June 2001
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Iceland: 2001 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of 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 2000 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 18, 2001** 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 April 11, 2001.** 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.

- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its May 2, 2001 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the authorities of Iceland.

The document listed below will be separately released.

Selected Issues and Statistical Appendix paper

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

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INTERNATIONAL MONETARY FUND

ICELAND

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with Iceland

Approved by Alessandro Leipold and Martin Fetherston

April 11, 2001

- The discussions were held in Reykjavík during January 10–18, 2001. The staff's concluding statement was released by the authorities.

- Staff representatives met with Mr. Birgir Gunnarsson, Governor and Chairman of the Board of Governors of the Central Bank, Mr. Geir H. Haarde, Minister of Finance, Mr. Arni M. Mathieson, Minister of Fisheries, other senior officials, and representatives of the Financial Supervisory Authority, the National Economic Institute, the Ministry of Commerce, the federations of labor and employers, and the financial and academic communities.

- The staff team comprised Mr. Hagemann (Head), and Messrs. Engels, Soikkeli and Thomas (all EU1). The mission was joined by Mr. Alexander (MAE) for follow-up on the Financial Sector Assessment Program (FSAP) mission. Mr. Törnqvist, Alternate Executive Director for Iceland, and Mr. Sigurgeirsson, Advisor in the Office of the Executive Director, also participated in the meetings.

- Iceland has accepted the obligations of Article VIII, Sections 2, 3 and 4. It maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.

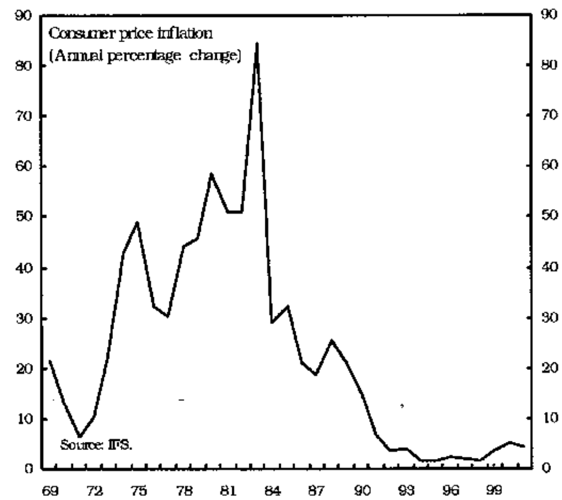
- A center-right coalition government has been in power since 1991. The most recent elections were held on May 8, 1999. The next elections are scheduled for May 2003.

Contents

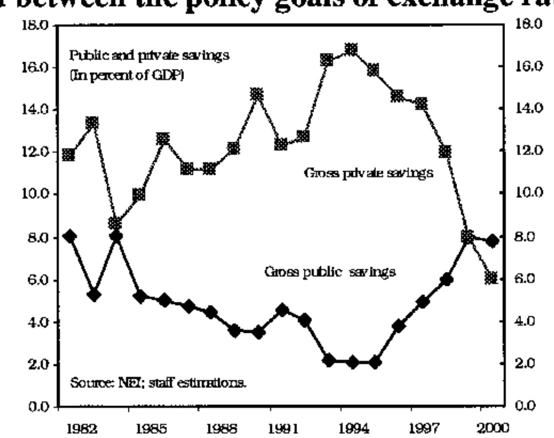
I. The Economic Setting

A. Introduction

1. **As a small open economy highly dependent on exports of marine and energy-intensive products, Iceland has historically been buffeted by supply-side and external shocks.** The macroeconomic policy response to shocks was traditionally accommodating, resulting in large current account deficits, often followed by currency devaluations that led to high and variable inflation. By the late 1980s, a shift in policies was needed to restore financial stability. The adoption in 1989 of the exchange rate as a nominal anchor and intermediate target for monetary policy, together with the government's subsequent commitment to fiscal consolidation and the earlier de-indexation of wage contracts, provided a framework for reducing inflation and restoring confidence.[1] By 1994, inflation had fallen to low single digits, setting the stage for a sustained economic recovery. During 1995–2000, real GDP expanded on average by 4 percent per year, driven initially by large-scale investment projects in energy-intensive industries, and later also by buoyant private consumption growth (Table 1).



2. **By the late 1990s, against a backdrop of liberalized financial markets and an open capital account, increasing tensions had emerged between the policy goals of exchange rate stability and monetary independence.** As the domestic demand-driven recovery matured, imbalances rose during 1997–98: private credit grew rapidly, inflation expectations deteriorated, and the current account deficit increased markedly. With improvements in public saving insufficient to offset the fall in private saving, the monetary authorities, using the room available within the fluctuation bands, raised the policy interest rate on several occasions both to slow down domestic demand growth and to reduce inflation. The



[1] The króna was pegged to a trade-weighted basket of currencies. Fluctuation bands were initially set at ±2¼ percent, but subsequently widened to ±6 percent in 1995 and to ±9 percent in early 2000.

resulting widening of interest rate differentials vis–à-vis abroad, however, attracted short-term foreign capital, which became a source of credit growth and put upward pressure on the króna. Domestic and external imbalances in turn deteriorated (Figure 1).

3. **At the conclusion of the last consultation on May 5, 1999, Directors welcomed the continued impressive and dynamic performance of the Icelandic economy, but also expressed concerns about overheating.** They urged the authorities to shift policy toward containing inflationary pressures and restoring a sustainable saving-investment balance. Most Directors felt that fiscal policy should play the primary role in lowering the current account deficit, and saw scope for a supportive tightening of monetary policy. While Directors agreed that the then current exchange rate regime had served Iceland well, some recommended that the authorities make greater use of the flexibility provided by the exchange rate bands to contain overheating. Over the medium term, they saw a need for a broader reassessment of the regime, including in the context of the eventual enlargement of the euro area.

4. **In the event, the boom persisted during 1999–2000, and macroeconomic imbalances widened.** Against a backdrop of surging domestic demand and rising inflation, the Central Bank of Iceland (CBI) repeatedly raised its policy interest rate. The increased international interest rate differentials in favor of Iceland, and the likely perception of limited exchange rate risk arising from the adjustable peg, provided incentives to domestic financial institutions to borrow abroad for domestic onlending. Credit grew rapidly, and both macro- and micro-prudential indicators deteriorated, pointing to an increase in the risk exposure of the financial system and its vulnerability to macroeconomic shocks, especially interest and exchange rate shocks, as confirmed by an FSAP mission in November 2000 (Box 1).[2] In view of the persistent widening of domestic and external imbalances and negative news on the total allowable fish catch, downward pressures on the króna emerged in mid-2000, resulting in a steady depreciation through the first quarter of 2001.

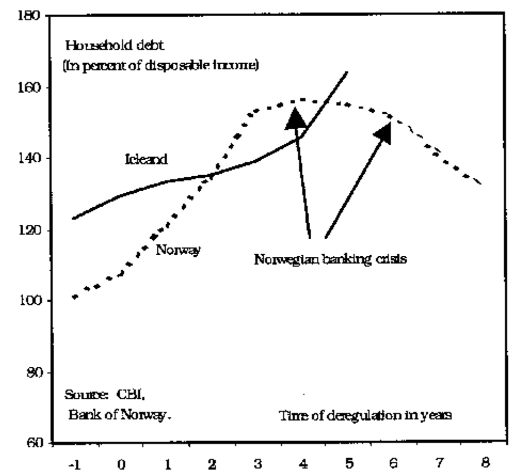
B. Recent Economic Developments

5. **The sustained economic expansion has been fueled increasingly by private credit growth.** Driven mainly by buoyant private consumption and investment (Figure 2), output growth remained well above estimated potential growth for the fifth year in a row in 2000, widening the output gap to 2.4 percent.[3] The more recent expansion has been fueled mostly by a falling private saving rate and by rapidly rising household borrowing. Household debt as a percentage of disposable income rose from 129 percent to 163 percent during 1995-2000. Private investment, which picked up markedly in 2000 mostly on account of investments in the fisheries and ICT sectors and took place against a backdrop of falling profitability and rising real interest

[2] See separate *Financial System Stability Assessment* (FSSA), (SM/01/106).

