I. ECONOMIC ENVIRONMENT

(1) OVERVIEW

1. Iceland's economic growth has averaged around 3.6% per year since its last Review in 2000. Per capita GDP is US$33,500, one of the world's highest. Growth slowed and then declined in 2001-02, but resumed in 2003; it has been led mostly by domestic demand, particularly large-scale investment projects in the aluminium and power subsectors, and buoyant private consumption. As growth gained momentum in 2004, signs of overheating manifested themselves in rising inflation, rapid credit growth, booming asset prices, a widening current account deficit, and rising external indebtedness. In this context, monetary policy has been tightened, and the fiscal stance has become more restrictive. There is a risk that growing imbalances could spark a sharp correction in the exchange rate, which, in the context of high external indebtedness, could result in a significant retrenchment in domestic demand.

2. Iceland's economy has historically been markedly volatile, partly due to its size and strong dependence on a handful of export goods (fisheries and energy-intensive products). Major investments in the energy and aluminium industries have also contributed to volatility due to their lumpiness and size relative to the economy. However, there has been a decline in the volatility of real GDP growth, exports, and private consumption since the early 1990s, reflecting the increased diversification of the economy, and the implementation of structural reforms and improved macroeconomic policies. Iceland's public finances are sound. Monetary policy has been conducted within an inflation targeting framework since 2001.

3. EEA membership seems to have had an effect on Iceland's export pattern, which is increasingly dominated by the European Union (EU). The share of merchandise trade in GDP has remained relatively stagnant since at least 1980, and is low for a small economy like Iceland's. On the other hand, services trade has been very dynamic in recent years, as has been direct investment, both inward and outward.

(2) STRUCTURE OF THE ECONOMY, OUTPUT, AND EMPLOYMENT

4. The contribution of the agriculture sector to output has shrunk mildly since Iceland's last Review, as has manufacturing (excluding fish processing) (Table I.1). The share of fishing and fish processing in GDP has fluctuated, but overall has also declined. The weight of the service sector has continued to increase, reaching around 80% of GDP in 2004.

5. Following a period of strong growth between 1996 and 2000, real GDP growth slowed in 2001 and declined in 2002 (Table I.2). The economic slowdown happened in the context of deteriorating global economic conditions and a reversal of capital flows into Iceland. Growth recovered swiftly in 2003, and has remained strong; it has been led mostly by domestic demand, although exports have picked up since 2004. The increase in domestic demand is being driven by increased private investment and consumption.

6. Fixed investment increased by around 20% per year during 2003-04 (Table I.2). It is estimated to grow at an even faster pace in 2005. The sharp increase in private investment since 2003 largely reflects large-scale projects in the aluminium and power subsectors (Chapter IV(5)). These projects, which are scheduled to be completed in 2008, amount to around one quarter of GDP.[1]

[1] Central Bank of Iceland (2005a).

Table I.1
Gross domestic product by industry, 1999-04
(Per cent)

	1999	2000	2001	2002	2003[a]	2004[b]
Agriculture	1.9	1.9	1.5	1.6	1.5	1.4
Fishing, operation of fish hatcheries and fish farms	7.7	7	7.7	7.8	6.6	6
Mining and quarrying	0.2	0.1	0.1	0.1	0.1	0.1
Manufacturing	14	13.6	14.6	12.9	12.3	12.3
Fish processing	3.3	2.8	4.6	2.9	2.7	2.7
Electricity, gas and water supply	3.5	3.4	3.7	3.7	3.6	3.4
Construction	7.7	8.3	7.6	7.1	8	8.7
Wholesale and retail trade	12.5	12.1	10.6	10.7	11.2	11.5
Hotels and restaurants	1.6	1.7	1.7	1.6	1.6	1.6
Transport, storage and communication	8	8.1	8	8.5	7.7	7.9
Financial intermediation	5.7	6.3	7	7.3	7.5	7.3
Real estate, renting and business activities	12.9	13.5	13.5	14.1	14.3	14.6
Public administration; compulsory social security	5.9	5.8	5.5	5.7	5.8	5.6
Education, health, and other services	18.4	18.2	18.6	19	19.8	19.4
Total[c]	100	100	100	100	100	100

a Preliminary.
b Estimated.
c May not add to 100 due to rounding.

