The national economic forecast for 2013

(Presented by the Minister of Finance and Economic Affairs,

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The Ministry of Finance and Economic Affairs

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Introduction

At present, the economy has been brought back from the trough of the recession and it is therefore important to formulate economic policy for the future based on the coordination of policy instruments where the division of tasks is made clear and each administrative unit will be robust enough to undertake the numerous and complicated issues facing the small and open Icelandic economy that is vulnerable to business fluctuations. In light thereof, the economic policy responsibilities of the Ministry of Economic Affairs and Commerce were transferred to the (renamed) Ministry of Finance and Economic Affairs on September 1st 2012. This change in organisation will strengthen the work currently under way in the preparation of a new and comprehensive fiscal budget that will provide a frame for improved management of fiscal finances. Moreover, this will provide an opportunity for strengthening the use of fiscal finances as a tool of economic policy, since the international financial crisis has unequivocally shown that fiscal finances play an important role, both before and in the wake of economic crises. The Ministry of Finance and Economic Affairs will also prepare the meetings of the ministerial committee on economic affairs. The committee has in recent years been a key factor in the coordination of economic policy. In addition, the Ministry of Finance and Economic affairs will lead in measures of the Government in the overall management of the financial system, since such management is playing an increasingly important role in a number of countries as the third tool of economic policy, alongside monetary and fiscal policy.

Economic developments and prospects at home and abroad

Since the second half of 2010 the Icelandic economy is gradually recovering from the collapse of the currency and the banking system. Real GDP has increased steadily, driven by domestic demand, i.e.

private consumption and investment, as well as by the growth in exports. For 2013, the forecast indicates that real GDP per capita will be at a similar level as in 2005, and the same applies to real disposable income. The economy has some way to go before it has recovered the loss of income caused by the bank collapse and the adjustment of the economy after the years of overexpansion.

Real GDP rose by 2.6 per cent in 2011, and every indication points to continued growth over the next several years. Statistics Iceland forecasts 2.8 per cent growth in 2012 and 2.7 per cent in 2013, driven by private consumption and investment. Private consumption grew at a good pace last year and real wages increased by 2 per cent. Private consumption may be expected to increase further over the next several years in light of the debt resolution measures already taken and following the Supreme Court verdict of last February on the settlement of exchange-rate tied loans, although the increase in real wages may be expected to be slightly lower next year. Unemployment increased rapidly in the wake of the collapse but has declined steadily in concert with increased economic activity. Investment is expected to increase in 2012, mostly on account of energy-related business investment, investment in ships and aircraft and residential construction. Business investment accounted for 9.4 per cent of GDP in 2011 and is expected to exceed 11 per cent this year, not far below the 12.2 per cent historical average since 1990.

Inflation has been substantial in recent years, but at present there are signs that it is gradually abating in line with a stronger exchange rate and the declining world price of petrol. Statistics Iceland assumes that the consumer price index may increase by 5.4 per cent this year and 3.9 per cent next year. Fuel prices and prices of domestically produced food have increased in excess of general prices, and prices of imported foodstuffs have increased as well. Housing prices have increased in line with general prices following a sharp downturn; the forecast of Statistics Iceland indicates that housing prices will increase by 1 per cent a year in excess of general prices.

The króna exchange rate has fluctuated considerably in recent years in spite of capital controls. The exchange rate has strengthened by 3-6 per cent from the beginning of the year, depending on the reference currency, mostly over the summer months. The policy interest rate has increased steadily since August 2011, and further increases may be expected as the economy gathers strength. The economies of Iceland's principal customer countries are not exactly robust at present. The IMF forecasts dimmer prospects for the world economy. The euro-area is expected to contract slightly this year and yield only a small margin of growth next year. Growth in the developing countries is also expected to be lower. The difficulties of the international economy are threefold. First, the financial markets, especially in Europe, are beset with great difficulty and can barely perform their principal task. Second, public debt is widely seen as excessive, both because of the cost of the international financial crisis and the indifference of public authorities before it. Third, the economic environment of major economic systems is not conducive for economic growth, in part because of strict restrictions in the labour market and scant investment in human resources and infrastructure. Instead of measures that induced sustainable growth for the future, it was supported by the facile access of the private sector and public entities to low-interest loans throughout most of the decade prior to the close of the century.

