



# Icelandic Economic Update

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## Cuts in expenditure

- The government's draft budget for next year was presented on Friday. According to the draft the treasury is set to return a deficit of ISK 36 billion in 2011, compared with a deficit of ISK 75 billion this year. The treasury is expected to generate a surplus from 2012 onwards. The surplus stems from the revenue side only, as revenues are expected to increase by ISK 55-66 billion in 2012-2013, which is interesting in light of the moderate assumptions for economic growth in the next few years. There are plans to issue treasury notes worth ISK 37 billion net in 2011 according to the new draft budget presented on Friday. Based on the expected fiscal deficit (ISK 36 billion) it is clear that the state is planning to bridge the gap entirely by issuing treasury notes, while leaving its deposits at the Central Bank untouched.

## Calendar

Date	Title	Period
8 October 2010	Auction Treasury Bonds	September 2010
12 October 2010	Unemployment figures	
13 October 2010	Auction Treasury Bills	
22 October 2010	Auction Treasury Bonds	October 2010
27 October 2010	Consumer Price Index	

## Cuts in expenditure

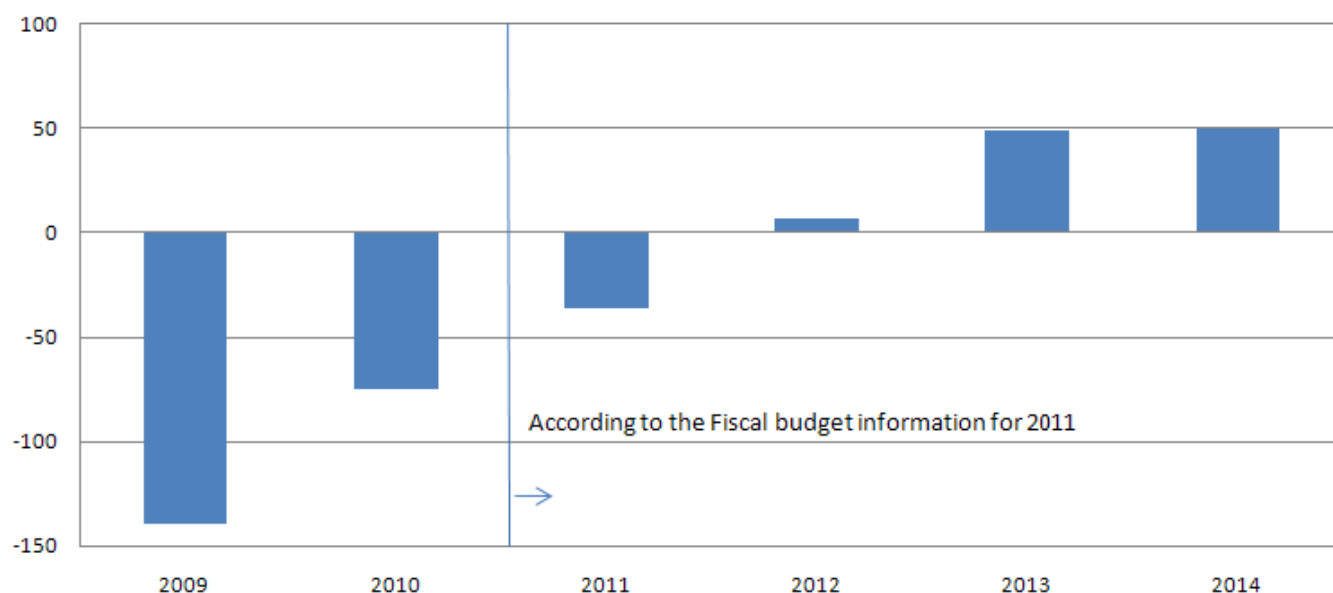
The government's draft budget for next year was presented on Friday. According to the draft the treasury is set to return a deficit of **ISK 36 billion in 2011**, compared with a deficit of ISK 75 billion this year. The lion's share of the adjustment is made on the expenditure side (or  $\frac{3}{4}$ ). The treasury's revenues in 2011 are estimated at ISK 477 billion and expenditure at ISK 514 billion. It is notable that the government's assumptions for turning the deficit into a surplus in 2012 and 2013 seem to be based on an extensive increase in revenues at a time when economic growth remains low – in other words the fiscal budget for 2012 and 2013 seems to be based on a further increase in taxes.

