INTERNATIONAL MONETARY FUND

Public Information Notice (PIN): IMF Concludes 2002 Article IV Consultation with Iceland

On June 21, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iceland.[1]

Background

The past decade has witnessed a substantial strengthening of the Icelandic economy, due in part to macroeconomic policies that emphasized stability and predictability. The economic expansion was underpinned by the successful disinflation of the early part of the 1990s and by policies of market liberalization, privatization, and other structural reforms. The rapid growth that took place during the second half of the 1990s, however, eventually led to overheating and the development of internal and external imbalances. The expansion evolved gradually into a consumption boom fueled by brisk credit growth. Domestic expenditure growth in excess of national income resulted in a widening external current account deficit that peaked at 10 percent of GDP in 2000, and a rekindling of inflationary pressures. The rapid expansion of bank lending – financed mainly by external borrowing for domestic on-lending – led to increased risk exposures and weakened banking sector prudential indicators.

Economic developments since early 2001 have been characterized by progress in the correction of some of these imbalances. As sentiment turned, the currency depreciated sharply and growth in economic activity decelerated from 5½ percent in 2000 to 3 percent in 2001 – bringing it closer to its long-term sustainable pace. The balance of demand switched swiftly from consumption and other domestic expenditure to net exports and, as a result, the current account deficit fell to about 4½ percent of GDP. At the same time, however, the twelve-month inflation rate rose rapidly, exceeding the Central Bank of Iceland's (CBI) upper tolerance limit of the target range since June 2001, and stood at 5.9 percent in May 2002. The main cause of inflation has been the pass-through effect of the depreciation, but inflation has also been supported by wage increases that have outpaced prices on average and by a sizable fiscal impulse in 2001 resulting largely from overruns in public wages and other current spending.

Notwithstanding significant stresses in securities and foreign exchange markets and increases in nonperforming loans, the banking system maintained profitability during 2001 and increased its capital ratio from 9.9 percent in 2000 to 11.5 percent in 2001. Progress was made in addressing the weaknesses of the prudential regulatory and supervisory system identified by the 2001 Financial System Stability Assessment (FSSA) report.

The steep depreciation of the króna in 2001 and the attendant inflationary spike hindered the manage-

1. Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the Executive Board discussion based on the staff report.

ment of monetary policy and consolidation of the new inflation-targeting regime. In several policy moves, the CBI lowered the policy rate to 8.8 percent: in March 2001 at the time of introduction of the new inflation-targeting regime, in November 2001, and in March-May 2002, mainly on the perception that its monetary policy stance had tightened in real terms. Inflation developments and inflation expectations, however, proved difficult to gauge in 2001 and occasional sterilized interventions in the foreign exchange market failed to contain the depreciation of the króna. In this context, the newly introduced inflation-targeting framework had yet to fully anchor inflation expectations – which on the basis of the January 2002 public survey stood at 6½ percent.

During the first half of 2002, underpinned by the decline in domestic demand and the turnaround in the trade balance, the monthly inflation rate declined rapidly and the króna appreciated substantially. This led to a significant tightening of monetary conditions.

The consolidation of public finances turned earlier budget deficits into surpluses, allowing for reductions in net government debt and setting aside funds to cover future public pension obligations. The general government deficit in 2002 is projected at ½ percent of GDP, slightly higher than the deficit outturn in 2001. However, on a cyclically adjusted basis, the 2002 budget represents a fiscal withdrawal, reflecting the objective of a return towards a cyclically adjusted surplus of about 1 percent of GDP over the medium-term.

Current indicators point to an additional moderation in economic activity during 2002 with GDP declining year-on-year by ½ percent, bringing output to or slightly below its long-term trend. The redirection of demand and activity towards the external sector is expected to continue as households and businesses, which have both accumulated high levels of indebtedness, consolidate their balance sheets. As a consequence, the current account deficit is projected to contract further to 2 percent of GDP.