Source: Statistics Iceland online information. Available at: http://www.statice.is/?pageid=1271&src=/temp_en/thjodhagsreikningar/framleids luuppgjor.asp [26 January 2006].

7. Private consumption increased by around 6% per year during 2003-04 (Table I.2). The year-on-year increase in the first two quarters of 2005 was almost 12%. Private consumption has been bolstered by the confidence and income effects of the large-scale investment projects, the rise in housing prices, and a surging equity market. The easing of mortgage credit conditions following changes to the state-owned Housing Financing Fund and the entry of commercial banks into the mortgage market has amplified these effects (see Chapter IV(6)(iii)).

8. Disposable income growth, although brisk, has not kept pace with the evolution of private consumption in recent years, resulting in an increase in household indebtedness, to around 180% of disposable income in 2004, one of the highest among OECD countries. According to the IMF, Iceland's high level of household debt is explained largely by a high home-ownership rate, the well-funded pension system, and the young age of the population.[2]

9. Labour market pressures remained strong during 1999-01, reflecting brisk economic activity. The seasonally adjusted unemployment rate declined from 2.1% in early 1999 to 1.2% in October 2001. As growth slowed, the unemployment rate edged up towards the end of 2001, and remained at a relatively high level well into 2004. The number of vacancies during these two years increased, however, reflecting stronger labour demand that was partly met through imported labour.[3] The unemployment rate averaged 2.1% in 2005. Real wage gains have broadly kept pace with productivity since 1998.

10. Iceland's economic performance has been highly volatile relative to other OECD countries, due in part to the small size of the economy.[4] Nonetheless, the volatility of real GDP, private consumption, and exports between 1992 and 2003 decreased significantly compared with the period

[2] IMF (2005a).
[3] Sigurdardottir (2005).
[4] Central Bank of Iceland (2005a).

1970-91, through the increased diversification of the economy and improved macroeconomic management.[5] Further increases in aluminium exports when the on-going investment projects have been completed could add to volatility, especially as there is a strong correlation between aluminium prices and the global economic cycle.[6]

Table I.2
Basic macroeconomic indicators, 1999-05
(Percentage change, unless otherwise specified)

	1999	2000	2001	2002	2003	2004[a]	2005[b]
GDP (ISK billion, current prices)	615.1	669.2	750.0	782.3	811.2	885.0	988.7
Per capita GDP (US$, in PPP)	27,356	28,604	29,633	29,515	29,862	33,580	..
Mean population (thousands)	277.2	281.2	285.1	287.6	289.3	292.6	297.3
National accounts (constant prices)							
GDP	4.2	5.0	3.3	-1.3	3.6	6.2	4.7
Private consumption	7.8	4.1	-3.2	-1.8	5.8	6.9	11.1
Public consumption	4.9	4.4	3.1	5.0	1.5	2.8	3.0
Gross fixed investment	-3.8	14.7	-4.9	-19.6	20.5	21.0	31.0
Business sector	-5.6	15.1	-13.3	-26.2	28.4	23.3	55.8
Residential construction	0.6	12.9	15.4	5.0	16.1	5.7	11.8
Public	-0.7	14.7	8.0	-23.1	3.0	26.9	-11.2
Total domestic demand	4.3	6.6	-2.8	-3.8	7.2	8.4	13.3
Exports of goods and services	3.9	4.3	7.4	3.9	1.4	8.3	3.6
Imports of goods and services	4.3	8.5	-9.1	-2.6	10.7	14.2	24.5
Net national disposable income	3.9	3.5	1.7	2.6	0.4	5.4	..
Employment, wages, and prices							
Unemployment (% labour force)	1.9	1.3	1.4	2.5	3.4	3.1	..
Nominal wage index (1988=100)	6.8	6.6	8.8	7.2	5.6	4.7	6.8
Consumer price index	3.4	5.0	6.7	4.8	2.1	3.2	4.0[c]
Other indicators							
Net savings (current prices, % of GDP)	2.9	1.7	4.9	6.3	2.7	2.2	..