This threefold problem has been most pronounced in Europe. Most indications point to a contraction in the euro-area in 2012 and not much adversity would be needed to turn the anaemic economic growth currently forecast for 2013 in the euro-area (plus the UK and Denmark) into a contraction. The US economy also faces considerable problems – especially because of heavy public deficits and public debt

– and there are signs of concern afoot for many emerging economies where growth has slowed down.

The difficulties of the euro-area will initially be reflected in adversity for the exports of goods and services since the EU is Iceland's most important market for merchandise exports and tourism services. The disquiet in financial markets can also obstruct the access to foreign financing, both for investment projects and the necessary refinancing of the Treasury and the banks before the abolition of the capital controls. The dim prospects for growth in Iceland's most important customer countries, the continued danger of a more serious depression in the euro-area along with the profound problems of the international financial market clearly highlight the importance of adhering to the main principles of improved public finances that have been in place since 2009. This has made it possible to further strengthen the recovered confidence in fiscal finances and the overall economy in recent years.

The challenges after the collapse

In spite of rather vigorous economic growth and declining unemployment, the economy is still faced with important challenges in the wake of the collapse. The debt of the Treasury, households and businesses is large and calls for special attention in the formulation of economic policy. The debt problem is closely related to the elimination of capital controls, since the economy is vulnerable to all financial shocks as long as the indebtedness of all major sectors of the economy is as large as now. The elimination of currency controls is on the other hand important for the longer-term growth of the economy. The prospects for growth in the long run will also be partly determined by the ability of the government to resist long-term unemployment and prevent the unemployed from leaving the labour market.

In light of all the difficulties that the nation has had to suffer from the collapse of the banking system, it is evident that a frame around the banking and financial system must be completed so that it can tend to the needs of households and businesses without threatening the stability of the economy or the finances of the public sector. Laws applying to the banking sector as well as the financial market as a whole must be strengthened in order to ensure a comprehensive oversight over the financial system instead of only viewing individual financial institutions. The consequences of the collapse for Iceland’s economic management have not all been on the downside. The decline in the exchange rate has substantially increased the country’s competitive position. It is important to maintain the competitive position and prevent the instability and disequilibrium that has characterised the economy from resurfacing anew.

The heavy indebtedness of households and businesses has made the economy vulnerable to unexpected adversity and instability. Heavy indebtedness can also deter economic growth in the long run. Although the debt of households and business has declined from about 400 per cent of GDP in 2010 to 300 per cent at the end of 2012, the debt ratio is still high. It is evident that private sector debt must decline still further over the next several years, both through the repayment of debt and further write-downs by financial institutions. Earlier periods of the reduction in private sector debt in other countries have been six to seven years on average. Over this period, the debt/GDP ratio has declined by 25 per cent. The indebtedness of Icelandic companies and households was so high after the collapse that the debt must probably decline more than this comparison indicates. The need for a large decline in debt need not mean that the adjustment period would have to be longer than other countries have experienced, since the banks have been restored with substantial equity capital and loan loss reserve accounts in order to meet inevitable write-offs.

Ever since the collapse, efforts have been made to facilitate the debt adjustment of individuals within the boundaries of a very difficult financial position of the Treasury. The 2013 fiscal budget bill places emphasis on helping families with children, since research indicates that young families with children are in a difficult position. For this reason, 4.5 billion krónur in new appropriations are proposed to increase the support for families with children, such as through increased child benefits, rent subsidies, interest credits and childbirth leave payments.

In addition to the heavy indebtedness of the private sector, public sector debt has sharply increased and is almost as high as annual GDP following the heavy cost of the bank collapse and an accumulated deficit of 350 billion krónur in the years 2009-2013. This debt is offset with considerable assets, such as the foreign exchange reserves, and the net debt of the Treasury is close to the average of the OECD-countries. A small economy such as the Icelandic one must have fairly robust reserves and be able to apply economic measures even if the access to foreign financial markets is temporarily unavailable. The reduction in public debt is therefore of prime importance, both so as to reduce the interest cost of the Treasury and create a room for manoeuvre for the authorities to intervene in situations of looming economic instability. The strengthening of the regulatory and surveillance framework for the financial market should limit the possibility for financial shocks and the cost that could be an inevitable consequence thereof.