### Cuts in 2011 will amount to ISK 44 billion

The overall cuts total ISK 44 billion, divided as follows.

- **Cuts of ISK 33 billion.** Operating expenses (wages and other expenses) contract by more than ISK 11 billion. Consumption and operating transfers fall by ISK 9 billion, including unemployment benefit, child benefits, mortgage interest allowance and parental leave. Moreover, public-sector road construction will be limited next year as expected, with an estimated drop of more than ISK 8 billion between years.
- **Tax hikes of ISK 11 billion.** No changes will be made to income and consumer taxes, those taxes having played a major role in the adjustment process in recent years and having also reduced household disposable income. However, taxes on the capital and assets of households and companies will be raised. Thus, capital income tax will be raised along with inheritance and wealth taxes. Moreover, a special excise tax on liquor and tobacco will be levied on duty free goods next year.

### Treasury balance (in ISK billion)

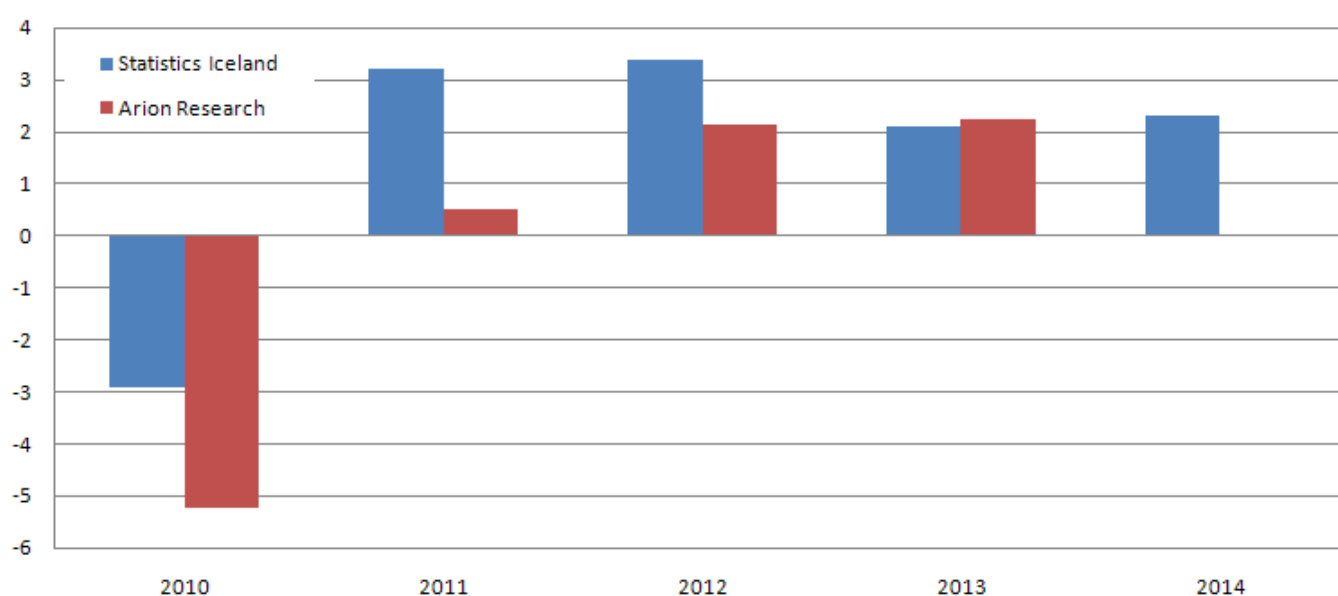


Source: Ministry of Finance

### What if assumptions are not accurate?

The treasury's revenue side is based on a macroeconomic forecast published by Statistics Iceland in June. The forecast predicts more than 3% economic growth next year, driven by a robust turnaround in private consumption and business sector investment. In our opinion, the forecast for economic growth next year is on the optimistic side as purchasing power has fallen and is unlikely to recover sufficiently next