International Monetary Fund
Iceland – 2004 Staff Visit
Concluding Statement
October 25, 2004

This document contains the conclusions of the IMF staff that visited Iceland during October 20–25, 2004. The staff team would like to thank the authorities and all other participants in the meetings for the open and helpful discussions as well as their gracious hospitality.

1. The implementation of well-designed structural reforms over the last decade, the adoption of an inflation targeting framework, and significant improvements in financial supervision have transformed Iceland into one of the world's most flexible and dynamic economies. This flexibility was evident in the relatively soft landing achieved in 2001 and 2002 as the imbalances built up during the boom in the late 1990s unwound. The quick return of robust growth in 2003 is a testament to the economy's dynamism. Encouragingly, the rebound in growth is being driven by large power-intensive investment projects that will help diversify the economy and increase its export capacity in the medium term. However, with the confidence effects from these projects fueling a rapid expansion in household demand that has continued to accelerate into 2004, imbalances have started to emerge in inflation, the current account, and external debt. Over the near term, containing these imbalances will be the key challenge for both monetary and fiscal policy.

The Outlook

2. Output growth is projected to be slightly above 5 percent in 2004 and is expected to continue to expand at a rate of close to 5 percent in both 2005 and 2006. Private fixed

investment related to the power-intensive projects and household spending are forecast to be the key drivers of growth. Strong growth in private domestic demand is projected to result in a current account deficit of approximately 12 percent of GDP at the peak of the investment cycle in 2006, roughly double what had been expected a year ago. Further, increases in the import of consumption as well as investment goods underlie the current account deficit. The rapid domestic demand growth will also increase pressures on supply capacity that combined with high oil prices will keep inflation above the central bank's target rate.

3. Over the near term we see upside risks to the outlook, while further out the risks to growth are on the downside. Three factors suggest that household spending growth and, consequently, inflation could be higher than forecast over the next two years. First, commercial banks' recent entry into the mortgage market has significantly increased the range of finance options available to households. Second, the relaxation of lending constraints at the Housing Financing Fund (HFF) may also add to housing demand. Third, the proposed reductions in labor income taxes will increase expectations of permanent income, the effects of which are often difficult to accurately predict. The upside risks to inflation are also compounded by the potential reopening in November 2005 of the recently concluded four-year wage agreement. In the medium term, the potential for a sharp retrenchment in growth to unwind built up imbalances in the current account, and between domestic supply and demand conditions represents the key downside risk.

The Financial Market

4. Over the last two years, bank lending to both households and firms has been growing rapidly. This has been partly financed with foreign borrowings, a significant share of which is short term in duration. Further, this rapid credit growth has occurred in parallel with a

spectacular boom in the equity market that has helped to enhance banks' profitability and balance sheets. Some comfort can be taken from the fact that the financial supervisory authority has recently released guidelines on foreign currency liquidity management. The diversification of Icelandic banks into foreign markets is a positive development that should strengthen income stability. Additionally, stress tests conducted by the financial supervisor indicate that the high capitalization of the banks suggests that they could absorb a sharp reversal in equity and bond prices, and a significant increase in non-performing loans. At the same time, the financial supervisory authority needs to strengthen its ability to conduct stress tests on the banking sector's exposure to refinance and exchange rate risks, particularly with 20 to 30 percent of foreign currency lending going to firms that do not have foreign currency revenues. The supervisor should also be prepared to quickly exercise its authority to ensure that banks' capitalization levels reflect their assessed risk exposure.

5. The entry of banks into the mortgage market is a welcomed development as it allows banks to strengthen their balance sheets by increasing the proportion of mortgage loans. The financial supervisor, however, will need to closely monitor the evolution of banks' balance sheets as they continue their expansion into the mortgage market to ensure that it does not result in duration mismatches, lead to additional foreign currency risk exposure, or undermine profitability. It is important that policymakers recognize the positive aspects of a reduced role for the Housing Financing Fund in the mortgage market and focus future reforms to the HFF on enhancing its ability to fulfill social objectives rather than increasing its ability to compete with banks.