Executive Board Assessment

Directors commended the authorities for the remarkable growth performance of the Icelandic economy over the last decade. They noted that this performance owed much to the policies, adopted since the early 1990's, of market liberalization; fiscal consolidation; and structural reforms aiming to foster investment, enhance competitiveness, and diversify exports.

Directors welcomed the appreciable progress realized over the past year in redressing the economic imbalances that had developed as a result of the earlier overheating of the economy. They noted, in particular, the reduction of the current account deficit in 2001 and the sharp turnaround of the trade balance in the first half of 2002, resulting from the weakening of domestic demand and the successful redirection of activity toward the external sector. Directors noted that these developments had underpinned the stabilization and subsequent appreciation of the króna, and the rapid decline in inflation during 2002.

Against this background, Directors agreed that – after a modest contraction of output this year – the prospects were for resumption of more balanced growth in late 2002, under the impetus of strong net exports and a gradual recovery of private spending. These developments should bring output close to its long-term trend, while the current account deficit should narrow further toward balance. However, Directors considered that upside risks remained, and that appropriately cautious policies would be necessary to forestall a re-emergence of the earlier imbalances in an economy that still has a quite high level of external debt. In this regard, they noted the high level of resource utilization and the recovery of consumer sentiment. A number of Directors warned that wage demands in export-oriented industries and recent public sector pay increases could spill over to the rest of the economy, posing risks of inflationary pressure. A few speakers also called attention to the possible overheating that could result if several large investment projects materialized.

Directors welcomed the noteworthy progress made by the authorities in addressing the financial sector vulnerabilities identified by the well-timed 2001 FSSA, and their decision to participate in an FSSA follow-up in 2003. Directors noted the improved profitability of the banking system and the expansion of its regulatory capital base in 2001 – despite adverse financial market developments, the depreciation of the króna, and the slowdown in activity. They welcomed the tightening of prudential regulations and supervision, and the allocation of addi-

Iceland: selected economic indicators

	1998	1999	2000	2001	2002[1]
Real economy (change in %)					
Real GDP	5.0	3.6	5.5	3.0	-0.5
Domestic demand	12.7	4.0	6.6	-2.5	-2.9
CPI	1.7	3.4	5.0	6.7	5.2
Unemployment rate (%)	2.8	1.9	1.3	1.7	2.3
Gross domestic investment (% of GDP)	29.6	-3.4	14.7	-6.2	-13.0
General government finances (% of GDP)					
Financial balance[2]	0.5	2.4	2.4	-0.1	-0.5
Structural primary balance	2.1	3.8	2.3	0.1	1.4
Gross debt	48.9	44.2	41.6	46.8	41.9
Money and credit (change in %)					
Deposit money bank credit (end of period)	30.4	23.2	24.6	17.3	...
Domestic credit (end of period)	27.6	22.3	43.8	14.5	...
Broad money – M3 (end of period)	15.2	17.0	11.0	15.5	...
CBI policy rate (period average, in %)	7.3	8.4	10.5	10.9	...
Balance of payments (in % of GDP)					
Trade balance	-4.4	-3.6	-5.6	-0.8	0.8
Current account balance	-7.0	-6.9	-10.1	-4.4	-2.0
Financial and capital account	8.0	9.8	10.5	5.4	...
Gross external debt	72.4	84.5	108.9	124.3	...
Reserve cover (in months of imports)[3]	1.6	1.8	1.5	1.4	...
Fund position (as of April 30, 2002)					
Holdings of currency (in % of quota)	.	.	.	.	84.2
Holdings of SDRs (in % of allocation)	.	.	.	.	0.4
Quota (in millions of SDRs)	.	.	.	.	117.6
Exchange rate					
Exchange rate regime	Floating exchange rate				
Present rate (May 17, 2002)[4]	129.2				
Nominal effective rate (change in %)	1.8	0.2	-0.1	-20.1	...
Real effective rate (change in %)	1.6	1.8	2.9	-12.9	...