[3] The output gap is calculated as the difference between actual and estimated potential GDP, as a percent of the latter.

rates, also followed substantial increases in bank lending. As a consequence, the debt-equity ratio of the corporate sector increased from 0.96 in 1998 to an estimated 1.1 in 2000.



6. **Demand pressures are reflected in increasing tightness in the labor market** (Figure 3). The unemployment rate fell to an average of 1.3 percent during 2000, and vacancy rates among private firms recently reached a ten-year high. In turn, wage increases continued apace, with the overall wage index rising by 9.3 percent year-on-year in January 2001, implying real wage growth of about 4.3 percent. Wage growth in the private sector could slow down in the period ahead on the basis of centralized wage agreements signed earlier in 2000, providing for a cumulative increase in the average wage of about 18½ percent over the next three years.

7. **Inflation picked up markedly during 1998-2000, but has recently decelerated somewhat.** The year-on-year increase in the CPI reached 5 percent in 2000, and is now well above rates in trading partner countries. Inflation declined somewhat in early 2001, however, to 3.9 percent in March, on account of decelerating housing costs. Inflation expectations, as measured by the difference between the yield on inflation–indexed and non-indexed bonds, also declined recently, to 4 percent, from a peak of 5½ percent at end-2000. Notwithstanding the recent sharp fall in international equity prices, the ICEX-MAIN stock index remained some 6 percent higher at end-March 2001 than two years earlier. Real estate prices also rose rapidly, and on a more sustained basis, by 15½ percent year-on-year in 2000.

8. **The most notable sign of sustained excess demand is the widening of the current account deficit, which has been accompanied by a substantial increase in private sector external debt.** The widening of the current account deficit to 10.3 percent of GDP in 2000 is due fully to a decline in private sector savings (Table 2), and is notable for the shift from capital goods to consumer durables imports (especially automobiles in 1999) and travel services. In addition, net foreign direct investment turned negative as from mid-1999, driven by direct investments abroad by Icelandic firms. A large and rapid increase in external debt accompanied the widening of the current account deficit. Despite redemptions of external debt by the public sector, gross external debt rose from 63 percent of GDP in 1995 to 109.1 percent in 2000. In addition, accompanied by a shortening of maturities, net external liabilities of the six largest banks for maturities up to 12 months increased to 268 percent of gross official reserves by end-2000, compared with 141 percent a year earlier.[4]

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[4] The ratio does not reflect the CBI's large unconditional credit lines, of which US$ 610 million were readily accessible at end-January 2001.

Selected External Indicators (in percent)

	1997	1998	1999	2000
Current account deficit to GDP	-1.7	-6.9	-7.0	-10.3
Gross external debt to GDP	66.0	71.9	83.2	109.1
Net official reserves to short-term debt	0.4	0.4	0.3	0.1
Export growth (goods and services) in USD	1.3	6.6	2.1	0.3
Import growth (goods and services) in USD	1.3	22.5	3.0	7.0
Real effect exchange rate (eop; y-o-y change)	2.5	-0.2	6.7	-7.0
Terms of trade change	2.5	5.2	0.4	-1.7

Sources: CBI; NEI; and staff estimates.

C. Macroeconomic Policies and Financial Sector Developments

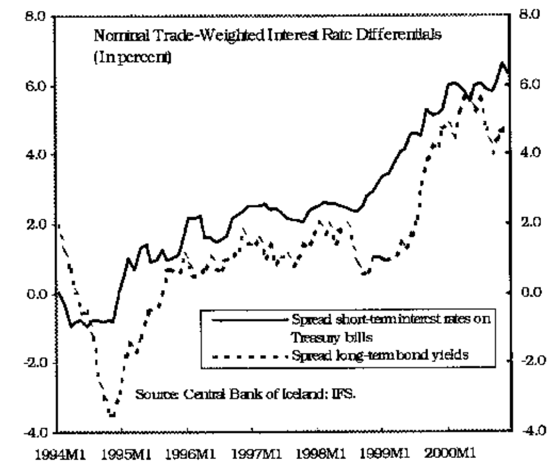
9. **Fiscal policy remains guided by the objective of eliminating net public debt by 2004.** The general government surplus, first achieved in 1998, increased to 2.8 percent of GDP in 2000, while net public debt fell to 22½ percent of GDP. When judged on the basis of the change in the overall structural balance, fiscal policy remained tight during 1999-2000. Improvements in the primary balance, however, have been limited due in large part to expenditure overruns in non-interest spending, notably in public investment and transfers. Growth of the public sector wage bill has also been especially rapid, partly reflecting recent pay reforms, which have consisted of trading increases in current pay for a flattening of the experience-earnings profile of the public pay matrix. During 1997–2000, the public sector wage index increased by 38 percent (24 percent in real terms), outpacing wage growth in the private sector.

Key Fiscal Indicators
(General government finances, in percent of GDP)

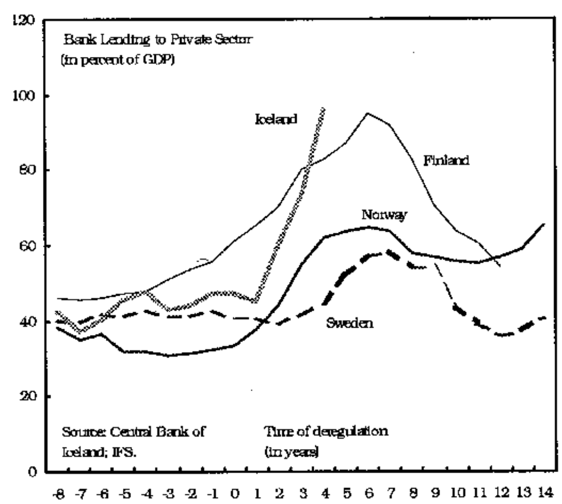
	1997	1998	1999	2000	2001 1/
Revenue	39.4	40.5	43.2	43.8	43.9
Expenditure	39.4	40.1	41.1	41.0	41.2
Real expenditure growth (in percent)	1.4	6.3	6.9	2.2	3.8
Financial balance	0.0	0.4	2.2	2.8	2.7
Structural balance					
Level	-0.4	-0.5	0.4	0.9	1.2
Change	-0.7	-0.1	0.9	0.4	0.3
Structural primary balance					
Level	2.1	1.9	2.5	2.4	2.8
Change	-0.8	-0.2	0.5	-0.1	0.4
Gross debt	53.2	48.6	43.6	42.2	40.2

1/ Staff forecast.
Sources: CBI; NEI; and staff estimates.

10. **Monetary policy remained focused on containing inflation, but was increasingly constrained by the exchange rate regime.** Widening interest rate differentials in favor of Iceland accompanied successive interest rate hikes during 1999, leading to an appreciation of the



króna. Another rate hike in early 2000, requiring a widening of the fluctuation bands to ± 9 percent (Figure 4), led to further appreciation of the currency until end-April. Following the announcement that the allowable cod catch for the 2000/01 season should be reduced by some 20 percent,[5] the króna came under sustained downward pressure, despite a 130 basis point increase in the repo rate in several steps, to 11.4 percent by November. Notwithstanding massive interventions by the CBI (Figure 5), the effective exchange rate of the króna fell by 13¾ percent between end-April 2000 and mid-March 2001 (Figure 4), leaving the exchange rate index some 1½ percent above its lower fluctuation band.[6] Following the publication of a revised official economic forecast underscoring the durability of external imbalances, pressures intensified toward end-March. Domestic market participants began speculating against the króna, probably also because of growing expectations that the authorities were likely to allow the currency to float. On March 27, following three days of interventions totaling US$76.5 million (roughly 20 percent of gross international reserves), the government and Central Bank jointly announced the decision to abolish the fluctuation bands and to switch to inflation targeting, accompanied by a draft Central Bank Act providing, among other things, full instrument independence to the Central Bank.[7] The draft legislation is to be considered by Parliament during the Spring 2001 session. The Central Bank also decided to lower its policy interest rate by 50 basis points (to 10.9 percent) to counter an expected slowdown of economic activity.