The national economic forecast for 2012 outlined an economic policy that placed emphasis on the supply side of the economy instead of the cyclically-prone and demand-driven economic growth of earlier years. One of the main aspects of this policy is to maintain the improved competitive position created by the decline in the real exchange rate following the collapse. The positive effects of the improved competitive position have been particularly felt in sectors that can easily increase their supply. This is evident in the large increase in the number of tourists, and exports of other services and goods, other than from energy-intensive production, have also increased sharply. Such a sharp decline in the exchange rates of Sweden and Finland in the wake of economic depressions in those countries took place some 20 years ago. In both countries the real exchange rate has remained considerably lower than the average of earlier years. Research by the IMF from earlier this year indicated that the real exchange rate was slightly too low for the longer run (on average by 10 per cent, depending on the calculation method used). This research did not take into account the possible short-term decline on account of a sharp outflow at the time of the abolition of capital controls. The real exchange rate has strengthened somewhat in recent months, or by 8 per cent from the lowest point last March. The room for further strengthening of the real exchange rate seems limited under the current circumstances if an adequate competitive position is to be maintained. It cannot be excluded that the real exchange rate will follow the traditional upward path when the economy is further strengthened, along with the concomitant adverse effects for the business environment. The historical experience indicates that the real exchange rate has strengthened and become too high, in part because of excess profits in the fisheries industry. The substantial increase in the tax on fish catches should do much to reduce such excess profits and should abate the upward pressure on the exchange rate and the consequent adverse effects on other sectors. It is important that the pricing and the development of the energy sector will contribute through its excess rate of return to stronger Treasury finances, either through ownership in energy companies or through normal taxation.

Increased investment with an adequate rate of return is of prime importance for the economy to enable it to make use of its improved competitive position. In this respect, investment in intangible assets, such as education and research, is no less important than investment in the traditional sense. In this regard, it is worth noting that the OECD has in recent years emphasised that the development of new industries is the main accelerator of economic growth in developed industrial countries. In light of the importance of stimulating investment in the economy, next year's fiscal budget bill contains a 3.8 billion krónur appropriation to projects under the investment programme introduced by the Cabinet last May. Of this amount, a third is reserved for research and technology funds. The fiscal budget bill implies in addition that benefits worth 1.1 billion krónur would accrue to new development projects of private companies due to recently enacted laws.

Public investment in research and development is especially important in small economies such as the Icelandic one where most companies are small and larger companies are generally more successful in international competition than smaller ones.[1] By coordinating the strengths of the economic system and the possibilities afforded through the access to the inner market of Europe, the inadequacies of the size of the economy may be offset.

Capital controls

One of the main tasks of economic policy is to abolish the capital controls without creating economic and financial instability. The Central Bank is working towards this goal according to a plan on the abolition of restrictions adopted by the Cabinet in March 2011. Later that year, the Althingi approved amendments to foreign exchange legislation that extended the authority to maintain capital controls until the end of 2013. On that occasion the Minister reiterated that the authority to further extend the controls would be sought from the Althingi if needed. The capital controls will have an adverse impact that must be taken into account. Aside from these long-term effects, the capital controls have given the economy room to regain its

[1] Lars Rubini et al. Breaking down the barriers to firm growth in Europe. The fourth EFIGE policy report. Brussel: Bruegel.

strength. This room for manoeuvre has been important in light of the great uncertainty that has characterised international economic developments in recent years.

In the course of 2012, the Central Bank has held four auctions where it purchased Icelandic krónur for foreign currency in accordance with the plan for abolishing capital controls. A total of ten auctions of Icelandic krónur for foreign holders have been held, on one hand through the so-called investment plan and with the purchase of government bonds on the other. Further auctions will be planned this year, and the next auction will take place at the beginning of October. Foreign investors still hold considerable short-term assets in Icelandic krónur that they could choose to cash in if the capital controls were abolished too fast. It is important that those investors who choose to relinquish their position over time will do so without threatening the stability of the exchange rate and the economy as a whole. The expansion of the economy and the success in economic policy, which was confirmed with the Treasury issue of ten-year notes earlier in the year, should deter foreign holders from relinquishing their Icelandic assets, at least in contrast to the situation immediately after the collapse of the banking system.

