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# Iceland: 2008 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Iceland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2008 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 4, 2008, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 20, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement of September 8, 2008, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 10, 2008 discussion of the staff report that concluded the Article IV consultation, **prior to the recent Board discussion on a Stand-By Arrangement for Iceland**.

- A statement by the Executive Director for Iceland.

The document listed below has been separately released.

Financial System Stability Assessment

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ICELAND

# Staff Report for the 2008 Article IV Consultation

Prepared by the European Department

(In consultation with other departments)

Approved by Poul Thomsen and Martin Fetherston

August 20, 2008


## Executive Summary

**Background:** The long expansion is coming to an end, exposing the economy's overstretched private sector balance sheets, large macroeconomic imbalances, and high dependence on foreign financing. With external liquidity constraints binding, economic activity is expected to slow significantly from unsustainably high levels, inflation to remain well above target, and the current account to narrow. Uncertainty surrounding the outlook is unusually large, dominated by significant downside risks—both external and domestic. In the event of a prolonged external liquidity crunch, the economy could face severe financial strain, especially if domestic risks materialize simultaneously.

**Staff views:** The main challenge is to facilitate an orderly rebalancing process, while mitigating risks. A key concern is external liquidity risks, which could also trigger an unwinding of domestic vulnerabilities. Monetary policy should continue to be tight, to return inflation to target and shore up confidence in the króna, given prevailing inflationary pressures and external vulnerabilities. The highly expansionary fiscal policy should be restrained to help support the central bank's efforts to combat inflation and maintain confidence. Further actions to mitigate financial sector vulnerabilities should be pursued with vigor, as concerns about banks' funding are at the core of the external liquidity risks. Contingency planning needs to continue in full force.

**Authorities' views:** The authorities broadly agree with the staff's diagnosis and recommendations. However, while external risks are recognized to be substantial, the policy focus has shifted to addressing concerns about a deep domestic recession. Accordingly, the authorities see limited room to tighten monetary and fiscal policies. At the same time, they welcomed staff's recommendations to mitigate financial sector vulnerabilities and strengthen contingency planning.

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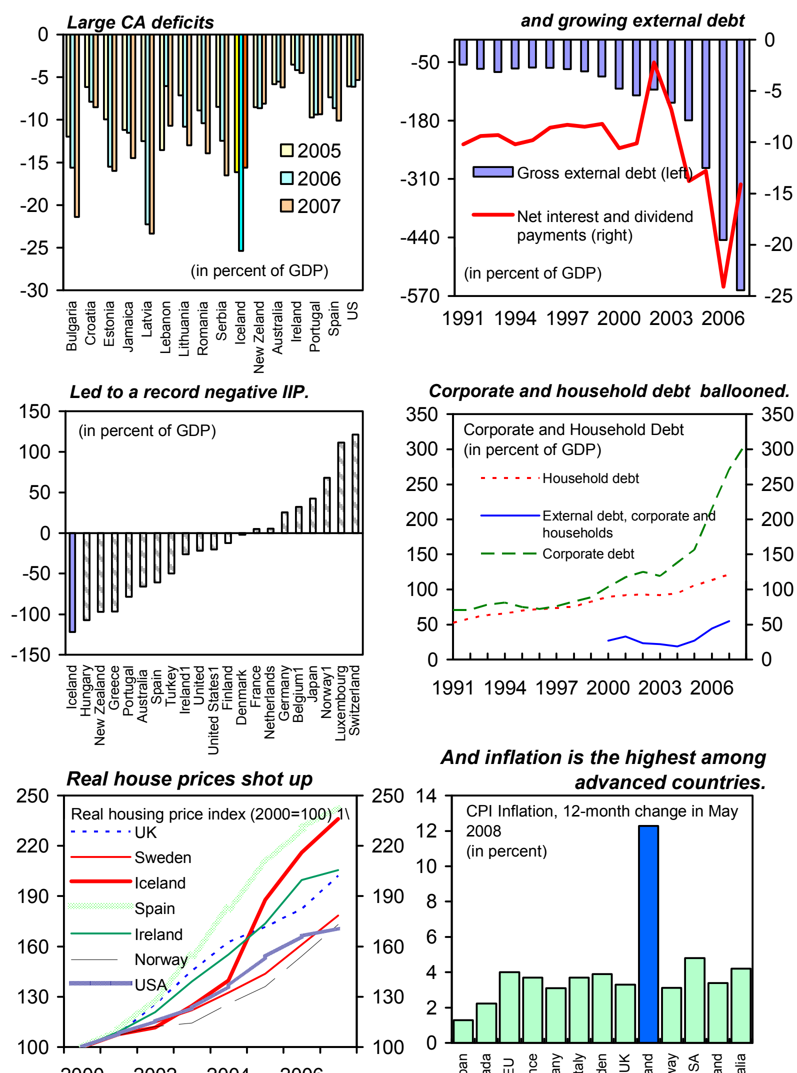
# I. Introduction

1. **Iceland is at a difficult and uncertain turning point**. The economy is prosperous and flexible, and its long-term prospects are promising, given sound institutions and bountiful renewable natural resources (Figure 1). But a long home-grown, foreign-funded boom led to large macroeconomic imbalances, overstretched private sector balance sheets, and high dependence on foreign financing (Box 1). The current account deficit exceeded 15 percent of GDP in each of the past three years; inflation moved away from target; the króna became overvalued; domestic credit growth reached new peaks; and house prices shot up to record levels. The financial sector expanded to over 1,000 percent of GDP, while gross external indebtedness reached 550 percent of GDP at end-2007, largely on account of the banking sector. The indebtedness of households and corporations also swelled. The boom is now coming to an end, exposing these vulnerabilities to an uncertain external environment.

Iceland: Large Imbalances Built Up During the Boom

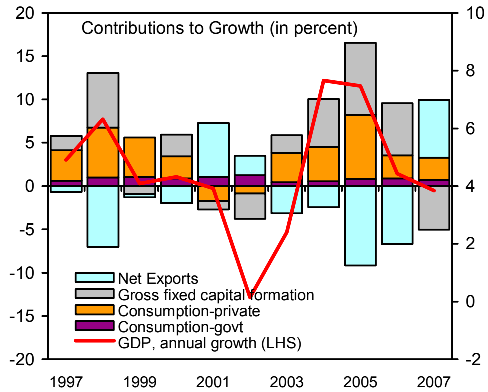


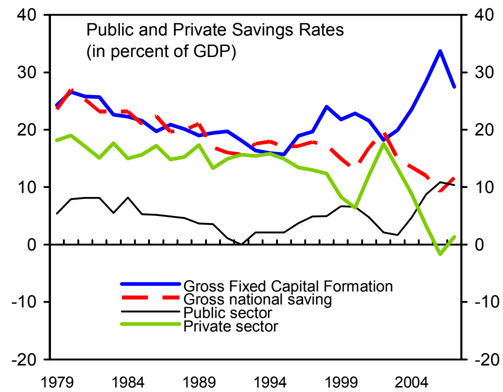

1\ 2007 numbers are averages of available quarters.
2\ Estimates by the Central Bank of Iceland.

Source: Haver Analytics, Iceland Central Bank, Land registry of Iceland, OECD, WEO, IMF staff calculations.

## Box 1. Background: Origins of the Long Boom

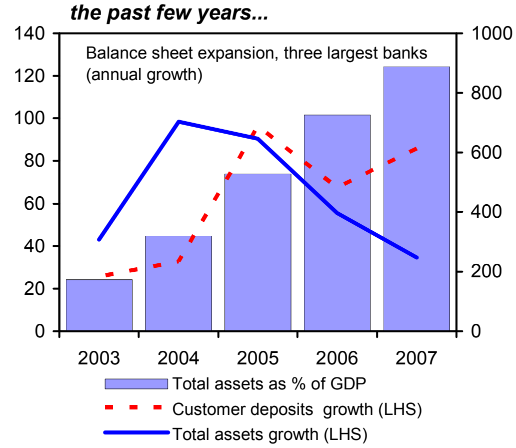
**A dramatic acceleration of domestic demand was at the core of Iceland's boom**. Real output rose by over 25 percent during 2003–07, jump-started with a large aluminum-sector investment project in 2003 and sustained by an unprecedented rise in private consumption, which pushed the savings rate into negative territory. The spending boom reflected higher disposable income, easy credit, higher housing and equity wealth, an appreciated currency which led to cheaper imports, and lower unemployment (Figure 2).



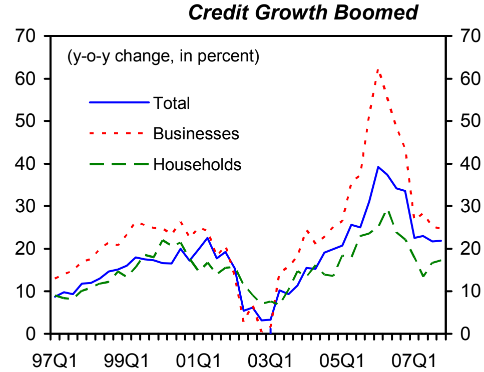




**Ample global liquidity and low risk premiums fuelled the boom**. Buoyed by benign global financing conditions and the excellent sovereign credit rating, the recently fully-privatized banks took advantage of carry trade investment opportunities to secured cheap foreign financing to expand across all business lines. Banks' consolidated assets increased from 100 to almost 900 percent of GDP between 2004 and 2007, due to a rapid expansion abroad through acquisitions abroad, which relied heavily on investment-banking and capital-market activities and foreign wholesale funding. The bank expansion contributed to a domestic credit expansion to corporations and households, thereby supporting the housing and consumption booms. With relaxed liquidity constraints, firms could borrow directly from abroad.

***Banks expanded tremendously over the past few years...***



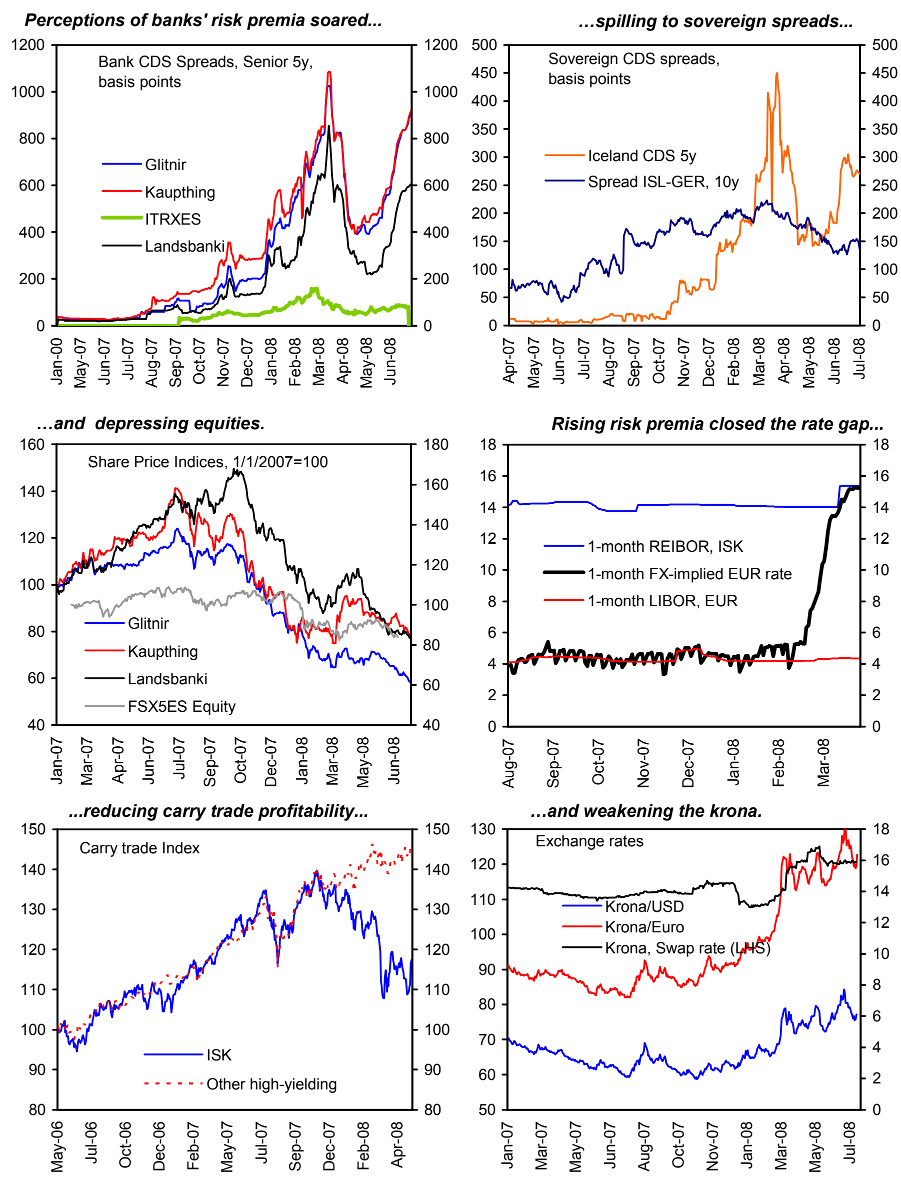

***Credit Growth Boomed***




**Policies were tightened during most of the expansion, but could not prevent an overheating**. The central bank raised its key policy rate, but its efforts were undermined by the unexpected strength of the expansion, króna appreciation, rapid financial innovation, and increased competition in credit markets. Buoyed by strong revenue growth on the back of rising asset prices, fiscal policy was countercyclical during most of the expansion, but turned firmly expansionary in 2007.

2. **As global external conditions deteriorated, Iceland faced severe financial turbulence in early 2008**. In March, the CDS spreads of the three main commercial banks rose to over 1,000 basis points—partly due to investor concerns about their large funding needs and high dependence on wholesale funding. Despite minimal public sector debt, the sovereign was faced with a significantly increased risk premium, likely reflecting concerns about its potential liabilities in the event of banking problems. At the same time, the sudden jump in risk premiums prompted a large króna depreciation (of about 30 percent in December 2007-March 2008), with negative repercussions for already-high inflation.

Iceland: Hard Hit by the Financial Turbulence




Source: Bloomberg, Datastream

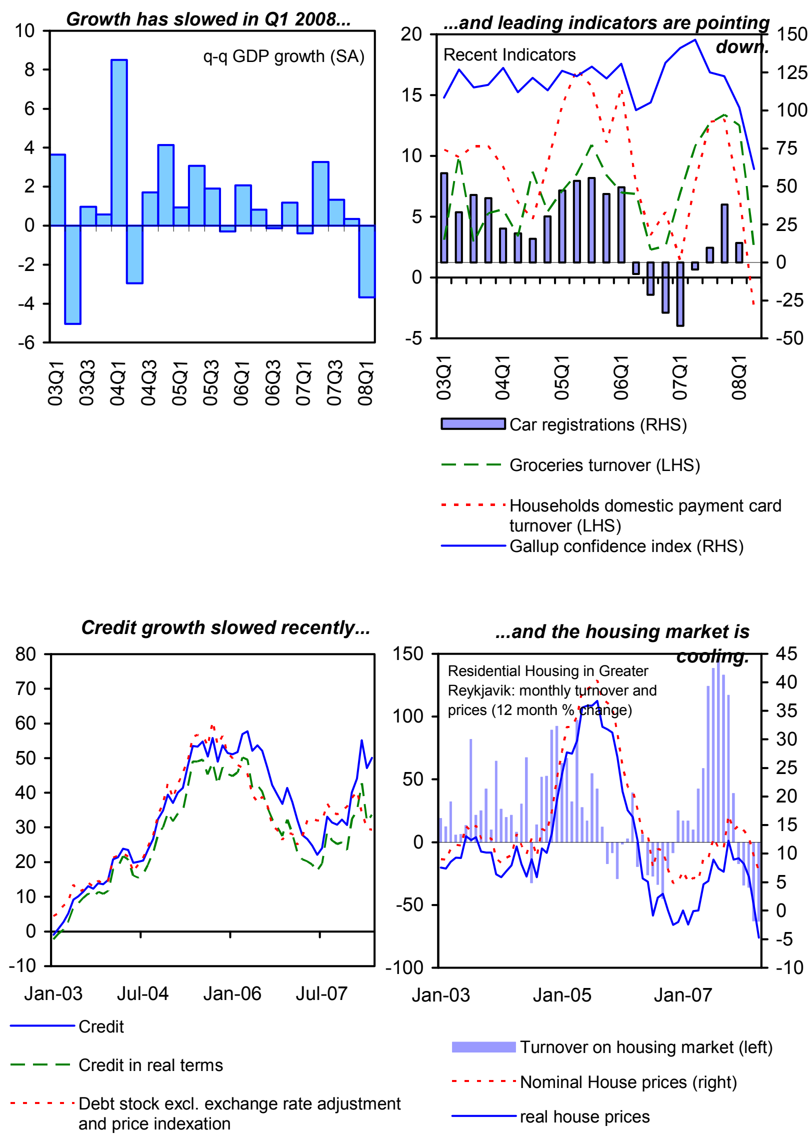
3. **In response to intensifying external pressures, the authorities took steps to shore up confidence**. The Central Bank of Iceland (CBI) tightened the policy rate and enhanced liquidity provision to reduce pressures in foreign exchange and domestic markets. In mid-May, it entered into currency swap arrangements with the central banks of Denmark, Norway, and Sweden, providing access to 1.5 billion euros, if needed. The government expressed its willingness to boost CBI's international reserves and pledged to pursue fiscal prudence and reforms of the fiscal framework and the Housing Financing Fund (HFF).

**Iceland: Recent Policy Measures and Pledges**

| Policy area | Action | Date |
|---|---|---|
| **Monetary** | CBI raised policy rate by cumulative 175 basis points, in two steps (March 25 and April 10). Left rates unchanged at 15.5 percent on May 22 and July 3. | Mar 25-Jul 3 |
| | Government pledged to reform the HFF. Several measures announced since then. | May 16, June 19 |
| **Liquidity management** | CBI and Treasury increased the supply of short-term instruments (certificates of deposit and T-notes); CBI CDs are transferable and registered, eligible for clearing, settlement and custody in Clearstream. Later, the authorities announced plans to roll over CDs at maturity, and issue more short-term debt. | Mar 25-Jul 21 |
| | CBI eased rules on eligible collateral and reserve requirements for banks. | Mar 25 |
| **Reserve management** | CBI entered into currency swap agreements with central banks of Denmark, Norway, and Sweden, providing it access to 1.5 billion euros, if needed. | May 16 |
| | Government approved a bill allowing the CBI to borrow up to 500 billion krona (4.2 billion euros, about 40 percent of GDP) in foreign currencies. | May 29 |
| **Fiscal** | Government pledged to keep public debt at low level and strengthen the fiscal framework. | May 16 |
| **Banking supervision** | CBI tightened the rule on the mismatch between banks' foreign currency assets and liabilities, not to exceed 10 percent of own funds (down from 30 percent). | June 4 ( in effect July 1) |

4. **In late June, the Article IV discussions took place amidst renewed worsening of market and economic conditions**. Bank and sovereign CDS spreads were approaching their March peaks. The foreign exchange swap market remained frozen and the króna volatile. With liquidity constraints becoming more binding, the overheated economy was quickly cooling—as indicated by the sharp growth slowdown in the first quarter of 2008—while inflation increased to the highest level among industrial countries.

