

# English translation of the Weekly Web Release



MINISTRY OF FINANCE IN ICELAND

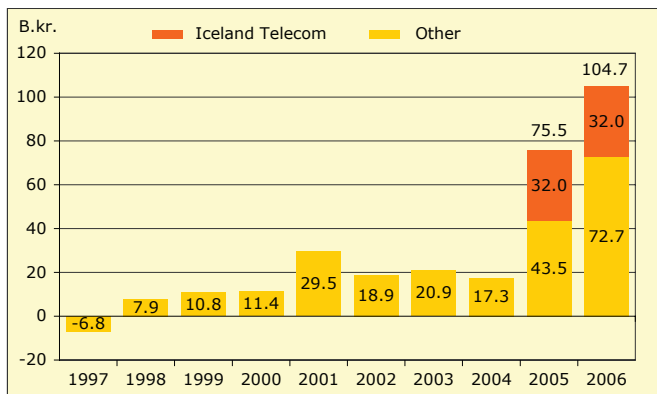
October 26<sup>th</sup> 2006

## Government assets at the Central Bank of Iceland

A recent [Weekly Web Release](#) dealt with the stabilisation role of fiscal policy in Iceland. It was pointed out that the restrictiveness of fiscal policy in Iceland was among the greatest of the OECD countries in recent years due to the successful management of Treasury finances. In that context it is worth noting that the large budget surpluses and privatisation proceeds have been used to reduce Treasury debt and increase Treasury net assets at the Central Bank. In this way these funds have been put on hold in order to restrain further expansionary tendencies in the economy. This article takes a closer look at the development of the government's Central Bank assets.

Until 1997, the Treasury net assets at the Central Bank were usually negative to the tune of 5-10 billion krónur. After the persistent budget deficits of the previous years had been overcome, however, the net assets of the Treasury at the Central Bank began to grow and reached around 30 billion krónur in 2001, when the last business cycle peaked. In the following years, GDP growth slowed down and net assets declined to 20 billion. When GDP growth became more vigorous in 2004, it was decided to increase substantially the amounts the government sets aside in this way.

Assets in the Central Bank of Iceland 1997-2006



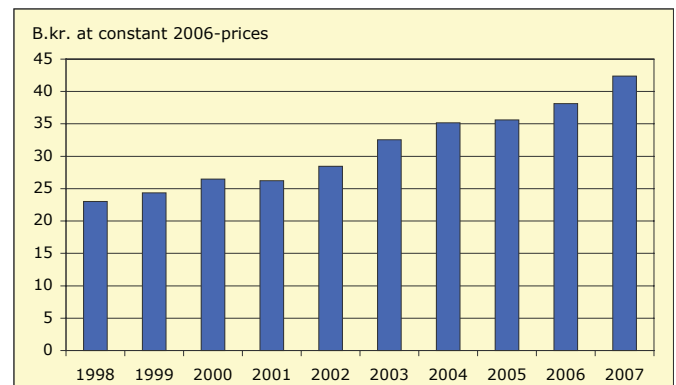
Last August, the net assets of the Treasury at the Central Bank reached around 105 billion krónur, equivalent to 10 per cent of GDP. It is safe to say that the government has never before had such a large net asset position at the bank. Around one third of the assets is due to the successful privatisation of Iceland Telecom in 2005, amounting to 67 billion krónur. It was decided to immobilize 32 billion thereof in bonds issued by the Central Bank for a few years, while most of the remainder was used to trim down Treasury debt and thereby reduce interest payments. Around two thirds of the current assets, about 73 billion krónur, are derived from budget surpluses due to the operation of automatic stabilisers and the restrictive stance of Treasury finances, mostly during the upswing in 2005 and 2006. According to the Treasury's medium-term plan and laws enacted in 2005, part of the funds will be used to off-set an expected contraction in business investment in 2007-2010. Government investment will be increased, in particular in the transportation system and health sector, amounting to around 32 billion krónur, which corresponds to the bonds issued on the basis of the proceeds from the sale of Iceland Telecom.