11. **Despite repeated CBI interest rate hikes, monetary and credit aggregates grew rapidly, spurred by banks' foreign borrowing for domestic onlending.** The liberalization of financial markets and the opening of the capital account fostered the development of a sophisticated financial system, facilitated the introduction of new instruments of monetary policy, and strengthened

[5] In fact, given the Ministry of Fisheries' final decision on the total allowable fish catch, the volume of the fish catch is expected to shrink by 7.2 percent in the 2000/01 season.

[6] The increase in spring 2000 in the allowable share of foreign assets in pension fund portfolios was accompanied by sizeable portfolio capital outflows, adding to downward pressure on the króna.

[7] See Selected Issues, chapter II.

market forces. At the same time, however, and similar to experiences in other Nordic countries, liberalization was accompanied by a rapid increase in the financial sector's risk exposure, as financial institutions expanded their balance sheets to increase market share (Table 3). The widened international interest rate differentials, coupled with the possible perception of limited foreign exchange risk, enabled banks to expand domestic lending by borrowing heavily abroad. Banks' share of foreign currency onlending accounted for almost 63 percent of overall lending to domestic residents during 1999-2000. Overall bank-lending growth remained strong at above 20 percent year-on-year through January 2001.

12. **After three years of brisk monetary and credit growth, deteriorating macroprudential indicators suggest that the risk exposure of the financial system has risen, as confirmed by the FSAP mission** (Table 4). Although banks are generally hedged against direct foreign exchange risks, indirect exposures have increased due to the increase in foreign exchange lending to sectors with no or only limited access to direct foreign exchange revenues.[8] With more than half of loans indexed to inflation, the sensitivity of the private sector to interest rate changes has also risen, exposing financial institutions to credit and market risk. Moreover, to the extent that domestic residents' holdings of foreign equities have grown rapidly in recent years, sudden swings in foreign equity prices could reduce their ability to service their debts, raising the system's exposure to credit risk.

13. **Microprudential indicators have also weakened, exacerbated by shortcomings in the regulatory and supervisory frameworks, and point to a decline in the capacity of the financial system to absorb a shock** (Box 2). Risk-weighted capital adequacy ratios (CAR) of the banking system have declined, reflecting the rapid expansion of banks' balance sheets without a corresponding growth in profitability. Sustained losses on portfolio investments and, more recently, a sharp decline in equity prices, further contributed to the trend decline in CARs. Moreover, as the financial system, and especially the banking sector, is highly concentrated and inter-connected, the risk of contagion from financial fragilities across financial and corporate sectors is a distinct possibility.

II. The Discussions

14. **The discussions were characterized by a shared sense that the accumulated imbalances required a concerted policy response to reduce the current account deficit and lower the risk exposure of the financial system.** There was agreement that the greater integration of the Icelandic economy in international capital markets, and the increased vulnerability of the financial system to interest rate and exchange rate shocks, implied that fewer policy options were now available to the authorities than a few years ago. The authorities—well aware of the factors contributing to the present imbalances—expressed their resolve to secure a smooth landing and avoid financial sector distress.

[8] About 50 percent of banks' foreign currency loans have been provided to service industries and households.

15. Against this background, the discussions, in addition to covering the outlook for 2001 and beyond, centered around three topics:

- the recommendations of the FSAP mission to reduce the risk exposure of the financial system;
- the linkages between the monetary policy framework and the build-up of domestic and external imbalances on the one hand, and financial sector vulnerabilities on the other;
- the scope for fiscal and incomes policies to help reduce the external imbalance.

A. The Outlook

16. **The official outlook is for an appreciable but manageable moderation of growth, from 3.6 percent in 2000 to 2.0 percent in 2001.** The slowdown in economic activity is expected to result mainly from a moderate decline in private consumption growth, driven by negative wealth effects of declining equity values and a rising household debt service burden. A decline in investment will be a further brake on domestic demand. The very low unemployment rate is expected to increase slightly, while CPI inflation is forecast to fall modestly to 4.3 percent, with easing domestic demand pressures expected to outweigh the pass-through of last year's decline in the exchange value of the króna into domestic prices. Overall export growth is forecast to remain robust, as increased exports of services are likely to outpace the expected decline in this year's allowable fish catch. Since Iceland's merchandise exports are mainly supply-side constrained, repercussions of a global economic slowdown are more limited than elsewhere. However, the current account deficit is projected to remain at slightly above 10 percent of GDP, not least because of higher debt service payments following the recent decline in the króna.[9]

17. **While the mission broadly concurred with the authorities' outlook for a moderate slowdown, it harbored concerns that perceptions of the durability of the current account deficit could precipitate intensified downward pressures on the króna and eventually result in a hard landing**. Although staff projected a somewhat lower growth of aggregate demand on account of a smaller increase in real disposable income (Table 1), it cautioned that there were as yet few signs of the projected slowdown; bank lending and merchandise import growth remained brisk, and approved housing loans continued to rise in early 2001. Moreover, on expectation of a slight deterioration in the terms of trade, staff projected a somewhat higher current account

[9] The current account deficit in 2001 could be larger than presently projected due to the fishermen's strike that started in mid-March in protest over the price used in catch valuation, which in turn affects wages in the sector. While the government has issued legislation to postpone the strike until April 1 to make full use of the capelin catch, marine research reports suggest that this migrant fish has already moved out of Icelandic fishing grounds.

deficit. Looking beyond 2001, on current policies, only a gradual decline in the current account deficit was expected over the medium-term (Table 5), due to moderate export growth of marine products and services.[10] Given the size and durability of external imbalances, the marked decline in the overall profitability of export-oriented industries, and increased unit labor costs, staff argued that the real exchange rate appeared overvalued, notwithstanding its recent decline (see Annex I). The authorities disagreed, arguing that PPP analysis did not suggest that the level of the real exchange rate was out of line relative to historical experience; nor had there been any large terms-of-trade shock recently. They also felt that the widening of the current account deficit could be due to temporary factors, including a catch-up in consumption following the deep recession of the early 1990s, and changes in investment and consumption patterns in the aftermath of financial liberalization.

B. Financial Sector Issues and the Monetary Framework

18. **The mission stressed that lowering the vulnerability of the financial system to shocks warranted urgent action.** In this respect, the findings and recommendations of the FSAP mission, including on the regulatory and supervisory frameworks, were especially pertinent. In addition to the principal aim of improving the health of the financial system, implementation of some of the proposed measures could also have the subsidiary advantage of helping curb credit growth.

19. **Following up on the findings of the FSAP mission, staff stressed that the deterioration of microprudential indicators was exacerbated by weaknesses in the regulatory and supervisory frameworks relative to international best practices.** The Financial Supervisory Authority (FME) lacked clear legal authority to issue prudential regulations, and the State Housing Fund, mutual funds and, until recently, the payment system, had not been subject to effective supervision. Understaffing of the FME had contributed to fewer than desirable on-site inspections of large banks, insurance companies and pension funds. Also, consolidated supervision had been limited when viewed against the high degree of inter-connectedness of the financial system. The FME also needed to further improve prudential supervision of risk management and corporate governance of financial institutions. Finally, current arrangements for asset classification and loan-loss provisions of banks allowed for an excessive leeway for the setting aside of provisions, and collateral had been given excessive weight in establishing such provisions. The mission therefore urged that the corresponding FSAP recommendations be adopted quickly. It was urgent to raise required CARs, provide supervisors with clear legal authority to mandate increased capital requirements for banks at particular risk, and strengthen asset classification and loan-loss provisioning standards along the lines of international best practices.

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[10] Further envisaged large-scale investments in the energy-intensive industries have not been included in the medium-term scenario, pending final decisions by the government and investors.