.. Not available

a Preliminary.
b Estimate.
c November.

Source: Statistics Iceland online information. Available at: http://www.sedlabanki.is/?PageID=234 [7 March 2006]; and Central Bank of Iceland (2005b). Available at: http://www.sedlabanki.is/?PageID=234.

11. Although Iceland's average productivity growth of around 3% per year during 1995-04 is among the fastest in the OECD, hourly productivity remains below the EU and OECD averages. Thus, Iceland's high per capita GDP reflects high labour utilization, rather than high productivity levels.[7] In turn, Iceland's high labour utilization is the result of its high labour-force participation rate and late retirement age relative to other OECD countries. The aluminium-related investments should raise overall productivity, since productivity in this industry is higher than the average for the economy as a whole.[8]

[5] OECD (2005a).
[6] Gudmundsson, M. F. (2005).
[7] OECD (2005a).
[8] Ministry of Finance (2003).

(3) MONETARY AND EXCHANGE RATE POLICIES

12. The goal of monetary policy is price stability. A new monetary policy framework was put in place in March 2001, when the Government announced that monetary policy would be conducted within an inflation-targeting framework.[9] Although price stability had been the main goal of monetary policy since the early 1990s, this goal was pursued within a nominal exchange rate-targeting framework prior to 2001.[10] According to the Central Bank, the decision to adopt inflation targeting was taken partly because of the difficulties associated with maintaining an exchange rate target in the context of increased capital mobility since the mid 1990s.[11] Additionally, the Central Bank indicated that the implementation of an exchange rate target had sometimes been at odds with the objective of price stability, most recently in 1999-00.

13. Under the new monetary policy framework, price stability is defined as a 12-month rise in the consumer price index of 2.5%, subject to a 1.5 percentage point tolerance band. The Central Bank must present a report to the Government whenever the rate of inflation deviates from the tolerance band, explaining the reasons for the deviation, and the Bank's policy response.

14. The Central Bank relies primarily on the interest rate on its 14-day repurchase agreements with credit institutions to attain its inflation target. As of 2006, the Central Bank announces its interest rate decisions according to a pre-determined schedule and procedure.[12]

15. Following the announcement of a new monetary policy framework, Iceland adopted a new Central Bank Act in 2001.[13] The Act defines the objective of the Central Bank as the promotion of price stability. The Central Bank may promote other government policies only to the extent that they are consistent with the achievement of price stability.[14] The Central Bank must seek the Prime Minister's agreement when determining the target for the inflation rate, though not when deciding on the policies to achieve that target.[15] In contrast to earlier legislation, the Central Bank must not grant credit to the government.[16]

16. The Central Bank has indicated that, following the adoption of the new Central Bank Act, its independence is similar to that of central banks in other OECD countries.[17] A 2000 study had found that the Central Bank of Iceland was one of the least independent of 94 central banks.[18]

17. A tight monetary policy stance prevailed between 1999 and 2001. Beginning in 2002, the Central Bank cut its policy rate gradually through early 2003, resulting in a broadly neutral stance (Table I.3).[19] Since 2004, the Central Bank has reverted to a tight monetary stance by raising the repurchase rate by almost five percentage points, to 10.75% (January 2006).

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[9] Central Bank of Iceland (2002).
[10] See WTO (2000).
[11] Central Bank of Iceland (2002).
[12] Central Bank of Iceland online information, "Interest rate decision by the Board of Governors of the Central Bank of Iceland on Thursday, January 26, 2006". Available at: http://www.sedlabanki.is/?PageID=287&NewsID=1103 [27 January 2006].
[13] Act on the Central Bank of Iceland, No. 36/2001, 18 May 2001.
[14] Article 3, Act No. 36/2001.
[15] Article 3, Act No. 36/2001.
[16] Article 16, Act No. 36/2001.
[17] Central Bank of Iceland (2001).
[18] Central Bank of Iceland (2001).
[19] Central Bank of Iceland (2004a).

