International Monetary Fund

Article IV Consultation: Concluding Statement

The International Monetary Fund conducted Article IV consultations with Iceland over the period June 2-13, 2005. Below is the Concluding Statement of the IMF Mission delivered at the end of the consultations on June 13.

Introduction

1. Overall, economic performance in Iceland has been impressive. The government should be commended for its consistent commitment to implementing and following policies that have laid a sound foundation for strong economic growth. These policies include structural reforms that have increased the economy's dynamism and flexibility, significant improvements in financial supervision, the introduction of a flexible exchange rate and inflation targeting, and a sustained period of sound fiscal management.

2. Another key element of economic policy in Iceland has been the promotion of power-intensive projects that exploit Iceland's comparative advantage in clean energy. These projects further diversify the economy and significantly add to export capacity and wealth. At the same time, the magnitude of these projects relative to the size of the economy has contributed to economic volatility.

3. Looking ahead, smoothing this volatility presents the key challenge for policymakers as they strive to ensure both strong and stable growth. In particular, at the current point in the economic cycle, appropriate policy measures need to be in place so that the imbalances that are evident in the current account, external debt, domestic demand and inflation do not lead to excessive volatility in real activity as they unwind following the completion of the current investment projects.

The Outlook

4. Economic growth is expected to be rapid with real GDP growing by roughly 6 percent in 2005 and only slightly below that rate in 2006. Private consumption and investment in energy-intensive projects are expected to be the primary sources of growth. This expansion in domestic demand is forecast to widen the current account deficit to over 12 percent of GDP in 2005, with only a slight improvement in 2006. While the increased flexibility associated with the use of foreign labor has prevented the investment projects from directly exerting pressures in the labor market, demand pressures in other sectors are currently projected to keep inflation above the central bank's target rate over the next two years. Looking further out, once the investment projects are completed and the new capacity becomes productive, growth is forecast to rebalance toward the external sector, quickly reducing

the current account deficit. However, there are significant risks to this outlook.

5. In the near term, the risk to the outlook is seen to be on the upside, with downside risk further out. Consumption could be stimulated more than forecast by the strong growth in disposable income and asset prices combined with the significant increase in households' ability to borrow at low cost. A more rapid expansion in consumption would add to the increase in interest rates required to stabilize inflation at the target rate. Higher short-term interest rates could put additional upward pressure on the exchange rate with the likely consequence of further widening the growing imbalances in the current account and external debt. Once the investment projects are completed, the built-up imbalances will need to unwind. The larger they are, the greater is the likelihood that the adjustment will be sharp, significantly slowing economic activity. Policy measures, along the lines outlined below, need to be implemented now to reduce this risk.

Fiscal Policy

6. Although fiscal policy has been tightening, a more restrictive stance than that contained in the 2005 budget is required to help contain demand pressures, minimize the build-up in imbalances and help ensure that they unwind in an orderly fashion. The increased flexibility of the economy, particularly in the labor market, has enhanced its ability to quickly adjust. However, prudence is called for to avoid the potentially large negative impact on the economy that could occur if the quickly building imbalances were to unwind in a disorderly fashion. Since the time of the 2005 budget, the outlook for aggregate demand has been revised upward considerably and projected imbalances have widened. Consequently, fiscal policy should be tightened appropriately.

7. Both tax and expenditure measures should be used to achieve the tightening. On the expenditure side, additional public investment projects, including some of those planned for the remainder of 2005, should be delayed until after the peak in the energy-intensive investment cycle. Although the longer-term benefits on labor supply of reducing income taxes are welcomed, the impact is likely to unfold only gradually and be modest at its peak. Therefore, it would be prudent to postpone the tax cuts announced for 2006 and beyond until it is clear that excess demand in the economy has dissipated. If tax cuts cannot be delayed, offsetting cuts in government expenditure beyond the advised reductions in public investment should immediately be identified and implemented. Given the nominal increase of roughly 7 percent budgeted for government consumption in 2006, this would be an appropriate area for reductions. To help improve overall efficiency in healthcare and education, this may also be an opportune time to introduce or extend the application of user fees in these sectors. Additionally, the government can help minimize building

demand pressures by directing the proceeds from the privatization of Iceland Telecom to debt reduction.

8. Although public finances are on an extremely sound footing from a medium-term perspective, the medium-term fiscal framework should be strengthened. The introduction of multi-year spending targets has been a step in the right direction, but more can be done. Defining the multi-year spending targets in nominal terms at the general government level would be beneficial. Additionally, there should be increased cooperation between the central and local governments to prevent slippages. Accelerating the pace of consolidation of local governments could facilitate such cooperation. Further, the multi-year spending targets should be derived from a rules-based approach that ensures the simultaneous achievement of the government's medium-term target for public debt and a consistently counter-cyclical fiscal stance. This would help achieve the systematic coordination of monetary and fiscal policies, which, in a very small economy like Iceland, would considerably enhance the prospects for achieving both strong and stable growth.