20. **The supervisory authorities agreed with most of the FSAP recommendations, with, however, some nuances.** They acknowledged that CARs were too low, and that current practices for asset classification and loan-loss provisioning needed strengthening. But they preferred to wait for the revision to the Basel capital accord to be finalized and for decisions to be reached by an EU task force presently reviewing loan-loss provisioning rules before acting on either issue. In the interim, the FME was cooperating with individual financial institutions in their efforts to enhance risk management practices, and was relying on moral suasion to convince banks to increase their capital base. While not contesting the view that the FME's effectiveness would be strengthened by an increase of staffing, and was indeed moving forward with new hiring, the supervisory authority doubted the need for a sizable increase. In any event, recruitment was proving difficult in the present tight labor market for skilled labor.

21. **There was agreement that the pegged exchange rate regime, while having served Iceland well during the period of disinflation, had become less suitable in present circumstances.** Events during the past several years had demonstrated the policy conflicts between price stability, exchange rate stability and external competitiveness inherent to the peg (Box 3). Most notably, against a backdrop of positive interest rate differentials and a perceived guarantee against exchange rate risk, the regime was likely to have contributed to the accumulation of risks in the financial system. The soft peg had also proved difficult to maintain in a world of free capital movements, and had been limiting the monetary authorities' room for maneuver. Indeed, the substantial widening of the fluctuation bands since 1992 reflected the need for greater flexibility. A further widening, however, could undermine the credibility of the peg, and intervention, while an effective means of smoothing exchange rate movements, was not viable over time. Moreover, there was limited room for additional interest rate increases, not only because it could counteract the needed real depreciation achieved to-date, but also because of the growing risk exposure of the financial system. Finally, many characteristics of the Icelandic economy, notably the asymmetry between Iceland's economic cycle and that of its main trading partners, argued for a flexible exchange rate. While acknowledging the difficulties of switching to a floating exchange rate regime during a period of downward pressures on the króna, the mission felt there was some urgency to effecting the change, which clearly would have to be accompanied by adoption of a new nominal anchor for monetary policy, such as an inflation target.

22. **The authorities agreed that a shift to an inflation targeting regime would be an effective alternative to the present exchange rate anchor.** Moreover, they recognized that a number of preconditions, absent several years ago, were either now in place or would soon be. First, the CBI's performance with short-term inflation forecasting had improved considerably; more work, however, was needed on forecasting over a longer horizon. Second, labor unions appeared supportive of switching to inflation targeting, given the importance attached to low and stable inflation in the negotiation of recent multi-year wage contracts. Third, there was growing political awareness that the limited exchange rate flexibility of the current monetary policy framework constrained monetary policy and that a change in the framework was needed.

23. **On March 27, subsequent to the discussions, the authorities announced the floating of the currency and the shift to an inflation targeting framework for monetary policy,**

effective the following day. Under the new arrangement, the CBI aims to achieve 2½ percent headline inflation by no later than end-2003, with margins of ± 1½ percentage points. During the transition, the framework provides for a wider target range of 1-6 percent in 2001, narrowed to 1-4½ percent in the following year. If inflation exceeds the targeted range, the CBI is required to explain publicly the reasons for the deviations. The inflation forecast, based on a two-year forecast horizon, will be published on a quarterly basis. The announcement of the regime change was accompanied by a 50 basis points reduction in the CBI's policy rate in view of the authorities' perception of emerging signs of a more accelerated slowdown of the economy than previously expected. The announcement was also accompanied by the publication of draft legislation to revise the Central Bank Act, establishing the legal and institutional basis for the inflation targeting framework to be viable over time. Among other things, the draft legislation provides that: (i) price stability will be the CBI's main objective; (ii) a target range for inflation will be set jointly by the CBI and the government; and (iii) the CBI will be provided full independence to use its instruments to meet the inflation target.[11]

24. **The discussions also reviewed the FSAP mission's conclusion that several aspects of monetary operations were likely to contribute to credit growth and raise the vulnerability of the financial system to shocks.** First, the fixed-rate repo auction had on several occasions resulted in greater injections of liquidity by the CBI than needed for banks to meet reserve requirements, contributing to credit growth (Figure 5). While staff acknowledged that the fixed-rate auction provided a clear signal to market participants regarding the CBI's policy rate, it also stressed that a fixed-quantity auction could provide useful feedback to the central bank regarding banks' liquidity needs. The authorities, however, saw improvements in their liquidity forecasting techniques as a prerequisite for such a change. A second likely source of credit growth was the structure of the interest rate corridor. The overnight interbank interest rate had typically remained close to the central bank's overnight lending rate and, on several occasions, exceeded the latter. In these circumstances, banks with excess collateral had financed overnight liquidity needs with overnight loans from the central bank at low cost rather than from the interbank market. This was likely to have depressed turnover in the interbank market, reducing the robustness of systemic liquidity arrangements. The authorities acknowledged the importance of re-centering the repo rate within the corridor. A step in this direction was taken on March 27 when, on the occasion of the cut in the repo rate, the CBI lowered its overnight deposit rate by 20 basis points while leaving its overnight lending rate unchanged.

C. Fiscal and Incomes Policies

25. **While there was agreement that no further tightening of the fiscal stance *per se* was needed beyond that envisaged in the budget for 2001, the mission raised concerns about the recurrence of expenditure overruns and, in particular, about public sector wage growth.** The general government budget surplus is targeted to fall slightly to 2.6 percent of GDP, implying, on a cyclically-adjusted basis, a moderate tightening of the fiscal stance. However, the

[11] The present Central Bank Act assigns multiple objectives to the CBI without establishing an ultimate goal for monetary policy.

mission was concerned that, even though fiscal policy had been cautious in recent years, the stance had been weakened by expenditure overruns in non-interest categories of spending, and the stage appeared set for a repeat this year. Wages posed a particular problem, and staff cautioned that generous increases recently granted to secondary teachers, associated with the front-loaded pay reform, not spill over into pay agreements with other public employee unions still negotiating at that time. Incomes policies were an important pillar in a policy package designed to slow domestic demand growth, and in this respect the public sector had a leading role to play in maintaining wage moderation. The authorities stressed that the relatively rapid growth of public sector wages in recent years was due mostly to pay reforms, which should secure slower wage growth in the future. There was agreement that this would require firmness in holding the line on wage growth in present and future budgets, especially since the pay reforms had raised future pension obligations.[12]

26. **Sizeable overruns had also occurred in capital outlays and in transfers in recent years.** Public investment was putting pressure on the already stretched construction sector. Moreover, a recent Supreme Court ruling requiring higher and retroactive payments to disabled persons with working spouses was likely to lead to additional outlays on transfers. The mission therefore argued that higher-than-budgeted transfers should be offset by cuts in other spending categories, and suggested postponing less urgent public investment projects. The sheer size of the external current account imbalance, as well as ongoing downward pressures on the króna, argued for a signal from the public sector to market participants of its concern about the situation and its willingness to act. Moreover, stronger expenditure controls should be put in place, facilitated by the adoption of a medium-term fiscal framework. While agreeing on the need to respect budgeted expenditure limits and to preserve any revenue over-performance, the authorities argued that postponing investment projects would be politically difficult. In any event, staff suggested that expected spending-overruns could be offset by cuts elsewhere.

27. **The authorities agreed that public debt management had an important role to play in avoiding additional tensions in the foreign exchange market.** They had decided to postpone retiring external debt this year since this would add to current pressures on the exchange rate. Staff also cautioned that early retirement of domestic debt could cause liquidity problems in domestic bond markets and, thus, urged the authorities to continue reducing the unfunded liability of public pension funds with net injections from the budget surplus.

D. Structural Issues

28. **The Icelandic pension system is generally funded, but further progress is needed to reduce the unfunded liability of the pension scheme of state employees.** Staff felt that the government's recent decision to use a portion of the budget surplus in 2001 to this effect was commendable, all the more since doing so would also help maintain the domestic market for

[12] At end-March, unions representing more than half of the public sector employees were still negotiating wage contracts with the government.

government securities, which was already thin. Recent public sector wage agreements, which raised the government's future pension obligations, increased the urgency of setting funds aside to offset the government's unfunded pension liability. Although appropriate from a pension fund management perspective, the recent increase in the ceiling on the share of pension fund assets that can be invested abroad seemed ill-timed because, in stimulating capital outflows, it had contributed to downward pressure on the króna. The authorities acknowledged this development, but saw little opportunity to lower the ceiling at this stage. They did, however, agree that any future increases would have to be phased in more gradually.

