International Monetary Fund

Article IV Consultation: Concluding Statement

The International Monetary Fund conducted Article IV consultations with Iceland in the period from May 21 to June 2, 2003. Below is the Concluding Statement of the IMF Mission delivered at the end of the consultations on June 2.

Concluding Statement of the Mission June 2, 2003

This document contains the conclusions of the IMF mission that visited Iceland during May 21 - June 2, 2003. The mission team would like to thank the authorities, as well as other participants in the meetings, for their excellent cooperation and hospitality. The discussion of the staff report for the Article IV consultation with Iceland is expected to be held by the Executive Board of the IMF by end-August 2003.

1. Developments over the last year confirm the correction of the macroeconomic imbalances that had developed during the economic boom of the late 1990s and the economy appears now poised for a resumption of growth after a minor recession. The authorities are to be commended for the successful landing of the economy, which owes much to farsighted stability- and growth-enhancing economic policies implemented over a number of years. The remarkable flexibility shown by the economy is, to a large extent, the consequence of structural reforms implemented since the early 1990s, including financial and external capital account liberalization undertaken in connection with membership in the European Economic Area (EEA), consolidation of the public finances, privatization, and other market-oriented initiatives. More recently, the adoption of inflation targeting, Central Bank of Iceland (CBI) independence, and a floating regime for the króna have resulted in a strong and transparent monetary policy framework that has successfully undergone its "baptism of fire," prevailing on inflation, anchoring inflation expectations, and supporting confidence. The newly created Financial Supervisory Authority (FME), with its proactive approach to prudential supervision, has been instrumental in overcoming the financial vulnerabilities that emerged around 2000-2001 – resulting in a strengthened financial system.

2. But as no achievement is without challenges, the following issues will require particular policy attention in the years ahead.

   - The unbalanced expansion of past years has left a legacy of high external liabilities of the Icelandic economy. By end-2002, reflecting high private sector indebtedness, net external liabilities of Iceland represented about 80 percent of GDP (the highest level among advanced economies) and gross external debt amounted to about 130 percent of GDP. Moreover, the short-term maturity component of the debt appears to have trended upwards. This poses vulnerabilities since the economy remains exposed to external shocks owing to its size and openness. Policies should aim to increase national saving and reduce gradually this level of indebtedness.
   - The upcoming investment projects will substantially increase growth and export rev-

enues, and by further diversifying the export base they will ultimately enhance the stability of the economy. But during the construction period, they will put pressure on limited resources. Therefore, policies will need to focus on avoiding economic overheating and an over-appreciation of the real exchange rate that could cause lasting damage to the export and import-competing sectors. To this end, the demand expansion will need to be accommodated primarily through a tight fiscal policy, thus mitigating the need for high interest rates and alleviating upward pressures on the króna.

- Continued progress on market-oriented structural reforms and on strengthening the institutional policy frameworks, particularly on the fiscal area, will be crucial to seize the new growth opportunities and further increase the resilience and flexibility of the Icelandic economy.

Outlook

3. Output growth is projected to recover to about 2¼ percent in 2003 and gather pace subsequently, as the investment projects in electricity generation and smelting take place. Growth is currently being spurred by a pickup in private consumption, albeit from low levels and tempered by household debt overhang. Slack in the use of resources is expected to disappear in early 2004. Nevertheless, in the short term, some downside risk exists as the external economic recovery, particularly in Europe, could be more protracted than currently expected. The upcoming wage round in early 2004 and the potential demonstration effect of recent public sector wage increases represent countervailing upside risks.

4. Over the medium term, the envisaged investment projects will impart a significant impetus to economic activity and output will grow for some years above its long-run trend pace, while the risks will tilt to the upside. Investment-related capital inflows are expected to result in a temporary widening of the current account deficit. Provided that a tight fiscal policy stance is adopted, we think that the demand push could be accommodated with only a moderate appreciation of the real exchange (some of which appears to have already taken place), while gross external debt could decline to below 100 percent of GDP by 2008. The main risks will remain the emergence of overheating and loss of external competitiveness, particularly if an asset price boom or unrealistic expectations of income growth develop. Also, the high levels of external debt, particularly short-term liabilities, will continue to make the economy vulnerable to unexpected swings in sentiment and external financial conditions.