Monetary Policy

9. Monetary policy has been responding appropriately to emerging demand and inflationary pressures. Rising house prices have contributed significantly to inflation. However, they are indicative of the general overheating of the economy and hence, the policy response has been appropriate. While temporary factors have recently lowered measured CPI inflation, policy should continue to focus on the underlying demand conditions that are the primary source of persistent inflation. It appears likely that the parties to the private sector wage agreements will act responsibly, as they have in the past, when deciding if wage agreements need to be reviewed in November of this year. However, the central bank will need to monitor the discussions closely to assess any possible implications for wages and prices. The developments in the mortgage market, which have lowered the cost of long-term financing to households at a time when the central bank has been tightening short-term rates, have increased the challenge of stabilizing inflation. The central bank will need to be prepared to respond to changing economic circumstances while recognizing the risk that having to rely heavily on the exchange rate channel for the transmission of monetary policy could increase imbalances and the sharpness of the eventual unwinding.

10. Because of the small size of the economy, stabilizing inflation in Iceland is a much more difficult task than in larger inflation-targeting countries. One innovation that might help enhance inflation stability by more firmly anchoring inflation expectations is to introduce a schedule for pre-announced monetary policy meetings that conclude with a public announcement of the central bank's decision regarding interest rates. In addition, although the *Monetary Bulletin* has evolved into a very clear, transparent and ef-

fective communication device, it could be enhanced further. The inclusion of a scenario based on an interest rate path that would return inflation to its target given the central bank's view on the current state of the economy and its likely evolution could help anchor inflation expectations. Scenarios that do not show inflation returning to target may easily be misinterpreted. If a variable-interest-rate scenario is included, it will be important to stress its conditional nature so that the public understands that the central bank is not committing to that particular path. The public would then realize that as economic circumstances change, the central bank would adjust the path accordingly.

11. Once the current investment cycle is completed, further enhancements to the monetary policy framework may be possible to increase the stability in both inflation and real economic activity. Although the indexation of mortgage loans in Iceland, among other reasons, makes it important to continue to target a measure of inflation that includes house prices, removing volatile components such as energy or food, as has been done in other countries, could be considered.

Financial Sector

12. It is essential that the risks to financial stability of the ongoing credit boom be monitored closely, and prudential measures be implemented quickly if required. Financial institutions have strong balance sheets, as attested by the stress tests conducted by the Financial Supervisory Authority (FME). However, as asset prices continue to accelerate sharply, it will be important that the FME move ahead promptly with the implementation of the more stringent stress tests that are currently being developed. Further, the FME should accelerate the pace of the development and implementation of stress tests to assess the risks to the financial sector arising from changes in interest rates and sharp movements in the exchange rate. This is becoming particularly important as banks intermediate a rapidly growing volume of foreign lending, a portion of which is not naturally hedged, and expand their shares of the domestic mortgage market. If the FME identifies vulnerable institutions, it should immediately exercise prudential measures, including increasing capital adequacy ratios, to quickly reduce those vulnerabilities.

13. The entry of commercial banks into the mortgage market has been a positive development from a longer-term financial stability perspective. Holding a larger portfolio of first mortgages will help diversify banks' balance sheets and stabilize their earnings provided this activity can be sustained profitably. If they must compete directly with the Housing Financing Fund (HFF), which enjoys a funding advantage because of its state guarantee, this is unlikely to happen. Consequently, expeditious reform of the HFF is necessary. The reform of the HFF should be guided by the following principles:

- Banks and savings institutions should have access to funding that allows them to compete profitably for first mortgages;
- The funding expertise that has been developed by the HFF should be fully utilized;
- Economies of scale in funding should be retained so that Iceland receives the lowest possible cost of mortgage finance, and domestic bond markets remain liquid;
- Competition in the retail mortgage market should continue to be strong; and
- State support should be tightly focused on ensuring access to homeownership for those with low incomes and those residing in remote regions of the country.

14. Historically, Icelandic policymakers have responded quickly and effectively as economic circumstances have changed. The current juncture, while presenting some difficulties, is still not as challenging as situations experienced in the past. In the short term, it will be important that fiscal policy be tightened and the HFF be reformed quickly to minimize emerging imbalances and downside risk further out. Over the medium term, continued improvement in policy frameworks will help ensure that both strong and stable growth can be achieved.