29. **The privatization program is re-gaining momentum.** The government has announced its intention to sell up to 49 percent of its holdings in the telecommunications company in three tranches during 2001, and to relinquish its majority stake in 2002. Staff welcomed in particular the government's decision to allow foreign participation. Two banks partially owned by the government—Landsbanki and Bunadarbanki—were to have been merged and subsequently privatized. Although the proposal was not approved by the Competition Council on concerns about the new entity's potentially excessive market share, the government had decided to proceed with the separate divestiture of both banks this fiscal year. Staff noted that in contrast to the case of the telecom company, the privatization of the separate banks was less likely to attract foreign investors than if the banks had been merged. In any event, staff considered that higher-than-budgeted privatization proceeds should be set aside to reduce the unfunded liability of the pension scheme of state employees.

30. **Iceland's agricultural sector remains heavily regulated and a drain on the budget.** The extensive system of agricultural support has led to a producer subsidy equivalent of 70 percent, one of the highest in the world and almost double the OECD average.[13] Thus, staff welcomed the decision to buy back the sheep production quotas despite the sizeable budgetary cost this year, and encouraged the authorities to curtail the current regime of farm support further.

31. **The fisheries management system is undergoing change.** The present system is built around an exclusive 200-mile fishing zone and the enforcement of tradable quotas within this limit. The allocation of the quotas free of charge to vessel owners in the early 1980s has been a highly contentious issue in Iceland on distributional grounds. Free allocation was viewed as a means of ensuring that small operators could continue fishing. While avoiding the distributional issue, staff has argued that granting free quotas is equivalent to an off-budget transfer, and that a preferred approach would be to raise revenues from the issuance of fishing rights and bring any subsidies to less efficient operators on-budget. The staff therefore welcomed the initiatives underway to reform the quota system, including various options for extracting a portion of the economic rents stemming from utilization of common property resources. These initiatives,

[13] Despite the prevalence of sizeable tariff and non-tariff barriers on farm products, Iceland's trade regime is considered relatively liberal, scoring 4 on a scale from 1 to 10 on the IMF's Trade Restrictiveness Index.

together with the decision to provide explicit income support to adversely affected small fishing communities, will help improve further the transparency of Iceland's fiscal policy.

32. **Iceland was among the first countries to accede to the OECD anti-bribery convention.** During the first phase of monitoring the implementation of the convention, Iceland has undergone a follow-up peer review which, following minor legislative changes by the authorities, confirmed the country's compliance with the convention.

III. Staff Appraisal

33. **Iceland has clearly benefited from the policy re-orientation introduced just over a decade ago.** First, adoption of an exchange rate anchor was instrumental in wringing out high and variable inflation. Second, budgetary consolidation has helped put Icelandic fiscal policy on a generally solid, sustainable, footing. Third, structural reforms have spurred competition and injected dynamism to the economy. Financial liberalization and the opening of the capital account have furthered Iceland's integration into global capital markets, attracting large flows of foreign direct investment and, to an increasing extent, portfolio investment and other capital inflows. Job creation, falling unemployment, solid income gains, higher levels of consumption and increased production diversification are all notable benefits derived from the improved economic environment. In this setting, the recent shift to an inflation targeting framework is timely, and should help promote long-term financial stability.

34. **The emergence of domestic and external imbalances in recent years, however, is cause for concern.** The unwinding of previous financial repression made possible by the increased openness of Iceland's financial markets, in combination with the emergence of a large positive interest rate differential and a soft exchange rate peg, led to a surge in foreign borrowing by banks for domestic on-lending. This contributed to excessive domestic credit and demand growth. Macroprudential indicators suggest that the financial system's risk exposure has increased considerably, while microprudential indicators point to a decline in the system's capacity to absorb shocks, with the latter exacerbated by shortcomings in some areas of the regulatory and supervisory frameworks of the financial system.

35. **An urgent task is to lower the risk exposure of the financial system.** The authorities should move swiftly to raise the minimum capital adequacy requirements of domestic banks and assign clear legal authority to the FME to mandate increased capital requirements for banks thought to be at particular risk. The authorities should take regulatory and legislative steps needed, inter alia, to improve asset classification and loan-loss provisioning of domestic banks. Given the accumulation of financial sector risks, corrective actions should be taken even before completion of the revision to the Basel capital accord and the review of EU loan-loss provisioning rules, as moral suasion had been less than fully effective during the past few years. Recent increases in staffing at the FME are a step in the right direction toward a further strengthening of prudential supervision.

36. **Given the inherent conflict between Iceland's soft exchange rate peg and the conduct of an independent monetary policy, the recent decision to allow the króna to float,**

accompanied by adoption of an inflation targeting framework for monetary policy, is welcome. The move to a floating exchange rate regime is a natural extension of the progressive widening of the exchange rate bands during the past decade, and will serve Iceland better in view of its sensitivity to external and supply shocks and its integration in international capital markets. An inflation target is an appropriate alternative to the previous exchange rate anchor, and Iceland is well placed to make this move. The reforms to the Central Bank Act contained in draft legislation will provide the needed legal and institutional foundation for the implementation of inflation targeting, and these should be enacted swiftly.

37. **However, the recent reduction in the CBI's policy rate was ill-advised and, together with the sterilization of previous interventions, has fueled further liquidity growth.** It would have been more prudent to await additional signs of decelerating inflation before reducing the policy interest rate; credit growth remains unsustainably high and is inconsistent with low inflation, and the labor market is overly tight. The merits of these concerns have been borne out by the surge in liquidity that followed the rate reduction. Current conditions therefore call for reining in liquidity and credit growth through a moderate hike in interest rates, either explicitly, or implicitly via increases in the haircut on repos, and reinforce the urgency of implementing the measures proposed by the FSSA and enumerated earlier in the Staff Appraisal.

38. **Fiscal policy, while on a generally sound medium-term footing, needs to play a supporting role in addressing the domestic and external imbalances.** Although the structural budget balance has improved in recent years, overruns have occurred in all major public expenditure categories. The stage is set for a possible repeat this year, and it would be important to offset previously unexpected higher expenditures for wages and transfers to the disabled with cuts in other spending categories. Postponing public investment projects would also help reduce pressures, especially in the construction sector. In any event, a strengthening of existing expenditure control mechanisms—which would be buttressed by adoption of a medium-term fiscal framework—is needed to ensure the success of the fiscal strategy. Securing the planned public debt reduction would provide room for maneuver to fiscal policy, were an adverse shock to result in a hard landing.

39. **The government's intention to re-invigorate the privatization program is welcome** The expected sale of the two remaining state owned banks will reduce markedly state involvement in domestic financial markets, and the planned sale of shares of the state-owned telecommunications company should provide a desirable boost to reserves through foreign participation.

40. **While the Icelandic pension system has a strong financial foundation, the government should continue to reduce the unfunded liability of the state employee pension scheme.** Against the backdrop of a fully funded occupational pension component, and with the state pension scheme being reinforced through the establishment of a fully funded system for new public employees, the government's decision to use part of the budget surplus to reduce the remaining unfunded liability of the old state pension scheme is welcome. However, as recent changes in the structure of public sector wages will raise the government's future pension

obligations, it should use the proceeds stemming from prospective privatizations to further reduce its unfunded public pension liability.

41. **After roughly two decades of heated domestic debate, fisheries management is being reformed in a positive way.** The authorities have agreed on the politically difficult decision to extract a portion of the economic rents stemming from utilization of common property resources and, thus, have paved the way forward for agreeing on how this is to be achieved in the fisheries sector. The various options under consideration, together with the decision to provide explicit income support to adversely affected small fishing communities, should help improve Iceland's transparent fiscal policy.

42. **Iceland publishes a wide array of economic and financial information that is broadly adequate for the purpose of surveillance.** Nonetheless, improvements are needed to strengthen the coverage and quality of a number of data series to achieve full compliance with SDDS requirements (see Appendix III). The recent development of quarterly national account data, the revision of Iceland's National Data Summary page (NSDP), and the public disclosure of monthly reserve data on the basis of the new reserve template represent welcome progress in this area.