year. Further, unemployment is still high and household expectations are downbeat. Similarly, the outlook is for minimal construction projects and it is unlikely that aluminium sector investments at Helguvík will go ahead, although they are included in Statistic Iceland's forecast assumptions. On the other hand, investments in the Straumsvík plant will be somewhat more extensive than had been anticipated. However, what remains is that if economic growth turns out to be lower than forecast by Statistics Iceland it is clear that further austerity measures are needed to achieve set targets for a balance in state finances, whether it be in the form of tax hikes or further cost cutting.

#### Economic growth forecast (%) - real changes in GDP between years

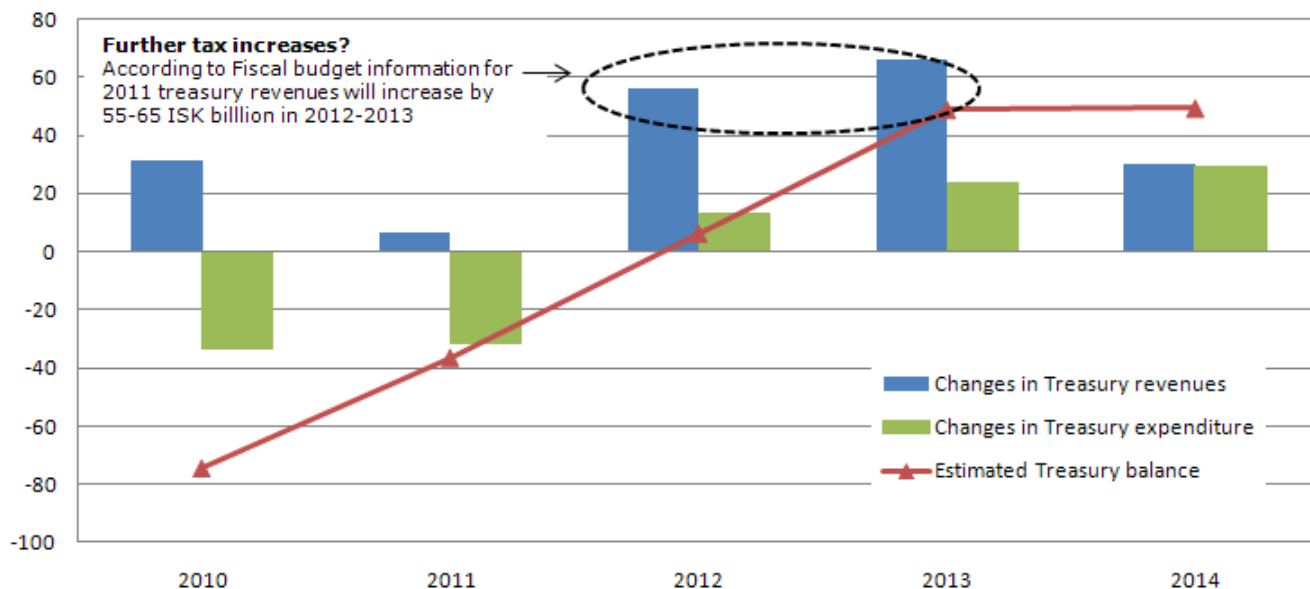


Source: Statistics Iceland & Arion Research estimates

### Are further tax increases imminent?

The treasury is expected to generate a surplus from 2012 onwards. As illustrated in the figure below the surplus stems from the revenue side only, as **revenues are expected to increase by ISK 55-66 billion in 2012-2013**, which is interesting in light of the moderate assumptions for economic growth in the next few years. (Economic growth is expected to be 2-3% until 2014). In view of the outlook for economic growth, it is therefore clear that such an extensive increase in revenues cannot materialise unless taxes are increased further in 2012-2013. The question arises therefore whether the long-term plan published simultaneously to the draft budget includes tax hikes for the next few years.