18. The introduction of inflation targeting implied the adoption of a floating regime for the króna, which previously had been subject to a peg.[20] After a sharp slide in 2000 and 2001, the króna strengthened significantly, reflecting the increase in capital inflows connected with the large-scale investments, the widening short-term interest rate differential between Iceland and the rest of the world (Table I.3).

Table I.3
Selected monetary and exchange rate indicators, 1999-05

	1999	2000	2001	2002	2003	2004	2005
Money and credit (end of period, % change)							
Base money	75.9	-10.4	-14.2	17.2	-33.5	77.7	23.0
M3	17.1	11.2	14.9	15.3	17.5	15.0	23.4
Interest rates (end of period, %)							
Central Bank policy rate	9.0	11.4	10.1	5.8	5.3	8.25	10.25[a]
3-month Treasury bills	9.8	11.5	10.0	5.8	4.8	7.4	9.1
10-year Treasury bonds	4.7	5.5	5.1	4.9	4.3	3.6	7.75
Exchange rate							
ISK per US$	72.61	79.02	97.95	91.81	76.94	70.29	63.32
Nominal effective exchange rate[b] (% change)	0	0.2	-16.6	2.5	6.2	1.8[c]	9.1[d]
Real effective exchange rate[b] (% change, based on CPI)	1.8	2.9	-13.0	5.7	6.3	3.2[c]	10.8[d]

a October.
b A "-" sign indicates depreciation.
c Preliminary.
d Forecast.

Source: Central Bank of Iceland (2005b). Available at: http://www.sedlabanki.is/?PageID=234 [7 March 2006].

19. Real exchange rate appreciation has helped the Icelandic economy to accommodate the large-scale investment projects in aluminium and power. This has led some analysts to observe that Iceland is experiencing symptoms of "Dutch disease".[21] Others have argued that Iceland has suffered from "Dutch disease" for a long time, as reflected in a stagnant export-to-GDP ratio of around 33% since at least 1945, among other factors.[22]

20. After an initial burst following the 2001 depreciation of the króna, the 12-month rate of CPI inflation receded in 2002, remaining close to the Central Bank's target of 2.5% in 2003 (Table I.2). The following year, inflation edged up sharply, reflecting cost and demand pressures. Cost pressures arose from higher oil and commodity prices; demand pressures were felt mostly in the housing market. Housing prices accounted for roughly half of the total CPI increase in 2004.[23] Price pressures continued to mount in 2005, although they have been dampened somewhat by lower import prices, aided by a substantial exchange rate appreciation. However, during 2005, inflation twice exceeded the Central Bank's ceiling of 4%. Housing prices accounted for the bulk of inflation.

(4) FISCAL POLICY

21. The process of fiscal consolidation undertaken by Iceland in the 1990s has resulted in a sound fiscal position.[24] However, the overall fiscal balance deteriorated between 1999 and 2003, from a

[20] See WTO (2000).
[21] The term "Dutch disease" refers to a situation in which currency inflows and the use of limited labour and capital to develop a new export industry tend to squeeze existing industries (see Gudmundsson, 2005).
[22] Gylfason (2001).
[23] Central Bank of Iceland (2005c).
[24] IMF (2005b); and OECD (2005a).

surplus of 2.4% of GDP to a deficit of around 2.1%. The IMF estimates that about half of this change was the result of automatic stabilizers; the remainder reflects increases in health, education, and social spending.[25] The fiscal stance was tightened in 2004, and a surplus achieved again (Table I.4).

22. The Ministry of Finance forecasts a surplus of 3.8% of GDP in 2005; in cyclically adjusted terms this surplus is estimated at 3.4% of GDP, which exceeds the surplus realized during the late 1990s.[26] Several tax reduction measures will be implemented from 2006.[27] The Ministry of Finance considers that the current fiscal stance is adequate under current economic conditions, and that increased flexibility following the implementation of a new monetary policy framework and structural reforms has enhanced the economy's ability to adjust to macroeconomic imbalances.[28]

23. The share of public debt in GDP has declined significantly in recent years. It was at 44% in 2004, down from 60% in 1995.