Iceland: The Overheated Economy is Quickly Slowing




## II. Report on the Discussions

5. **Against this backdrop, discussions focused on the policies needed to facilitate an orderly rebalancing process, while mitigating mounting risks by shoring up confidence**. Topics of discussions included the coordination between monetary and fiscal policies, and actions to address vulnerabilities stemming from the banking sector. With external financing conditions quickly deteriorating, staff inquired about the authorities' plans to follow up on the confidence-building measures and pledges announced earlier this year.

6. **Several questions guided the discussions**:

- What is the outlook for restoring macroeconomic balance under current policies, and what are the main risks associated with it?
- Which monetary policy stance would be best suited to re-establish price stability and mitigate prevailing risks?
- How should the fiscal policy stance be adjusted and fiscal framework reformed to support monetary policy efforts and contribute to confidence building?
- What are key financial sector vulnerabilities, and what steps can be taken to promote financial stability and strengthen contingency planning?

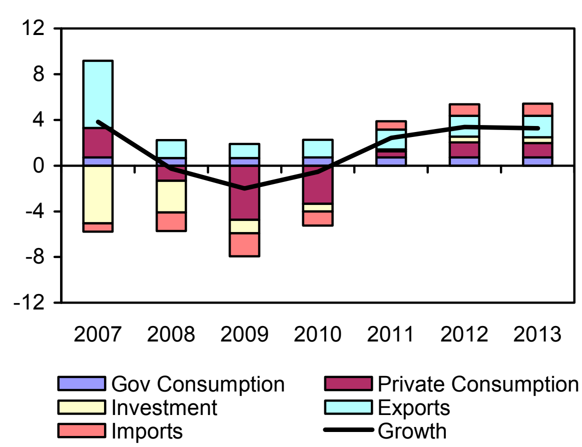
## A. Outlook and Risks

7. **Despite differences in precise timing, staff and the authorities agreed that a recession was imminent, led by a contraction in domestic demand.** While staff saw output come to a standstill in 2008 and contract in 2009–10, the authorities projected somewhat higher growth this year, followed by a recession. All growth projections were driven by a sharp retrenchment in private consumption, owing to tighter lending conditions, significantly lower real estate prices, weaker private sector balance sheets, and declining purchasing power. While staff and the Ministry of Finance (MoF) projected a decline in overall investment in 2009–10, the CBI expected high public sector and aluminum-related investment to quickly offset a sharp fall in other investment beyond 2008. Net exports were expected to support growth over the next few years, on the back of strong aluminum exports and a contraction in imports. Assuming that the nominal exchange rate would remain broadly constant, both the authorities and staff projected the current account deficit to narrow significantly over the medium term.

**Iceland: Real Growth Projections**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| **IMF** | **-0.3** | **-2.1** | **-0.8** |
| CBI | 1.1 | -2.0 | -1.9 |
| MoF | 0.5 | -0.7 | 0.8 |
| OECD | 0.4 | -0.4 | .... |
| Moody's | 1.4 | 0.4 | .... |
| Fitch | 0.6 | -0.8 | .... |
| S&P | 1 | -1.9 | -1.5 |
| *Private Avg.* | *1.0* | *-0.8* | .... |

Growth Projections: Component contributions to Growth



8. **Both sides expected the fiscal position to deteriorate to a varying degree—due to a weaker economy and stimulative policy measures—and spending pressures to rise**. The MoF projected the general government balance to turn into a deficit of 1¾ percent of GDP in 2010, a 7 percentage point deterioration since 2007. Cyclical factors explain about half of the deterioration, while the rest reflects structural measures, including a sharp increase in public investment in 2008, the implementation of announced tax cuts, and higher spending in 2009–10. Given these policies, but more pessimistic macroeconomic assumptions (and their impact on tax revenues), staff forecast a fiscal deficit peaking at around 5 percent of GDP in 2010, and net debt growing to above 20 percent of GDP by 2013. The authorities acknowledged that pressures to increase spending are mounting, given possible: (i) further demands to boost infrastructure investment; (ii) pressure on social spending as unemployment rises; and (iii) a difficult round of public wage renegotiations in 2009.

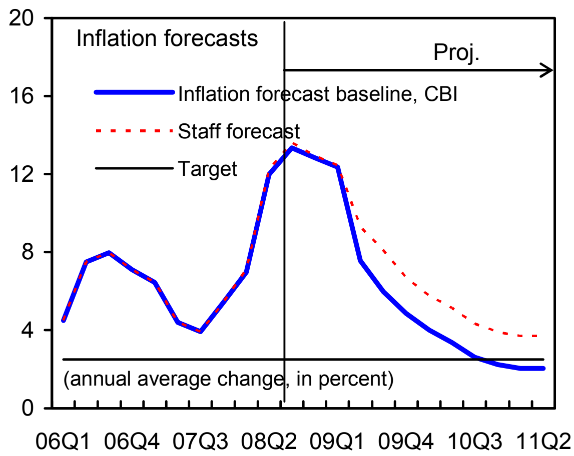
Iceland: Summary of the General Government Fiscal Accounts
(In percent of GDP)

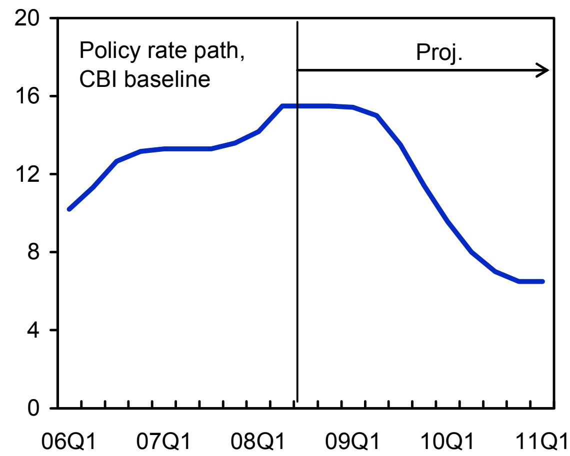
| | | Staff projection | | | Change |
|---|---|---|---|---|---|
| | 2007 | 2008 | 2009 | 2010 | 2008-201( |
| Total revenue | 50.1 | 48.4 | 45.9 | 45.2 | -3.2 |
| Total expenditure | 44.8 | 46.3 | 48.9 | 50.2 | 3.9 |
| Overall balance | 5.2 | 2.2 | -3.1 | -5.0 | -7.2 |
| Gross debt | 28.6 | 27.8 | 29.5 | 33.6 | 5.8 |
| Structural balance 1/ | 1.6 | 0.9 | -1.9 | -2.5 | -3.4 |
| Structural change 1/ | -1.3 | -0.7 | -2.8 | -0.6 | ... |
| Memorandum items: | | | | | |
| Real current primary expenditure growth 2/ | 6.4 | 1.1 | 1.3 | 1.4 | 0.3 |
| Output gap 3/ | 4.3 | 1.6 | -1.5 | -3.4 | -5.0 |

Sources: Ministry of Finance; and Fund staff estimates and calculations.
1/ In percent of potential GDP; structural estimates adjusted to account for the effect of the asset price moveme
2/ Percent change, deflated by CPI inflation.
3/ Actual output less potential in percent of potential.

9. **Inflation is expected to remain persistently above target, with significant risks on the upside.** Inflation, above the 2.5 percent target since 2004, is now at its highest in 18 years (reaching 13.6 percent in July) and shows no signs of abating (Figure 3). Inflation expectations are unhinged (in both survey and market data). Money growth is robust, and real interest rates are falling. Although wage growth has been benign so far, pressures could emerge as wage agreement contracts come up for renegotiation in early 2009. Accordingly, and despite a sharp projected slowdown in real activity, staff expects inflation to peak at close to 14 percent in Q3 2008, and return to target only in the second half of 2012. Moreover, risks to this outlook are firmly on the upside, stemming mainly from a further króna depreciation. Based on the same policy rate assumption and inflation outturns up to June, the CBI forecast inflation to fall sharply in early 2009, and return to the target in the second half of 2010.[1] However, the July *Monetary Bulletin* acknowledges that the uncertainty surrounding the CBI's inflation forecast is very high, with the risk profile tilted to the upside.

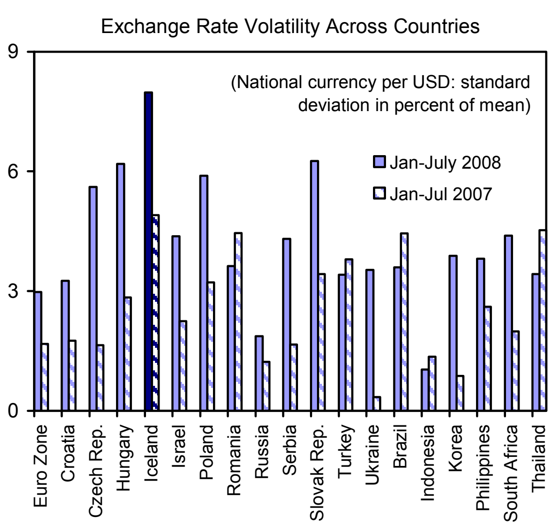
[1] Over the three-year forecast horizon, staff assumes an unchanged nominal exchange rate, while the CBI projects a slight appreciation in the short term, followed by a roughly similar depreciation. The exchange rate pass-though to consumer prices is estimated to be about 40 percent.

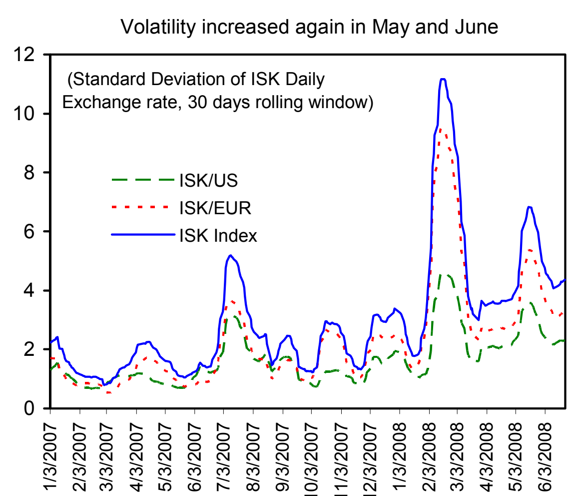



10. **With unusually large uncertainty surrounding the outlook, concerns about downside risks dominated—staff saw external risks as prevailing, while the authorities emphasized domestic ones.**

- In staff's view, **external liquidity risks** remained a key concern, given the high foreign debt of the private sector, chiefly related to the large funding needs of the banking sector. Even though the króna has already depreciated by over 30 percent since end-2007, under the currently deteriorating external market conditions and heightened króna volatility (see text charts), a further reduction in net capital inflows could lead to further króna depreciation fueling inflation and exacerbating the already-tight domestic credit conditions. This could trigger a chain reaction of additional adjustment in domestic asset prices and balance sheets, with correspondingly large effects on consumption and investment (Box 2).



## Box 2. Real-Financial Linkages: Up Together, Down Together

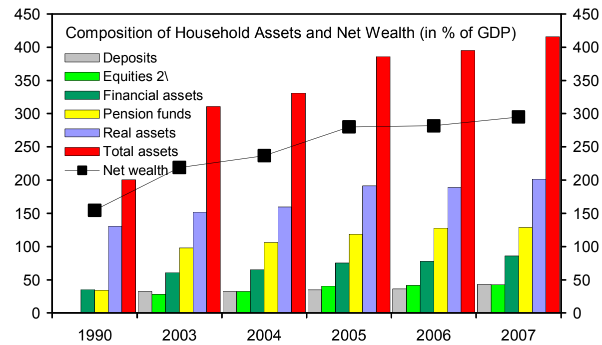
**Staff estimates suggest that favorable financial conditions may account for about ⅓ – ½ of real growth in 2003–2007.** Consumption was propped up by strong income and wealth effects, owing to higher disposable income and house prices, partly fuelled by bank credit. Investment was supported by bank lending and direct market borrowing abroad.

**Effects of a increases in real credit growth and net wealth**

| Effects | Real credit growth<br>10 percent increase | Net wealth<br>10 percent increase |
|---|---|---|
| **Consumption growth** | 3 percent | … |
| **Net wealth** | 15 percent | … |
| **Consumption level (compared to baseline)** | … | ¾ percent |

**As global liquidity tightens, the same mechanisms that lifted the economy should be expected to operate in reverse, but with adverse effects on real activity that are highly uncertain**, due to the large asset price and balance sheet imbalances.

- **Household balance sheets** are highly sensitive to financial conditions. About $^{2}/_{3}$ of household assets are dependent on real estate or other asset prices; around 80 percent of the household debt is inflation-indexed and 13 percent is in foreign currencies. Therefore, tighter access to credit and high inflation would reduce real income growth; a housing market downturn would largely unwind past net wealth gains; and an exchange rate depreciation (and ensuing inflation) would increase the debt stock. Taken together, these factors may push the average debt burden above 30 percent of disposable income—raising the likelihood of sharp consumption cutbacks and household default (see OECD, 2006).




Sources: Central Bank of Iceland, Land Registry of Iceland, OECD, Haver, IMF staff calculations
1\ 2007 numbers are averages of available quarters.

- The condition of **non-financial corporate balance sheets** is uncertain and possibly highly sensitive to market conditions. Leverage rose substantially, especially for unlisted companies—ranging between 300 to 400 percent, according to available data. While recent data on the quality of corporate assets are unavailable, existing indicators imply a large amount of goodwill, which is highly dependent on market sentiment. Hence, binding liquidity constraints could not only dampen investment, which depends on credit availability and asset price increases, but also increase the likelihood of substantial investment cutbacks and corporate default.

Corporate debt, selected countries, 2007 (in percent of GDP)

| | |
|---|---|
| Iceland | 308 |
| Euro area 1\ | 77 |
| UK 2\ | 278 |
| USA | 73 |

1\ Latest data is for 2005
2\ Financial liabilities

Household debt, selected countries, 2006

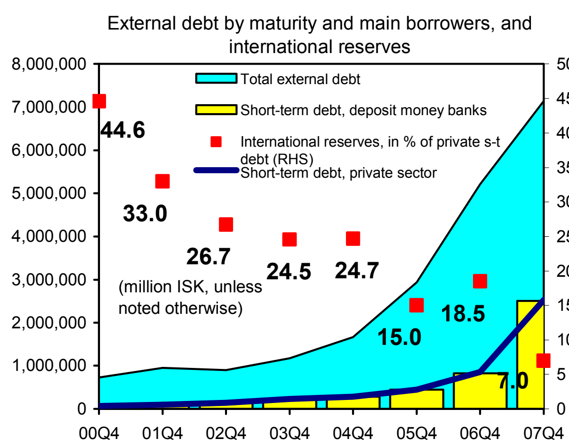
| | % of GDP | % of DI |
|---|---|---|
| Iceland | 103 | 225 |
| Spain | 80 | 140 |
| Ireland | 90 | 180 |
| USA | 98 | 134 |

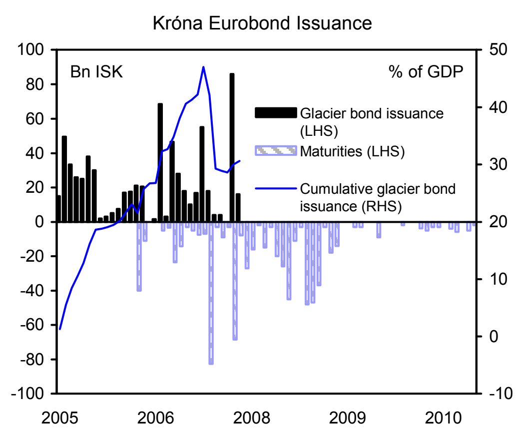
- The above vulnerabilities may, in turn, negatively affect **banks' balance sheets**, triggering a confidence shock that could prompt a new round of króna depreciation. This could lead to further deleterious (and potentially non-linear) effects on domestic asset prices and private sector balance sheets, with correspondingly large impact on consumption and investment. Corporate vulnerabilities could be especially important given the complex links between Iceland's non-financial corporations and banks.

- While recognizing that external risks were substantial, but beyond their control, the authorities put greater emphasis on the significant **domestic risks** stemming from the real estate market and the corporate sector. Specifically, a larger-than-expected downturn in the housing market would lower private consumption even further, while tighter credit conditions and depressed economic activity would hurt corporate profitability. Staff agreed these risks are also important, but thought that they were more likely to be ultimately triggered by external factors. Moreover, staff argued that some adjustment in asset prices and balance sheets is inevitable (and part of a necessary rebalancing), given their rapid expansion in the past years.
- It was broadly agreed that the increased vulnerability of private sector balance sheets raised the **uncertainty** about the overall effects of both external and domestic shocks. It was also acknowledged that a prolonged external liquidity crunch entailed the risk of financial stress, especially if domestic risks materialized simultaneously.

## B. External Stability

11. **The current account deficit is expected to move closer to equilibrium over the medium term, and the real exchange rate is in a range broadly consistent with long-term fundamentals** (Box 3). Both staff and the CBI see the current account deficit moving closer toward its equilibrium level of around 4–5 percent of GDP over the medium term. The trade balance is projected to improve gradually. Given the large level of external indebtedness, the income balance is expected to decline more sluggishly over time. After its recent adjustment (of about 20 percent in real effective terms since end-2007), the evidence suggests that that the real exchange rate is broadly in line with fundamentals; its current level is deemed by both staff and the authorities to be somewhat below its equilibrium level.



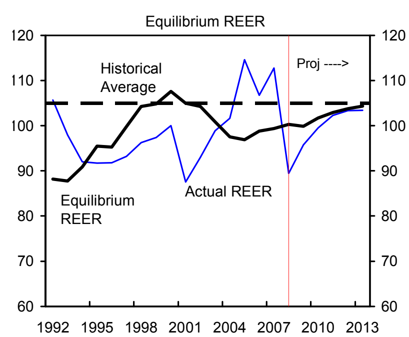

12. **However, there are growing concerns about the presence of external instability resulting from the highly vulnerable capital and financial accounts**. The external balance sheet structure remains overstretched and fragile. Private sector external debt is high—mostly due to the large foreign liabilities of the banking sector—and the share of short-term debt has

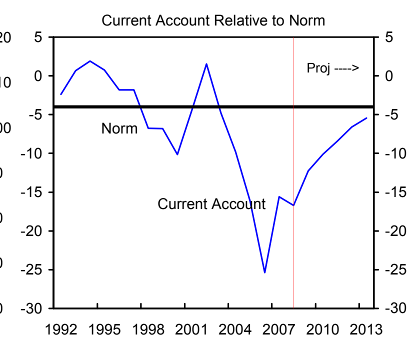
risen, also on account of the banks. The reserve coverage of short-term debt is low. Moreover, potential difficulties to finance the current account could arise if net capital inflows decrease substantially—for example, significant amounts of Glacier bonds[2] are maturing in the coming quarters, and rollover could be limited—triggering a further króna depreciation, and risking debt-servicing difficulties (Annex I). With banks' funding risks at the core, these vulnerabilities are large and could unwind quickly in the currently turbulent global financial climate. Consequently, staff is concerned about the presence of capital-account based instability; this, however, is not a result of exchange rate policy, as the króna is freely floating and the authorities do not intervene in the foreign exchange market. The authorities generally agreed that there are significant capital account-based vulnerabilities, but pointed to a number of mitigating factors, such as Iceland's increased debt-servicing capacity (due to the expansion in the aluminum and energy sectors) residents' large foreign assets, as well as a very low level of government debt and a funded pension system.