43. **The 2001 budget provides for a slight increase in Iceland's ODA.** While this is a welcome policy action, the authorities are encouraged to raise ODA over time from the present level of 0.1 percent of GNP toward the UN target of 0.7 percent of GNP.

44. **Trade policies could be further improved.** Despite the welcome decision to buy back sheep production quotas, Iceland's relatively liberal trade regime could benefit further from a reduction of tariff and non-tariff barriers on farm products. In addition, the authorities are encouraged to adopt the recent EU decision to grant duty-and quota-free treatment to exports of the Least Developed Countries.

45. It is proposed that Iceland remain on a 24-month cycle. In view of the uncertainties surrounding the outlook and the increased vulnerability of the financial system, a staff visit is envisaged later this year to review developments and policies with the authorities.

Box 1. Vulnerabilities of the Icelandic financial system

A recent FSAP mission concluded that the Icelandic financial system is vulnerable to possible shocks, particularly to the indirect effects of a depreciation of the exchange rate and an interest rate shock. Macroprudential and microprudential indicators consistently suggest that the financial system's risk exposure has increased considerably in recent years and that its capacity to absorb the impact of shocks has declined.

Macroprudential indicators and the macroeconomic environment

- ***Increased domestic bank exposure to indirect foreign exchange risk.*** Banks are broadly hedged against direct foreign exchange risks; however, indirect risks have risen due to continued domestic onlending of foreign loans to industries and households with limited access to foreign currency revenues.

- ***Asset price inflation has raised direct and indirect credit risk exposure to falling asset prices.*** Declining house prices would reduce consumer spending and have an adverse impact on the retail and services sectors, to which the banks have become increasingly exposed. They would also directly affect the State Housing Fund and the pension funds through the decrease in the value of real estate collateral that was pledged to secure their loans. Also, financial institutions appear to have lent to households to support investments in the stock market and, to the extent that equities have been used as collateral for loans, a drop in prices would therefore seriously expose lenders to credit risk. Banks have also been lending against fish quotas and would thus be exposed to a sudden drop in quota prices.

- ***The sensitivity of households and corporations to interest changes has risen.*** Given the marked increase in household debt, and with more than half of borrowing contracted at indexed interest rates, not only would unindexed portfolios be adversely affected by a change in nominal interest rates, but indexed instruments would also be affected if real interest rates rose.

Microprudential indicators and the institutional environment

- ***Banks' risk-weighted capital adequacy ratios (CAR) have declined.*** The decrease of solvency ratios reflects the continued rapid growth of the banks' balance sheets without a corresponding growth in profitability due mainly to sustained losses on portfolio investments.

- ***The Icelandic financial system is highly concentrated and interconnected.*** Icelandic banks are predominantly exposed to fisheries and fish processing, retail and service sector enterprises, of which they have several large borrowers in common. Also, cross-ownership between financial institutions is pervasive.

- ***Non-bank financial institutions are exposed to market and credit risk.*** Both insurance companies and pension funds have lent extensively (as there are no statutory ceilings on loans) to consumers and fund members, exposing them to credit and market risks. Moreover, recent shifts in their portfolio composition toward foreign equity, brought about by changes in the regulatory framework, have contributed to liquidity management problems for banks.

Regulatory framework

- ***The legal authority of the financial supervisory authority (FME) is limited.*** Licensing and de-licensing of financial institutions still rest with government, and the FME lacks legal authority to issue prudential regulations.

- ***Lacunae in the legislative framework.*** Neither equity funds nor the State Housing Fund are currently subject to supervision.

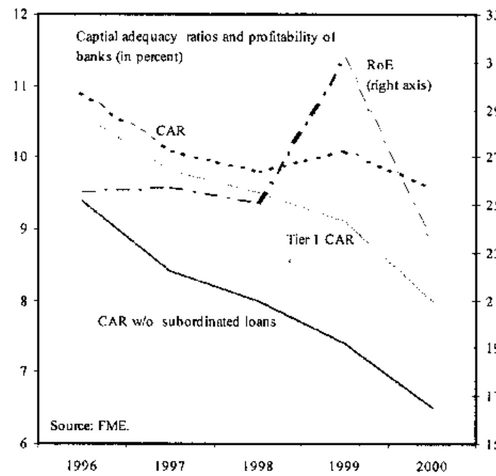
- ***Deficiencies in the implementation.*** The FME lacks sufficient staff to carry out its increasing supervisory functions as warranted, including regular on-site inspections especially of the largest banks and adequate supervision of corporate governance and risk management. At present, consolidated supervision is only partially implemented.

- ***Weak sector-specific regulatory frameworks.*** Asset classification and loan-loss provisioning regulations in the banking sector fall short of international best practices. Collateral is given excessive weight when establishing provisions against non-performing loans. In addition, loans are not classified as non-performing until after being delinquent for six months.

Box 2. The Capacity of Iceland's Banks to absorb the Impact of Shocks

Recent developments in the macroeconomic environment, accompanied by weaknesses in the regulatory and supervisory framework of the financial system—as identified by the FSAP mission—have led to a decline in the health of the financial system. Trends in microprudential indicators suggest that the ***capacity of financial institutions to weather shocks to their balance sheets has declined.***

Aggregate risk-weighted capital adequacy ratios (CAR) have steadily declined to 9.6 percent and, excluding subordinated loans, to 6.5 percent at end-2000, reflecting the increase in the overall risk exposure of Icelandic banks induced by the rapid balance sheet growth of the last years. Moreover, presently recorded CARs appear to overstate banks' capital due to weaknesses in the regulatory framework for asset classification and loan-loss provisioning. Since observed CARs are usually lagging indicators of banks' financial conditions, their decline signals increased stress in the financial system.



Icelandic banks have large exposures to fisheries and fish processing companies. As cross-ownership between financial institutions is pervasive and banks have several large borrowers in common, ***concentration and interconnectedness among financial institutions is high.*** This raises the potential for spillover effects across financial and corporate sectors, although non-performing loans (NPL) have yet to increase. The quality of loan portfolios is likely to have declined recently due to the sustained rapid expansion of credit, which could lead to an increase in NPL ratios in near future. Moreover, as banks are provided with a wide leeway for loan-loss provisioning, banks' cushion against a possible deterioration of credit portfolios could be limited in the event of a rise in NPLs.

Indicators of management soundness hint at a decline in the profitability of banks. Operating expenses have continued to rise, resulting in a trend increase in cost-income ratios. Declining returns on assets and equity also point to a lower profitability. As the share of non-interest income in overall income has remained high by international standards, banks' profitability could be subject to substantial fluctuations over the business cycle.

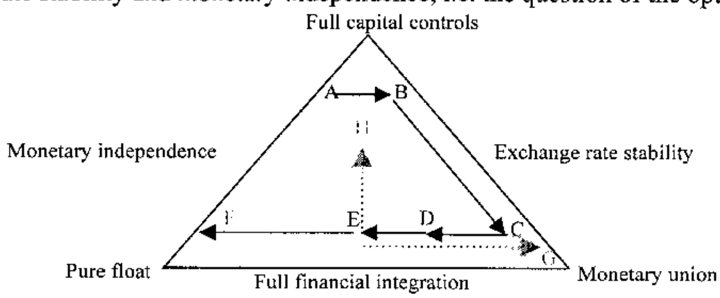
Selected Microprudential Indicators
(In percent, unless otherwise noted)

	1997	1998	1999	2000 1/
Risk-based CAR	10.1	9.8	10.1	9.6
Loans to fisheries in percent of total loans	23.9	29.4	27.3	22.7
Loans to households in percent of total loans	24.1	26.9	24.0	25.7
NPL in percent of total loans	4.3	2.7	2.8	1.9
Provisions as percent of NPL	23.2	35.9	35.5	35.7
Earnings per employee in ISK mn.	8.3	9.1	11.2	11.3
Net-interest income as percent of gross income	62.9	59.8	58.1	61.4
Loans-to-deposits ratio	1.27	1.35	1.39	1.87

1/ Based on a sample of all commercial banks and 5 of the 6 largest savings banks, equivalent to 93 percent of deposit money banks' assets.
Sources: FME; CBI.