Table I.4
General government finances, 1999-05
(ISK billion, unless otherwise specified)

	1999	2000	2001	2002	2003[a]	2004[a]	2005[b]
Total revenue	**278.6**	**301.1**	**328.5**	**350.6**	**368.4**	**416.7**	**476.8**
Direct taxes	115.6	128.8	149.3	157.5	168.7	188.6	214.4
Indirect taxes	124.5	131.0	129.7	133.1	144.3	167.0	191.4
Interest income	8.7	10.2	14.6	19.5	13.6	14.2	15.4
Other income	6.0	5.8	6.8	7.6	5.1	7.9	14.4
Sales of goods and service	23.8	25.4	28.0	32.9	36.7	39.0	41.2
Total expenditure	**264.0**	**284.6**	**327.2**	**357.1**	**385.1**	**417.2**	**444.6**
Operational costs	166.3	183.3	204.7	233.4	248.3	265.2	285.9
Interest expenditure	22.7	22.6	28.6	25.1	25.7	25.7	26.4
Subsidies	10.0	10.8	12.8	12.7	12.5	12.8	13.4
Income transfers	42.7	47.2	53.8	63.9	77.6	79.8	87.6
Gross investment	26.1	25.8	32.0	26.6	26.1	37.3	36.7
Depreciation (-)	12.6	13.5	14.5	15.2	16.0	17.2	18.6
Capital transfers	8.8	8.4	9.9	10.7	11.1	13.4	13.2
Financial balance	**14.6**	**16.6**	**1.3**	**-6.6**	**-16.7**	**-0.5**	**32.1**
Percentage of GDP							
Revenue	45.3	45.0	43.8	44.8	45.4	47.1	49.0
Expenditure	42.9	42.5	43.6	45.7	47.5	47.1	45.7
Revenue balance	2.4	2.5	0.2	-0.8	-2.1	-0.1	3.3
Taxes	39.0	38.8	37.2	37.1	38.6	40.2	41.7
Public consumption	23.2	23.6	23.6	25.6	26.1	25.6	25.1

a Provisional.
b Forecast.

Source: Ministry of Finance online information. Available at: http://eng.fjarmalaraduneyti.is/statistics [January 2006].

[25] IMF (2003).
[26] Ministry of Finance (2006).
[27] The tax cuts will be phased in through 2007. Net wealth taxes will be eliminated in 2006; the main rate of the personal income tax will be reduced from 25.75% in 2004 to 21.75% in 2007. The annual cost of these measures is estimated at around ISK 20 billion or 2% of projected GDP for 2005, taking into account the expansionary side effects of the measures.
[28] Ministry of Finance (2005).

(5) BALANCE OF PAYMENTS

24. The economic boom of the late 1990s was accompanied by a sizeable current account deficit that reached 10% of GDP in 2000 (Table I.5). After a surplus during the 2002 recession, the current account moved back into deficit. Initially, this reflected depressed export revenues, following declines in fish catch and prices, and rising imports. Although exports have recovered, the merchandise trade deficit widened rapidly after 2002 as a result of accelerating imports of consumer and investment goods. The deficit in the services balance has also expanded significantly. The deficit in the income balance has been contained in part due to the strong growth in reinvested earnings from companies located overseas.

Table I.5
Balance of payments, 1999-05
(ISK million)