1. Projection.
2. National accounts basis.
3. In months of imports of goods and services.
4. Trade-weighted exchange rate index of the króna (Dec. 31, 1991 = 100).

Sources: National Economic Institute, Central Bank of Iceland, Ministry of Finance and IMF staff estimates.

tional resources to the recently created Financial Supervisory Authority (FSA). Further along these lines, Directors saw a need for strengthening loan classification, provisioning, and collateral valuation standards and monitoring. Also, they advised vigilance regarding emerging securities lending and investment banking activities, and encouraged the authorities to place high priority on the prompt passage of financial legislation, currently under discussion, to expand and strengthen the mandate of the FSA.

Directors supported the inflation-targeting monetary policy regime, and the floating of the króna in March 2001 – considering this framework well suited to the circumstances of the Icelandic economy. Directors emphasized that monetary policy should be firmly focused on consolidating confidence in this new framework by bringing inflation down to within the tolerance range by end-year, and to the 2.5 percent target in 2003. In light of recent favorable inflation and exchange rate developments, Directors viewed the current monetary policy stance as broadly appropriate. However, with risks to the intended inflation path considered to remain largely on the upside, a cautious policy stance would likely be required for some time. Directors stressed that cuts in interest rates needed to be consistent with the CBI inflation forecast, and paced in line with emerging evidence that inflation will stay low even after the effects of one-time measures have worn off. In sum, Directors noted that the CBI should thus stand ready to act symmetrically – delaying, or reversing, the reduction in interest rates, if this proved warranted.

Directors emphasized the importance of nurturing the newly accorded independence of the CBI, as well as the predictability and transparency of the inflation-targeting system. In this connection, several Directors suggested that the authorities consider publishing a calendar of the monetary policy meetings of the Board of Governors of the CBI, and in addition, the detailed considerations that led to policy decisions. They also advised considering reforms of the CBI's liquidity facilities, with a view to encouraging banks to resort to the interbank market and avoiding money market distortions.

Directors agreed that the public finances and the authorities' medium-term fiscal plans were essentially sound, but they expressed concern about the slippages in current spending that had taken place in recent years. They supported the authorities' goal of rapidly returning to moderate budget surpluses and reducing government liabilities, in order to provide a necessary buffer against external shocks. They suggested that, in working toward those goals, more emphasis be placed on budgetary discipline and restraint in current spending – including notably the government wage bill – and less on cuts in capital spending, which they saw as crucial for maintaining infrastructure and safeguarding the basis for long-term growth. Directors recommended that the fiscal policy framework be reinforced by introducing multi-year budget plans with explicit expenditure limits and cyclically-adjusted balance targets, as well as budgetary accounting and coverage that conform to established national accounts methodology.

Directors commended the authorities' consistent pursuit of growth-oriented structural reforms. They supported efforts at reforming the tax system to foster saving and minimize economic distortions while bringing corporate taxation closer to international practices. They also welcomed the resumption of the privatization process, as well as the decision to continue devoting the proceeds mainly to redeeming public debt. The authorities were encouraged to introduce more flexibility in the wage settlement process to better reflect productivity differentials. Most Directors also suggested that they should consider expanding the role of the private sector in the provision of public services such as health and education.

Directors welcomed the authorities' efforts to combat money laundering and the financing of terrorism. They noted that Iceland has a well-developed system to fight financial crime, including provisions on customer identification, reporting of unusual transactions, regulations to seize assets, and training of the staff of financial institutions. Directors welcomed the passage of legislation by the parliament to implement the United Nations resolutions and conventions related to terrorism.

Directors welcomed the granting of tariff concessions to least developed countries similar to those that apply to members of the European Economic Area, and the removal of tariffs on most imports of agricultural products; but they noted the high level of agricultural subsidies and called for a plan to reduce the protection accorded to this sector. They welcomed the authorities' commitment to increase official development assistance and encouraged progress toward the United Nations target of 0.7 percent of GNP.

Iceland publishes statistical data on a sufficiently timely and comprehensive basis to permit effective surveillance.