Box 3. Iceland's Impossible Trinity

Recent episodes of exchange rate policy in Iceland provide compelling evidence of inherent policy conflicts between price stability, exchange rate stability, and external competitiveness in a small open economy. In choosing a monetary policy framework, policymakers are principally faced with the dilemma that they cannot strive simultaneously for exchange rate stability, monetary independence and financial market integration; they rather must choose between two of the three policy goals. This policy conflict is known as 'eternal triangle' or 'impossible trinity'.[1] In today's integrated capital markets, however, the above tradeoff tends to narrow to the choice between exchange rate stability and monetary independence, i.e. the question of the optimal exchange rate regime.



Given Iceland's history of high inflation, the choice of the exchange rate regime has been governed by the decision about the appropriate nominal anchor. The policy shift from a managed float (point A) to an almost rigid exchange rate peg with narrow fluctuations bands (point B) that took place in 1989 helped stabilize inflation expectations through the credible commitment to a nominal exchange rate anchor and set the stage for an impressive disinflation process. Iceland's subsequent move to increased financial integration, accelerated by the liberalization of the capital account in 1995, pushed the country toward the bottom of the policy triangle (point B to point C) at a constant degree of exchange rate stability. Iceland's monetary policy framework then moved toward an intermediate exchange rate regime as the fluctuation bands were gradually enlarged (e.g., the move from point C to point D with the widening from ± 2 ½ percent to ± 6 percent, and then to point E with the further widening to ± 9 percent). On March 27, 2001, the authorities announced the floating of the króna (point F), accompanied by adoption of an inflation targeting framework.

In view of Iceland's high exposure to adverse supply and external shocks, the adjustable exchange rate peg entailed fundamental and interrelated policy conflicts. First, as monetary policy, inter alia, relied on an exchange rate anchor to achieve the primary goal of price stability, shocks to the real exchange rate induced inflation-deflation cycles, as essentially domestic prices and wages accommodated such shocks. This pointed to a policy conflict between price and exchange rate stability, which was intrinsic to a country like Iceland that had a pegged exchange rate and faced substantial fluctuations of the real exchange rate (see Figure 7). Second, the adjustable peg of the króna provided some degree of policy independence to pursue the objective of price stability. Consequently, the central bank repeatedly raised the policy interest in response to inflationary pressures stemming from the overheating of the economy. As the positive international interest rate differential started to widen, additional capital inflows were attracted, which prompted a prolonged nominal appreciation of the domestic currency, and thus aggravated the prevailing external imbalances. This pointed to a policy conflict between price stability and external competitiveness, which was particularly accentuated in Iceland given its largely integrated financial markets and the intermediate exchange rate regime. Moreover, as domestic agents most likely perceived the adjustable peg as an implicit guarantee against a potential depreciation, the soft peg set the stage for moral hazard, as domestic market participants increased their borrowing in foreign exchange massively.

Third, notwithstanding the policy maneuver provided by the adjustable peg, monetary independence and the ability to prevent pressures on the exchange rate remained fairly limited against the backdrop of highly integrated capital markets. In view of the overheated economy, the central bank was eventually forced to intervene repeatedly in the foreign exchange market so as to defend the peg against increasing downward pressures. Foreign exchange interventions, however, usually tend to generate the perception among market participants that exchange rate stability, rather than price stability, is the main objective of monetary policy. Lack of clarity on the monetary policy objective, in turn, may have contributed to the decline in the credibility of the pegged exchange rate.

Both the above stated policy tensions and the specific structure of the Icelandic economy suggested a move toward increased exchange rate flexibility (point F), declared by the authorities on March 27. Absent the exchange rate as an intermediate target, however, an alternative nominal anchor for monetary policy was crucial. The announcement of an inflation target, which accompanied the floating of the króna, represents the most suitable anchor for monetary policy in Iceland.[2]

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[1] Each side of the triangle represents full achievement of the particular policy goal. See Jeffrey A. Frankel, "No Single Currency Regime is Right for All Countries or at All Times," *NBER Working Paper* No. 7338, September 1999.

[2] See Selected Issues, chapter I.

Table 1. Iceland: Selected Economic Indicators

	1995	1996	1997	1998	1999	2000 Official Estimate	2001 Official Forecast 10/	2001 Staff Forecast
				(Percentage change unless otherwise noted)				
National Accounts (constant prices)								
Gross domestic product	0.9	5.6	5.3	4.5	4.1	3.6	2.0	1.9
Total domestic demand	3.0	7.7	6.2	12.1	4.7	5.4	1.5	1.3
Private consumption	2.2	5.4	5.5	10.0	6.9	4.0	2.5	2.2
Public consumption	1.7	1.2	2.5	3.4	5.1	3.7	3.1	3.0
Gross fixed investment	7.6	23.5	12.3	26.6	-0.8	9.0	-2.5	-2.4
Export of goods and services	-2.1	9.9	5.8	2.2	4.4	5.1	3.4	0.3
Imports of goods and services	3.9	16.8	8.5	23.3	5.7	9.3	0.9	-0.9
Output gap 1/	-5.1	-2.3	0.7	2.1	3.0	2.4	1.2	1.1
Selected Indicators								
Fish catch	-0.6	8.1	-1.3	-7.9	-1.6	0.0	-3.5	--
Unemployment rate	5.0	4.3	3.9	2.7	1.9	1.3	1.5	1.8
Real disposable income per capita 2/	3.5	4.0	4.1	7.4	2.6	1.9	2.0	1.1
Consumer price index	1.7	2.3	1.8	1.7	3.4	5.0	4.3	4.6
Nominal wage index	4.5	6.4	5.4	9.4	7.6	6.6	7.5	6.2
Nominal effective exchange rate 3/	-0.8	0.2	-1.3	-1.6	0.1	0.0	--	--
Real effective exchange rate (CPI) 3/	0.1	1.9	2.5	-0.2	6.7	-7.0	-5.3	--
Terms of trade	1.1	-3.0	2.5	5.2	0.4	-1.7	0.0	-0.6
Money and Credit								
Deposit money bank credit (end-period)	1.2	12.0	12.7	30.4	23.2	26.4	--	--
Domestic credit (end-period)	0.9	8.8	15.5	27.6	22.3	18.4 4/	--	--
Broad money (end-period)	2.2	6.8	8.7	15.2	16.9	11.0	--	--
Repurchase rate (period average)	6.9	6.6	6.9	7.3	8.4	10.5	--	--
				(In percent of GDP, unless otherwise noted)				
Public Finance								
Treasury 5/6/								
Revenue	25.3	26.4	25.2	31.3	35.7	33.5	35.6	35.6
Expenditure	27.3	28.9	24.9	32.8	31.9	30.1	30.9	30.8
Balance	-2.0	-2.5	0.2	-1.5	3.8	3.4	4.8	4.8
Net borrowing requirement	4.1	2.5	-0.5	-2.9	0.0	-3.3	-4.8	--
Local government balance 6/	-0.3	-0.1	-0.6	-0.7	-0.5	-0.4	-0.4	--
General government balance 6/	-3.0	-1.6	0.0	0.4	2.0	2.8	2.6	2.7
Balance of Payments								
Current account balance	0.8	-1.6	-1.7	-6.9	-7.0	-10.3	-10.1	-10.6
Trade balance	3.0	0.2	0.0	-4.3	-3.6	-5.7	-5.0	-5.9
Financial and capital account	-0.1	2.1	3.2	7.9	9.7	9.9	--	10.2
o/w: reserve assets 7/	-0.1	-2.1	0.6	-0.4	-0.9	0.8	--	0.5
Net errors and omissions	-0.6	-0.4	-1.5	-0.9	-2.7	0.4	--	0.0
Gross external debt 8/	63.0	63.4	66.0	71.9	83.2	109.1	--	117.7
Debt service ratio 9/	29.2	23.1	19.6	22.0	23.1	--	--	--
Central bank gross reserves (in months of imports of goods and services)	1.7	2.1	1.5	1.5	1.7	1.6	--	--

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

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ Deflated by the consumer price index.
3/ A positive (negative) sign indicates an appreciation (depreciation); annual percentage change of end-of-period figure.
4/ The definition varies slightly from the IFS data presented for 1995-97.
5/ Including social security finances.
6/ Accrual basis; including imputed contributions for unfunded pensions for the general government.
7/ A positive (negative) sign indicates a decrease (increase) in gross official foreign reserves.
8/ External liabilities minus equity investment. The debt stock is valued at end-of-period exchange rates.
The authorities, in valuating the debt stock on basis of the average-of-period exchange rate, report a gross debt to GDP ratio of 99.1 percent in 2000.
9/ Ratio of long-term external debt service payments to exports of goods and services.
10/ The official forecast is based on figures published by the NEI on March 20, 2001.