Monetary Policy

6. With inflation rising above the target rate in 2004, the central bank has been responding appropriately by increasing its policy rate. In spite of some slack in the labor market, the recent inflation outcomes reflect international developments in oil prices as well as domestic factors, notably increases in housing and public service prices. Although increases in inflation arising from shocks such as oil prices require a measured monetary policy reaction, primarily focused on ensuring that second-round effects do not emerge, inflation arising from domestic demand pressures requires a decisive and prompt response. This is particularly important for a relatively young inflation targeting regime that is in the process of building the credibility central to anchoring long-term inflation expectations. The annual rates of private sector wage increases in the recently negotiated four-year agreement suggest that the central bank's target enjoys a fairly high degree of credibility. However, the potential for the reopening of the wage agreement in November of next year, should inflation remain persistently high, increases the importance of anchoring long-term inflation expectations.

7. The expected evolution of demand pressures and the resulting outlook for inflation suggest that monetary conditions will need to tighten further in the future. With real short-term interest rates having only just begun to increase from a rate below plausible estimates of the neutral rate, the additional required increase in short-term interest rates could be substantial. Recent developments in the mortgage market, which are reducing long-term mortgage interest rates, are adding to the amount by which short-term interest rates will need to rise. However, relying exclusively on short-term interest rates to manage demand pressures and return inflation to target increases the potential for appreciation in the real

exchange rate, reducing competitiveness and adding further to emerging imbalances. The greater are the build up of imbalances, the greater is the risk of a disruptive unwinding. In particular, once project-related investment flows cease there could be a sharp downward adjustment in the exchange rate and a dramatic slowing in real activity.

8. Minimizing the build up of imbalances over the near term should be the focus of policymakers. In this regard, the peak in the required increase in short-term interest rates will be lower the sooner the central bank responds. Accordingly, the central bank is encouraged to continue raising short-term interest rates. At the same time, the potential longer-term negative implications of relying too heavily on monetary policy alone to manage the growing demand pressures argue strongly for a balanced tightening in monetary and fiscal policy.

Fiscal Policy

9. The sharp fiscal stimulus imparted in 2003 has been withdrawn in 2004. The 2005 budget proposal continues that degree of fiscal restraint, closely following the multi-year guidelines for real spending growth announced in the 2004 budget. However, the current outlook argues for a tighter fiscal stance than envisaged in the budget proposal. Specifically, the target for the general government surplus as a share of GDP should be at least as large as the 2.5 percent surplus achieved in 2000, the peak of the previous investment-driven expansion.

10. This tightening in fiscal policy should come both from the tax and expenditure sides. Ideally, all the planned reductions in taxes outlined in the budget proposal should be delayed until 2007, when private investment expenditure is expected to decline sharply. At a minimum, the reductions planned for 2006 should be postponed until 2007. On the expenditure side, further restraint is called for to avoid public demand adding to the expected

private demand pressures, especially if tax cuts are implemented. The proposed 6 percent growth in nominal public consumption is high, particularly when applied to the 2004 base that includes overruns. The introduction and/or expansion of user fees and co-payments in education and healthcare should be considered to reduce expenditures and increase the overall efficiency in these sectors. Importantly, it is key that the government demonstrates strong leadership in controlling wage growth. Growth in public sector wages, which have persistently grown faster than those in the private sector, should be kept at the rate contained in the recent four-year agreement. Consideration should also be given to delaying additional public investment projects until 2007.

11. With a low and declining ratio of government debt to GDP, public finances remain sound. However, it will be important for the government to strengthen its medium-term fiscal strategy used to guide the budgeting process. Multi-year spending targets, defined at the general government level, would then be dictated by medium-term objectives. Specifying these spending targets in nominal levels would add to transparency and enforceability. In addition, making the targets for discretionary spending legally binding would help avoid expenditure overruns not associated with automatic stabilizers.