INTERNATIONAL MONETARY FUND

Article IV consultation: Concluding statement

An Article IV Mission of the International Monetary Fund visited Iceland from January 10-18. Its concluding statement is printed below.

1. The past decade has witnessed a substantial strengthening of the Icelandic economy, due in large part to major changes in economic policy formulation toward an emphasis on stable and predictable macroeconomic policies, and on structural reforms. The adoption of the exchange rate as a nominal anchor and intermediate target for monetary policy was key to the successful disinflation of the first half of the decade, which in turn set the stage for the economic recovery that began in 1995. Iceland's strong economic performance has also benefited from the government's tenacity in consolidating the public finances and perseverance in enhancing competition through market liberalization and privatization. Notwithstanding, the maturing cyclical upswing has been accompanied in recent years by the emergence of overheating pressures and a large external imbalance.

2. During the past two years, the economic expansion continued apace, accompanied by further income and employment gains. Given the strength of activity, output remained well above the economy's capacity for the fourth consecutive year, driven mainly by excessively rapid domestic demand growth. Fears of eventual overheating expressed at the time of our last visit – barring a sufficient tightening of policies – appear to have been well founded. Inflation has yet to be put on a sustained downward path, despite repeated increases in the Central Bank's policy interest rate; the labor market has become increasingly tight; and both the current account deficit (9 percent of GDP in 2000) and the net external liability position (59.2 percent of GDP at end-September 2000) have now reached levels that require an early policy response.

3. The official outlook is for a moderation of growth from 4 percent in 2000 to 1.6 percent in 2001. The slowdown in economic activity is expected to result from a reduction in real disposable income growth, a fall in this year's allowable fish catch, and a sizable decline in investment. The very low unemployment rate is expected to increase slightly, while inflation is likely to remain at around 5 percent on the assumption that some of last year's decline in the exchange value of the króna is passed through into prices. Finally, the current account deficit is projected to rise above 9 percent of GDP, not least because of high debt service payments. The mission is less confident about the prospects of achieving such a soft landing, notably in view of the size and apparent durability of the current account deficit and the increased fragility of the financial system, as indicated, for example, by recent declines in capital adequacy ratios.

4. Fiscal policy has generally been prudent during the past decade, resulting in a shift from structural deficit to structural surplus, which allowed for a significant decline in the ratio of public debt to GDP. Nevertheless, given the overheating pressures emanating mainly from a surge in private consumption, the stance of fiscal policy could have been tightened more during the past

three years. This would have taken pressure off monetary policy in containing domestic overheating and lessened the deterioration in the current account balance. In effect, with the aim of slowing domestic demand growth and containing inflationary pressures, the Central Bank's policy interest rate was increased by 390 basis points in seven steps, which required a widening of the fluctuation bands of the exchange rate from ±6 percent to ±9 percent in early 2000.

5. The monetary authorities have faced difficulties in containing demand pressures, however. The increased openness of Iceland's financial markets, in combination with the emergence of a large positive interest rate differential and a soft exchange rate peg, led to a surge in foreign borrowing by banks for domestic on-lending, which in turn fueled domestic credit and demand growth. Not surprisingly, macroprudential indicators suggest that the financial system's risk exposure has increased considerably, while microprudential indicators point to a decline in the system's capacity to absorb shocks. While there are signs that credit growth of deposit banks has slowed down recently, credit and monetary growth still exceed levels that are compatible with low and stable inflation. The mission does not believe, therefore, that there is a basis for lower interest rates at this time. Indeed, if the recent decline in the exchange value of the króna were to persist and lead to additional inflationary pressures, the Central Bank would need to tighten its policy stance. At the same time, however, sizable interest rate hikes would put pressure on banks' profitability and reduce capital adequacy ratios further.

6. The mission is of the view that addressing the present imbalances requires a mix of policy measures. This package would include improving the health of the financial system, raising national saving, and strengthening incomes policies. The effectiveness of these measures would be enhanced by a change in the monetary framework that would allow for greater exchange rate flexibility.

7. An urgent task is to lower the risk exposure of the financial system. The authorities should move swiftly to raise the minimum capital adequacy requirements of domestic banks and empower the Financial Supervisory Authority to mandate increased capital requirements for banks thought to be at particular risk. The potential vulnerability of the financial system can also be traced to some inadequacies – particularly when compared to international best practice – in its legislative, regulatory and supervisory frameworks. The mission therefore urges the authorities to take regulatory and legislative steps that are needed, inter alia, to improve loan classification and provisioning of domestic banks. Greater resources should be given to the Financial Supervisory Authority. In particular, there is a need for intensified on-site inspections and a further strengthening of prudential supervision, especially with regard to connected lending and risk management practices of financial institutions. Since the Central Bank's fixed-rate repo auctions have on occasion provided excess liquidity to the banking system, consideration could be given to putting in place the institutional framework that would be needed for fixed quantity/variable interest rate repo auctions. In any event, the repo rate should be re-centered within the interest rate corridor – through a shift in its bands – in order to provide banks with increased incentives to use the interbank market.