Monetary policy and the monetary policy framework

5. Since our last visit, the CBI has adroitly managed its policy rate, bringing inflation down to its target, and we support the current broadly neutral monetary policy stance – which strikes a balance between incipient domestic demand pressures and the cooling effect of the appreciation of the króna. At present, output is possibly below potential, as suggested by the temporary increase in unemployment. But retail sales, credit card turnover, car registrations, imports of durables, and other high frequency indicators all point to rising consumption in 2003. Other underlying factors also suggest a revival of demand, including improved confidence. Soft labor markets notwithstanding, real earnings and disposable income growth have been sustained, owing partly to buoyant public wages. And both real housing and stock prices resumed an upward trend in 2002 – possibly rekindling wealth effects and mitigating the dampening impact of high private indebtedness. Finally, the lagged effects of earlier rate cuts and the recent reform of banks' reserve requirements will continue to impart a moderate stimulus. Upward tension, however, has been countered by the appreciation of the króna which can be expected to generate downward price pressures into 2004.

6. In the period ahead, as the upturn in activity takes hold, the CBI will need to start an interest rate tightening cycle, with the rate remaining restrictive over the medium term. This is currently the central expectation of market partici-

pants as well as the policy intention of the CBI, in keeping with its price stability mandate and the necessary forward-looking approach to policy action under inflation targeting.

7. But, given the size and duration of the expected project-related demand expansion, maintaining macroeconomic balance will primarily be the responsibility of fiscal and other government policies. As recent events have proved, monetary policy can be relied upon to maintain price stability and should remain the first line of defense against unexpected and short-term demand and external shocks. Still, safeguarding the competitiveness of Iceland's domestic costs and prices relative to abroad (the real exchange rate) over an extended period of high demand will mainly be the responsibility of fiscal and structural government policies. In this connection, we caution against the announced expansion of credit by the Housing Financial Fund (HFF) which, if not maintained within strict limits, could undermine CBI's liquidity management and contribute to higher real interest and exchange rates as well as to housing price increases.

8. The recent episode of price and output stabilization has consolidated confidence in the inflation targeting framework, further buttressed by ongoing market infrastructure reforms. Through outreach activities and regular publications, the CBI has enhanced confidence and understanding of the monetary policy framework by market participants. Inflation expectations – survey and market-based – appear now anchored around the CBI inflation target. Further in this direction, we suggest consideration of holding regular rate setting meetings of the CBI Board of Governors and publishing their minutes. The ongoing purchases of foreign currency conducted by the CBI through a pre-announced schedule to bolster its net foreign reserves should further cement confidence in the capacity to face unexpected liquidity shocks. We welcome the reforms of the payments and securities settlement systems undertaken by the authorities along best international practices, which increased their efficiency and safety. We also recommend exploring reforms that could promote the depth of domestic money markets, hence reducing banks' reliance on the CBI's repo facility and external borrowing for short-term funding needs.

Fiscal policy

9. Although the underlying position of the public finances remains strong and public debt is low, the general government budget balance has deteriorated markedly in recent years as a consequence of both weaker economic conditions and expenditure slippages. We welcome the continued allocation of privatization proceeds mainly to retire public debt and capitalize future public pension liabilities. Also, to the extent that the budget deterioration is the result of the built-in automatic stabilizers (weaker revenues and higher unemployment and welfare payments accompanying the economic cycle), it should not be a cause of concern – it sustains the economic recovery and in time the turnaround in activity will reverse the budget shortfall. Nevertheless, the fiscal balance has declined by about 2¾ percentage points of GDP in 1999-2002, of which only about half is estimated to correspond to automatic stabilizers. The additional budget erosion was caused by expenditure overruns in health and education – mainly on wages – that will not recede automatically as growth picks up. Rather, there is a risk that recurrent spending may crowd out necessary supply-enhancing public investment.

10. Looking forward, we encourage the authorities to set ambitious medium-term fiscal consolidation goals to accommodate the upcoming demand expansion without jeopardizing the stability and competitiveness of the economy, while also providing for a gradual decline in external debt. As an indicative scenario, preliminary projections suggest that fiscal surpluses of about 3 percent of GDP – similar to those experienced in 1999-2000 – could be required during the peak in project-related activity. Almost half of the necessary fiscal adjustment could stem from the free play of automatic stabilizers, with the remaining effort contributed by expenditure restraint. This would limit the current account

deficit and allow Iceland's external debt-to-GDP ratio to decline, albeit modestly, over the next few years. Hence, we welcome the cautious approach to tax cuts adopted in the recent Policy Statement of the Government. In particular, we recommend that tax cuts be preceded by commensurate spending curbs in order to ensure the necessary overall net public savings profile.