The continued improvement of fiscal finances is one of the main prerequisites for the abolition of capital controls without causing major adverse effects for the economy. The holders of non-resident krónur assets own a large part of short-term Treasury debt. If capital controls are abolished without continuing the responsible policy of public finances, the interest burden of the Treasury would be in danger of increasing rapidly. In addition to the pursuit of a prudent fiscal policy, the Treasury has prepared the abolition of capital controls – along with a possible increase in interest rates – by ensuring a large liquidity position and the lengthening of the repayment profile of its debt.

In order to strengthen the path towards abolition of capital controls and ensure a wide-ranging support for the measures required, the government has strengthened its consultation with all interested parties. A committee consisting of representatives of all parties represented in the Althingi plays a key role in this respect. In addition, a working group on the abolition of capital controls has been established with representatives from the Icelandic government, the EU, the ECB and the IMF. The work of this group provides an opportunity to seek the advice of foreign experts and relate the abolition process to developments in the international arena and the foreign commitments of Iceland.

Public finances

The main objective of the programme for fiscal finances has been to arrest the accumulation of debt caused by the Treasury deficits in the wake of the banking collapse and revert back to an acceptable surplus in order to bring down the debt load. Efforts have been made to reach this goal with a combination of revenue measures and cuts in expenditure, having at the same time regard to the welfare system and the increase in income equality. The successful international issues of Treasury debt over the past two years show beyond doubt that the Treasury finances are going in the right direction.

Since the collapse, a fiscal consolidation programme has been followed in order to bring the public budget primary surplus (i.e. excluding interest cost and interest income) into surplus and the overall surplus thereafter. The current plan, formulated in cooperation with the IMF early in 2009 and reviewed in 2011, expects that a primary surplus equivalent to 1 per cent of GDP on a cash basis will be attained in 2012. The primary deficit in 2009, in the first year after the bank collapse, amounted to 100 billion krónur on an accrual basis. If the fiscal programme is realised, the turnaround on the primary balance on an accrual basis will be about 160 billion krónur by next year and the primary balance will by then be in surplus by about 3 per cent of GDP instead of a deficit equivalent to 6.5 per cent of GDP in 2009. The aim is that the current account will be in surplus by 2014. This would mean that the turnaround in the primary surplus would be about 10-11 per cent of GDP and that fiscal finances would be sustainable after several years of the greatest economic setback that has taken place since the Second World War.

A goal expressed in figures, such as the one that has been followed in the past four years, can be useful in reaching clear goals after a great shock. In order to ensure that public debt declines rapidly enough towards an acceptable goal, a surplus on public sector operations must be maintained over the longer run. For this reason, the time is now to look forward over a longer period and begin with an analysis and implementation of a long-term objective that total public debt, i.e. of the central government as well as local governments, should decline to at least 60 per cent of GDP. A still lower debt ratio would be desirable for a small open economy such as Iceland's that is vulnerable to demand fluctuations. The Ministry of Finance and Economic Affairs has begun work on a longer-term goal. The Ministry has also, in extensive cooperation with various government agencies including the fiscal budget committee of the Althingi, begun the preparation of a bill on public finances with the aim of greatly improving the coordination of public finances and strengthening their entire framework. The aim is to improve the formulation and the setting of goals for public finances followed by a stronger and more disciplined budget implementation. It is important that such a policy formulation and fiscal rule receives careful consideration in the political arena and in the country as a whole. A broad consensus needs to be created around a long-term goal for public finances in order for it to be attained and not be subject to change during each period in office of the Althingi. Such a long-term vision is in place in most economies that have been most successful in this area.

A new Local Government Act that was passed in 2011 created a firmer framework on the finances of local governments. This framework must be coordinated with the overall setting of goals for public finances. It is important that both levels of government work in tandem, although it is clear that the responsibility for applying public finances in the management of the economy lies primarily with the Treasury.

The labour market

The labour market has turned around sharply in recent months. Unemployment is expected to continue declining this year and next in concert with increased economic activity. Statistics Iceland forecasts that the unemployment rate will be 6 per cent this year and decline to 5.3 per cent next year. Unemployment is forecast to decline further over the long term, down to 4 per cent by 2016.