**Box 3. External Stability from an Exchange Rate Perspective**

**Results from a CGER-type analysis applied to Iceland suggest that the current level of the real exchange rate (REER) is broadly in line with long-term fundamentals**, given the recent króna depreciation:

- According to the macroeconomic balance approach, the REER may be under/overvalued by some 5 to 9 percentage points, based on a gap of -1 to -2 percent of GDP between the underlying and the norm current account.
- According to the real exchange rate approach, the current and medium-term levels of the REER appear undervalued by 11 and 1 percent, respectively.
- According to the external sustainability approach, the REER appears to be undervalued by 9 percent, based on a gap between the underlying and the NFA-stabilizing CA of about -2 percent of GDP.




| Results | Macroeconomic Balance | External Sustainability | Equilibrium REER |
|---|---|---|---|
| REER over/under valuation | -4.9% to-9.1% | -9.0% | -10.8% in 2008<br>-1.2% by 2013 |
| CA | CA norm: -3.4 to -4.2 %of GDP<br>Underlying CA: -2.5% of GDP | NFA-stabilizing CA: -4.2% of GDP | |

This analysis builds on and updates the work in Tchaidze's paper "Estimating Iceland's Real Equilibrium Exchange Rate (2007). His results suggested that the REER was overvalued by about 15-25 percent at end 2007. Since then, however, the REER depreciated by more than 20 percent as of end-June 2008, the reference date for this analysis. Hence, results in this analysis are broadly consistent with those of Tchaidze, given the margins of error of this exercise.

[2] See FSSA (¶37) for a description of the Glacier bonds.

### C. Monetary Policy

13. **Given prevailing external risks and strong inflationary pressures, staff favored a somewhat tighter policy stance than the authorities.**

- CBI officials viewed the current policy stance as appropriately tight to help bring inflation down in the context of weakening economic activity. While acknowledging the difficult inflation environment, they saw limited room for further rate hikes at this juncture, arguing that the rapid economic slowdown and binding foreign liquidity constraints were already slowing credit growth and making domestic interest rates increasingly important for private sector borrowers. Accordingly, the CBI kept its key policy rate unchanged at 15½ percent at its July 3 meeting—amidst enormous pressures for rate cuts from the business community, unions, and academics, among others.

- The mission agreed with maintaining a tight stance and emphasized that pressures to ease should be resisted until there are clear signs that inflation is on a firm downward path. In addition, staff noted that a further (small) increase in the policy rate could be useful to signal the CBI's commitment to achieving the target and shoring up confidence in the króna.[3] Mindful of domestic risks, staff nevertheless argued that failure to contain inflation could erode confidence in the króna, which could feed back into inflation and adversely affect balance sheets, ultimately requiring even higher policy rates.[4] Moreover, the direct impact of modestly higher interest rates on banks would appear limited (according to the authorities' stress tests), although there could be (hard-to-quantify) indirect effects stemming from the deterioration of corporate balance sheets—these, however, are also vulnerable to depreciation (Box 2).

14. **It was recognized that the central bank's liquidity provision posed new challenges**. The authorities explained that the recent issuance of short-term government debt and CBI paper was done to help restore normal functioning of the foreign exchange swap market,[5] while the alignment of the CBI's definition of repo-eligible collateral with that of the ECB was implemented to alleviate domestic liquidity pressures. Staff welcomed these measures, but cautioned that the CBI's level of liquidity provision may not be consistent with

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[3] See Box I-1 of the CBI's April *Monetary Bulletin* for a detailed discussion on the importance of anchoring expectations in Iceland, including on the rationale for a different monetary policy response than in the United States.

[4] Moreover, given the price indexation of most household debt, high inflation would hurt households disproportionately by reducing purchasing power and increasing debt burdens.

[5] See Box III-1 of the April *Monetary Bulletin* for a detailed discussion of the impact of the financial turmoil on Iceland's foreign exchange swap market.

its tight monetary policy stance.[6] In this regard, plans to further increase the supply of short-term government debt would be helpful not only to support the foreign exchange swap market, but also as an additional liquidity-management tool.

15. **No significant progress has been achieved in reforming the HFF.** The HFF is the largest provider of mortgage loans in the market, offering interest rates that do not respond quickly to policy rates, hindering the effectiveness of monetary policy. The authorities and staff agreed that, to remove this structural impediment, the HFF's role in the financial market could be redefined by separating the social component that provides targeted support from the market-based element that should not benefit from state aid. However, despite the government's recent pledge to reform the HFF, the reform content is still far from being finalized. The authorities indicated that implementation is unlikely before 2009.

16. **The recent HFF measures aimed at jumpstarting the lower-end of the real estate market and easing funding pressures were controversial**. Specifically:

- The already-implemented measures to raise HFF lending limits and loan-to-value ratios were seen by staff as going against the aforementioned reform. These measures would hinder monetary policy efforts to combat inflation and delay a much-needed price adjustment in the overheated real estate market. The authorities, however, expected the economic impact of these changes to be limited.

- The announced measures related to collateralized borrowing could be potentially beneficial, in staff's view, as they could ease funding pressures and improve the CBI's collateral quality. The mission cautioned, however, that these measures should be carefully drafted to prevent a potential risk transfer from private to public balance sheets and a further significant increase in domestic liquidity provision.

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[6] As of end-June, the stock of collateralized loans was 330 billion ISK (about 25 percent of nominal GDP in 2007).

**Iceland: Recent HFF Measures**

| Action | Date |
|---|---|
| Two new classes of HFF loans are established:<br><br>Lending to financial institutions for the purpose of refinancing existing mortgages. Loan limit is 30 bn ISK, loan-to-value ratios and credit assessment are the same as for the HFF. Lending is in the form of HFF bonds, to be used exclusively as collateral in transactions with the CBI.<br><br>Lending to financial institutions for the financing of new mortgage loans. A bill will be introduced to parliament in the fall proposing that the HFF be given the authority to buy new mortgages from financial institutions. | June 19 (announced)<br><br>July 18 (in effect) |
| The HFF loan limit is increased to 20 mn ISK (up from 18 mn ISK) | June 19 (in effect July 1) |
| The fire insurance value reference for HFF lending (less than 50 percent of the purchase price in the greater Reykjavík area) is discontinued. The reference amount is now up to 80% of the purchase price of the property. | June 19 (in effect July 1) |
| Authorisations to take HFF rental housing loans are expanded to the general market. | June 19 (in effect July 1) |

## D. Fiscal Policy

17. **Staff and the authorities had different views regarding the priorities and role of fiscal policy, stemming mainly from differing positions on prevailing risks**.

- Staff argued for a more cautious fiscal stance to build confidence and support monetary policy efforts to combat inflation, especially given the risk of a further króna depreciation.[7] With private sector debt and the government's contingent liabilities already large, keeping the (on-balance sheet) public sector debt low would also convey a positive signal to financial markets. In addition, tax revenue projections could prove optimistic given potential downside effects of the unwinding of the asset price boom. Accordingly, the mission argued that while automatic stabilizers should be allowed to operate fully, most of the planned stimulus (estimated at 3½ percent of GDP in 2008–10) should be clawed back, preferably through a slowdown in expenditure growth.[8]

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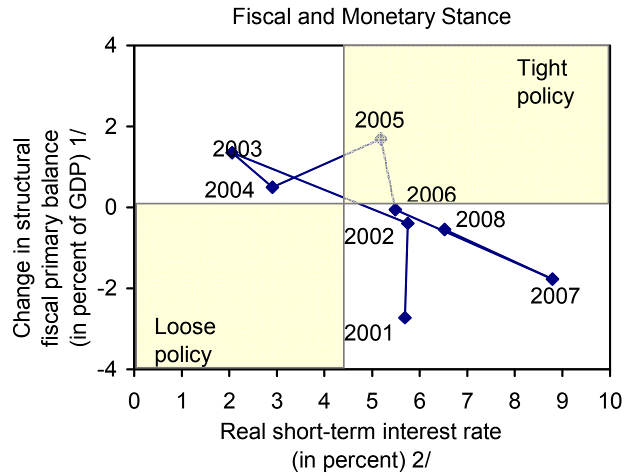
[7] Moreover, unlike monetary policy, tightening fiscal policy is less likely to induce the adverse balance sheet effects described in Box 2.

[8] As mentioned in Appendix IV of the April *Monetary Bulletin*, Iceland's expenditure multipliers tend to be smaller than in larger economies such as the United States, the United Kingdom, and the Euro Area, suggesting that discretionary fiscal policy is less effective in stabilizing the economy.




Source: IMF estimates.
1/ Structural balance adjusted for the effect of asset price boom.
2/ CBI's target rate minus inflation expectations.

- In contrast, the authorities believed that domestic risks prevailed, and hence the policy focus should shift toward preventing a sharp economic downturn. In addition, rolling back the implementation of the recent pledges and quickly adjusting other spending (especially social spending and wages) were seen as politically unfeasible, or very difficult. More generally, the authorities argued that fiscal policy should play a countercyclical role, using past fiscal savings to smooth the economic downturn. In the event of a much sharper-than-expected downturn, the authorities noted that with little public tolerance for high unemployment, the government would be called upon to support labor markets and help affected groups.

- Staff saw a more active stabilizing role for fiscal policy only if such a scenario were to materialize, considering that monetary policy would still need to shore up confidence in the króna and keep inflation expectations under control. In this context, targeted and temporary measures could be used, with additional positive distributional effects (e.g., housing support, unemployment benefits).

18. **Looking forward, staff stressed the benefits of a more rules-based fiscal framework to help improve macroeconomic stabilization**. The authorities agreed that the current medium-term framework lacked effective, binding spending controls. To achieve better expenditure control, one reform objective was to develop a multi-year budgeting approach consistent with policy goals. However, with no other specific plans in the near term, the authorities saw fiscal reform as a slow-moving process. Staff reiterated the need to make multi-year targets more binding and increase control of local government finances.

## E. Financial Sector Policy

19. **A recent FSAP Update points to high and rising vulnerabilities in the financial sector.** Despite reported financial indicators of the banking system being fully compliant with regulatory requirements (Figure 4), there are several key risks:

- ***Liquidity and funding risks***, associated with the banks' reliance on market funding and sizeable funding needs due to a significant amount of debt maturing over the next two years. Given the difficult market situation, challenges in securing adequate liquidity coverage at acceptable price could also reduce bank profitability.
- ***Credit and market risks***, stemming from the foreign currency and equity exposures and high levels of debt of domestic borrowers,[9] as well as from collateralized lending,[10] connected lending and large exposures (mostly related to holding companies);
- ***Operational risks***, associated with the banks' rapid expansion in recent years, including in new markets and business lines, which could strain risk management capacity and internal controls;
- ***Quality of capital risks***, related to complex ownership structures, perceived substantial related-party lending, and uncertainty about the financial strength of shareholders following the decline in equity markets.[11]

20. **Despite efforts to address market concerns, managing these risks remains a challenge for the banking sector**. The three largest banks have responded by slowing lending growth, consolidating funding needs, withdrawing from marginal markets, mobilizing retail deposits abroad, and reducing costs. As a result, they reported adequate liquidity to meet debt obligations over the next 12 months. But banks' ability to de-leverage has been limited by global risk aversion, and their market and credit risk have increased, pointing to significant risks going forward. Hence, as highlighted by the FSAP Update, it remains unclear whether these adjustments are sufficient in today's financial environment. Access to foreign liquidity remains severely limited, and banks' CDS spreads have been rising toward their March peaks. Some smaller banks have reportedly come under liquidity pressures as well. In this environment, the central bank is now the key liquidity provider to the banking system.

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[9] As noted in FSSA (¶19), some indications of a slippage in credit quality have already appeared.

[10] See FSSA (¶20).

[11] The large banks protected their capital against foreign currency fluctuations by hedging with derivatives.

21. **Accordingly, discussions focused on policy options to further mitigate financial sector risks**. Staff welcomed the progress made over the past few years by the Financial Supervisory Authority (FME) and the CBI to boost monitoring, analysis, and stress-testing of liquidity, credit, and market risks. Staff stressed, however, that a successful policy going forward will require strengthening financial buffers and increasing transparency as regards banks' ownership and lending relations.[12] Accordingly, drawing on the FSAP's recommendations, staff outlined possible options to mitigate risks further, including by: (i) raising capital cushions, including for operational, credit, and quality-of-capital risks; (ii) reviewing the robustness of liquidity coverage under different stress scenarios that take into account the interlinkages among banks and boosting liquidity buffers appropriately; (iii) improving overall transparency concerning progress in reducing related-party transactions and concentrated lending. There was broad agreement that, if successfully implemented, these policies could contribute to a significant slowdown in banks' balance sheet growth. However, as mentioned in the FSAP's findings, more decisive steps to further deleverage may become necessary.

22. **The mission also covered other issues related to financial stability.** Specifically, staff welcomed the progress made to enhance the **quality of supervision**, including by boosting the supervisory powers and resources of the FME and advancing the work on high-frequency monitoring and modeling. At the same time, the mission stressed that **lack of the timely and comprehensive data on the non-financial corporate sector** (especially non-listed companies) impedes the analysis of the sector's financial situation and its potential implications for the banks. Therefore, staff urged boosting the enforcement of disclosure requirements for all corporations—a recommendation that the authorities welcomed.

## F. Contingency Planning

23. **Given the large vulnerabilities of the system, discussions also focused on key elements of contingency planning**. In recent years, supervisory powers and resources have been boosted, formal frameworks for coordination between domestic agencies and across the Nordic region established and tested,[13] and the task force on liquidity crisis management (established in late 2007) advanced its work on high-frequency monitoring and modeling.

- Noting the progress already made, staff stressed that these efforts should continue in full force,[14] including by **compiling all existing elements of contingency planning into a single framework**—a recommendation welcomed by the authorities.
- There was general agreement that **the bank resolution framework** should be strengthened to provide the FME with additional legislative powers.

[12] On transparency, see FSSA (¶18, ¶27, and Key Recommendations).

[13] An MOU was signed between the Nordic countries to deal with cross-border crises in 2003.

[14] See FSSA, Section III, B and C on cross-border policy coordination and crisis management and bank resolution, respectively.

- The CBI clarified that **the liquidity swap agreement with other Nordic banks** was only a precautionary, confidence-building measure.

- With **foreign exchange reserves** still low relative to potential liabilities, the authorities confirmed (and staff welcomed) their commitment to increase the CBI's reserves "at the right time."

- In response to a query, CBI officials mentioned no specific plans or intentions to boost the CBI's LOLR capacity. A review of deposit insurance is underway.

## III. Staff Appraisal

24. **Iceland's prosperous and flexible economy is now starting a difficult and highly uncertain adjustment process.** Its long expansion has come to an end. Its legacies are overstretched private sector balance sheets, large macroeconomic imbalances, and high dependence on foreign financing. As liquidity constraints are becoming more binding, economic activity is expected to slow significantly from unsustainably high levels, inflationary pressures to persist, and the current account to normalize. Uncertainties surrounding the outlook are unusually large, with significant downside risks dominated by external factors. Although the current level of the (freely-floating) króna is estimated to be somewhat below its equilibrium level, the external balance sheet structure remains fragile—mainly due to the large funding needs of the banking sector—raising concerns about capital account-based external instability. If risks were to materialize in full, Iceland could face severe financial strains.

25. **Against this backdrop, policies will have the challenging task to facilitate an orderly rebalancing process, while mitigating risks by shoring up confidence**. Close coordination between monetary and fiscal policies, along with actions to address financial sector vulnerabilities, will be key in this respect.

26. **A continued tight monetary policy stance is needed to return inflation to target and maintain confidence in the króna**. A further króna decline would fuel inflationary pressures, squeeze private balance sheets, and erode households' purchasing power. In turn, such developments could further undermine confidence, feeding back into currency weakness. To prevent this, monetary policy should remain tight until there are clear signs that inflation is on a firm downward path, while domestic liquidity provision should be carefully managed. Pressures to ease prematurely should be resisted.

27. **Promptly acting on the pledge to reform the publicly-owned HFF is crucial to increase the effectiveness of monetary policy**. Its role in the financial market could be redefined by separating the social component that provides targeted support from the market-based element that should not benefit from state aid.

28. **The highly stimulative fiscal policy needs to be restrained**. Given the prevailing external risks and high leverage in the economy, a more neutral fiscal stance is warranted to

help shore up confidence and support the central bank's efforts to combat inflation. To achieve a more balanced macroeconomic policy mix, most of the planned stimulus should be clawed back, preferably by slowing expenditure growth. At a minimum, mounting pressures to increase spending should be resisted.

29. **The commitment to strengthen the fiscal framework is welcome and should be followed by concrete steps**. Important elements of reform could include: more binding annual expenditure limits, a multi-year budgeting based on clear policy commitments, and mechanisms to better control local government finances.

30. **Policy options to mitigate banking sector risks should be pursued with vigor**. A successful policy going forward will require strengthening financial buffers and increasing transparency as regards the condition of the banks. Possible options could include: (i) raising capital cushions, including for operational, credit, and quality-of-capital risks; (ii) reviewing the robustness of liquidity coverage under different stress scenarios that account for the interlinkages among banks and boosting liquidity buffers appropriately; (iii) improving overall transparency concerning progress in reducing related-party transactions and concentrated lending. The implementation of these policies could contribute to a slowdown in banks' balance sheet growth. If such efforts proved unsuccessful, however, more aggressive steps to deleverage would be necessary.