11. In order to facilitate budget discipline and increase transparency and understanding of fiscal policies, we encourage the authorities to introduce a comprehensive multiyear budgeting framework, with cyclically adjusted balance targets and expenditure limits. This fiscal policy framework places the emphasis on medium-term horizons and sustainability, which should be particularly suited to the times ahead. Different variations of this policy framework have been successfully implemented in many advanced economies, including in the Nordic area, resulting in a more efficient allocation of public expenditure and increased market confidence. We welcome the authorities' intention to adopt national accounts methodology for budget formulation and improve the efficiency of the budgeting process. In this context, the decentralization of spending decisions should be complemented with parallel accountability to ensure consistency with the overall budget objectives.

12. In light of past cost overruns and the need for sustained budget consolidation, it would be useful to expand the private sector role in the provision of public services and strengthen the link between user payments (which could be means-tested) and actual costs where these threaten budget integrity – notably in health and education. Also, other structural reforms mentioned below, including curbing subsidies to agriculture, would alleviate strains on the budget.

Financial sector

13. An IMF mission visited Iceland in April 2003 to update the 2001 Financial System Stability Assessment (FSSA). Its findings confirmed that the financial sector imbalances that were identified in the 2001 FSSA have subsided and Iceland's financial sector has returned to a more balanced risk profile, aided by a proactive supervisory response. Icelandic banks recorded increased profits in 2001 and 2002 and, encouraged by supervisory recommendations, banks bolstered their regulatory capital ratios in each year. Savings banks experienced more difficult conditions than commercial banks, as their nonperforming loans and credit losses were larger as a proportion of total loans.

14. The legal, regulatory, and supervisory financial frameworks have been significantly strengthened, and the new assessment found major improvements in compliance with Basel Core Principles (BCP). We welcome the passage of the Law on Financial Undertakings and other related pieces of financial legislation, as well as the increased resources allocated to the FME. As a result of the quick and comprehensive regulatory and supervisory changes implemented since the 2001 FSSA, Iceland is now compliant or largely compliant with all but Principle 11 of the BCP – owing to the lack of a country risk reporting system. We encourage the authorities to remain vigilant in the coming years in light of the potential for emerging macroeconomic tensions, including from high levels of indebtedness.

15. Without detriment of these reassuring conclusions, there remain some areas that could benefit from additional improvement. The HFF, although under the oversight of the Ministry of Social Affairs and Parliament, is exempt from regular prudential laws and regulations, such as capital requirements, provisioning rules, etc. We recommend that the HFF be subject to explicit prudential guidelines regarding its operations. Also, careful monitoring of some weaker savings banks continues to be warranted to ensure improvements in their management and solvency position, notwithstanding their minimal systemic importance.

Structural Issues

16. The authorities have an excellent track record in undertaking structural reforms, which have underpinned the enviable overall growth performance of Iceland. Recently, the remaining public shares in the banking system were privatized, which opened the door to efficiency gains in the sector. We welcome the determination of the authorities to continue their privatization agenda by divesting the public stake in telecommunications. Progress is being made in the liberalization and rationalization of the energy sector, albeit much remains ahead. In this direction, we suggest that the authorities consider opening gradually the bulk of the mortgage market to commercial banks by reducing over time the role of the HFF to strictly social lending.

17. In the context of the upcoming multilateral world trade negotiations (the Doha round), we encourage the authorities to embrace an ambitious trade liberalization agenda. Iceland ranks among the advanced economies with the highest trade barriers relating to farming protection – to the detriment of the Icelandic consumer. Efforts have been made toward agricultural liberalization, including the shifting from production quotas to direct income support, and the replacement of seasonal tariffs with budget subsidies, with resulting sizable reductions in consumer prices. The mission urges the authorities to redouble their efforts to liberalize agriculture over the medium term, while replacing production-linked support and quotas with direct income support in the interim. Finally, we welcome the duty-free access granted to most imports from least developed countries and encourage the authorities to increase Official Development Assistance, currently 0.16 percent of GNP, towards the U.N. target of 0.7 percent of GNP.