Box VII-1

Changes in Central Bank forecasts of the trade balance

According to Statistics Iceland, the trade surplus measured 8.5% of GDP in 2011. The Central Bank's current baseline forecast assumes that the surplus will be 6½% this year, just over 7% in 2013, and about 6½% in 2014. Although this is a somewhat larger surplus than was forecast in August, it is considerably smaller than in the Bank's November 2011 forecast, which provided for a surplus of 10% of GDP or more for all three years.

It turns out that the surplus in 2011 and 2012 was smaller than in the *Monetary Bulletin* 2011/4 forecast primarily because of adverse developments in terms of trade; that is, developments in export prices versus import prices have been more negative than was assumed in the 2011 forecast.[1] Another reason for the smaller surplus in 2011 and 2012 is the strength of import growth, which is due mainly to stronger imports of ships and aircraft than predicted in *Monetary Bulletin* 2011/4. The outlook for a smaller surplus this year explains in large part why a smaller surplus is expected next year, and this largely explains the smaller surplus in 2014. As a result, it is not assumed that the developments causing the smaller surplus in 2012 will reverse. Neither is it assumed that terms of trade will deteriorate further than was projected in November 2011 nor that developments in external trade will prove more disadvantageous than was forecast at that time.

Breakdown of forecast deviations in the trade balance

The trade balance is defined as the difference between the nominal value of exports and imports of goods and services:

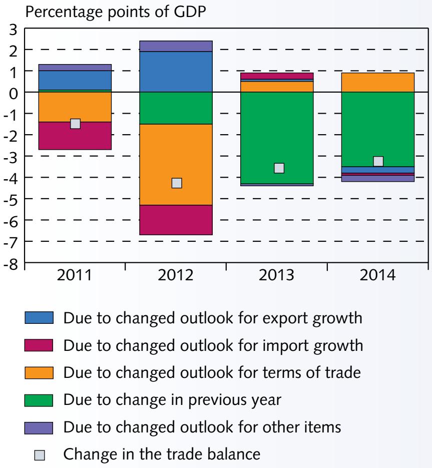
$$T = PX \times X - PM \times M$$

where T is the trade balance at current prices, PX is the price level of exports in Icelandic krónur, X is the volume of exports, PM is the price level of imports in Icelandic krónur, and M is the volume of imports.

1. It is well known that countries highly dependent on exports of commodities and food products, such as Iceland, must usually tolerate relatively volatile terms of trade, which can cause fluctuations in the trade balance.

Chart 1

Changes in the outlook for the trade balance between MB 2011/4 and MB 2012/4



Sources: Statistics Iceland, Central Bank of Iceland.

If t is defined as the trade balance as a share of GDP, $t = T/(PY \times Y)$, where PY is the price level of GDP, Y is GDP at constant price levels, the ratio in year 1 can be expressed as:

$$t_1 = t_0 + \{[(1+\dot{p}_x)(1+\dot{x}) - (1+\dot{p}_m)(1+\dot{m})]sm_0 + [(1+\dot{p}_x)(1+\dot{x}) - (1+\dot{p}_y)(1+\dot{y})]t_0\}/[(1+\dot{p}_y)(1+\dot{y})]$$

where the dot over the variable represents the proportional change in the variable concerned, t_0 is the trade balance as a share of GDP in year 0, and sm_0 is imports as a share of GDP in year 0; that is, $sm = PM \times M/(PY \times Y)$.

It is possible to use this equation to analyse why the outlook for the trade balance has changed in the Bank's forecasts; e.g., in the current forecast as compared with the Bank's forecast from the same time last year. As Chart 1 indicates, the 1.5 percentage point smaller surplus in 2011 is due to the deterioration in terms of trade, which accounts for 1.4 percentage points, and stronger import growth than previously assumed (which is attributable largely to stronger services imports), which accounts for 1.3 percentage points. Export growth was somewhat stronger than projected, however, which improves the surplus by 0.9 percentage points.

In addition, this year's forecast of a 4.3 percentage point decline in the surplus as compared with the November 2011 forecast is due principally to poorer terms of trade. For instance, 3.8 percentage points of the smaller surplus can be attributed to poorer terms of trade, while 1.5 percentage points can be traced to a smaller surplus in 2011 and 1.4 percentage points to stronger import growth (owing mostly to stronger imports of ships and aircraft) than previously forecast. Offsetting this is the outlook for considerably stronger export growth than was projected in *Monetary Bulletin* 2011/4 (mostly due to stronger marine product exports), which improves the surplus by 1.9 percentage points. To a large extent, the smaller surplus in 2013 and 2014 is explained by a smaller surplus in the previous year.