INTERNATIONAL MONETARY FUND

Article IV consultation: Concluding statement

The International Monetary Fund conducted Article IV consultations with Iceland in the period from March 18 to March 27, 2002. Attached is the Concluding Statement of the IMF Mission delivered at the end of the consultations on March 27.

1. The growth of the Icelandic economy over the last decade has been impressive. Output increased by 38 percent in 1992-2001 and GDP per capita (measured at purchasing parity prices) reached US$29,000 in 2001, one of the highest among OECD countries. This performance owes much to the authorities' policies of market liberalization, public sector rationalization, privatization, and other structural reforms that fostered entrepreneurship, investment, and growth. The economic expansion was underpinned by the successful disinflation of the early part of the 1990s and by macroeconomic policies that emphasized stability and predictability. Essential in this regard was the authorities' farsighted determination to consolidate the public finances turning earlier budget deficits into surpluses, reducing substantially the net government debt, and setting aside funds to cover future public pension obligations.

2. The rapid growth that took place during the second half of the 1990s, however, led to overheating and the development of internal and external imbalances. The expansion, which was initially sparked by burgeoning investment, evolved eventually into a consumption boom fueled by brisk credit growth. Domestic expenditure growth well 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. Moreover, the rapid expansion of bank lending-financed mainly by external borrowing for domestic onlending-led to increased risk exposures and weakened banking sector prudential indicators.

3. Economic developments since early 2001 have been characterized by progress in the correction of some of these imbalances, which is still underway; but inflation has increased and remains high, posing risks to macroeconomic stability. As sentiment turned, against the background of the international slowdown in economic activity and lower capital inflows, the misalignment of the króna with respect to fundamentals unwound and the currency depreciated sharply during 2001, before stabilizing at the end of the year and recovering somewhat since then. In the wake of the depreciation, a more sustainable balance between the internal and external sectors of the economy is being restored. Growth in economic activity decelerated from 5½ percent in 2000 to 3 percent in 2001–bringing it closer to its long-term sustainable pace. More notably, the balance of demand switched swiftly from consumption and other domestic expenditure to net exports, which contributed to output growth in 2001 by 6 percentage points of GDP owing to both a sharp decline in imports and buoyant exports. As a result, the external current account deficit shrank to about 4½ percent of GDP. At the same time, however, the twelvemonth 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 8.7 percent in March 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, on average, outpaced prices and by a sizable fiscal impulse in 2001 resulting largely from overruns in public wages and other current spending.

4. The new official macroeconomic projections released on March 19 point to an additional moderation in economic activity during 2002 with the GDP declining year-on-year by ½ percent. This would bring 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 indebtness, consolidate their balance sheets. As a consequence, the current account deficit is projected to contract further to 2 percent of GDP. This envisaged rise in domestic savings and reduction of the external deficit are preconditions for the return to a sustainable growth path over the medium term. The prospects for turning the ongoing adjustment into a resumption of sustainable growth, however, hinge crucially on economic policies.

5. The mission supports the objective stated by the CBI of bringing the 12-month rate of inflation down to within the tolerance limits of the inflation target range–that is, below 4 percent–by the beginning of 2003 and close to the target of 2½ percent by the end of that year. The mission believes, however, that the balance of risks to this inflation path are distinctly on the upside. Statistical analyses based on the past experience of the Icelandic economy indicate that a significant part of the inflationary pass-through effects of the recent depreciation are yet to be realized and will continue generating inflationary pressures in the months ahead. The CBI inflation forecast is based on a benign wage projection that is threatened by the currently large wage drift and by a possible overshooting of the May 2002 inflation threshold (6.3 percent) that could trigger a wage review. In this respect, inflation expectations are high, as evidenced by recent opinion surveys, and could become entrenched–impinging on wage negotiations and pricing behavior. Also, the CBI inflation forecast was based on lower growth in 2001 than currently envisaged. Finally, the substantial increase in lending by the CBI through its repo facility and the growth rate of monetary aggregates point to excess liquidity in the monetary system that could jeopardize the decline of inflation towards the target.

6. Given this balance of risks, the mission believes that the March 26 interest rate cut by the CBI was inappropriate. The mission is concerned that the current monetary policy stance is loose and could contribute to excessive liquidity, and higher actual and expected inflation. Moreover, an inflation-targeting monetary policy framework requires that rate decisions be guided by coherence between the inflation forecast and the agreed inflation target. In this light, the mission considers the rate cut inconsistent with the recent upward revision of the two-year-ahead CBI inflation forecast to 3 percent (½ percentage point above target), and with current and projected inflation rates for 2002 above the statutory upper tolerance limit for inflation.

7. Looking forward, the mission urges the authorities to stand ready to raise interest rates as soon as evidence emerges that inflation is not abating or if the inflation rate appears unlikely to fall below the 4 percent tolerance range by early 2003. More generally, the authorities should be vigilant of indications of increased inflationary pressures, such as signs of a wage-price spiral; continued excess liquidity; or reemergence of downward pressure on the króna–all of which would require a rate increase. In this regard, the mission stresses that attempts by the CBI to fend off potential downward pressure on the króna undertaking sterilized interventions in the foreign exchange market as a substitute for a tighter interest rate stance would undermine the inflation-targeting policy framework and be ineffective in the medium term.

