International Monetary Fund
Iceland – 2005 Article IV Consultation
Summary of the Concluding Statement
June 13, 2005

This document contains a summary of the conclusions of the IMF mission that visited Iceland during June 2-13, 2005. The mission team would like to thank the authorities and all others participating in the meetings for the open and helpful discussions as well as their gracious hospitality.

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. One component of these policies has been the promotion of power intensive projects that exploit Iceland's comparative advantage in clean energy. However, the magnitude of these projects has contributed to economic volatility. Smoothing this volatility presents a key challenge for policymakers. At this point in the economic cycle, appropriate policy measures need to be in place so that the imbalances in the current account, external debt, domestic demand and inflation do not lead to excessive volatility as they unwind following the completion of the projects. Further, policy frameworks can be improved to help increase overall macroeconomic stability while still supporting strong economic growth.

2. 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. Both tax and expenditure measures should be used to achieve this tightening. Although public finances are on an extremely sound footing from a medium-term perspective, the medium-term fiscal

framework should be strengthened. 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 the public debt and a consistently counter-cyclical fiscal stance. This would help ensure the systematic coordination of monetary and fiscal policies, essential for achieving both strong and stable growth.

3. Monetary policy has been responding appropriately to emerging demand and inflationary pressures. Although temporary factors have recently lowered measured CPI inflation, policy should continue to focus on the underlying demand conditions that constitute the primary source of persistent inflation. The developments in the mortgage market have increased the challenge of stabilizing inflation. Consequently, the central bank will need to be prepared to respond to changing economic conditions 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. The introduction of a pre-announced schedule for monetary policy meetings that conclude with a public announcement of the central bank's decision regarding interest rates would enhance inflation stability by more firmly anchoring expectations, as would the publication of a scenario based on the expected interest rate path required to return inflation to target.

4. It is essential that the risks to financial stability of the ongoing credit boom be monitored closely, and prudential measures be implemented immediately if required. Financial institutions have strong balance sheets, as attested by the stress tests conducted by the Financial Supervisory Authority (FME). It will be important for the FME to move ahead with the implementation of the more stringent and broader stress tests that are being

developed so that potential vulnerabilities are identified promptly. The entry of commercial banks into the mortgage market has been a positive development from a longer-term financial stability perspective, but it will be necessary to quickly reform the HFF to ensure that banks' presence in this market can be sustained. The reform should be guided by principles that will retain all the positive aspects of the current system while allowing it to evolve in a manner that will strengthen the stability of the financial system.

5. 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.