

International Monetary Fund

Article IV Consultation: Concluding Statement

The International Monetary Fund conducted Article IV consultations with Iceland over the period May 8-15, 2006. Below is the Concluding Statement of the IMF Mission delivered at the end of the consultations on May 15.

Introduction

1. The medium-term outlook for the Icelandic economy remains enviable. Institutions and policy frameworks are strong. Markets are open and flexible, and the skillful management of the country's natural endowments has diversified the economy and helped to ensure sustainability. Further, these factors are combined within a culture of entrepreneurial dynamism that has led to economic outcomes that belie the country's small size.
2. However, at the current juncture, mounting macroeconomic imbalances are concerns that policymakers must promptly address. The level of excess demand, high and rising inflation, the large current account deficit, and highly leveraged households and firms, particularly banks, are generating financial market turbulence that threatens near-term stability. Looking back, these circumstances could have been mitigated by more coordinated policy actions that would have implied a tighter fiscal stance and reform of the Housing Financing Fund.

The Outlook

3. The economy is expected to grow by roughly 4 percent in 2006 with a considerable easing in growth close to 1 percent in 2007. Investments in the aluminum smelting sector and robust private consumption are forecast to support growth over the remainder of 2006. In 2007, moderating private consumption and a sharp reversal in private investment, reflecting the completion of the projects, should result in a much-needed contraction in domestic demand. The current account deficit is expected to decline only marginally in 2006 as domestic demand remains strong. However, a significant pickup in net exports and notably lower domestic demand are projected to cut the current account deficit roughly by half in 2007. Inflation pressures are expected to remain strong over the rest of the year, reflecting the overhang from rapidly rising wages, a strong housing market, and currency depreciation. Provided wage agreements are not significantly altered in November of this year, inflation should moderate throughout 2007, returning toward the central bank's target.
4. However, this outlook is predicated on policy actions being taken quickly to reduce domestic demand pressures, anchor inflation expectations, and remove uncertainties that could undermine

financial stability. Given the heightened risk of a sharp adjustment, a prompt, multidimensional, and coordinated policy response is called for.

Fiscal Policy

5. The low and declining level of public debt is a testament to responsible fiscal management as well as a key element underpinning the favorable medium-term outlook for the Icelandic economy. Nevertheless, at this point, an adjustment to the current fiscal plan is essential because macroeconomic imbalances are notably wider than expected at the time of the 2006 budget. The widening in imbalances has increased the risk that the economy could experience an abrupt and disruptive contraction as a result of international financial market conditions becoming considerably less favorable for Iceland.
6. On current plans, the fiscal surplus will decline in 2006 relative to what was achieved in 2005. With considerable excess demand projected for 2006, appropriate measures at the central and local government levels are required to maintain fiscal restraint. This can be achieved by reducing the high growth budgeted for nominal public consumption and delaying more public investment. At the same time, the government should announce that additional fiscal restraint will be introduced in the budget for 2007 if domestic demand pressures do not abate as required. Areas for potential adjustment include planned tax cuts, public investment, and public consumption.
7. Thinking of the future, this is the appropriate time to continue strengthening the fiscal framework to help reduce the volatility in the Icelandic economy in the years to come. The introduction of multi-year budgeting was the first step along the path to a rules-based fiscal framework. The next step is to add more structure to the budgeting and the implementation process to ensure that fiscal policy provides consistent and substantial offsets to the fluctuations in private demand that have generated enormous swings in economic activity in Iceland. Such systematic fiscal policy would consistently reinforce monetary policy, thereby limiting these swings that have historically created uncertainty and hardship.

Monetary Policy

8. Further increases in the policy rate will be required as monetary policy faces a considerable challenge to anchor inflation expectations and return inflation to target. Although house prices, which have driven inflation well above target in the recent past, are starting to show some signs of moderation, rising prices of imported and domestic goods and services are forecast to keep inflation persistently high for an extended period. Additional pressures could come from developments in domestic wage formation. Wage growth has been well in excess of the rate consistent with the inflation target given labor productivity growth and, with

the potential for wage contracts to be reexamined later this year, there is a risk of further acceleration. All social partners need to be aware that monetary policy will be forced to respond to any additional wage growth that could delay inflation returning to target.

9. Given the current risks to inflation and the high output cost of returning inflation to target should expectations of high inflation become entrenched, the central bank should be biased toward a tight monetary stance. However, there are comforting signs that monetary policy is starting to have more of an impact on the credit conditions faced by domestic households and firms, and these developments will need to be monitored carefully to gauge the appropriate degree of monetary policy restraint. Moreover, inflation expectations should now be better anchored with the introduction of a preannounced schedule for monetary policy meetings that conclude with a public announcement of the central bank's decision regarding its policy rate. Inflation expectations should also be positively influenced by the central bank's open discussion of the interest rate path that could be required to return inflation to target.

Financial Sector

10. The financial system appears sound, but actions should continue to be taken to reduce vulnerabilities. The balance sheets of Icelandic banks have been growing at a staggering pace, both at home and abroad. International markets are concerned that this rapid growth has exposed the Icelandic financial system to vulnerabilities that could undermine its health as the economy adjusts to restore balance. Potential vulnerabilities include considerable near-term refinancing needs, credit quality, the long-term sustainability of the banks' presence in the domestic mortgage market, and the crossholdings of equity.
11. Stress tests performed by the central bank and the Financial Supervisory Authority (FME) suggest that banks' capitalization can withstand very large shocks. Should there be a sharp downturn in the economy, the impact would likely show up in reduced profitability through a reversal of trading gains, higher financing costs, and increases in non-performing loans. Banks are taking significant steps to meet their funding needs over the near term, even in the event of dramatic tightening in international credit conditions. Should systemic issues arise, the authorities have put in place contingency plans to maintain financial stability. Banks' increased recognition of the need for careful liquidity management should reduce the risk of similar vulnerabilities developing in the future. In addition, the banks have begun reducing crossholdings of equity, thereby making ownership structures more transparent. At this point in the economic cycle, it will also be important for banks to be increasingly vigilant regarding credit quality and, given global credit conditions, to expand their balance sheets more slowly than they have in the recent past. The authorities need to ensure that banks carry on addressing all of these sources of vulnerability.

12. The continued strengthening of the FME's supervisory framework is welcome. For example, the broadening and increased stringency in the stress tests should provide positive assurance for international markets, as should the banks' willingness to make the bank-by-bank results of these tests public. To further improve the stress tests, the FME should adjust the interest rate component to make it more transparent and more closely match how interest rates along the yield curve would likely evolve as monetary policy tightens.
13. The Housing Financing Fund (HFF) needs immediate reform. The consultation process is underway, but it should be expedited. The unhealthy competition between the banks and the state-subsidized HFF has undermined the effectiveness of monetary policy, unnecessarily exacerbated macroeconomic imbalances, and threatened financial stability. In a modern industrial country like Iceland with highly competitive, world-class private financial institutions, there is no need for a significant state presence in the mortgage market. Turning the HFF into a privately-held wholesale funding institution would retain important economies of scale in mortgage funding. As international experience proves, the social objective of adequate access to mortgage financing can be achieved with more efficient and targeted public programs.
14. Icelandic policymakers have a history of responding appropriately when economic circumstances warrant prompt adjustment. The present situation requires a similar response to ensure that the current imbalances in the economy unwind in an orderly fashion and financial stability is maintained.