8. CBI lending through the repo facility has experienced rapid growth and outstandings are currently about ISK90 billion. At their current level, repos are replacing to a significant extent regular sources of bank financing and distorting activity in the money markets. Moreover, they may be creating incentives to increase risk and short-term exposures. We suggest that the authorities consider reforming the repo facility to improve the management and control of CBI liquidity. Ultimately, however, a persistent demand for liquidity deemed incompatible with the inflation target would indicate an excessively low policy rate and should prompt a rate increase.

9. The credibility of the inflation-targeting framework introduced in March 2001 needs to be fostered in these early stages of its implementation. First and foremost, this will be accomplished by pursuing the necessary policies to bring inflation swiftly to within the inflation target range, as envisaged by the CBI inflation forecast. In this connection, the recently accorded central bank operational independence necessitates that the CBI be free to set a tight monetary stance as required, unencumbered by outside pressures from other government institutions. In addition, transparency, predictability, and credibility of monetary policy would be enhanced by establishing regular rate-setting meetings of the CBI Board of Governors and publishing subsequently a detailed statement containing the analysis and considerations that led to the adopted policy decision—as it is common in many other inflation-targeting countries.

10. Notwithstanding significant stresses in securities and foreign exchange markets, the banking system maintained profitability and improved its capital adequacy position. Commercial banks' profits increased in 2001, bolstered by increasing interest rate margins, cost efficiencies, and the favorable net effects of inflation on banks' balance sheets. In comparison, savings banks reported less favorable results, as they suffered greater loan losses and were slower in consolidating costs. Nonperforming loans increased substantially in 2001 reflecting the downturn in domestic demand on the consumer, retail, and other non-exporting sectors. In response to the increase in nonperforming loans, banks increased provisions, but provisioning standards remain weak compared to international best practices.

11. Looking forward, several risks to financial stability merit additional attention. Loan portfolio credit quality is expected to deteriorate again in 2002 reflecting the decline in economic activity. Timely monitoring of collateral values and associated provisions will be necessary, particularly in view of the ongoing decline in inflation-adjusted real estate prices. Beyond the banking sector, securities lending by pension funds may generate unmonitored credit risk exposures. Securities lending to related financial entities increases connectedness and could generate moral hazard conflicts that may hamper proper internal controls. Also, the combination of inflation and declining real housing values, if sustained, may pose risks to the Housing Fund Authority and pension funds in the medium term, as the servicing burden of indexed mortgages and other debt increases.

12. The authorities have made significant progress in addressing the weaknesses of the prudential regulatory and supervisory system identified by the 2001 Financial System Stability Assessment (FSSA) report. The Financial Supervisory Authority (FME) was instrumental in encouraging banks to raise their capital. The authorities' efforts have already produced improvements in macro- and micro-prudential indicators of financial vulnerability and in management practices of financial institutions. The mission welcomes the significant strengthening of financial regulations and supervisory resources, as well as the proactive approach to supervision demonstrated by the FME. Further along these lines, the mission recommends that additional guidance be issued tightening minimum standards for loan classification, provisioning, and collateral valuation. It also recommends more frequent on-site examinations and careful monitoring of rapidly growing securities lending and investment bank-

ing operations. Prompt enactment and implementation of pending financial legislation should be considered a priority, as these laws will allow integrated supervision of increasingly linked financial activities, consolidated supervision of connected groups, and prescription of additional capital requirements for banks according to their individual risk profiles. The mission welcomes the authorities' decision to conduct a follow-up of the 2001 FSSA report.

13. As a result of past efforts at fiscal consolidation, the public finances are sound and the mission considers appropriate the authorities' objective of achieving a cyclically adjusted surplus of 1 percent of GDP over the medium term. This would contribute to increase national savings and provide a necessary buffer to the small and open Icelandic economy against external shocks. The general government deficit in 2002 is projected at ½ percent of GDP, slightly higher than the deficit outturn in 2001. Still, on a cyclically adjusted basis, the 2002 budget represents a fiscal withdrawal. The mission concurs with the authorities that this is necessary to correct for the overspending of recent years and initiate a return towards the intended medium-term fiscal path and a stronger external position. Nevertheless, in light of the need to foster growth and productivity, it would be preferable if the budgetary retrenchment concentrated on current spending, rather than on public investment as it is currently planned. The growth of recurrent expenditure at the expense of the capital budget is not a sustainable policy and could lead to a budgetary expansion in the medium term. In this regard, the mission encourages the authorities to reinforce budgetary discipline and introduce improvements in the budgeting process. In the mission's view, the fiscal policy framework should strengthen its medium-term orientation and transparency by incorporating multi-year budget plans with explicit expenditure limits and cyclically-adjusted balance objectives; and extending the coverage of the budget formulation and reporting to all levels of the public sector on a national accounts basis.

14. On the area of structural policies, the authorities should be commended for the implementation of a wide range of reforms aiming to improve the efficiency and growth prospects of the economy. The tax reform introduced in 2002 will streamline the taxation of income, particularly from savings and investment, and will bring the Icelandic tax system closer to common international practices. The mission welcomes the decision to introduce a levy on fishing activities, designed to tap the economic rents stemming from this key national resource. The mission also notes the resolve to continue reducing the net public debt position of the government through the privatization of several public enterprises which was postponed in 2001 owing to market conditions. In this regard, the mission encourages the authorities to consider widening the scope for private sector provisioning of services that are currently within the public sector sphere, including potentially in the areas of health care and education. Initiatives in this direction could improve the efficiency in the provision of these services while reducing strains on the budget. The mission also suggests considering measures to liberalize the labor market, allowing for wider variation in wage increases that better reflect productivity differentials across sectors and firms–thus facilitating the redeployment and efficient use of resources.