Iceland—2008 Article IV Consultation
Concluding Statement

July 4, 2008

This document contains the conclusions of the IMF mission that visited Iceland during June 23—July 4, 2008. The mission team would like to thank all participants in the meetings for excellent cooperation, frank discussions, and the usual warm hospitality.

Introduction

1. The Icelandic economy is prosperous and flexible. Per capita income is among the highest and income inequality among the lowest in the world. Labor and product markets are open and flexible. Institutions and policy frameworks are strong, and the government’s debt is very low. The remarkable management of the country's natural resources has enabled Iceland to diversify the economy and help ensure sustainability. Against this backdrop, the long-term economic prospects for the Icelandic economy remain enviable.

2. At present, however, the economy is at a difficult and uncertain turning point. The long home-grown, foreign-funded boom is coming to an end. Its legacies are overstretched private sector balance sheets, large macroeconomic imbalances, and high dependence on foreign financing. With tightening global liquidity conditions and fragile market sentiment, Iceland’s banks and currency have come under significant pressure. In response, banks have started to slow lending growth and rationalize balance sheets. As liquidity constraints are becoming more binding, the overheated economy is showing signs of cooling.

3. In response to intensifying external pressures, the authorities have already taken steps to shore up confidence. The central bank has tightened the policy rate, enhanced liquidity provision to reduce pressures in foreign exchange and domestic markets, and improved its foreign exchange liquidity access by entering into currency swap agreements with other Nordic central banks. The government has expressed its willingness to boost the foreign exchange reserves of the central bank and pledged to pursue fiscal prudence and reforms of the fiscal framework and the Housing Financing Fund (HFF).

4. Looking forward, policies will have the difficult task to facilitate an orderly rebalancing process, while mitigating risks by shoring up confidence. Close coordination between monetary and fiscal policies, along with actions to address financial sector vulnerabilities, will be key in this respect.

Outlook

5. Economic activity is expected to slow significantly from unsustainably high levels.

- Output is projected to come to a halt in 2008 and contract by 2-3 percent in 2009, led by a contraction in domestic demand. Private consumption will decline as lending conditions tighten, real estate prices correct, private sector balance sheets retrench, and purchasing power decreases. High public sector and aluminum-related investment will only partially offset a sharp fall in other investment. Net exports will support growth as imports contract and exports hold up. With the rebalancing of growth away from the domestic sector, the current account deficit is expected to narrow.

- Inflation is expected to remain above target well beyond 2008, reflecting the recent króna depreciation, unhinged inflation expectations, and continued global inflationary pressures. Further out, a widening output gap and falling house prices should help to bring inflation down.

This outlook is based on the assumption that the exchange rate is broadly stable going forward.

6. Uncertainties surrounding the outlook are unusually large, with significant downside risks dominated by external considerations. External liquidity risks remain a key concern, given the high foreign debt of the private sector, chiefly related to the banking system. If the outflow of capital continues, the króna could depreciate more (moving ever further below its equilibrium level), leading to tighter domestic credit conditions. Domestic risks (related to inflation, house and equity prices, and household and corporate indebtedness) are also substantial, although they are more likely to be triggered by external factors.

Monetary Policy

7. Given prevailing inflationary pressures and external risks, the central bank should continue to pursue its tight policy stance to return inflation to target and shore up confidence in the króna. The exchange rate channel plays a central role in the monetary transmission mechanism, although the credit channel may be strengthening as foreign liquidity constraints bind. A further króna decline could fuel inflationary expectations, squeeze private balance sheets, and erode households' purchasing power. In turn, such developments could further undermine confidence, feeding back into currency weakness. To prevent this, the central bank will need to maintain a tight policy stance until there are clear signs that inflation is falling rapidly, while carefully managing domestic liquidity provision; pressures to ease prematurely should be resisted.

8. Promptly acting on the pledge to reform the publicly-owned HFF is crucial to increase the effectiveness of monetary policy. The HFF is the largest provider of mortgage loans in the market, offering interest rates that do not respond quickly to policy rates. To remove this structural impediment, its role in the financial market could be redefined by separating the social component that provides targeted support from the market-based element that should not benefit from state aid. Among the recently announced measures, of which some are still being finalized, the decision to raise lending limits and loan-to-value ratios could impede the efforts of monetary policy to combat

inflation and possibly delay a much needed price adjustment in the overheated real estate market.

Fiscal Policy

9. The already stimulative fiscal policy needs to be restrained. The fiscal position is set to deteriorate sharply in the near term. Given the prevailing external risks and high leverage in the economy, a more neutral fiscal stance is warranted to help shore up confidence and support the central bank's efforts to combat inflation. To achieve a more balanced macroeconomic policy mix, the central and local governments will need to slow the planned sharp acceleration in public investment and resist pressures to boost spending, including on the wage bill and social benefits. Any further fiscal relaxation would only undermine the government's stated commitment to fiscal prudence and the effectiveness of monetary policy, risking higher inflation and further króna depreciation.

10. The government's commitment to strengthen the fiscal framework is welcome and should be followed by concrete steps. Important elements of reform could include: more binding annual expenditure limits, a multi-year budgeting based on clear policy commitments, and mechanisms to better control local government finances. These steps should increase transparency and accountability for all levels of government.

Financial Sector Policies

11. Despite efforts to address market concerns, the banking sector still faces significant risks:

- *Liquidity and funding risks*, associated with the banks' reliance on market funding, sizeable funding needs over the next two years, and difficulties in securing adequate liquidity coverage in wholesale markets;
- *Credit and market risks*, stemming from the foreign currency exposure and high indebtedness of private sector borrowers, as well as from connected lending and large exposures (mostly related to holding companies);
- *Operational risks*, associated with the banks' rapid expansion in recent years, including in new markets and business lines, which could strain risk management capacity and internal controls;
- *Other risks*, related to complex ownership structures, perceived substantial related-party lending, uncertainty about the financial strength of shareholders, and the potential impact of these factors on the quality of capital.

12. Policy options to mitigate these risks should continue to be pursued with vigor. Importantly, the Financial Supervisory Authority (FME) and the central bank have been working to address these issues for the last few years—boosting monitoring, analysis, and stress-testing of liquidity, credit, and market risks. A successful policy going forward will require strengthening financial buffers and increasing transparency as regards the condition of the banks. Possible options could include: (i) raising capital cushions,

including by incorporating operational and credit risks, and the systemic importance of the banks; (ii) reviewing the robustness of liquidity coverage under different stress scenarios that account for the interlinkages among banks and boosting liquidity buffers appropriately; (iii) improving overall transparency concerning progress in reducing related-party transactions and concentrated lending, and better enforcement of disclosure requirements for all corporations. The implementation of these policies could contribute to the retrenchment of banks' balance sheets.

13. The authorities should strengthen the crisis prevention and resolution framework further, building on the progress already made. Supervisory powers and resources have been significantly boosted. The formal frameworks for coordination between domestic agencies and across the Nordic region have been established and tested. The task force on liquidity management, established in the fall 2007, has advanced its work on high-frequency monitoring and modeling. All these efforts should continue in full force, including by compiling all existing elements of contingency planning into a single framework. In addition, the bank resolution framework should be strengthened to provide the FME with additional legislative powers.