Job-related labour market measures have yielded considerable results, and a number of people have participated in them. The success was most in projects related to innovation where more than 80 per cent were no longer on the unemployment rolls three months after having participated. Temporary measures such as job training, provisional hiring and special measures have also yielded good results.

Education towards a job is a measure that has yielded results and is a cooperative venture between the government and the labour market participants aimed at strengthening the labour market. The main goal of this venture is to respond to growing long-term unemployment by creating opportunities for job seekers to begin training through such support.

Unemployment among men is about 1 per cent higher than among women according to the labour market survey of Statistics Iceland. Registered unemployment of women, on the other hand, is higher than among men, according to the Labour Office. The explanation for this disparity is that women accepting unemployment compensation are less prepared than men to begin work within two weeks in light of household circumstances and are therefore counted as being outside the labour market, as unemployment is measured by Statistics Iceland. There is good reason to research this gender difference, especially in relation to long-term unemployment and labour market participation.

The public authorities place great emphasis upon increasing the level of education of the nation and encouraging the interest of students in both vocational and academic education. Success in this area will mean that demand for educated labour can better be met, thus helping strengthen know-how that would support the competitive agility and innovation in business.

The financial system

The Icelandic financial system primarily needs to be secure, efficient and of a size that fits the economy. In order for this to come about, the banks need to complete the reorganisation of their finances and operations. A successful and effective regulatory framework needs to be put in place and a frame as well as tools for the overall management of the financial system. Such an approach can also serve as third instrument of economic management, alongside monetary and fiscal policy.

A considerable success has been achieved in the reorganisation of debt in recent years. Banks have divested themselves of ownership in unrelated companies, and companies have resumed listing their stock on the stock exchange. There is still some way to go before the banks can concentrate on planning for the future instead of working on the resolution of the asset portfolio. The recalculation of exchange-rate-linked loans is an important issue that needs to be settled. In light of history and with regard to the speed of moving cases of this type through the courts, as well as coordinating the work of affected parties on the pursuit of necessary court cases, one may expect that a conclusion can be reached soon. It is also important that companies will not be left too indebted when the financial reorganisation is completed. The oversight of the Competition Authority and the Financial Supervisory Authority of the debt resolution process and financial situation is of prime importance in this respect.

The increased efficiency of the banking system is also of importance to ensure that the banking system is competitive when the capital controls are lifted. The banking system is still expensive and labour-intensive. Figures on the number of bank employees in Iceland in comparison with neighbouring countries indicate that the banks need to rationalise further, although it is evident that a part of the bank staff is still occupied with debt resolution. The imposition of a special wage tax on financial undertakings in 2012 is in part intended to encourage increased rationalisation with a positive macro-economic effect, since financial undertakings can push up the wage cost in other sectors, partly because of their special position in being exempt from the value added tax.

The legal framework for the Icelandic financial market has been greatly improved in the past four years, as was documented in the report of the Minister of Economic and Commerce to the Althingi, The Future Organisation of the Financial System.[2] Fundamental changes in the banking system are also ahead with the adoption of new European legislation based on international guidelines from the Basel Committee[3]. The new legislation will call for stricter rules on

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[2] Framtíðarskipan fjármálakerfisins, http://www.efnahagsraduneyti.is/media/Acrobat/Framtidarskipanfjarmalakerfisins.pdf

[3] CRD IV (Capital Requirements Directive IV) consisting of a Directive and a Regulation. The aim is to adopt it within the EU in steps as of the beginning of 2013.

equity capital and the adoption of binding rules on liquidity. In addition, there will be instruments for the overall management of the financial system. The equity ratio of the banks already exceeds these new minimum requirements, as the Financial Supervisory Authority has required. The Central Bank is also drafting new regulations on minimum liquidity that should be available before the end of the year. The new banking legislation should help in reducing the likelihood of new bank crises and reduce the cost of the Treasury and the nation as a whole as a result. In order to respond to ailing banks, new rules are being drafted on the response to such circumstances in the international arena. The EU Commission issued a draft of a new Directive in July 2012. The draft is based on the experience of a number of European countries that already have adopted a comparable regulatory framework, not unlike the many provisions adopted here with the Emergency Act and subsequent amendments thereto. Such provisions have in part been adopted in this country, either with amendments to the Act on Financial Undertakings that deals with dissolution procedures or with a provisional amendment to the same Act that originally was passed alongside the Emergency Act and will, other things being equal, cease to be in effect at the end of 2013.