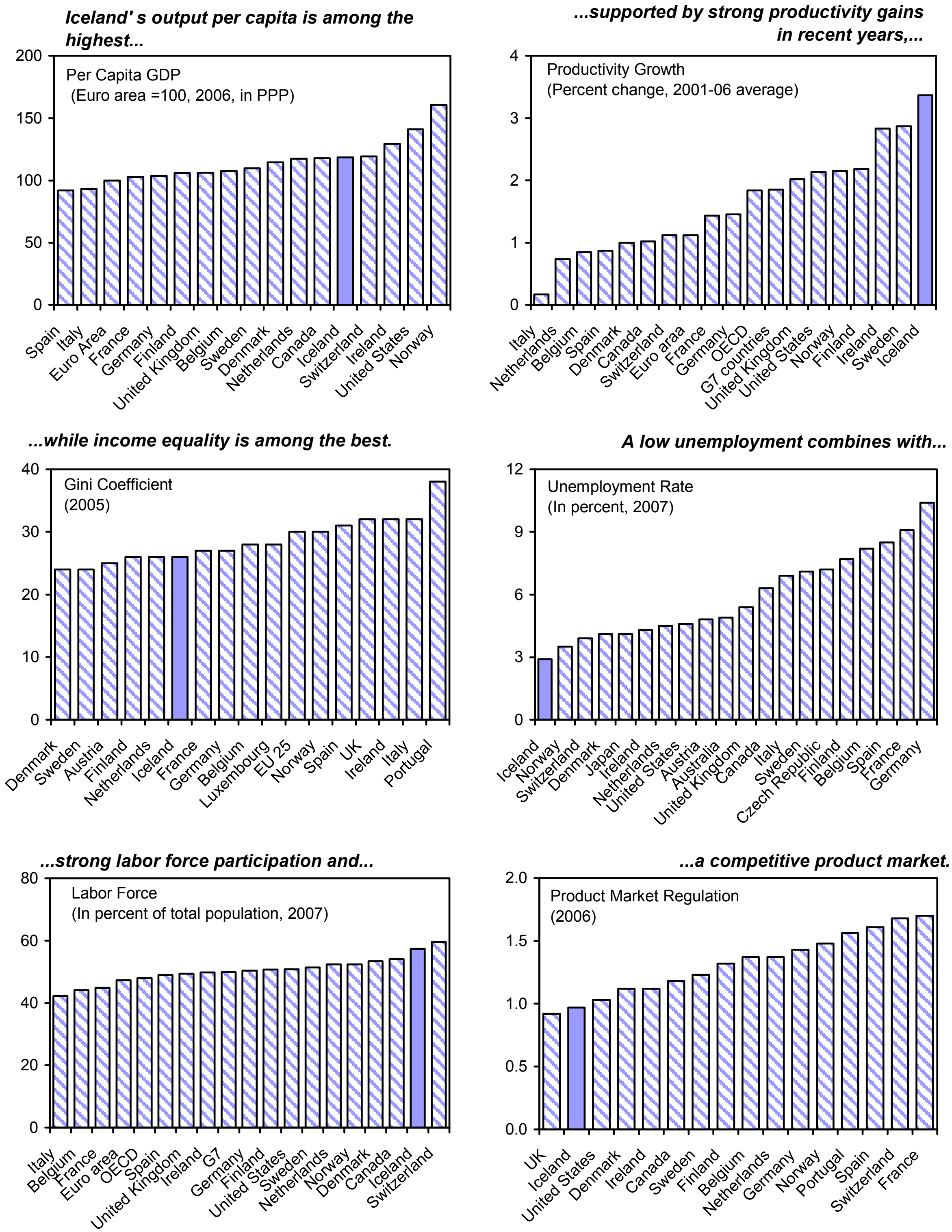
31. **Better enforcement of disclosure requirements for all corporations is needed**. More timely and comprehensive information on the balance sheets of all companies will help improve understanding of the financial health of the corporate sector and its implications for financial stability.

32. **The crisis prevention and resolution framework could be strengthened further, building on progress to date**. Ongoing efforts should continue in full force, including by compiling all existing elements of contingency planning into a single framework. In addition, the bank resolution framework should be strengthened to provide the FME with additional legislative powers. Finally, the commitment to boost the CBI's reserves should be fulfilled at the appropriate time.

33. **The Icelandic economy faces significant challenges in the near term, but its long-term prospects remain enviable**. The economy has a track record of rebounding quickly from shocks. Labor and product markets are open and flexible; government debt is very low; the pension system is funded; institutions are sound; and renewable natural resources are bountiful and well-managed.

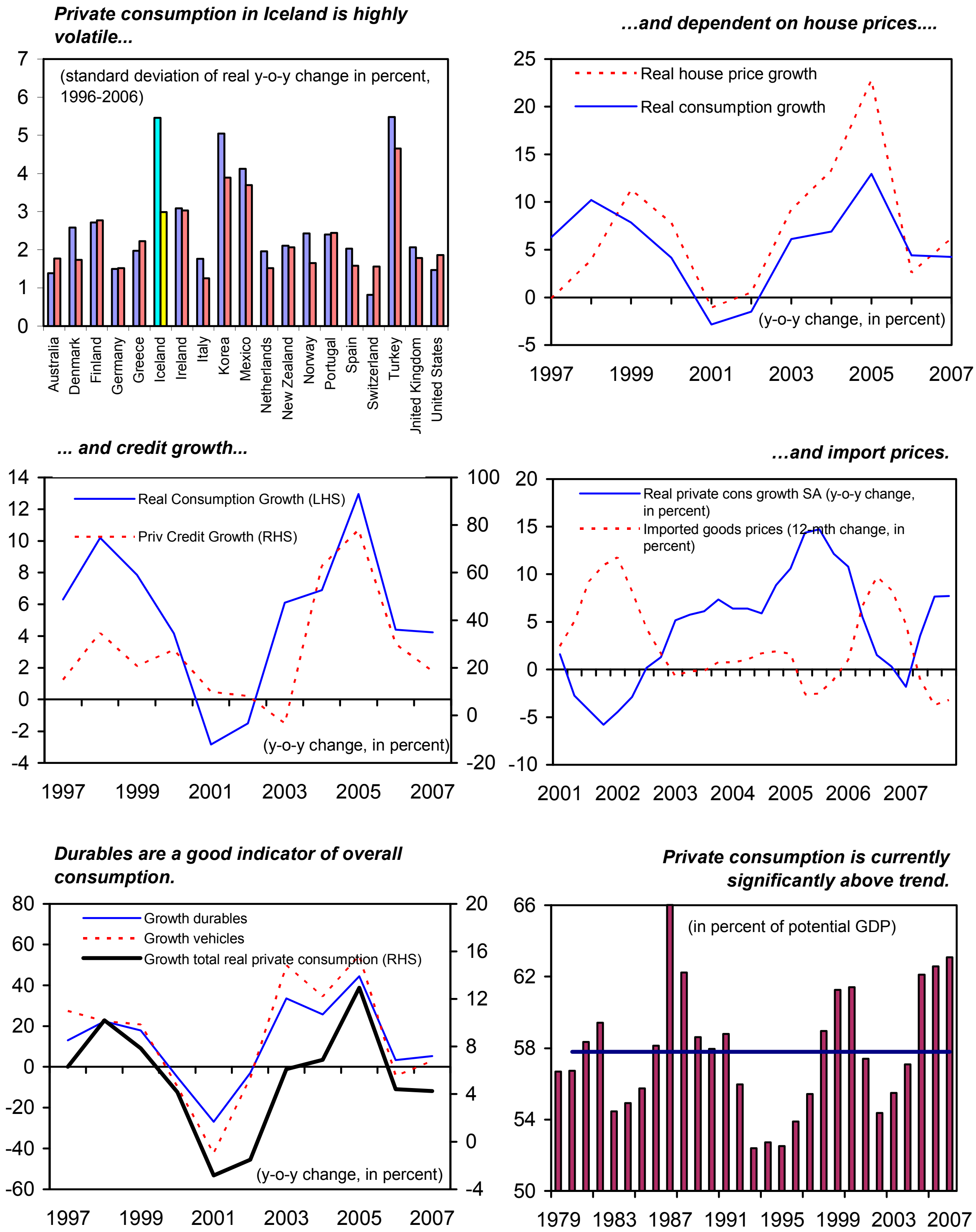
34. It is proposed that the next Article IV consultation be held on a 12-month cycle.

Figure 1. Iceland's Strong Economic Performance



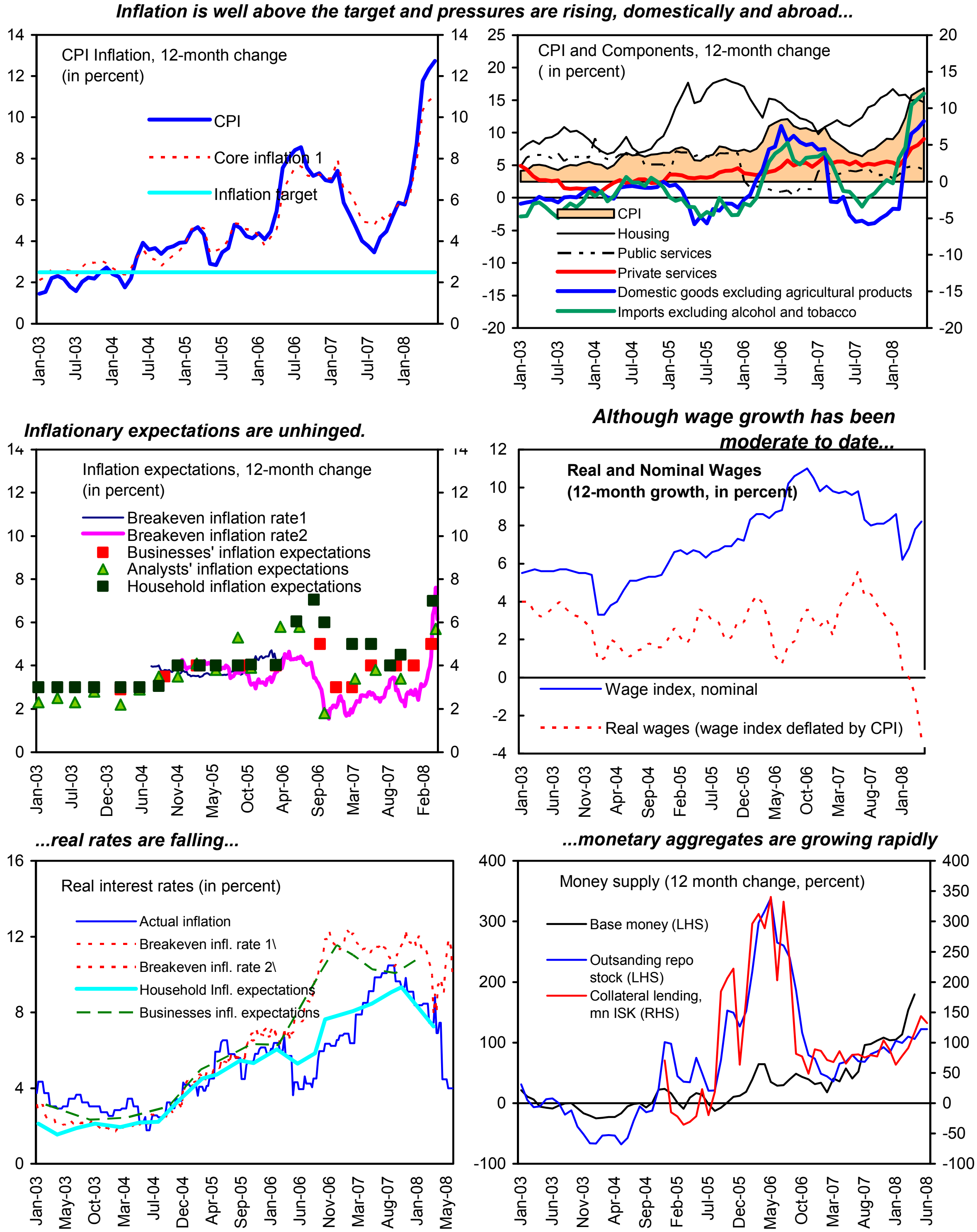

Source: OECD; Iceland Central Bank.

Figure 2. Iceland: Private Consumption Sustained the Long Boom



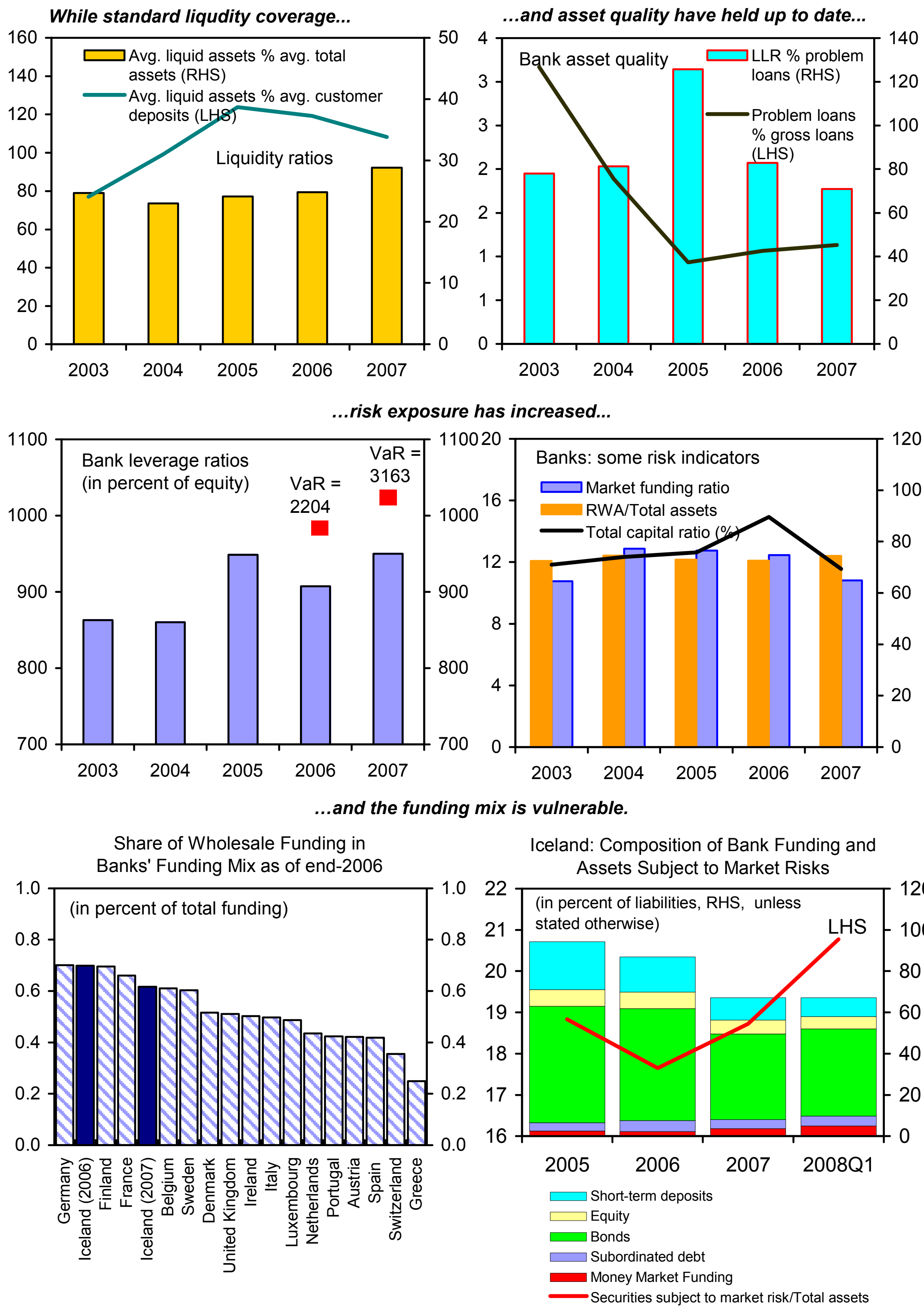

Source: OECD, Iceland Statistics, Iceland Central Bank, IMF calculations.

Figure 3: Iceland: Inflation Is High and Expectations Are Unhinged




Source: Central Bank of Iceland

Figure 4. Iceland: Banking Sector Indicators




Source: Central bank of Iceland, FME, and BankScope.

Table 1. Iceland: Selected Economic Indicators, 2000-09

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 est. | 2008 staff proj. | 2009 staff proj. |
|---|---|---|---|---|---|---|---|---|---|---|
| | (Percentage change unless otherwise noted) | | | | | | | | | |
| **Real economy** | | | | | | | | | | |
| Gross domestic product | 4.3 | 3.9 | 0.1 | 2.4 | 7.7 | 7.5 | 4.4 | 3.8 | -0.3 | -2.1 |
| Total domestic demand | 5.9 | -2.1 | -2.1 | 5.6 | 9.9 | 16.0 | 9.9 | -2.4 | -3.2 | -5.0 |
| Private consumption | 4.2 | -2.8 | -1.5 | 6.1 | 6.9 | 13.0 | 4.4 | 4.2 | -2.2 | -8.0 |
| Public consumption | 3.8 | 4.6 | 5.3 | 1.8 | 2.2 | 3.5 | 3.9 | 3.3 | 2.6 | 2.4 |
| Gross fixed investment | 11.8 | -4.3 | -14.0 | 11.1 | 28.1 | 35.7 | 20.4 | -14.9 | -10.0 | -4.7 |
| Exports of goods and services | 4.2 | 7.4 | 3.8 | 1.6 | 8.4 | 7.2 | -5.0 | 18.1 | 4.3 | 3.2 |
| Imports of goods and services | 8.6 | -9.1 | -2.6 | 10.7 | 14.5 | 29.4 | 10.2 | -1.4 | -3.4 | -4.3 |
| Output gap 1/ | 1.3 | 1.3 | -2.5 | -3.9 | -0.5 | 3.0 | 3.8 | 4.3 | 1.6 | -1.5 |
| Unemployment rate 2/ | 1.3 | 1.4 | 2.5 | 3.4 | 3.1 | 2.1 | 1.3 | 1.0 | 2.2 | 3.9 |
| Consumer price index | 5.1 | 6.6 | 4.8 | 2.1 | 3.2 | 4.0 | 6.8 | 5.0 | 11.7 | 9.7 |
| Nominal wage index | 6.4 | 8.5 | 7.8 | 5.6 | 4.6 | 6.5 | 9.1 | 9.3 | 11.7 | 9.7 |
| **Money and Credit** | | | | | | | | | | |
| Deposit money bank credit (end-period) | 46.8 | 17.9 | 14.2 | 26.7 | 41.9 | 76.0 | 44.4 | 56.6 | ... | ... |
| of which to residents (end-period) | 46.0 | 13.8 | 11.6 | 20.0 | 37.2 | 54.7 | 33.6 | 28.3 | ... | ... |
| Broad money (end-period) | 11.2 | 14.9 | 15.3 | 17.5 | 15.0 | 23.2 | 19.6 | 56.4 | ... | ... |
| CBI policy rate (period average) 3/ | 10.5 | 10.9 | 8.4 | 5.4 | 6.1 | 9.4 | 12.5 | 13.4 | ... | ... |
| **Public Finance** (in percent of GDP) | | | | | | | | | | |
| General government 4/ | | | | | | | | | | |
| Revenue | 45.4 | 43.7 | 43.4 | 44.6 | 45.9 | 48.9 | 49.7 | 50.1 | 48.4 | 45.9 |
| Expenditure | 43.7 | 44.4 | 46.0 | 47.4 | 45.9 | 44.0 | 43.4 | 44.8 | 46.3 | 48.9 |
| Balance | 1.7 | -0.7 | -2.5 | -2.8 | 0.0 | 4.9 | 6.3 | 5.2 | 2.2 | -3.1 |
| Structural balance | 1.1 | -1.3 | -1.2 | -0.3 | 0.4 | 2.2 | 3.2 | 2.0 | 1.0 | -2.0 |
| **Balance of Payments** (in percent of GDP) | | | | | | | | | | |
| Current account balance | -10.2 | -4.3 | 1.5 | -4.8 | -9.8 | -16.1 | -25.4 | -15.6 | -16.7 | -12.3 |
| Trade balance (goods) | -5.5 | -0.8 | 1.7 | -1.9 | -3.9 | -9.1 | -13.4 | -6.9 | -5.6 | -4.4 |
| Financial and capital account | 11.9 | 2.6 | -1.1 | 1.2 | 12.7 | 13.5 | 36.4 | 13.3 | 16.7 | 12.3 |
| o/w: reserve assets 5/ | 0.8 | 0.6 | -0.7 | -2.8 | -1.5 | -0.5 | -7.3 | -0.5 | -2.8 | -0.7 |
| Net errors and omissions | -1.7 | 1.7 | -0.4 | 3.6 | -2.9 | 2.6 | -11.0 | 2.3 | 0.0 | 0.0 |
| Gross external debt | 108.3 | 123.3 | 110.6 | 139.6 | 179.1 | 285.8 | 445.9 | 557.9 | 545.7 | 545.3 |
| International Invesment Position | -67.7 | -77.8 | -68.9 | -62.6 | -67.5 | -84.3 | -119.2 | -123.8 | -128.1 | -133.9 |
| Central bank gross reserves (bln USD) | 0.4 | 0.4 | 0.5 | 0.8 | 1.1 | 1.1 | 2.3 | 2.6 | 2.9 | 3.1 |
| Central bank gross reserves (in months of imports of goods and services) 6/ | 1.5 | 1.4 | 1.5 | 2.2 | 2.1 | 1.8 | 3.4 | 3.3 | 3.2 | 3.5 |
| Nominal effective exchange rate 7/ | 0.0 | -15.7 | 2.5 | 6.2 | 1.8 | 10.4 | -10.8 | 2.7 | ... | ... |
| Real effective exchange rate (CPI) 7/ | 2.7 | -12.5 | 6.2 | 6.3 | 2.8 | 12.8 | -6.8 | 5.7 | ... | ... |
| Terms of trade | -2.4 | 0.3 | 0.6 | -4.1 | -1.3 | 1.0 | 3.5 | 0.1 | ... | ... |
| Memorandum item: | | | | | | | | | | |
| Nominal GDP (bln ISK) | 683.7 | 771.9 | 816.6 | 841.5 | 928.7 | 1,026.3 | 1,167.7 | 1,279.4 | 1,424.0 | 1,502.0 |

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and staff estimates.