Year	1999	2000	2001	2002	2003	2004	2005[a]
Current account	**-42,833**	**-69,035**	**-33,093**	**10,361**	**-41,039**	**-85,313**	**-164,060**
As % of GDP	-7.0	-10.3	-4.4	1.3	-5.1	-9.6	-15.0[b]
Exports of goods and services	212,166	229,520	299,412	305,474	288,227	316,291	313,216
Imports of goods and services	-241,482	-278,637	-306,897	-292,110	-313,277	-367,265	-446,457
Income and transfer, net	-13,517	-19,918	-25,608	-3,003	-15,989	-34,339	-30,819
Balance on goods	-22,382	-37,480	-5,936	14,082	-15,900	-36,547	-93,039
Merchandise exports f.o.b.	144,928	149,272	196,582	204,303	182,580	202,373	194,356
Merchandise imports f.o.b.	-167,310	-186,752	-202,518	-190,221	-198,480	-238,920	-287,395
Balance on services	-6,934	-11,637	-1,549	-718	-9,150	-14,427	-40,202
Exports of services, total	67,238	80,248	102,830	101,171	105,647	113,918	118,860
Transportation	30,819	38,721	46,986	48,477	50,195	63,232	62,354
Travel	16,070	17,967	22,881	22,835	24,531	26,079	25,752
Other receipts	20,349	23,560	32,963	29,859	30,921	24,607	30,754
Imports of services, total	-74,172	-91,885	-104,379	-101,889	-114,797	-128,345	-159,062
Transportation	-25,622	-32,697	-36,721	-38,610	-39,685	-48,799	-56,244
Travel	-31,487	-37,082	-36,401	-33,406	-39,818	-48,501	-61,232
Other expenditures	-17,063	-22,106	-31,257	-29,873	-35,294	-31,045	-41,586
Balance on income	-12,792	-19,156	-24,649	-4,173	-14,823	-33,159	-29,100
Receipts	9,328	11,603	16,914	27,160	28,548	32,515	93,485
Compensation of employees	4,901	5,516	5,772	5,417	6,236	5,624	4,639
Dividends & reinvested earnings	2,134	2,581	7,780	16,932	18,002	18,477	67,440
Interest payments	2,293	3,509	3,362	4,811	4,310	8,414	21,406
Expenditures	-22,120	-30,759	-41,563	-31,333	-43,371	-65,674	-122,585
Compensation of employees	-341	-844	-533	-702	-465	-817	-1,533
Dividends & reinvested earnings	-751	-1,266	294	821	-13,484	-29,379	-59,999
Interest payments	-21,028	-28,649	-41,324	-31,452	-29,422	-35,478	-61,053
Current transfer, net	-725	-762	-959	1,170	-1,166	-1,180	-1,719
Capital and financial account	**56,289**	**75,695**	**18,954**	**-60**	**16,340**	**127,793**	**178,183**
Capital transfer, net	-57	-222	362	-122	-402	-234	-1,691
Financial account	56,346	75,917	18,592	62	16,742	128,027	179,874
Financial account excl. reserves	61,692	70,123	13,773	5,726	40,143	142,257	184,594
Direct investment, net	-4,094	-17,510	-16,801	-21,306	-4,087	-134,506	-274,655
Abroad	-8,918	-30,969	-33,734	-29,646	-28,518	-179,754	-421,331
In Iceland	4,824	13,459	16,933	8,340	24,431	45,248	146,676
Portfolio investment, net	41,658	43,152	61,522	21,986	228,000	483,150	853,104
Assets	-32,392	-50,369	-5,643	-30,017	-45,320	-98,695	-210,898
Equities	-26,785	-49,947	-5,812	-25,735	-40,579	-104,293	-127,896
Debt securities	-5,607	-422	169	-4,282	-4,741	5,598	-83,002

Table I.5 (cont'd)

Year	1999	2000	2001	2002	2003	2004	2005[a]
Liabilities	74,050	93,521	67,165	52,003	273,320	581,845	1,064,002
Equities	3,026	-1,266	9,836	4,508	-5,598	20,200	4,526
Debt securities	71,024	94,787	57,329	47,495	278,918	561,645	1,059,476
Financial derivatives, net	166	-93	0	0	0	0	0
Other investment, net	23,962	44,574	-30,948	5,046	-183,770	-206,387	-393,855
Assets	-12,662	-7,112	-47,101	-30,426	-156,116	-237,570	-814,995
Liabilities[a]	36,624	51,686	16,153	35,472	-27,654	31,183	421,140
Reserve assets	-5,346	5,794	4,819	-5,664	-23,401	-14,230	-4,720
Net errors and omissions	-13,456	-6,660	14,139	-10,301	24,699	-42,480	-14,123
Memorandum items:							
Financial Account	56,346	75,917	18,592	62	16,742	128,027	179,874
Equity capital, net	-27,853	-68,723	-12,777	-42,533	-50,264	-218,599	-398,025
Net external debt	84,199	144,640	31,369	42,595	67,006	346,626	577,899
Monetary authorities	-5,356	16,446	-979	-841	-39,190	-14,181	-4,681
General government	5,708	16,331	42,323	17,479	-10,387	9,940	-32,210
Deposit money banks	46,691	69,891	-9,470	18,145	101,700	362,149	555,091
Other sectors	37,156	41,972	-505	7,812	14,883	-11,282	59,699