The reserves discussed here provide the government, if necessary, with greater scope for manoeuvre to withstand a reduction in revenue associated with lowering taxes on food items and, perhaps, temporary increases in government expenditure if GDP growth proves to be lower than forecast. The stabilising impact of fiscal policy is therefore largely reflected in the Treasury's net asset position at the Central Bank. It is noteworthy that, at the same time that these large assets have been accumulated, the personal income tax has been lowered, the debt of the Treasury has been reduced substantially and large amounts have been deposited with the Pension Fund for State Employees.

## Expenditure on public pensions

In the 2007 budget proposal the expenditure on public pensions is expected to be 44 billion kronur including household supplements. Between the years 1998 and 2007 the expenditure on public pensions has increased by 84% in real terms. The increase is explained by the increase in the numbers of disability benefit recipients and special targeted rise in public pensions. It is expected that between the years 1998 and 2007 the number of disability benefit recipients will increase by 77% which is about 6,000 individuals. In the same period it is expected that the number of old age pensioners will increase by 12% and at the same time the expenditure on public pensions to that group will have increased by 56% in real terms.

Expenditure on public pensions 1998-2007



## Medium-term plan for Treasury finances 2007-2010

In the Government's budget proposal for 2007 a [medium-term plan for Treasury finances for the years 2007-2010](#) was introduced. The Government has increasingly adopted an economic policy stance that looks several years ahead in order to strengthen the credibility of economic policy and contribute to economic stability. The drafting of such policy objectives are laid out in the Government Financial Reporting Act of 1997 where it is stated in Article 28:

"Medium-term plan. A projection of government finances for the next three years following the next fiscal year shall accompany the fiscal budget bill each year. It shall outline the prospects for government finances with a view towards general economic conditions on one hand and the policy of the government with respect to fiscal finances on the other. The projection shall include an assessment of the fiscal impact on the economy and employment, intentions for the procurement of revenue and the division of expenditure, appropriations for investment and a summary of the government's debt operations and debt service. Once the fiscal budget bill has been passed into law the medium-term projection shall be reviewed and placed before the Althingi if significant changes have taken place in its premises."

The Government first set out its medium-term policy objectives for Treasury finances in the next four years, i.e. for the fiscal year 2004 and the following three years. The fiscal policy objectives were based on the Government's Policy Statement of May 23<sup>rd</sup> 2003. The medium-term plan has since been updated each year.

The following table shows the main elements of Treasury finances for the years 2007-2010. It is important to keep in mind that the forecast presented is based on many uncertain assumptions concerning both domestic and international factors.

Treasury finances 2007-2010 (% of GDP)

	2007	2008	2009	2010
Total revenue	31.7	30.1	29.8	29.6
Total expenditure	30.4	30.5	30.0	29.5
Financial balance	1.3	-0.4	-0.3	0.1

Treasury revenue January-August		
12 month changes (%)	2005	2006
Total tax revenue	18.5	14.9
Taxes on income & profit	15.7	29.7
Taxes on property	50.3	-33.3
Taxes on goods & services	18.6	10.5
Social contributions	16.6	15.5
Total revenue	21.1	12.2

Treasury expenditure January-August		
12 month changes (%)	2005	2006
General public services	22.1	-15.7
Health	7.9	7.6
Social security & welfare	3.5	5.2
Economic affairs	-4.0	1.9
Education	15.0	14.4
Total expenditure	7.6	2.9

Treasury finances January-August		
Million krónur	2005	2006
Cash from operations	16,298	35,558
Net financial balance	27,558	33,219
Debt redemption	-33,363	-32,592
Gross borr. requirement	-8,406	-2,013
Net borrowing	15,832	25,247
Overall cash balance	7,426	23,234

Economic indicators		
12 month changes (%)	2005	2006
Inflation (October)	4.8	7.6
Core inflation (October)	4.9	7.2
Wage index (September)	6.9	10.8
Total turnover (Jan. - June)	8.0	12.5
Retail turnover (Jan. - June)	6.4	5.1
Unemployment rate, sa (Sept.)	1.7	1.2