In addition to new and stricter regulatory requirements for financial undertaking and a future framework on their dissolution, it is important to put a law in place on a comprehensive deposit insurance scheme replacing the Cabinet declaration on deposit insurance. It is important that such insured deposits will enjoy seniority debt status against the assets of financial undertakings, as was assumed in a bill presented to the Althingi during its last session. Under the present Act, all deposits enjoy seniority over other claims in the same order.

The framework for the Icelandic financial market is based on the membership in the European Economic Area and thereby the internal market in financial services as well. The EEA Agreement ensures that the rules and regulations for Icelandic financial undertakings are comparable with those of neighbouring countries. The membership in the inner market is also intended to provide domestic financial undertakings with the necessary discipline through increased competition from outside. Moreover, the regulatory framework and oversight of the financial market based on internationally approved rules should help Icelandic financial companies to regain access to foreign capital.

Substantial changes have in recent years taken place in the nature of the inner market for financial services. New pan-European supervisory institutes have been established with authority for direct intervention into the operation of individual undertakings in member countries. One consequence thereof is that it will prove difficult to adopt a large part of new rules, given the current Constitution.[4] Ways and means are currently being sought to solve this problem in cooperation with other EEA/EFTA member countries and the EU Commission.

In addition to changes in the regulatory framework of the financial market, the role of the Financial Supervisory Authority (FSA) is being strengthened. The annual supervisory fee that goes to the FSA has been substantially increased in recent years. Moreover, the FSA has improved its organisation and work procedures, in part on the basis of the report of an internationally recognised consultant in 2011[5].

In addition to improved supervision over individual financial undertakings following the bank crash in 2008, increased emphasis is being placed upon finding methods for the overall management of the financial system. The purpose is to ensure the stability of the system as a whole so as not to rely exclusively on the financial strength of individual undertakings that create the system. Experience has shown that the supervision of each unit does not suffice to ensure the stability

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[4] *http://www.utanrikisraduneyti.is/frettir/nr/7134*

[5] *http://www.efnahagsraduneyti.is/media/Acrobat/Report-on-Iceland-Supervision.pdf*

of the entire system. It is necessary to view the properties of the financial system as a whole and the interrelationships of the undertakings within it in order to get assess its natural tendency for excessive expansion that could end in a collapse. The experience of recent years has shown that traditional tools of monetary and fiscal policy are inadequate in dealing with a financial crisis.

The Minister of Economic Affairs and Commerce presented a report to the Althingi in March 2012 that is intended to contribute to the discourse on future arrangements in this field. Partly on the basis of this report, proposals are being drafted for such comprehensive supervision of the financial system in this country. This work takes account of the most recent developments abroad, and most of neighbouring countries have in recent months been working on comparable improvements. Once a decision has been taken on the governance of these issues, the selection of tools for this purpose must also be made. Several such tools are listed in a new banking legislation that will be incorporated into the EEA Agreement and was discussed above. In addition to such general rules, it is likely that Iceland will have to apply further rules and align them to Icelandic circumstances. The latest report of the Central Bank, Prudential Rules following Capital Controls[6], is intended as a contribution to this discourse. It is important that these proposals will be used in a responsible and efficient manner. Amongst the proposals, there are tools intended to discourage the growth of the banking system, since the importance of preventing the banking system from overwhelming the overall economy is one of the most important lessons of the banking collapse. In addition, the overall frame of the financial system must be formed so that it will provide and efficient service for households and business. Financial markets can have a positive impact on economic growth as well as a negative impact, if allowed to

[6] *http://www.cb.is/library/Skráarsafn---EN/Reports/Sérrit%20nr%20%206%20Prudential.pdf*

develop in excess.[7] Nonetheless, regard must be had to Iceland's commitments under the EEA Agreement, since some of the proposals in the Central Bank's report may not be in accordance with the EEA Agreement. In such circumstances, the overall interests of the economy of its membership in the inner market of the EEA must be borne in mind.

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[7] *Stephem G. Cecchetti og Enisse Kharroubi. Reassessing the impact of finance on growth. IMF, July 2012.*