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ Data prior to 2007 refers to annual rate of return. 2007 and on, refers to nominal interest rate.
4/ National accounts basis.
5/ A positive (negative) sign indicates a decrease (increase) in gross official foreign reserves.
6/ Excluding imports from the construction of hydropower facility and smelters in 2003-04.
7/ A positive (negative) sign indicates an appreciation (depreciation).

Table 2. Iceland: Balance of Payments, 2004-2013

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | (billions of kronur) | | | | | | | |
| **Current Account** | -91.2 | -165.6 | -296.3 | -199.9 | -238.1 | -184.1 | -156.2 | -140.1 | -117.6 | -103.0 |
| Balance on Goods | -36.5 | -93.1 | -156.5 | -88.0 | -80.5 | -65.4 | -55.1 | -44.3 | -35.4 | -26.0 |
| Merchandise exports f.o.b. | 202.4 | 194.9 | 243.5 | 306.0 | 431.3 | 424.6 | 415.8 | 436.9 | 459.9 | 484.8 |
| Merchandise imports f.o.b. | -238.9 | -288.0 | -400.0 | -394.0 | -511.7 | -490.0 | -470.9 | -481.3 | -495.3 | -510.8 |
| Balance on Services | -14.7 | -32.4 | -50.1 | -42.7 | -49.8 | -46.1 | -45.2 | -38.0 | -30.9 | -23.6 |
| Exports of services, total | 113.9 | 128.3 | 128.6 | 143.5 | 203.4 | 199.7 | 194.8 | 204.9 | 216.1 | 228.2 |
| Imports of services, total | -128.6 | -160.6 | -178.6 | -186.2 | -253.2 | -245.8 | -240.0 | -242.9 | -247.0 | -251.8 |
| Balance on Income | -38.8 | -38.4 | -87.2 | -65.3 | -103.5 | -68.1 | -51.2 | -52.8 | -45.9 | -47.7 |
| Receipts | 32.9 | 91.2 | 180.8 | 322.3 | 498.5 | 519.8 | 550.2 | 553.3 | 585.3 | 620.1 |
| Expenditures | -71.8 | -129.5 | -268.0 | -387.6 | -602.1 | -588.0 | -601.4 | -606.1 | -631.2 | -667.8 |
| Current transfer, net | -1.2 | -1.7 | -2.5 | -3.9 | -4.3 | -4.5 | -4.7 | -5.0 | -5.4 | -5.7 |
| **Capital and Financial Account** | 117.9 | 138.6 | 424.5 | 170.5 | 238.1 | 184.1 | 156.2 | 140.1 | 117.6 | 103.0 |
| Capital transfer, net | -0.2 | -1.7 | -1.8 | -1.9 | -2.1 | -2.2 | -2.3 | -2.5 | -2.6 | -2.8 |
| Financial Account | 118.1 | 140.3 | 426.3 | 172.4 | 240.2 | 186.4 | 158.5 | 142.6 | 120.2 | 105.8 |
| Direct investment, net | -129.5 | -252.5 | -93.2 | -580.5 | 90.6 | 58.1 | 65.6 | 53.2 | 32.6 | 6.9 |
| Abroad | -181.2 | -446.5 | -373.6 | -777.8 | 5.0 | 11.9 | 39.5 | -18.5 | -37.7 | -57.2 |
| In Iceland | 51.7 | 194.0 | 280.4 | 197.3 | 85.6 | 46.2 | 26.1 | 71.7 | 70.3 | 64.1 |
| Portfolio investment, net | 465.3 | 767.5 | 798.2 | -435.8 | 269.6 | 189.9 | 87.4 | 74.4 | 73.0 | 85.7 |
| Assets | -115.4 | -295.2 | -208.2 | -486.2 | -23.9 | -92.8 | -144.2 | -151.1 | -148.2 | -135.1 |
| Liabilities | 580.8 | 1,062.7 | 1,006.4 | 50.4 | 293.5 | 282.7 | 231.7 | 225.6 | 221.2 | 220.7 |
| Other investment, net | -203.5 | -369.9 | -193.3 | 1,195.4 | -79.8 | -50.5 | 11.7 | 32.1 | 31.5 | 28.7 |
| Assets | -238.4 | -686.7 | -777.8 | -1,077.0 | -344.7 | -187.1 | -105.5 | -290.2 | -284.5 | -259.3 |
| Liabilities | 34.9 | 316.8 | 584.5 | 2,272.4 | 264.9 | 136.6 | 117.2 | 322.3 | 316.0 | 288.0 |
| Reserve assets | -14.2 | -4.7 | -85.4 | -6.7 | -40.2 | -11.1 | -6.3 | -17.2 | -16.9 | -15.4 |
| **Net errors and omissions** | -26.7 | 26.9 | -128.2 | 29.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **current account receipts (CARs)/GDP** | 37.6 | 40.4 | 47.3 | 60.3 | 79.6 | 76.2 | 75.1 | 71.7 | 70.6 | 70.4 |
| | | | (in percent of GDP) | | | | | | | |
| **Current Account** | -9.8 | -16.1 | -25.4 | -15.6 | -16.7 | -12.3 | -10.1 | -8.4 | -6.6 | -5.4 |
| Balance on Goods | -3.9 | -9.1 | -13.4 | -6.9 | -5.6 | -4.4 | -3.6 | -2.7 | -2.0 | -1.4 |
| Merchandise exports f.o.b. | 21.8 | 19.0 | 20.8 | 23.9 | 30.3 | 28.3 | 26.9 | 26.2 | 25.8 | 25.6 |
| Merchandise imports f.o.b. | -25.7 | -28.1 | -34.3 | -30.8 | -35.9 | -32.6 | -30.5 | -28.9 | -27.7 | -27.0 |
| Balance on Services | -1.6 | -3.2 | -4.3 | -3.3 | -3.5 | -3.1 | -2.9 | -2.3 | -1.7 | -1.2 |
| Exports of services, total | 12.3 | 12.5 | 11.0 | 11.2 | 14.3 | 13.3 | 12.6 | 12.3 | 12.1 | 12.1 |
| Imports of services, total | -13.8 | -15.7 | -15.3 | -14.6 | -17.8 | -16.4 | -15.5 | -14.6 | -13.8 | -13.3 |
| Balance on Income | -4.2 | -3.7 | -7.5 | -5.1 | -7.3 | -4.5 | -3.3 | -3.2 | -2.6 | -2.5 |
| Receipts | 3.5 | 8.9 | 15.5 | 25.2 | 35.0 | 34.6 | 35.6 | 33.2 | 32.8 | 32.8 |
| Expenditures | -7.7 | -12.6 | -23.0 | -30.3 | -42.3 | -39.1 | -38.9 | -36.4 | -35.4 | -35.3 |
| Current transfer, net | -0.1 | -0.2 | -0.2 | -0.3 | -0.3 | -0.3 | -0.3 | -0.3 | -0.3 | -0.3 |
| **Capital and Financial Account** | 12.7 | 13.5 | 36.4 | 13.3 | 16.7 | 12.3 | 10.1 | 8.4 | 6.6 | 5.4 |
| Capital transfer, net | 0.0 | -0.2 | -0.2 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| Financial Account | 12.7 | 13.7 | 36.5 | 13.5 | 16.9 | 12.4 | 10.3 | 8.6 | 6.7 | 5.6 |
| Direct investment, net | -13.9 | -24.6 | -8.0 | -45.4 | 6.4 | 3.9 | 4.2 | 3.2 | 1.8 | 0.4 |
| Abroad | -19.5 | -43.5 | -32.0 | -60.8 | 0.4 | 0.8 | 2.6 | -1.1 | -2.1 | -3.0 |
| In Iceland | 5.6 | 18.9 | 24.0 | 15.4 | 6.0 | 3.1 | 1.7 | 4.3 | 3.9 | 3.4 |
| Portfolio investment, net | 50.1 | 74.8 | 68.4 | -34.1 | 18.9 | 12.6 | 5.7 | 4.5 | 4.1 | 4.5 |
| Assets | -12.4 | -28.8 | -17.8 | -38.0 | -1.7 | -6.2 | -9.3 | -9.1 | -8.3 | -7.1 |
| Liabilities | 62.5 | 103.5 | 86.2 | 3.9 | 20.6 | 18.8 | 15.0 | 13.5 | 12.4 | 11.7 |
| Other investment, net | -21.9 | -36.0 | -16.6 | 93.4 | -5.6 | -3.4 | 0.8 | 1.9 | 1.8 | 1.5 |
| Assets | -25.7 | -66.9 | -66.6 | -84.2 | -24.2 | -12.5 | -6.8 | -17.4 | -15.9 | -13.7 |
| Liabilities | 3.8 | 30.9 | 50.1 | 177.6 | 18.6 | 9.1 | 7.6 | 19.3 | 17.7 | 15.2 |
| Reserve assets | -1.5 | -0.5 | -7.3 | -0.5 | -2.8 | -0.7 | -0.4 | -1.0 | -0.9 | -0.8 |
| **Net errors and omissions** | -2.9 | 2.6 | -11.0 | 2.3 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Sources: CBI; and IMF staff estimates.

Table 3. Iceland: Financial Soundness Indicators, 2000-2007
(as of year-end)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| **Capital adequacy 1/** | | | | | | | | |
| Risk-based capital adequacy ratio (CAR) (in percent) | 9.8 | 11.4 | 12.2 | 12.3 | 12.8 | 12.8 | 15.1 | 12.1 |
| CAR excluding subordinated loans (in percent) | 6.6 | 8.1 | 9.1 | 9.2 | 9.5 | 7.6 | 10.9 | 6.5 |
| Tier 1 capital ratio (in percent) | 8.1 | 9.1 | 9.7 | 9.7 | 10.4 | 10.2 | 11.7 | 10.1 |
| **Asset quality** | | | | | | | | |
| **Credit institutions 2/** | | | | | | | | |
| Total lending (in ISK billion) | 601.5 | 704.3 | 740.2 | 918.6 | 1,314.0 | 2,203.0 | 3,251.5 | 5,173 |
| thereof foreign currency loans (in percent) | 41.6 | 44.3 | 39.6 | 49.0 | 51.3 | 51.9 | 57.7 | 68.6 |
| Sectoral credit concentration | | | | | | | | |
| Real estate loans (as percent of total loans) | 6.6 | 5.8 | 5.3 | ... | ... | ... | ... | 9.6 |
| Loans to fisheries (as percent of total loans) | 22.9 | 21.2 | 17.1 | 13.4 | 10.9 | 10.9 | 3.1 | 2.5 |
| thereof foreign currency loans (in percent) | 86.5 | 86.8 | 87.0 | 90.1 | 90.3 | 84.0 | 91.4 | 93.4 |
| Loans to households (as percent of total loans) | 27.5 | 25.5 | 26.3 | 20.1 | 23.5 | 24.6 | 21.7 | 16.2 |
| thereof foreign currency loans (in percent) | 8.1 | 10.4 | 8.6 | 4.1 | 7.0 | 5.2 | 10.4 | 16.7 |
| Loans to businesses (as percent of total loans) | 65.2 | 64.2 | 62.6 | 61.9 | 59.1 | 50.5 | 50.9 | 43.4 |
| thereof foreign currency loans (in percent) | 55.6 | 54.7 | 49.4 | 56.9 | 57.1 | 54.1 | 60.1 | 61.6 |
| Loans to retail and services (as percent of total loans) | 29.4 | 30.0 | 32.7 | 35.5 | 37.7 | 33.4 | 34.9 | 26.5 |
| thereof foreign currency loans (in percent) | 37.0 | 36.1 | 33.7 | 49.9 | 51.6 | 50.0 | 55.3 | 56.9 |
| Loans to manufacturing et. al. (as percent of total loans) 3/ | 12.9 | 13.0 | 12.7 | 12.3 | 10.0 | 7.1 | 9.7 | 6.6 |
| thereof foreign currency loans (in percent) | 43.0 | 45.3 | 39.2 | 42.1 | 43.4 | 42.4 | 63.0 | 65.2 |
| Foreign sector (as percent of total loans) | ... | 3.6 | 6.2 | 12.3 | 14.6 | 22.8 | 25.0 | 38.5 |
| thereof foreign currency loans (in percent) | ... | 99.4 | 78.6 | 91.2 | 96.1 | 96.6 | 95.9 | 96.9 |
| Non-performing loans (NPL) as percent of total loans 1/ 4/ | 1.5 | 2.0 | 2.6 | 2.1 | 0.9 | 1.1 | 0.8 | ... |
| Total provisions as percent of average loans 1/ | 0.8 | 1.2 | 1.2 | 1.4 | 0.8 | 0.3 | 0.3 | 0.3 |
| Leverage ratio (equity as percent of total assets) 1/ | 6.2 | 6.5 | 7.2 | 7.1 | 7.1 | 7.4 | 7.8 | 6.9 |
| **Borrowing entities** | | | | | | | | |
| Debt-equity ratios | | | | | | | | |
| All listed companies (except financial companies) | 2.3 | 2.3 | 1.7 | 1.8 | 2.1 | 1.9 | 2.5 | 2.9 |
| Fisheries companies | 2.6 | 2.6 | 2.0 | 2.0 | 1.8 | 2.4 | 3.1 | 2.0 |
| Manufacturing companies | 1.5 | 1.4 | 1.4 | 1.6 | 1.5 | 2.2 | 2.5 | 2.8 |
| IT companies | 1.8 | 1.4 | 1.1 | 1.0 | 1.9 | 2.0 | 4.2 | 3.7 |
| Retail, services, and construction companies | 1.9 | 2.0 | 1.5 | 1.4 | 3.2 | 1.6 | 3.8 | 3.2 |
| Corporate profitability (EBITDA/turnover, in percent) | | | | | | | | |
| All listed companies (except financial companies) | 7.8 | 10.2 | 11.9 | 11.1 | 11.2 | 10.1 | 11.1 | 8.6 |
| Fisheries companies | 17.4 | 27.1 | 24.0 | 21.3 | 17.5 | 18.7 | 22.9 | 22.0 |
| Manufacturing companies | 12.5 | 13.4 | 12.9 | 11.0 | 19.0 | 15.9 | 15.3 | 10.6 |
| IT companies | 9.0 | 10.2 | 27.2 | 23.4 | 13.9 | 9.3 | 8.6 | 8.8 |
| Retail, services, and construction companies | 7.9 | 5.6 | 7.5 | 10.5 | 12.1 | 12.1 | 7.4 | 8.6 |
| Household indebtedness (debt/disposable income, in percent) | 165.4 | 176.9 | 182.4 | 172.0 | 183.5 | 214.7 | 216.0 | 226.5 |
| **Management soundness 1/** | | | | | | | | |
| Expense ratios | | | | | | | | |
| Operating expenses as percent of net operational revenue | 65.7 | 66.7 | 59.4 | 55.0 | 45.1 | 35.8 | 37.0 | 50 |
| Staff costs as percent of net operational revenue | 32.9 | 33.8 | 30.9 | 29.4 | 23.9 | ... | ... | ... |
| **Earnings and profitability 1/** | | | | | | | | |
| Return on assets (after taxes, in percent) | 0.7 | 0.8 | 1.1 | 1.3 | 1.8 | 2.3 | 2.6 | 1.5 |
| Return on equity (after taxes) | 10.7 | 13.5 | 18.1 | 22.1 | 30.9 | 41.7 | 39.1 | 22.4 |
| Interest margin (as percent of total revenue) | 54.5 | 63.8 | 51.4 | 44.2 | 40.7 | 39.7 | 37.9 | 46 |
| Fees and commissions (as percent total revenue) | 31.0 | 32.6 | 26.2 | 25.0 | 21.3 | 24.1 | 26.1 | 34.5 |
| Value adjustments of other financial operations (as percent of total re | (1.2) | (5.8) | 12.1 | 22.7 | 24.7 | 26.5 | 29.8 | 12 |
| Dividends from shares and other holdings (as percent of total revenue | 5.9 | 4.0 | 2.7 | 3.2 | 3.9 | 3.0 | ... | ... |
| Other income (as percent of total revenue) | 9.8 | 5.3 | 7.6 | 4.9 | 9.3 | 6.7 | 6.2 | 7.4 |

