132   | -160   | -452   | -459   | -565              |
| Travel                                       | -224   | -218   | -512   | -460   | -562              |
| Other expenditures                           | -79    | -119   | -305   | -408   | -360              |
| Communications services                      | -9     | -14    | -2     | -40    | -17               |
| Insurance services                           | -12    | -16    | -6     | -22    | -16               |
| Government services                          | -7     | -9     | -17    | -20    | -17               |
| Other services                               | -51    | -80    | -281   | -327   | -310              |
| <i>Balance on income</i>                     | -168   | -153   | -268   | -162   | -240              |
| Receipts                                     | 65     | 63     | 160    | 329    | 486               |
| Compensation of employees                    | 36     | 39     | 76     | 72     | 65                |
| Investment income                            | 29     | 24     | 84     | 257    | 421               |
| Dividends and reinvested earnings            | 5      | -1     | 36     | 207    | 322               |
| Interest payments                            | 24     | 25     | 48     | 50     | 98                |
| Expenditures                                 | -234   | -217   | -428   | -491   | -726              |
| Compensation of employees                    | -9     | -4     | -12    | -5     | -9                |
| Investment income                            | -224   | -212   | -417   | -485   | -716              |
| Dividends and reinvested earnings            | -7     | -13    | -21    | -156   | -332              |
| Interest payments                            | -218   | -200   | -396   | -329   | -384              |
| <i>Current transfer, net</i>                 | -3     | -4     | -11    | -13    | -14               |
| Public transfer, net                         | -5     | -7     | -11    | -8     | -16               |
| Private transfer, net                        | 2      | 3      | 1      | -6     | 2                 |

1. Preliminary figures. 2. Positive number represents inflow of capital due to foreign borrowing or decrease in assets. Negative number accounts for outflow of capital, debt repayments or increase in assets.

Source: Central Bank of Iceland.



Table A7 (continued) Balance of payments

| Million EUR                             | 1990  | 1995  | 2000  | 2003   | 2004 <sup>1</sup> |
|---|-------|-------|-------|--------|-------------------|
| <i>Capital and financial account</i>    | 2     | -5    | 1,045 | 191    | 1,567             |
| <i>Capital transfer, net</i>            | 124   | -3    | -3    | -5     | -3                |
| <i>Financial account<sup>2</sup></i>    | 181   | -1    | 1,048 | 195    | 1,570             |
| <i>Financial account excl. reserves</i> | 8     | 2     | 968   | 466    | 1,734             |
| Direct investment, net                  | -9    | -26   | -242  | -46    | -1,859            |
| Abroad                                  | -4    | -19   | -428  | -328   | -2,110            |
| Equity capital                          | -5    | -4    | -438  | -239   | -1,647            |
| Reinvested earnings                     | 0     | 2     | -6    | -157   | -230              |
| Other capital                           | 17    | -17   | 16    | 68     | -233              |
| In Iceland                              | 1     | -7    | 186   | 283    | 251               |
| Equity capital                          | -10   | 5     | 230   | 60     | 71                |
| Reinvested earnings                     | 27    | 2     | -18   | 67     | 276               |
| Other capital                           | 20    | -14   | -27   | 155    | -96               |
| Portfolio investment, net               | 0     | 120   | 596   | 2,637  | 5,881             |
| Assets                                  | 0     | -49   | -696  | -524   | -877              |
| Equities                                | 0     | -34   | -690  | -469   | -826              |
| Debt securities                         | 0     | -16   | -6    | -55    | -51               |
| Bonds and notes                         | 0     | -14   | 9     | -59    | -54               |
| Money market instruments                | 20    | -2    | -15   | 4      | 3                 |
| Liabilities                             | 0     | 169   | 1,292 | 3,161  | 6,758             |
| Equities                                | 20    | 0     | -17   | -65    | 234               |
| Debt securities                         | -1    | 169   | 1,309 | 3,226  | 6,523             |
| Bonds and notes                         | 21    | 145   | 1,251 | 2,548  | 6,261             |
| Money market instruments                | -1    | 24    | 58    | 677    | 263               |
| Financial derivatives, net              | -1    | 0     | -1    | 0      | 0                 |
| Assets                                  | 0     | -13   | 17    | 0      | 0                 |
| Liabilities                             | 153   | 12    | -18   | 0      | 0                 |
| Other investment, net                   | -41   | -91   | 616   | -2,125 | -2,287            |
| Assets                                  | 0     | 20    | -98   | -1,805 | -2,753            |
| Loans                                   | -21   | 0     | -44   | -1,040 | -1,965            |
| Deposits                                | -20   | 29    | -35   | -797   | -745              |
| Trade credits                           | 0     | -8    | -20   | 31     | -43               |
| Other capital                           | 194   | -1    | 0     | 0      | 0                 |
| Liabilities                             | 180   | -111  | 714   | -320   | 466               |
| Loans                                   | 200   | -121  | 715   | -492   | 164               |
| Long-term borrowing                     | -20   | -188  | 384   | -411   | -249              |
| Short-term borrowing                    | 0     | 67    | 331   | -81    | 413               |
| Deposits                                | 14    | 3     | -14   | 56     | 217               |
| Trade credits                           | -1    | 1     | 1     | 116    | 88                |
| Other capital                           | -57   | 5     | 12    | 0      | -3                |
| Reserve assets                          | -22   | -3    | 80    | -271   | -165              |
| <i>Net errors and omissions</i>         | 0     | -36   | -88   | 276    | -720              |
| <i>Memorandum items:</i>                |       |       |       |        |                   |
| Debt securities, loans, etc., net       | 199   | 58    | 2,023 | 2,906  | 6,990             |
| Long-term borrowing, net                | -1    | -42   | 1,635 | 2,137  | 6,012             |
| Monetary authorities                    | 14    | 0     | 0     | 0      | 0                 |
| General government                      | -12   | 150   | 67    | 59     | 100               |
| Deposit banks                           | 198   | -99   | 1,051 | 2,038  | 5,894             |
| Other sectors                           | 15    | -93   | 517   | 40     | 18                |
| Short-term borrowing, net               | -1    | 101   | 388   | 768    | 977               |
| Monetary authorities                    | 21    | 16    | 148   | -183   | 0                 |
| General government                      | -8    | 24    | 158   | -179   | 15                |
| Deposit banks                           | 2     | 57    | -29   | 1,019  | 877               |
| Other sectors                           | 1     | 4     | 111   | 112    | 85                |
| <i>Conversion rate: ISK per EUR</i>     | 74.18 | 83.61 | 72.39 | 86.47  | 86.30             |