a Preliminary.
b Estimate by the Ministry of Finance (January 2006).

Source: Central Bank of Iceland online information. Available at: http://www.sedlabanki.is/?PageID=548 [7 March 2006].

25. The Central Bank expects the current account deficit to reach around 15% of GDP in 2005, up from around 9.6% in 2004 (Table I.5). Imports related to the large-scale investment in aluminium and power account for around half of the deficit; the rest is driven mainly by the torrid growth of private consumption.[29] The current account deficit reflects Iceland's growing investment and low savings rate (Table I.2). As noted in Iceland's last Review, efforts to increase national savings are likely to be required to achieve a reduction in the current account gap.[30]

26. The current account deficit is being financed by foreign borrowing, primarily by domestic banks. This borrowing has funded a rapid expansion of domestic credit in recent years. In 2005, for example, banks' lending to households almost doubled, while lending to firms increased by slightly less than one third. Thus, total external indebtedness has risen substantially: the net external debt was 130% of GDP in 2004, up from 70% in 1999. This high level of indebtedness entails the risk of losses in the financial system that could result from a sharp weakening of the exchange rate. However, this risk is reduced by the relatively low percentage of debt denominated in foreign currency (foreign currency lending in Iceland amounts only to around one fifth of total credit), the significant share of lending to firms with foreign currency revenue streams, and by banks' expansion abroad, among other factors.

(6) EXTERNAL TRADE

27. The share of merchandise trade in GDP is modest compared with other economies of similar size. In addition, it has remained relatively stagnant since at least the 1980s, at around 50%.[31] This could be explained partly by Iceland's status as an island, its relatively high transport costs, the large share of raw materials in Iceland's exports, and the low level of intra-industry trade. In contrast, the

[29] Central Bank of Iceland (2005b).
[30] WTO (2000).
[31] Based on balance-of-payments data.

weight of services trade in GDP has edged up since Iceland's entry into the EEA in 1994, from around 20% to 27% in 2004.

28. Merchandise exports increased at an average annual rate of almost 7% between 1998 and 2004 (in nominal terms); they amounted to some US$2.8 billion in 2004 (Tables AI.1 and AI.3). Imports expanded at an average annual rate of 8% during the same period, despite a relatively large decline in 2001; they amounted to some US$3.6 billion in 2004 (Tables AI.2 and AI.4).

29. Exports of commercial services (excluding government services) increased by almost 11% per year between 1998 and 2004, when they reached US$1.5 billion. The performance of transportation, and to a lesser extent, tourism, has been strong; exports of software have also been increasing.[32] Imports of services expanded by around 12% per year between 1998 and 2004, driven mostly by above-average growth in transportation; they amount to US$1.8 billion.

30. Food, mostly in the form of fish products, remains Iceland's most important export category, accounting for 62% of total merchandise exports in 2004 (Table AI.1). This share has been declining steadily since 1994, when it was around 80%. The share of manufacturing in total exports increased sharply between 1998 and 2004; exports of medicines and orthopaedic appliances have shown particularly strong growth.[33]

31. Machinery and transport equipment are the main import category, accounting for almost 40% of the total, but with some fluctuations (Table AI.2).

32. Iceland's main trading partner is the EU, which accounted for three-quarters of exports and 60% of imports in 2004 (Tables AI.3 and AI.4). The United Kingdom, Germany, and the United States have been the main individual destinations for Iceland's exports since 1998, accounting for almost half of the total on average, though the Netherlands has overtaken the United States in recent years. The main individual suppliers of imports were Germany, the United States, and Norway.