Table 3. Iceland: Financial Soundness Indicators, 2000-2007 (concluded)
(as of year-end)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| **Liquidity** | | | | | | | | |
| Central bank credit to banks (end of period, in ISK billion) | 46.9 | 68.7 | 73.7 | 25.0 | 37.5 | 87.7 | 146.7 | 302 |
| Deposits to M3 ratio | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.1 | 1.0 | ... |
| Loans-to-deposits ratiom | 2.1 | 2.1 | 1.9 | 1.9 | 2.4 | 3.2 | 2.8 | 2.2 |
| Liquidity ratio (cash and short-term assets/ demand and short-term liabilities) | 1.2 | 1.2 | 1.2 | 1.2 | 1.3 | 1.5 | 2.0 | 1.7 |
| Measures of secondary market liquidity: | | | | | | | | |
| Interbank FX market turnover (Kr. Billions) | 768.0 | 1218.0 | 834.4 | 1185.6 | 949.9 | 2077.5 | 4421.6 | 4,994 |
| Interbank domestic market turnover (Kr. Billions) | 524.3 | 426.1 | 420.8 | 578.9 | 1073.3 | 1579.1 | 1646.8 | 1,356 |
| **Market-based indicators:** | | | | | | | | |
| Stock market index (ICEX-15; y-o-y change, in percent) | -19.3 | -11.2 | 16.7 | 56.4 | 58.9 | 64.7 | 16.0 | -2 |
| Residential housing prices (y-o-y increase, in percent) | 13.3 | 3.1 | 7.5 | 9.1 | 23.3 | 31.0 | 5.6 | 15 |
| Commercial property prices (y-o-y increase, in percent) | 16.3 | -2.8 | -12.6 | 11.6 | 6.9 | 12.6 | 35.0 | ... |
| Market capitalization at year-end (as a percent of GDP) | 59.5 | 57.0 | 68.2 | 81.3 | 126.2 | 182.3 | 340.8 | ... |
| Turnover rate (trading/market capitalization) (12 month trading) | 50.0 | 32.3 | 60.7 | 84.0 | 66.6 | 66.2 | 84.6 | ... |
| Credit ratings | | | | | | | | |
| Moody's short-term 1/ 2/ | P1-P2 | P1-P2 | P1-P2 | P1 | P1 | P1 | P1 | -1,P-1,P-1 |
| Moody's long-term 1/ 2/ | A2-A3 | A2-A3 | A2-A3 | A1-A3 | A1-A3 | A1-A2 | Aa3 | A1,A2,A2 |
| Fitch short-term 1/ 2/ | ... | F1 | F1 | F1 | F1 | F1 | F1 | F2,F1,F2 |
| Fitch long-term 1/ 2/ | ... | A | A | A | A | A | A | A-,A,A- |
| Sovereign yield spreads (spread between yields on Icelandic and foreign trade-weighted 3-month T-bills, percentage points) | 6.3 | 7.9 | 3.1 | 2.8 | 5.3 | 6.2 | 12.1 | 10.62 |
| **Financial market structure:** | | | | | | | | |
| Concentration ratios in the banking sector | | | | | | | | |
| Number of banks accounting for 25 percent of total assets 2/ | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | ... | 1 |
| Number of banks accounting for 75 percent of total assets 2/ | 3.0 | 4.0 | 4.0 | 3.0 | 3.0 | 3.0 | ... | 3 |
| Number of financial institutions (unconsolidated) | 29.0 | 29.0 | 29.0 | 28.0 | 28.0 | 28.0 | ... | 25 |
| Number of financial institutions (consolidated) 1/ 2/ | 10.0 | 10.0 | 10.0 | 10.0 | 10.0 | 10.0 | ... | 7 |

Sources: Financial Supervisory Authority and Central Bank of Iceland.

1/ Three lagrest commercial banks and four (six until 2005, five for 2006, four from 2007) largest savings banks.

2/ Deposit money banks. Figures from year 2003 onwards for sectoral breakdown of lendings is not comparable with the past because of new classification.

3/ Mining, manufacturing and construction.

4/The NPL ratios for 2005 and 2006 were not disclosed in the reports of most of the banks using IFRS for their annual accounts. The NPL ratios for these two years are provided by the FME for the largest financial institutions (2 commercial banks and 6 largest savings banks) based on loans to customers excluding financial institutions.

Table 4. Iceland: Summary Operations of the General Government, 2004-2013

(in percent of GDP)

| | 2004 | 2005 | 2006 | Prel 2007 | Staff projection 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Total revenue** | 45.9 | 48.9 | 49.7 | 50.1 | 48.4 | 45.9 | 45.2 | 45.6 | 45.8 | 46.1 |
| Current revenue | 44.1 | 47.0 | 48.0 | 48.3 | 46.5 | 44.0 | 43.1 | 43.4 | 43.7 | 44.0 |
| *of which:* | | | | | | | | | | |
| Direct taxes | 19.5 | 21.0 | 21.6 | 22.1 | 21.3 | 20.3 | 19.9 | 20.7 | 21.3 | 21.9 |
| Indirect taxes | 18.3 | 19.6 | 19.8 | 19.1 | 18.1 | 16.8 | 16.4 | 16.1 | 15.9 | 15.7 |
| Interest income | 1.1 | 1.0 | 1.7 | 2.3 | 2.0 | 2.0 | 2.0 | 1.8 | 1.7 | 1.6 |
| Other current income | 5.1 | 5.5 | 4.8 | 4.7 | 5.0 | 4.9 | 4.8 | 4.8 | 4.8 | 4.8 |
| Capital revenue | 1.8 | 1.8 | 1.8 | 1.8 | 1.9 | 1.8 | 2.1 | 2.1 | 2.1 | 2.1 |
| **Total expenditure** | 45.9 | 44.0 | 43.4 | 44.8 | 46.3 | 48.9 | 50.2 | 49.9 | 49.0 | 48.2 |
| Current expenditure | 41.2 | 40.1 | 38.9 | 39.7 | 40.2 | 42.2 | 44.1 | 43.8 | 43.0 | 42.2 |
| *of which:* | | | | | | | | | | |
| Interest expenditure | 2.4 | 2.2 | 2.2 | 2.3 | 2.2 | 2.2 | 2.4 | 2.6 | 2.8 | 2.9 |
| Capital expenditure | 4.7 | 3.8 | 4.6 | 5.1 | 6.1 | 6.7 | 6.1 | 6.1 | 6.1 | 6.0 |
| **Primary balance** | 2.5 | 7.1 | 8.5 | 7.5 | 4.4 | -0.9 | -2.6 | -1.7 | -0.4 | 0.7 |
| **Overall balance** | 0.0 | 4.9 | 6.3 | 5.2 | 2.2 | -3.1 | -5.0 | -4.3 | -3.2 | -2.1 |
| **Debt position** | | | | | | | | | | |
| General government gross debt | 34.5 | 25.4 | 30.2 | 28.6 | 27.8 | 29.5 | 33.6 | 35.5 | 36.3 | 36.4 |
| General government net debt | 20.8 | 9.4 | 7.8 | 7.7 | 7.9 | 10.5 | 15.2 | 18.4 | 20.4 | 21.4 |
| **Cyclically adjusted 3/** | | | | | | | | | | |
| Primary revenue 4/ | 45.0 | 46.5 | 46.2 | 46.0 | 45.8 | 44.3 | 44.1 | 44.4 | 44.4 | 44.4 |
| Primary expenditure | 43.3 | 43.0 | 42.9 | 44.4 | 44.8 | 46.0 | 46.2 | 46.0 | 45.7 | 45.3 |
| Primary balance | 1.8 | 3.5 | 3.4 | 1.6 | 1.1 | -1.7 | -2.1 | -1.6 | -1.2 | -0.9 |
| Total revenue 4/ | 46.1 | 47.5 | 48.1 | 48.4 | 47.9 | 46.3 | 46.0 | 46.2 | 46.2 | 46.1 |
| Total expenditure | 45.7 | 45.3 | 45.1 | 46.8 | 47.0 | 48.2 | 48.5 | 48.5 | 48.4 | 48.2 |
| Overall balance | 0.4 | 2.2 | 3.0 | 1.6 | 0.9 | -1.9 | -2.5 | -2.3 | -2.3 | -2.1 |
| **Memorandum items:** | | | | | | | | | | |
| Real expenditure change 2/ | 3.4 | 1.8 | 5.3 | 7.7 | 2.8 | 1.7 | -0.4 | 2.2 | 2.2 | 2.3 |
| Output gap 3/ | -0.5 | 3.0 | 3.8 | 4.3 | 1.6 | -1.5 | -3.4 | -2.7 | -1.3 | 0.0 |

Sources: Ministry of Finance; and Fund staff estimates and calculations.

1/ In percent of potential GDP.

2/ Change in percent, deflated by CPI inflation.

3/ Actual output less potential in percent of potential.

4/ Structural revenue estimates were adjusted to account for the impact of the asset boom price. The revenue-elasticity effect of the asset-price boom added on average about 1/2 percent of GDP to the structural balance each year during 2004-06 period.

Table 5. Iceland. Medium-term Scenario, 2004-13
(Percentage change, unless otherwise indicated)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| Real GDP | 7.7 | 7.5 | 4.4 | 3.8 | -0.3 | -2.1 | -0.8 | 2.3 | 3.3 | 3.3 |
| Real domestic demand | 9.9 | 16.0 | 9.9 | -2.4 | -3.2 | -5.0 | -3.5 | 1.3 | 2.4 | 2.4 |
| Private consumption | 6.9 | 13.0 | 4.4 | 4.2 | -2.2 | -8.0 | -6.0 | 1.0 | 2.5 | 2.5 |
| Public consumption | 2.2 | 3.5 | 3.9 | 3.3 | 2.6 | 2.4 | 2.5 | 2.6 | 2.6 | 2.6 |
| Fixed investment | 28.1 | 35.7 | 20.4 | -14.9 | -10.0 | -4.7 | -3.8 | 0.6 | 2.0 | 2.0 |
| Change in stocks 1/ | 0.1 | 0.0 | 1.6 | -1.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| | | | | | | | | | | |
| Net exports 1/ | -2.4 | -9.2 | -6.7 | 6.6 | 3.2 | 3.3 | 2.9 | 1.0 | 0.9 | 0.9 |
| Exports | 8.4 | 7.2 | -5.0 | 18.1 | 4.3 | 3.2 | 3.8 | 4.0 | 4.3 | 4.3 |
| Imports | 14.5 | 29.4 | 10.2 | -1.4 | -3.4 | -4.3 | -2.9 | 1.6 | 2.3 | 2.3 |
| Current account 2/ | -9.8 | -16.1 | -25.4 | -15.6 | -16.7 | -12.3 | -10.1 | -8.4 | -6.6 | -5.4 |
| | | | | | | | | | | |
| Inflation | | | | | | | | | | |
| Consumer Prices | 3.2 | 4.0 | 6.8 | 5.0 | 11.7 | 9.7 | 5.9 | 4.8 | 3.0 | 2.0 |
| | | | | | | | | | | |
| Labor market | | | | | | | | | | |
| Employment | 1.3 | 1.9 | 5.3 | 5.5 | -0.1 | -0.8 | 1.6 | 1.2 | 1.0 | 0.6 |
| Average unemployment rate | 3.1 | 2.1 | 1.3 | 1.0 | 2.2 | 3.9 | 3.3 | 2.9 | 2.6 | 2.6 |
| | | | | | | | | | | |
| Public finance | | | | | | | | | | |
| General government balance 2/ | 0.0 | 4.9 | 6.3 | 5.2 | 2.2 | -3.1 | -5.0 | -4.3 | -3.2 | -2.1 |
| General government structural balance 2/ | 0.4 | 2.2 | 3.2 | 2.0 | 1.0 | -2.0 | -2.5 | -2.4 | -2.3 | -2.1 |
| General government gross debt 2/ | 34.5 | 25.4 | 30.2 | 28.6 | 27.8 | 29.5 | 33.6 | 35.5 | 36.3 | 36.4 |
| | | | | | | | | | | |
| Output gap 3/ | -0.5 | 3.0 | 3.8 | 4.3 | 1.6 | -1.5 | -3.4 | -2.7 | -1.3 | 0.0 |

Sources: CBI; and IMF staff estimates.

1/ Contributions to growth
2/ In percent of GDP
3/ In percent of potential output

INTERNATIONAL MONETARY FUND

ICELAND

**Staff Report for the 2008 Article IV Consultation**
**Informational Annex**

Prepared by the European Department
(In consultation with other departments and the World Bank)

August 20, 2008

Contents Page

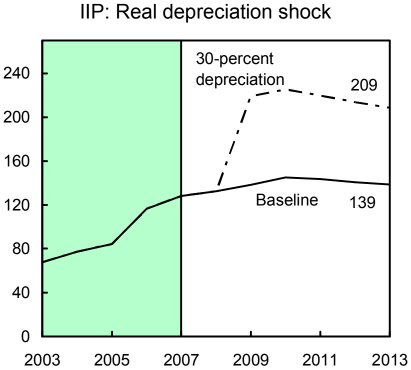
## ANNEX I. ICELAND: EXTERNAL DEBT SUSTAINABILITY

**Iceland's external debt has ballooned in recent years to a level close to 560 percent of GDP at end-2007.** Large current account deficits in the last five years, driven by investment projects and the expansion of Icelandic commercial banks and firms abroad, resulted in a sharp increase in gross external debt, from about 140 percent of GDP in 2003 to an estimated 558 percent of GDP at end-2007. The expansion of external debt of the banking sector (from 86 to 462 percent of GDP between 2003 and 2007) contributed to the bulk of the increase in Iceland's total external debt. Short-term debt also increased significantly, again mainly on account of the banks, from 31 to almost 200 percent of GDP between 2003 and 2007 (with the bulk of the increase occurring in 2007, thus implying a much larger financing need in 2008). Accounting for residents' holdings of assets abroad, net debt has increased from 101 to 252 percent of GDP, while the net international investment position (IIP) has deteriorated from -63 to -124 percent of GDP during 2003–07.

**Iceland's high external indebtedness and vulnerability, particularly to a króna depreciation, raise concerns about residents' ability to service debt and point to the existence of capital-account based external instability.** Under the baseline scenario, the level of net external debt will increase further and stabilize around 230 percent of GDP. Various shocks to growth, the non-interest current account, and the interest rate could drive debt up further by some 20–30 percentage points. However, debt is most vulnerable to an exchange rate shock. A one-time 30 percent depreciation of real exchange rate in 2009 could lead an increase in net debt topping 450 percent of GDP (under the baseline scenario, the real exchange rate is assumed to move toward its equilibrium level by 2013, which implies a depreciation of about 11 percentage points compared to its end-2007 level).

**Concerns about Iceland's external sustainability are somewhat mitigated by the greater resilience of the IIP to shocks and its potentially lower "true" value.** Given the large equity holdings of domestic companies abroad, which are not captured in the net external debt, the IIP may be a better measure of Iceland's true external position. Under the same extreme scenario (30 percent real depreciation in 2009), IIP position at end-2013 deteriorates from 139 to 209 percent of GDP, a sizeable, but much smaller adjustment than that in external debt. Moreover, potential measurement imperfections may lead to an undervaluation of the IIP, given the large stocks and differing asset and liability composition. With outward FDI more than double inward FDI, and its recording at book rather than market value, the IIP could have been undervalued by as much as 60 percent of GDP at end-2006.[1] Moreover, portfolio assets and receipts may also be underestimated, as their lower implicit rate of return appears at odds with the profitability and growth of Icelandic companies recently. Finally, some of the profit of firms owned by Icelandic holding companies registered abroad is counted as expenditure, further understating the true value of IIP.[2]

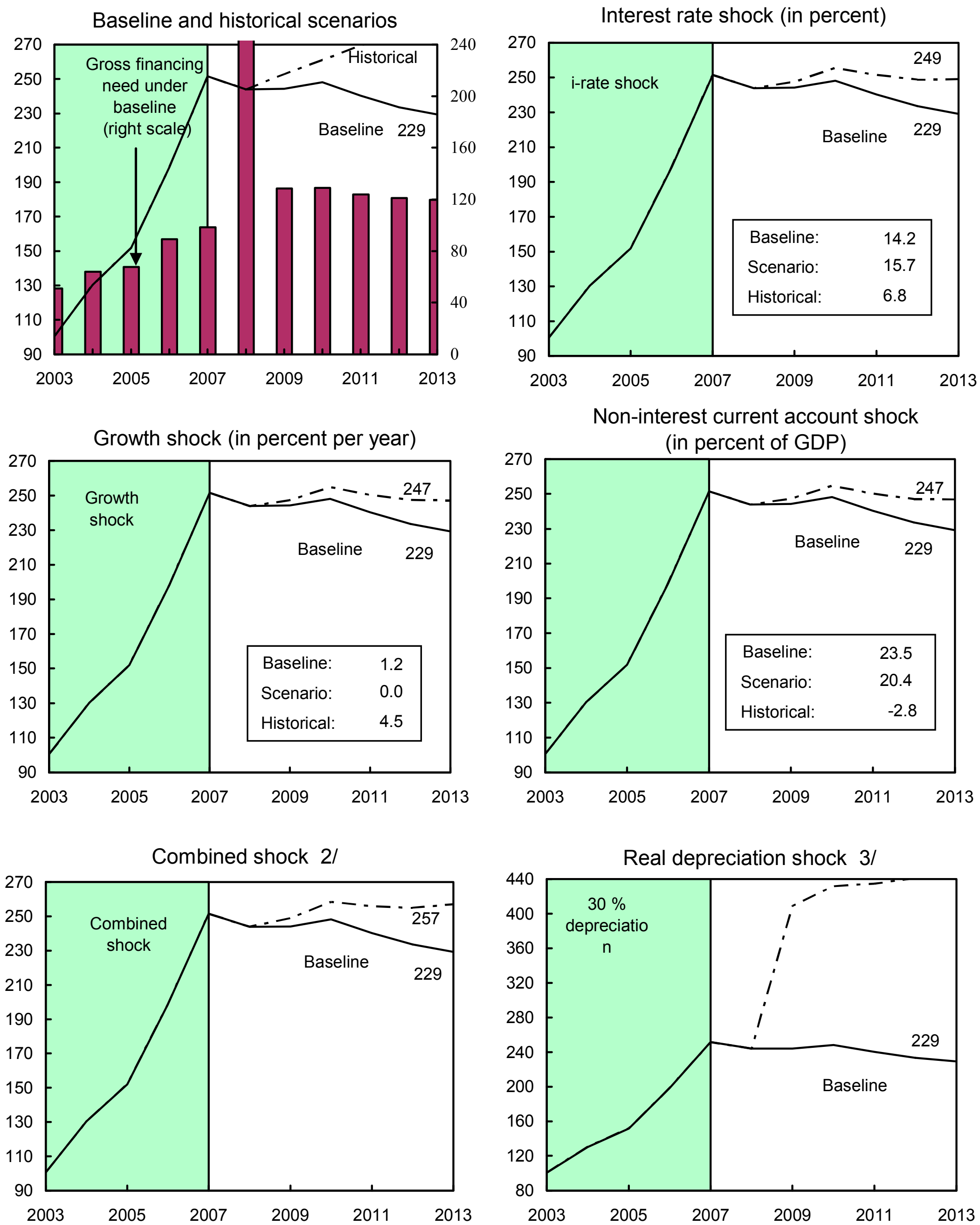
IIP: Real depreciation shock




[1] Daníel Svavarsson, "International investment position: market valuation and the effects of external changes," in Monetary Bulletin Vol. 10 no. 1 April 2008.

[2] Portes Richard, Baldursson Fridrik Mar, and Frosti Olafsson, "The Internationalization of Iceland's Financial Sector," Iceland Chamber of Commerce, Reykjavik Iceland, November 2007. http://www.chamber.is/news.asp?id=526&news_ID=603&type=one.