Table A8 Projected external debt service<sup>1</sup>

| <i>Million EUR</i>             | 2005  | 2006  | 2007  | 2008 | 2009  | 2010 | <i>Principal thereafter</i> | <i>Total</i> |
|--------------------------------|-------|-------|-------|------|-------|------|-----------------------------|--------------|
| <b>General government</b>      |       |       |       |      |       |      |                             |              |
| Principal                      | 365   | 340   | 249   | 106  | 187   | 54   | 1,418                       | 1,925        |
| Interest <sup>2</sup>          | 69    | 53    | 43    | 39   | 36    | 33   |                             |              |
| Total                          | 434   | 393   | 292   | 145  | 223   | 86   |                             |              |
| <b>Central government</b>      |       |       |       |      |       |      |                             |              |
| Principal                      | 325   | 269   | 200   | 67   | 140   | 0    | 1,232                       | 1,441        |
| Interest <sup>2</sup>          | 55    | 41    | 32    | 30   | 28    | 26   |                             |              |
| Total                          | 381   | 310   | 232   | 97   | 169   | 26   |                             |              |
| <b>Local government</b>        |       |       |       |      |       |      |                             |              |
| Principal                      | 40    | 71    | 49    | 39   | 46    | 54   | 186                         | 484          |
| Interest <sup>2</sup>          | 14    | 12    | 11    | 9    | 8     | 7    |                             |              |
| Total                          | 53    | 83    | 60    | 48   | 54    | 60   |                             |              |
| <b>Financial institutions</b>  |       |       |       |      |       |      |                             |              |
| Principal                      | 1,896 | 2,000 | 2,936 | 548  | 2,665 | 246  | 1,046                       | 11,336       |
| Interest <sup>2</sup>          | 334   | 273   | 204   | 138  | 94    | 37   |                             |              |
| Total                          | 2,229 | 2,273 | 3,140 | 686  | 2,758 | 282  |                             |              |
| <b>Banks</b>                   |       |       |       |      |       |      |                             |              |
| Principal                      | 1,860 | 1,987 | 2,908 | 540  | 2,658 | 240  | 1,034                       | 11,227       |
| Interest <sup>2</sup>          | 330   | 271   | 202   | 137  | 93    | 36   |                             |              |
| Total                          | 2,191 | 2,257 | 3,110 | 677  | 2,751 | 276  |                             |              |
| <b>Other loan institutions</b> |       |       |       |      |       |      |                             |              |
| Principal                      | 35    | 14    | 28    | 7    | 7     | 6    | 12                          | 109          |
| Interest <sup>2</sup>          | 4     | 3     | 2     | 1    | 1     | 1    |                             |              |
| Total                          | 39    | 16    | 30    | 9    | 8     | 6    |                             |              |
| <b>Other sectors</b>           |       |       |       |      |       |      |                             |              |
| Principal                      | 320   | 249   | 322   | 117  | 71    | 91   | -212                        | 1,749        |
| Interest <sup>2</sup>          | 63    | 50    | 40    | 32   | 28    | 25   |                             |              |
| Total                          | 383   | 299   | 362   | 149  | 99    | 116  |                             |              |
| <b>Total payments</b>          |       |       |       |      |       |      |                             |              |
| Principal                      | 2,580 | 2,589 | 3,507 | 771  | 2,922 | 390  | 2,251                       | 15,009       |
| Interest <sup>2</sup>          | 466   | 376   | 287   | 208  | 158   | 94   |                             |              |
| Total                          | 3,046 | 2,965 | 3,794 | 979  | 3,080 | 484  |                             |              |

1. Based on debt outstanding at end of year 2004. Conversion rate: ISK per EUR = 83.28. 2. Floating interest rate, LIBOR-USD is assumed at 3% and EURIBOR at 3% per year.

Source: Central Bank of Iceland.

## Tables and charts

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