33. Iceland's EEA membership seems to have affected its export pattern significantly, particularly since 1998. The share of the European Union in Iceland's total exports increased by 10 percentage points between 1998 and 2004. This increase has been largely driven by a rise in exports of medicines, which in 2004 accounted for almost 6% of Iceland's exports to the EU, up from virtually zero in 1998. Manufactures represent almost 14% of Iceland's exports to the EU. The share of the United States in Iceland's total exports declined from around 13% to 9% between 1998 and 2004. During this period, the weight of manufactures in Iceland's exports to the United States increased from around 22% to around 31%, driven largely by higher exports of non-electrical machinery and orthopaedic appliances. The share of Japan, Iceland's main trading partner in Asia, has also decreased, although less sharply. In value terms, exports to the United States and Asia increased slightly between 1998 and 2004.

34. In contrast, Iceland's import pattern remains largely unchanged since it became an EEA member in 1994. The share of the European Union has hovered around 60%. The share of the United States, at around 10%, has remained relatively steady, while Norway's share (10%) has been subject to some fluctuations.

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[32] Ministry of Finance (2005).

[33] Exports of mining products, defined according to ISIC, are minimal, amounting to around US$5.4 million in 2004. The corresponding amount in Table AI.1 is significantly higher, since aluminium smelting is classified under mining, rather than manufacturing, following the SITC classification.

(7) FOREIGN DIRECT INVESTMENT

35. The stock of foreign direct investment (FDI) in Iceland increased around four-fold between 1999 and 2004, to ISK 121.9 billion (around €1.4 billion). This has been driven by large increases in the stock of inward FDI in manufacturing, and software and research, which accounted for slightly more than 90% of the total FDI stock in Iceland in 2004. Belgium and Luxembourg, and the United States accounted for around 60% of total FDI stock in Iceland in 2004.

36. Outward investment by Icelandic companies has also been very dynamic. Between 2003 and 2004, the stock of outward FDI practically doubled, to ISK 245 billion (around €2.8 billion), largely through the acquisition of financial firms abroad (Chapter IV(6)(iii)). In addition to financial services, outward FDI has been directed mostly towards manufacturing, and real estate and business activities; these accounted for slightly more than 80% of the total stock of Icelandic FDI abroad in 2004. The United Kingdom, Denmark, and Belgium and Luxembourg accounted for two thirds of the total stock of Icelandic FDI abroad in 2004.

(8) OUTLOOK

37. The Ministry of Finance expects real GDP to grow by about 5% in 2005, driven by domestic demand.[34] Although domestic demand is expected to slow down in 2006, the Ministry of Finance forecasts a similar rate of GDP growth for 2006, reflecting increased aluminium exports that will result from the entry into operation of some of the aluminium-related investments. GDP growth is expected to ease to 2.7% in 2007. Unemployment is expected to be 1.7% in 2006, and to increase by around one percentage point in 2007, reflecting the slowdown in economic growth. The current account deficit is forecast to decline slightly in 2006, to around 13% of GDP, given the growing level of external debt and the expected gradual rise of foreign interest rates; it is forecast to fall to 6% of GDP in 2007. The Central Bank expects inflation to remain above the 2.5% target through 2007, assuming no changes in the policy rate and the exchange rate from their levels in December 2005.[35] The Ministry of Finance expects the exchange rate to decline modestly in 2006.

38. Particular caution is required in predicting economic developments in an economy historically subject to strong fluctuations like Iceland's. This is illustrated by the significant market impact of a rating agency's revision of Iceland's outlook in February 2006.[36] In the wake of that revision, the króna fell by around 9% against the dollar in less than two days.

[34] Ministry of Finance (2006).
[35] Central Bank of Iceland (2005b).
[36] See "Fitch Ratings revises Iceland's outlook to negative", Central Bank of Iceland online information. Available at: http://www.sedlabanki.is/?PageID=287&NewsID=1124 [29 February 2006].