Figure A1. Iceland: External Debt Sustainability: Bound Tests 1/
(Net external debt in percent of GDP)




Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2008.

Table A1. Iceland: External Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | **Debt-stabilizing non-interest current account 6/** |
| **Baseline: Net external debt** | 100.5 | 130.3 | 151.9 | 198.7 | 251.6 | **243.9** | **244.2** | **248.2** | **240.3** | **233.6** | **229.3** | **14.2** |
| Change in net external debt | -0.6 | 29.8 | 21.6 | 46.7 | 52.9 | -7.7 | 0.3 | 4.0 | -7.9 | -6.7 | -4.3 | |
| Identified external debt-creating flows (4+8+9) | -12.6 | 7.5 | 15.8 | 22.4 | 29.0 | 17.0 | 13.5 | 7.5 | -1.3 | -3.6 | -3.1 | |
| Current account deficit, excluding interest payments | 1.4 | 6.9 | 10.1 | 10.8 | -7.5 | -20.5 | -21.8 | -23.8 | -22.9 | -23.8 | -24.9 | |
| Deficit in balance of goods and services | 3.2 | 6.3 | 12.2 | 17.3 | 10.6 | 9.5 | 7.7 | 6.7 | 5.1 | 3.8 | 2.7 | |
| Exports | 37.0 | 39.1 | 31.5 | 31.1 | 36.3 | 46.1 | 43.0 | 40.8 | 39.8 | 39.2 | 38.9 | |
| Imports | 40.2 | 45.4 | 43.7 | 48.4 | 46.9 | 55.5 | 50.7 | 47.6 | 44.9 | 43.0 | 41.6 | |
| Net non-debt creating capital inflows (negative) | 0.9 | 13.5 | 24.1 | 1.0 | 45.9 | -1.2 | -4.0 | -4.9 | -4.7 | -3.2 | -1.5 | |
| Automatic debt dynamics 1/ | -14.9 | -12.9 | -18.4 | 10.5 | -9.4 | 38.6 | 39.4 | 36.2 | 26.3 | 23.3 | 23.3 | |
| Contribution from nominal interest rate | 3.8 | 4.4 | 6.0 | 13.9 | 23.7 | 37.8 | 34.5 | 34.3 | 31.6 | 30.6 | 30.5 | |
| Contribution from real GDP growth | -2.0 | -6.4 | -7.9 | -6.6 | -6.4 | 0.9 | 4.8 | 2.0 | -5.3 | -7.3 | -7.2 | |
| Contribution from price and exchange rate changes 2/ | -16.7 | -10.9 | -16.5 | 3.2 | -26.7 | ... | ... | ... | ... | ... | ... | |
| Residual, incl. change in gross foreign assets (2-3) 3/ | 12.0 | 22.3 | 5.8 | 24.4 | 23.9 | -24.7 | -13.2 | -3.4 | -6.6 | -3.0 | -1.3 | |
| External debt-to-exports ratio (in percent) | 271.8 | 333.4 | 482.6 | 638.2 | 692.5 | 529.2 | 568.0 | 607.6 | 603.4 | 596.6 | 588.8 | |
| **Gross external financing need (in billions of US dollars) 4/** | 5.6 | 8.5 | 11.0 | 14.9 | 19.7 | 48.8 | 27.2 | 28.2 | 29.3 | 30.9 | 32.5 | |
| in percent of GDP | 51 | 64 | 68 | 89 | 98 | 246 | 128 | 129 | 124 | 121 | 120 | |
| **Scenario with key variables at their historical averages 5/** | | | | | | **243.9** | **252.8** | **261.0** | **269.4** | **276.9** | **283.4** | **-1.5** |
| **Key Macroeconomic Assumptions Underlying Baseline** | | | | | | | | | | | | |
| Real GDP growth (in percent) | 2.4 | 7.7 | 7.5 | 4.4 | 3.8 | -0.3 | -2.1 | -0.8 | 2.3 | 3.3 | 3.3 | |
| GDP deflator in US dollars (change in percent) | 19.7 | 12.1 | 14.5 | -2.0 | 15.5 | -0.3 | 8.7 | 4.2 | 5.9 | 4.2 | 3.2 | |
| Nominal external interest rate (in percent) | 4.6 | 5.3 | 5.6 | 9.4 | 14.3 | 14.9 | 15.1 | 14.5 | 13.8 | 13.7 | 13.9 | |
| Growth of exports (US dollar terms, in percent) | 7.1 | 27.6 | -1.0 | 1.2 | 40.0 | 26.0 | -0.7 | -1.8 | 5.6 | 5.8 | 6.0 | |
| Growth of imports (US dollar terms, in percent) | 21.7 | 36.4 | 18.3 | 13.3 | 16.2 | 17.7 | -2.9 | -3.0 | 2.3 | 3.0 | 3.3 | |
| Current account balance, excluding interest payments | -1.4 | -6.9 | -10.1 | -10.8 | 7.5 | 20.5 | 21.8 | 23.8 | 22.9 | 23.8 | 24.9 | |
| Net non-debt creating capital inflows | -0.9 | -13.5 | -24.1 | -1.0 | -45.9 | 1.2 | 4.0 | 4.9 | 4.7 | 3.2 | 1.5 | |

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; $\rho$ = change in domestic GDP deflator in US dollar terms, g = real GDP, growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. $\rho$ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

## ANNEX II. ICELAND: FUND RELATIONS
(As of June 30, 2008)

- **Discussions**: June 23–July 4, 2008, in Reykjavik.
- **Team**: Mmes. Koeva Brooks (head), Ivaschenko, Velculescu, and Mr. Luzio (all EUR). An FSAP update mission took place during June 16–27, 2008.
- **Outreach**: Disseminated conclusions through press conference. Concluding statement was published.
- **Mission focus**: Discussed coordinated policies best suited to facilitate adjustment toward macroeconomic balance and mitigate risks of a hard landing.
- **Political situation**: A coalition government comprising the Independence Party and the Social Democratic Alliance has been in place since May 2007.
- **Exchange rate regime**: In March 2001, Iceland adopted an independently floating exchange rate regime for the króna.

I. **Membership Status**: Joined: December 27, 1945; Article VIII

| II. | **General Resources Account:** | **SDR Million** | **% Quota** |
|---|---|---|---|
| | Quota | 117.60 | 100.00 |
| | Fund holdings of currency | 99.01 | 84.19 |
| | Reserve position in Fund | 18.59 | 15.81 |
| | Holdings Exchange Rate | | |

| III. | **SDR Department:** | **SDR Million** | **% Allocation** |
|---|---|---|---|
| | Net cumulative allocation | 16.41 | 100.00 |
| | Holdings | 0.04 | 0.27 |

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Payments to the Fund** (SDR Million; based on existing use of resources and present holdings of SDRs):

| | Forthcoming | | | | |
|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012 |
| Principal | | | | | |
| Charges/Interest | 0.24 | 0.49 | 0.49 | 0.49 | 0.49 |
| **Total** | 0.24 | 0.49 | 0.49 | 0.49 | 0.49 |

VII. **Implementation of HIPC Initiative:** Not applicable

VIII. **Exchange Rate Arrangements:** Iceland adopted an independently floating exchange rate regime for the króna effective March 28, 2001, and the króna is de facto independently floating.

Iceland accepted Article VIII obligations and does not maintain any exchange restrictions or multiple currency practices except for exchange restrictions pursuant to UN sanction against Iraq.

IX. **Last Article IV Consultation :**

Discussion for the 2007 Article IV Consultation were held in Reykjavik during May 31–June 11, 2007. The Staff Report (Country Report No. 07/295) was considered by the Executive Board on August 22, 2007. Article IV consultations with Iceland are currently held on the 12–month cycle.

X. **Technical Assistance:** None

XI. **Resident Representative**: None

## ANNEX III. ICELAND: STATISTICAL ISSUES

Data provision to the Fund is adequate for surveillance purposes. Iceland subscribed to the Special Data Dissemination Standard (SDDS) in 1996, and is in observance of the SDDS specifications for coverage, periodicity, and timeliness, but uses a flexibility option on the timeliness and periodicity for the production index and the producer price index (PPI). The Statistics Department (STA) prepared a data module of the Report on the Observance of Standards and Codes (data ROSC) that was published on November 22, 2005.

Data on a wide range of economic and financial variables are provided to the Fund in a timely manner during and between consultations. In addition to periodic press releases, statistical information is disseminated to the public through a range of monthly, quarterly, and annual publications by three main institutions (The Central Bank of Iceland (CBI), the Ministry of Finance, and Statistics Iceland), and is increasingly available on their internet sites. Provision of electronic data in English has improved substantially in recent years, especially from Statistics Iceland.

As regards the national accounts data, the authorities shifted to ESA95 in August 2000 and revised the corresponding time series back to 1990. Another revision was carried out in 2002. A breakdown is disseminated by industry back to the beginning of the production approach in 1973. Data on GNP and national income, in current and constant prices, as well as data on net savings for the economy as a whole, are also disseminated. The quarterly data are seasonally adjusted.

The authorities publish Treasury returns on a monthly basis, and quarterly and annual data on the general government balance. Iceland reports government finance statistics in accordance with the *GFSM 2001* framework in the *GFS Yearbook*, and is an up-to-date contributor to the *International Financial Statistics (IFS)*.

Balance of payments data deviate from the IMF's *Balance of Payments Manual*, fifth edition *(BPM5)* in certain respects. In particular, the CBI follows the methodology applied by the European Central Bank (ECB) for the calculation of income payable by collective investment institutions (e.g., mutual funds). Unlike the *BPM5*, the ECB's methodology includes portfolio investors' shares of retained earnings in the balance of payments statement. Some other departures are: a) income on external debt is compiled on a due-for-payment basis, including between affiliated enterprises; b) debt between affiliated banks is not identified; c) banking sector loans are not classified separately from currency and deposits; d) in the international investment position, foreign direct investments are valued at book value; e) external debt is valued at face value; f) financial derivatives held by banks are not available as on-balance sheet items; and, g) domestic currency deposits held with banks by nonbank nonresidents are not recorded as part of external debt.

**Monetary and financial statistics**

The concepts and definitions broadly conform to the guidelines of the *Monetary and Financial Statistics Manual (MFSM)*. Departing from the *MFSM*, monetary aggregates include deposits of the foreign sector and the central government; and the currency-linked and indexed bonds held by nonresidents are classified as domestic instead of foreign liabilities. Classification and sectorization are mostly in line with the *MFSM*, except that, in the accounts of other depository corporations (that is, commercial and savings banks), financial derivatives are off balance sheet and positions of nonfinancial public corporations are included in the government accounts but cannot be identified; and, in the accounts of the CBI, fixed assets are off balance sheet and IMF accounts are included under other items net instead of as foreign liabilities. Several banks do not report at market value loans net of provisions and securities for investment. The CBI has yet to commence reporting monetary data to STA using the Standardized Report Forms.

## Iceland: Table of Common Indicators Required for Surveillance

(As of July 29, 2008)

| | Date of latest observation | Date received | Frequency of Data[7] | Frequency of Reporting[7] | Frequency of publication[7] | Memo Items: Data Quality – Methodological soundness[8] | Data Quality – Accuracy and reliability[9] |
|---|---|---|---|---|---|---|---|
| Exchange Rates | 7/25/2008 | 7/25/2008 | D and M | D and M | D and M | | |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | Jun 2008 | 7/7/2008 | M | M | M | | |
| Reserve/Base Money | Jun 2008 | 7/22/2008 | M | M | M | LO, O, LO, LO | LO, O, O, O, O |
| Broad Money | Jun 2008 | 7/22/2008 | M | M | M | | |
| Central Bank Balance Sheet | Jun 2008 | 7/5/2008 | M | M | M | | |
| Consolidated Balance Sheet of the Banking System | Jun 2008 | 7/22/2008 | M | M | M | | |
| Interest Rates[2] | 7/25/2008 | 7/25/2008 | D | D | D | | |
| Consumer Price Index | Jun 2008 | 7/25/2008 | M | M | M | O, O, O, O | O, O, O, O, O |
| Revenue, Expenditure, Balance and | 2007 | 4/24/2008 | A | A | A | O, LO, O, LO | LO, O, O, O, O |
| Revenue, Expenditure, Balance and Composition of Financing[3] – Central | Q1, 2008 | 6/12/2008 | A,Q | A,Q | A,Q | | |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | 2007 | 4/17/2008 | A | A | A | | |
| External Current Account Balance | Q1, 2008 | 6/4/2008 | Q | Q | Q | O, O, LO, O | LO, O, O, O, O |
| Exports and Imports of Goods and Services | June 2008 | 7/3/2008 | M | M | M | | |
| GDP/GNP | Q1, 2008 | 6/12/2008 | Q | Q | Q | O, LO, O, LO | LO, O, LO, LO, O |
| Gross External Debt | Q1, 2008 | 6/4/2008 | Q | Q | Q | | |
| International Investment Position[6] | Q1, 2008 | 6/17/2008 | Q | Q | Q | | |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds. [3] Foreign and domestic financing. 4 The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. 5 Including currency and maturity composition. 6 Includes external gross financial asset and liability position vis-à-vis nonresidents. 7 Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).. 8 Reflects the assessment provided in the data ROSC (published on November 22, 2005, and based on the findings of the mission that took place during February 1-15, 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA). [9] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies

INTERNATIONAL MONETARY FUND

ICELAND

**Staff Report for the 2008 Article IV Consultation with Iceland**

**Supplementary Information**

Prepared by the European Department

Approved by Poul Thomsen and Tessa van der Willigen

September 8, 2008

1. This supplement provides an update on economic and policy developments in recent weeks. The thrust of the staff appraisal remains unchanged.

2. **The risk premiums of the three largest Icelandic banks have eased following the banks' interim Q2-2008 results**.

- Buoyed by considerable gains on foreign exchange positions and inflation-linked assets, bank profits in the second quarter of 2008 were broadly in line with expectations. In all three banks, loan impairments on loans increased, albeit from very low levels, pointing to a deterioration in asset quality.

- The four largest banks passed the Financial Supervisory Agency's (FME) regular stress tests.[1] The FME indicated that the main banks can withstand considerable financial shocks, but need to focus on maintaining strong capital and even increase it to reflect rapidly changing financial conditions.

- Subsequently, the CDS spreads of the three main commercial banks eased by over 200 basis points (bps) in early August 2008 (Figure 1). However, they remain notably above those of similarly rated banks. The sovereign spread has declined to around 250 bps after reaching over 300 bps in July.

3. **Domestic price inflation continued to rise, mostly due to the past króna depreciation**.

- CPI inflation edged up 0.9 percent in August 2008 to reach 14.5 percent in 12 months. Core inflation maintained an upward trend, increasing to 12.9 percent over a year ago,

[1] Please see the Chapter II of the FSSA for a detailed explanation of the FME's stress tests.

compared to 11.7 percent in July. The impact of the recent króna depreciation continued to filter through to domestic prices, in line with staff's estimates.

- Wages rose 0.7 percent in July 2008, bringing the annual increase to 9.1 percent, largely due to the impact of previously-settled collective agreements in the public sector. Real wages continued to contract, denting households' purchasing power.

- The króna stabilized in August 2008 after reaching record lows in late June.

4. **Recent economic indicators continued to point to a sharp deterioration in domestic activity**. Consumer confidence edged up in August, but remained at a depressed level. Credit and debit card turnover continued to slide in July and new car registrations fell to a 5-year low. These readings point to a contraction in private consumption, as reflected in staff's baseline forecast.

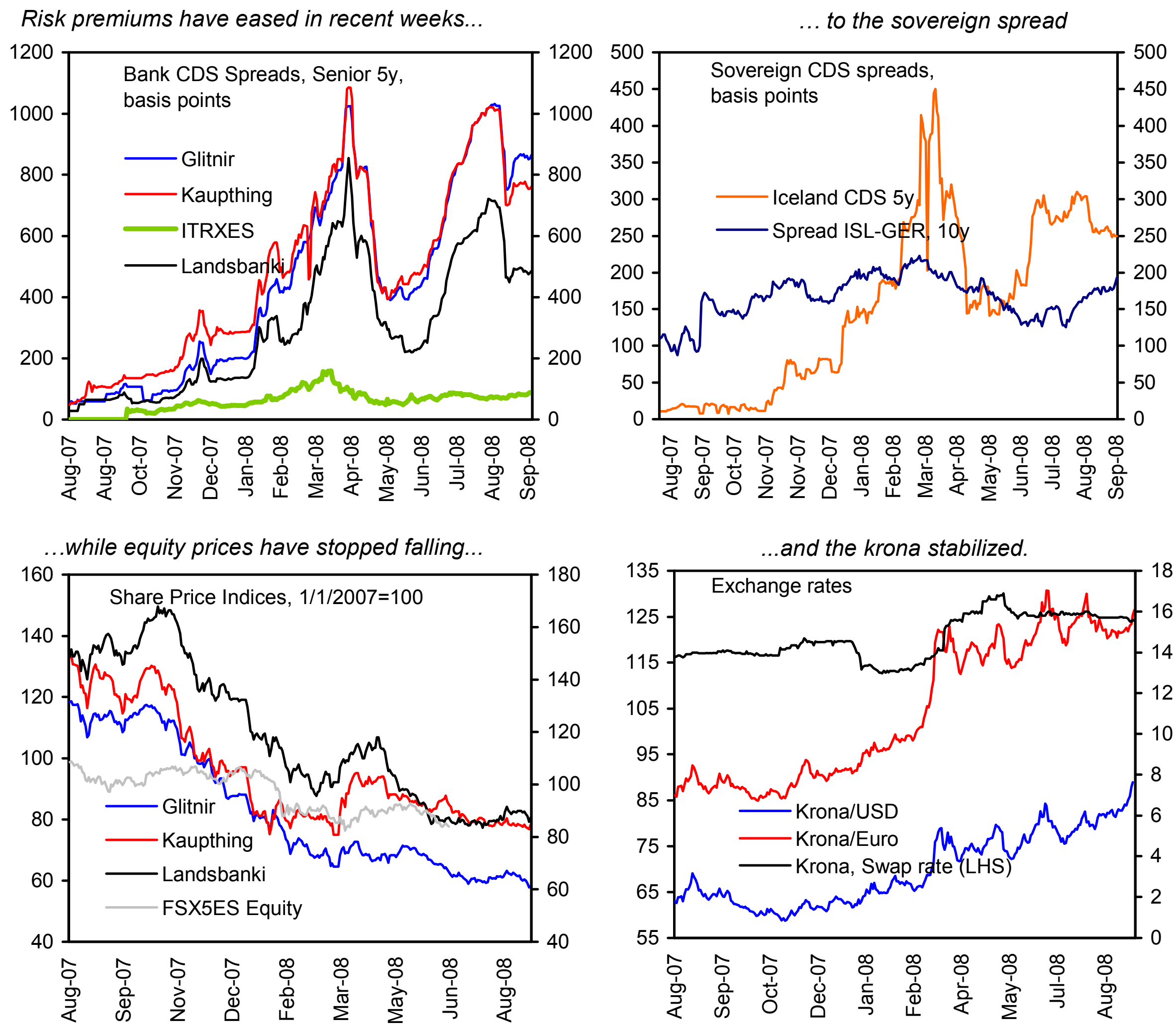
5. **The external position deteriorated further in the second quarter, while international reserves rose**.