8. In order to avoid the inherent conflict between Iceland's soft exchange rate peg and the conduct of an independent monetary policy, given the country's highly integrated capital markets, there is a need to allow for increased exchange rate flexibility. A move to a floating exchange rate regime would be an obvious extension of the widening of the fluctuation bands over the past decade and would serve Iceland better in view of its sensitivity to external and supply shocks.

9. A decision to allow the currency to float freely, however, would need to be accompanied by a credible alternative nominal anchor for monetary policy. The mission believes that an inflation target is the most appropriate alternative to the

present exchange rate anchor. Iceland is relatively well placed to make such a move. First, its public finances are on a sound medium-term footing. Second, the monetary authorities, together with the government, have demonstrated the ability and willingness to implement a credible anti-inflationary policy stance, as evidenced by the remarkable disinflation following the adoption of a nominal exchange rate anchor. Third, the Central Bank has made considerable progress in forecasting inflation and in improving the transparency of its operations vis-à-vis the public. Fourth, the social partners appear to attach the highest priority to the containment of inflation, and should therefore be supportive of a change in regime. The new inflation targeting framework could be successfully launched on the basis of a joint announcement by the government and the Central Bank that the latter would be assured practical independence in implementing monetary policy, pending legislation granting formal independence. The mission believes that the adoption of an inflation targeting framework would be well received in the financial markets by validating price stability as the primary objective of monetary policy.

10. Fiscal policy would need to play a supporting role in addressing the domestic and external imbalances. Although the structural budget balance has improved in recent years, overruns have occurred in all major public expenditure categories. The stage is already set for a possible repeat this year, with extra outlays projected for retroactive payments of transfers to the disabled following a recent ruling by the Supreme Court, and for additional wages for secondary school teachers. While the 2001 budget has already been adopted, the authorities have indicated that a supplementary budget will be needed to accommodate these expenditure developments. The mission urges the authorities to offset these unexpected higher expenditures with cuts in other spending categories, and to consider postponing public investment projects that could also help reduce pressures in the construction sector. Finally, more robust expenditure control mechanisms should be put in place.

11. Incomes policies also have an important role in helping to maintain low inflation and contain domestic demand growth. The recent positive news on the inflation front should dissuade the private sector from invoking the inflation clause in wage agreements signed last year. The budgetary envelope for the public sector wage contracts yet to be finalized should be respected, both for fiscal austerity reasons and to dissuade the private sector from invoking the escape clause based on compensating wage differentials. In any event, the mission strongly urges the government to resist possible calls for expenditure initiatives or tax measures to compensate for wage restraint.

12. Iceland has made considerable strides on the structural front. The government is to be commended for its privatization program over the past decade and for its resolve to continue this process. The mission welcomes the government's intention to carry through with its decision to privatize fully the remaining state owned banks, notwithstanding the rejection of the proposed merger of the two entities by the Competition Council. Equally welcome is the planned sale of shares of the state-owned telecommunications company.

13. The Icelandic pension system has a strong financial foundation. The occupational pension component is fully funded and has generated sizable returns in recent years. The state pension scheme has also been reinforced through the establishment of a fully funded system for new public employees and by the government's decision to reduce the unfunded liability of the old state pension scheme. However, these positive developments are mitigated somewhat by the increases in pensionable income associated with recent changes in the structure of public sector wages, which will raise the government's future pension obligations. Against this background, the mission urges the government to use the prospective privatization proceeds to further reduce its unfunded public pension liability. The decision to raise the ceiling on pension fund assets that can be invested in abroad, while allowing for

greater risk diversification, is likely to result in a continued large net portfolio outflow. In the current climate of a weak currency, this puts additional pressure on the króna. The authorities should therefore consider taking measures that would ensure a more gradual phasing-in of the portfolio shift into foreign securities.

14. The mission welcomes the initiatives underway to reform the fisheries quota system. Measures under consideration, including various options for extracting a portion of the economic rents stemming from the utilization of common property resources, should add further to the transparency of public policies.

15. While measures are being taken to reduce the financial burden of Iceland's agricultural sector, more needs to be done to deregulate the sector and make it less dependent on subsidies. Progress has been made in recent years, evident in the switch from market price supports and border protection to direct payments and in the government's decision to buy back the production quotas for sheep. However, with a producer subsidy equivalent to 70 percent of the value of production (one of the highest in the world), there is a need to curtail the current regime of farm support significantly further. Such action would provide benefits to Icelandic consumers (in terms of lower prices) and to developing countries (in terms of greater access to the Icelandic market) which would far exceed the benefits that the regime currently provides to farmers in Iceland.

16. Finally, the Icelandic authorities are encouraged to raise the nation's contribution to ODA in relation to GDP toward the generous levels provided by their Nordic neighbors.