### Treasury balance - changes between years

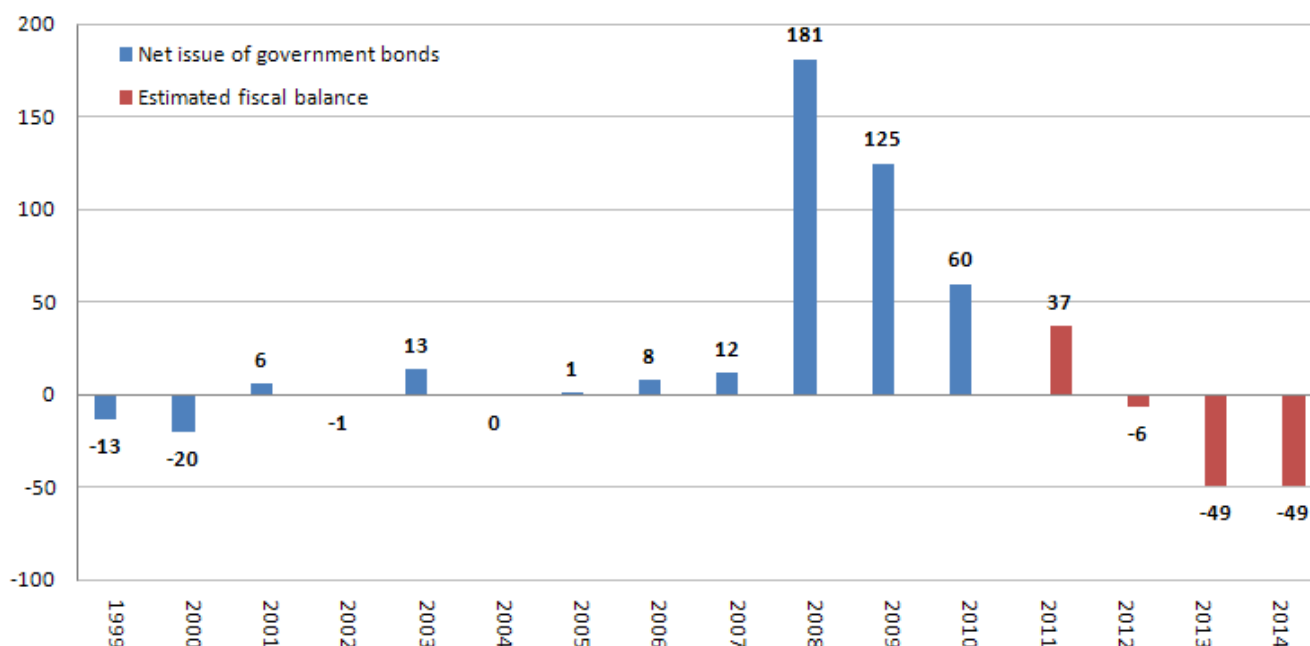


Source: Ministry of Finance

### Limited supply of treasury notes next year

There are plans to issue treasury notes worth **ISK 37 billion net in 2011** according to the new draft budget presented on Friday. Based on the expected fiscal deficit (ISK 36 billion) it is clear that the state is planning to bridge the gap entirely by issuing treasury notes, while leaving its deposits at the Central Bank untouched. When looking at the plan for balancing state finances in the next few years it appears that the treasury is expected to return a surplus from 2012 onwards, which means that the state will then no longer need to raise funds in the bond market to bridge its deficit. If nothing else changes, net issuance of treasury notes in 2012-2014 can therefore be expected to be negative, provided the plan according to the draft budget goes ahead.

### Net issue of government bonds (in ISK billion)



Source: Ministry of Finance

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