- The preliminary current account deficit in Q2-2008 was more than twice as large compared to the same period a year ago and to Q1-2008, mainly due to a higher income account deficit. The IIP position also deteriorated. These developments are broadly in line with staff's baseline forecast.

- After a significant deterioration of 28 percent in Q1-2008 (mostly due to krona depreciation), the net external debt position stabilized in Q2-2008 at Kr. 4.1 billion (about 287 percent of projected GDP in 2008). This development presents an upside risk to the staff's projection of 244 percent of GDP by year-end, which assumes an improvement in the debt position reflecting banks' plans to consolidate their balance sheets.

- The country's foreign currency reserves increased by USD 850 million last month and stood at around USD 3.7 billion as of end-August.

Figure 1. Iceland: Recent Financial Market Developments




Source: Bloomberg, Datastream

INTERNATIONAL MONETARY FUND
*Public Information Notice*
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

# IMF Executive Board Concludes 2008 Article IV Consultation with Iceland

On September 10, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iceland.[1]

**Background**

The economy experienced an extraordinary foreign-funded boom in recent years, with output rising by over 25 percent during 2003–2007. This rapid expansion, however, left a legacy of large macroeconomic imbalances, overstretched private sector balance sheets, and high dependence on foreign financing. The financial sector assets expanded to over 1,000 percent of GDP, while gross external indebtedness reached 550 percent of GDP at end-2007, largely on account of the banking sector.

The global turbulence has taken a significant toll on domestic financial markets since end-2007. The CDS spreads of the three largest domestic banks have risen sharply, approaching 1000 basis points and the freely-floating Icelandic króna has depreciated by over 40 percent.

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[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.

Despite minimum public sector debt, the sovereign is facing a significantly increased risk premium.

In response to the turmoil, the authorities have taken steps to shore up confidence. The Central Bank of Iceland (CBI) tightened the policy rate, enhanced liquidity provision to reduce pressures in foreign exchange and domestic markets, and improved its foreign exchange liquidity access by entering into currency swap agreements with other Nordic central banks. The government indicated its willingness to boost CBI's international reserves and pledged to pursue fiscal prudence and to reform the fiscal framework and the Housing Financing Fund (HFF).

At the same time, banks have sought to strengthen their balance sheets and enhance liquidity buffers. The three largest banks have slowed lending growth, consolidated funding needs, withdrawn from marginal markets, mobilized retail deposits abroad, and reduced costs, although their ability to de-leverage has been limited by global risk aversion.

With foreign financing constraints binding, the economy is cooling. Output growth slowed in the first half of 2008, pulled by a significant retrenchment in domestic expenditure. Consumer confidence plunged in the first half of 2008, retail sale turnover decelerated sharply, and domestic investment, especially in the construction sector, came to a halt.

The sharp depreciation of the Icelandic króna contributed to a jump in domestic prices. Annual inflation shot up from 5.9 percent at end-2007 to 14.5 percent in August 2008. With inflationary pressures mounting, the CBI raised its target interest rate by 1¾ percent in March-May 2008 and kept it unchanged at 15.5 percent since then. Inflation is expected to remain persistently above target in the near term, with significant risks on the upside.

The fiscal position is set to deteriorate and spending pressures to rise. The 2008 budget implies a loosening of the fiscal stance, and the government's commitment to cutting taxes further and boosting spending in early 2008 will contribute to an expansionary policy in 2009 and beyond. Given these policies, staff forecast the fiscal deficit to reach 5 percent of GDP in 2010.

Against this background, economic activity is projected to come to a standstill in 2008 and contract in 2009–10. Tighter lending conditions, significantly lower real estate prices, weaker private balance sheets, and declining purchasing power point to a sharp retrenchment in private consumption. Investment is also expected to decline in 2009–10 while net exports should remain supportive, on the back of strong aluminum exports and a contraction in imports. The risks to the outlook are on the downside, dominated by external considerations.

**Executive Board Assessment**

Executive Directors observed that the Icelandic economy is at a difficult turning point. The long economic expansion, initiated by aluminum sector investments, sustained by a boom in private consumption, and fueled by ready access to external financing, contributed to a build-up of macroeconomic imbalances and financial vulnerabilities. With external liquidity constraints binding, economic growth is expected to decline rapidly from unsustainably high levels and inflation to remain well above the central bank's target, although the current account deficit is likely to narrow. Directors considered that there are large uncertainties surrounding the near-term outlook, with significant downside risks. At the same time, they noted that the long-term prospects for the economy remain promising—even enviable—given Iceland's sound governance and stable institutions, open and flexible markets, large and well-managed renewable natural resource base, and the authorities' long track record of resilience and adaptability to changing circumstances.

Directors observed that the authorities face the challenge of facilitating an orderly rebalancing process, while mitigating risks. They welcomed the authorities' efforts to bolster confidence, including by entering into currency swap arrangements with other Nordic central banks, and by committing to maintain tight macroeconomic policies and boost international reserves. Effective coordination between monetary policy and fiscal policies, and actions to reduce financial sector vulnerabilities, will be key to achieving orderly adjustment.

Directors recommended that monetary policy maintain its tight stance in order to return inflation to target and bolster confidence in the króna. They noted the staff's assessment that the real exchange rate of the króna is somewhat below its equilibrium level. A further króna depreciation could fuel inflationary pressures, erode households' purchasing power, and, against the background of the high level of private sector external debt and the current global financial market turbulence, squeeze private sector balance sheets and exert pressure on the capital account. Directors therefore saw little or no scope for monetary easing until inflation is placed firmly on a downward path. They also called on the authorities to manage carefully the provision of domestic liquidity.

Directors encouraged the authorities to act promptly on their pledge to reform the publicly-owned Housing Finance Fund (HFF), which will be important to increase the effectiveness of monetary policy. They recommended redefining the HFF's role in the financial market by separating the social component, which provides targeted support, from the market-based component, which should not benefit from state aid.

Most Directors considered that a less expansionary fiscal policy would help support the central bank's efforts to combat inflation and maintain confidence, and called on the authorities to resist mounting pressures to boost spending further. A few Directors, however, laying greater emphasis on the threat of recession, saw scope for an active countercyclical fiscal policy to smooth the downturn. Directors welcomed the authorities' commitment to strengthen the fiscal framework.

Directors encouraged the authorities to pursue vigorously policy actions to mitigate banking sector risks. Measures to enlarge capital cushions and boost liquidity buffers could help restrain the growth of banks' balance sheets. Directors recommended strengthening overall transparency, including through better enforcement of disclosure requirements for all corporations.

Directors welcomed the progress made in strengthening the crisis prevention and resolution framework. They recommended that all existing elements of contingency planning be integrated into a single framework, that the bank resolution framework be enhanced, and that the authorities' commitment to boost the central bank's foreign exchange reserves be made effective when conditions permit.

Iceland: Selected Economic Indicators

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 1/ |
|---|---|---|---|---|---|---|
| **Real Economy** (change in percent) | | | | | | |
| Real GDP | 2.4 | 7.7 | 7.5 | 4.4 | 3.8 | -0.3 |
| Domestic demand | 5.6 | 9.9 | 16.0 | 9.9 | -2.4 | -3.2 |
| CPI | 2.1 | 3.2 | 4.0 | 6.8 | 5.0 | 11.7 |
| Unemployment rate (in percent of labor force) | 3.4 | 3.1 | 2.1 | 1.3 | 1.0 | 2.2 |
| Gross domestic investment (in percent of GDP) | 19.9 | 23.5 | 28.4 | 33.7 | 27.5 | 26.3 |
| | | | | | | |
| **General Government Finances** (in percent of GDP) | | | | | | |
| Financial balance 2/ | -2.8 | 0.0 | 4.9 | 6.3 | 5.2 | 2.2 |
| Structural overall balance | -0.3 | 0.4 | 2.2 | 3.2 | 1.6 | 0.9 |
| Gross debt | 40.8 | 34.5 | 25.4 | 30.2 | 28.6 | 27.8 |
| | | | | | | |
| **Money and Credit** (change in percent) | | | | | | |
| Deposit money bank credit (end of period) 3/ | 26.7 | 41.9 | 76.0 | 44.4 | 56.6 | 76.9 |
| Domestic credit (end of period) 3/ | 20.0 | 37.2 | 54.7 | 33.6 | 28.3 | 41.8 |
| Broad money (end of period) 3/ | 17.5 | 15.0 | 23.2 | 19.6 | 56.4 | 41.6 |
| CBI policy rate (period average, in percent) 4/ | 5.30 | 8.20 | 10.49 | 14.08 | 13.75 | 15.50 |
| | | | | | | |
| **Balance of Payments** (in percent of GDP) | | | | | | |
| Trade balance | -3.0 | -5.5 | -12.2 | -17.7 | -10.2 | -9.1 |
| Current account balance | -4.8 | -9.8 | -16.1 | -25.4 | -15.6 | -16.7 |
| Financial and capital account balance | 1.2 | 12.7 | 13.7 | 36.5 | 13.5 | 16.9 |
| Gross external debt | 139.6 | 179.1 | 285.8 | 445.9 | 557.9 | 545.7 |
| Reserves 5/ | 2.2 | 2.1 | 1.8 | 3.4 | 3.3 | 3.2 |
| | | | | | | |
| **Fund position** (as of June 30, 2008) | | | | | | |
| Holdings of currency (in percent of quota) | | | | | | 84.2 |
| Holdings of SDRs (in percent of allocation) | | | | | | 7.3 |
| Quota (in millions of SDRs) | | | | | | 117.6 |
| | | | | | | |
| **Exchange rate** | | | | | | |
| Exchange rate regime | | Floating Exchange Rate | | | | |
| Present rate (Sep 10, 2008) 6/ | | | | | | 159.4 |
| Nominal effective rate (change in percent) | 6.2 | 1.8 | 10.4 | -10.8 | 2.7 | ... |
| Real effective (change in percent) | 6.3 | 2.8 | 12.8 | -6.8 | 5.7 | ... |

Sources: Statistics Iceland, Central Bank of Iceland, Ministry of Finance, and IMF staff estimates.

1/ Projection.

2/ National accounts basis.

3/ 2008 data as of June.

4/ 2008 data as of September.

5/ In months of imports of goods and services.

6/ Broad trade weighted index of the exchange rate as kronur per unit of foreign currency (12/31/1991 = 100)

**Statement by Jens Olof Henriksson, Executive Director for Iceland and Bjorn Olafsson, Senior Advisor to Executive Director**
**September 10, 2008**

The Icelandic authorities greatly appreciate the discussions with the Article IV and FSAP missions that visited Reykjavík this summer. My authorities also greatly value the Fund's advice and dedication and endorse the thrust of the main conclusions in both reports.

Historically, the growth of the Icelandic economy has been based on Iceland's renewable marine and energy resources while the service sector has contributed increasingly in recent years. As a result of its small size and openness, the economy has been prone to volatility. Economic policy has a history of responding to such changes. Iceland is noted for its resilience and adaptability. While the short term may present challenges, the medium-term outlook remains favorable, even enviable as has been noted by staff.

**Growth and Trade**

After a five year period of robust economic growth, the Icelandic economy has entered a period of adjustment. It became increasingly imbalanced as reflected in rising inflation and a large current account deficit, sustained by easy access to global credit. Forecasts imply that GDP growth in 2008 will be below trend and may even turn negative in 2009 and 2010 while internal and external balance is restored.

The economic upswing was fuelled by rapid growth in the financial sector and large scale investment in aluminum smelters and associated power plants. Annual aluminum production capacity has tripled to 800 thousand tons since 2003 and power generation capacity (hydro and geothermal) increased by 80%. The share of aluminum in total merchandise exports will increase from 20% in 2005 to 40% in 2009.

The trade deficit is set to disappear quickly as large-scale investment projects come on stream and imports contract as a result of the depreciation of the króna.

The authorities believe that the IIP may overstate Iceland's true level of external imbalances, as it seems likely that residents' foreign assets have been underestimated by current statistical methodologies. The findings of a recent study suggest that it is likely that the value of both FDI assets and liabilities is significantly underestimated in the official statistics. This discrepancy is due to different accounting treatments of portfolio equity investment vs. foreign direct investment, the former being valued at market prices but the latter at book value. Due to the scale in outward FDI investment over the past years, which has significantly outpaced the growing inward FDI, the proportion of FDI to total foreign assets is much higher than on the liability side.

The compilation of timely balance of payments figures has become much more complicated because of the scale of internationalization of Icelandic business, as reflected in most recent BoP figures. However, the figures that were published last Thursday show that the trade and service figures are moving towards balance.

**Fiscal Policy**

For the last four years the public sector has delivered a considerable surplus, which coincided with the growth in the economy. The Treasury surplus from 2005 to 2007 averaged 5½ percent of GDP. The Ministry of Finance projects the surplus to be lower this year, as the economy slows down. More recent revenue and expenditure estimates indicate that the surplus will be larger than projected in the budget for 2008. While the fiscal surpluses have remained large, the stance of fiscal policy has recently turned more accommodative, as measured by the change to smaller surpluses. In 2008, this is linked to the automatic stabilization properties of fiscal policy as domestic demand contracts. The authorities believe that the executive summary description of a “highly expansionary fiscal policy” is therefore misleading. More so as it is based on further adjustment of the structural primary budget balance for the effects of the asset price boom. The increase in revenues due to asset price increases is in accordance with how the fiscal policy is structured and reflects the automatic stabilization of fiscal policy. Cancelling those revenues out, by adjusting for them, to determine the fiscal stance is a method that we do not agree with.

According to the macroeconomic forecast of the Ministry of Finance the public sector is expected to move into deficit in 2009 and 2010, amounting to about 1 percent of GDP each year. The deterioration can be traced primarily to the effects of the economic contraction on Treasury tax revenues, which are projected to decline considerably in real terms between 2008 and 2010. Revenues from taxes on personal financial income, corporate profits and consumption tax are also expected to contract, i.e. reflecting the adverse impact of the ongoing difficulties in international and domestic financial markets on economic activity. Fiscal policy is thus expected to remain counter-cyclical.

Even though the outlook for public finances is deteriorating it should be noted that record surpluses in recent years have been used to repay government debt and accumulate deposits with the Central Bank. Net Treasury debt has been reduced to zero and is set to move towards a net asset position of 4 percent of GDP at the end of 2008.

The key emphasis in budget management in Iceland is transparency, fiscal rules and discipline. There are two fiscal reforms in the pipeline, one relates to multi-year budgeting with the Treasury and the other is targeted at the local authorities requiring them to adopt expenditure rules to strengthen their medium-term fiscal framework.

**Monetary Policy**

Attaining the inflation target proved challenging in recent years, and inflation has remained above target since the second half of 2004. As a result of a sharp depreciation of the króna in early 2008, triggered by the global financial crisis, inflation has now reached an eighteen year high. To contain inflation expectations and bring inflation back to target over the medium term, the Central Bank of Iceland has maintained a tight monetary policy stance. Inflation is projected to fall during the winter months as the pass-through effects of the króna depreciation disappear and domestic demand contracts.

In August inflation measured 14.5 percent in terms of the 12-month rise in the CPI. To some extent the inflation stems from exogenous factors but the main contributing factors to the inflation performance are related to the depreciation of the króna and secondary effects from increasing food and energy prices. The monetary authorities fully realize the challenges brought on by the current situation. The policy rate is currently 15.5 percent and inflationary developments warrant a continued tight monetary policy. Economic indicators show that the economy appears to be cooling faster than previously anticipated. Declining demand could reduce inflationary pressures in the months to come.

At this juncture, there is a considerable uncertainty about the outlook in general but the Central Bank's priorities are clear. The inflation target takes precedence, not only because it is mandated by law, but also because the long-term cost of not anchoring inflation expectations is sizeable.

In order to increase the effectiveness of monetary policy and to remove distortions, the Government will promptly formulate and make public a credible plan for the restructuring and reform of the Housing Finance Fund system.

**The Financial System**

The Icelandic banking system has grown at an exceptional pace for the past several years. The bank's consolidated assets increased from 100 percent of GDP in 2004 to 900 percent in 2007. The contribution of the banking system to GDP has almost doubled in a decade. International acquisitions and internal growth have expanded the banks' combined balance sheets, and the commercial banks now have subsidiaries and branch offices in the UK, the US, Scandinavia and continental Europe.

The current environment in the global markets has proven challenging for many financial institutions and the Icelandic banks are no exception. Nevertheless, the three major banks showed profits in 2007, which has been sustained for the first half of 2008. As recognized by staff, liquidity ratios are high and capital levels are well above minimum levels. Also, the banks pass liquidity tests as required by the Central Bank and their capital ratios remain above required minimums in considerably stringent stress tests conducted by the Financial Supervisory Authority (FME).

My authorities concur with the assessment in the FSAP report that the main vulnerability in the Icelandic financial system relates to access to global international liquidity which has contracted significantly in the past year. As underlined by staff the banks have implemented various measures to manage their risks and increase market confidence. This *inter alia* includes diversification of funding resources, extension of maturities, enlargement of the deposit base, a contraction of loan books and the selling of noncore assets. Due to these measures, the banks estimated that they have at hand sufficient liquidity to meet their debt obligations through early 2009. The authorities cooperate closely on contingency planning and information sharing according to the Memorandum of Understanding on financial stability and crisis management by the Central Bank, Financial Supervisory Authority and the relevant Ministries.

The Financial Supervisory Authority (FME) monitors the banking system closely and has recently focused on credit risk in particular. The FME's scope of monitoring the Icelandic banks' operations extends to their overseas activities. While stress-testing methodologies have been significantly enhanced, my authorities agree with staff that improvements can still be made and they are working on further refinements.

The authorities continue to monitor carefully all new developments in the Icelandic financial system. Various measures have been undertaken by the authorities which *inter alia* include currency swap agreements between the Central Bank of Iceland and central banks of Denmark, Norway and Sweden, increased issuance of short-term instruments (CDs and T-notes), amended rules on eligible collateral and reserve requirements for banks at the CBI, aligning them with those of other central banks, and funding in the international market to buttress the foreign reserves of the Central Bank. In addition, the Financial Supervisory Authority has increased its cooperation with host authorities of the three major banks. Iceland will become a signatory to the Memorandum of Understanding (MoU) on co-operation between the Financial Supervisory Authorities, Central Banks and Financial Ministries of the European Union.

**Other Issues**

Iceland's pension system is virtually fully funded and the age distribution is favorable, making demographic trends easily manageable. At the end of last year the total assets of the pension system amounted to 133 percent of GDP. This situation creates added leeway for fiscal policy to be counter-cyclical and flexible in the face of rapid economic changes, more than offsetting tax cuts and measures to strengthen the welfare system.

The authorities have declared a target to increase ODA from 0.3 percent in 2008 to 0.35 percent of GDP by 2009. Iceland has the potential to make a purposeful contribution in certain fields, especially in the development of fishing industry and utilization of geothermal energy in the low-income countries.