Table 2. Iceland: Saving and Investment Balances

	1995	1996	1997	1998	1999	2000 Official Estimates	2001 Staff Projections
	(In percentage of GDP)						
General government 1/							
Gross savings	2.1	3.7	4.9	6.0	8.1	7.8	8.1
Net capital transfers	-1.6	-1.7	-1.4	-1.4	-1.6	-1.2	-1.4
Investment	3.5	3.6	3.5	4.1	4.3	3.8	4.0
Financial balance	-3.0	-1.6	0.0	0.5	2.2	2.8	2.7
Private sector							
Gross savings	15.8	14.6	14.3	11.9	7.8	5.7	4.1
Net capital transfers	1.6	1.7	1.4	1.4	1.6	1.2	1.4
Investment	13.7	16.3	17.3	20.7	18.5	20.0	18.8
Financial balance	3.7	0.0	-1.7	-7.4	-9.2	-13.1	-13.3
Total economy							
Gross savings	18.0	18.3	19.1	17.9	15.8	13.5	12.2
Investment	17.2	20.0	20.8	24.8	22.8	23.8	22.8
Financial balance (Current account balance)	0.8	-1.6	-1.7	-6.9	-7.0	-10.3	-10.6

Sources: National Economic Institute; and staff calculations.

1/ Including imputed contributions to unfunded pensions for the general government.

**Table 3. Iceland: Macroeconomic and Financial Vulnerabilities:
A Comparison of Iceland with Selected Nordic and Asian Countries**

	Iceland 2000		Finland 1989		Norway 1986	Sweden 1989	Korea 1996	Thailand 1996	
			(percentage change)						
Real GDP growth	4.0		5.6		3.6	2.3	7.1	5.5	
Inflation	5.0		6.6		7.2	6.3	4.9	5.9	
Broad money growth	11.0		7.5	2/	4.6	10.0	15.8	12.6	
Private sector credit growth	21.1	1/	15.3	3/	28.0	21.2	19.8	19.8	
in real terms	13.1	1/	8.2		19.4	14.0	11.1	13.1	
			(in percent of GDP)						
Current account balance	-10.3		-4.8		-6.0	-3.2	-4.7	-7.9	
Central government balance	3.4		1.8		3.1	1.8	0.3	1.0	
Net external position 4/	-67.6		-21.5		...	-20.6	...	-60.4	
Private sector credit	86.4	1/	82.3	3/	55.3	57.2	61.8	100.0	
Capital inflows 5/	9.9		2.8		7.9	5.0	4.8	10.6	
Short term flows as percent of CA balance 6/	105.6	1/	102.6		72.2	590.8	113.8	123.1	
Short-term external debt as percent of reserves 7/	285.0	8/	...		...	396.7	316.3	123.3	9/
M2 as percent of reserves 10/	704.2	1/	1336.0		353.0	1157.0	635.0	391.0	
M2/reserves growth rate	165.8	1/	39.7		17.9	-4.1	2.0	5.5	

Source: IMF, IFS.

1/ As of end-June 2000; private sector credit refers to lending by deposit money banks.
2/ M2.
3/ Claims on resident sectors other than general government.
4/ International investment position instead of national definition used for Iceland.
5/ Financial account as percent of GDP.
6/ Defined as the sum of net portfolio and other short-term net investments in the financial accounts.
7/ Reserves refer to foreign exchange reserves.
8/ Net short-term liabilities of the six largest banks.
9/ For Thailand the figure refers to debt maturing within 12 months, whereas for others debt with original maturity less than 12 months.
10/ National definitions for Iceland (using net reserves w/o contingent credit lines over M2) and Finland, money plus quasi-money from the IFS for the rest.
11/ As of end-September 2000.

Table 4. Iceland: Indicators of External and Financial Vulnerability

	1996	1997	1998	1999	2000	
External Indicators						
Exports of goods and services (annual percentage change, in U.S. dollars)	6.7	1.3	6.6	2.1	0.3	1/
Imports of goods and services (annual percentage change, in U.S. dollars)	16.8	1.3	22.5	3.0	7.0	1/
Terms of Trade (annual percentage change)	-3.0	2.5	5.2	0.4	-1.7	1/
Current account balance (in percent of GDP)	-1.6	-1.7	-6.9	-7.0	-10.3	
Capital and financial account balance (in percent of GDP)	2.1	3.2	7.9	9.7	9.9	
Foreign direct investment, net (in percent of GDP)	0.3	1.3	0.9	-0.5	-2.3	
Portfolio investment, net (in percent of GDP)	1.5	-3.3	-2.9	6.8	5.2	
Other investment, net (in percent of GDP)	2.4	4.6	10.3	4.2	6.2	
Gross official reserves (in millions of U.S. dollars)	458	392	419	495	450	
in months of next year's imports	2.1	1.5	1.5	1.7	1.6	1/
Net official reserves (in millions of U.S. Dollars)	462	393	364	443	255	
over short-term debt (ratio) 2/	0.6	0.4	0.4	0.3	0.1	
over short-term debt corrected for current account deficit net of FDI (ratio) 2/	0.5	0.4	0.3	0.2	0.1	
over broad money (ratio)	0.2	0.1	0.1	0.1	0.1	
over reserve money (ratio)	1.6	1.4	1.3	0.9	0.6	
Gross external debt (in percent of GDP) 3/	63.4	66.0	71.9	83.2	109.1	
Net external debt (in percent of GDP)	55.7	56.6	62.3	72.5	100.0	
Net external liabilities (in percent of GDP)	47.0	46.8	49.8	49.4	67.6	
Foreign assets of the financial system (in percent of total assets)	...	...	...	...	...	
Foreign liabilities of the financial system (in percent of total assets)	...	...	...	...	...	
Real effective exchange rate (cumulative yoy-change; (+) appreciation)	1.9	2.5	-0.2	6.7	-7.0	1/
Household indebtedness (in percent of real disposable income)	133.4	134.7	138.7	145.9	163.4	
Financial Markets Indicators						
Stock market index (ICEX-15; y-o-y change in percent)	59.1	12.6	4.7	44.4	-13.8	
Housing prices (y-o-y change in percent)	2.2	3	6	14.7	22.3	
Price/earnings ratio	...	...	19.3	21.7	...	
Market capitalization at year-end (in percent of GDP)	17.2	25.2	36.4	53.3	...	
Turnover rate (trading/market capitalization)	6.2	8.8	5.5	10.8	...	
Interest rate spreads on borrowing (average)	6.6	6.3	5.1	4.3	...	
Credit ratings (Moody's long-term/short-term liabilities)	...	A3/P2	A3/P2	A3/P2	A2-A3/P1-P2	
Sovereign yield spreads 4/	2.84	2.70	3.40	5.70	6.35	
Financial Sector Risk Indicators						
Risk-weighted capital adequacy ratio (CAR)	10.9	10.1	9.8	10.1	9.6	
Tier 1 capital ratio	10.6	9.8	9.5	9.1	8.0	
CAR excluding subordinated loans	9.4	8.4	8.0	7.4	6.5	
Sectoral credit concentration (in percent of total loans)						
Real estate	8.3	7.9	5.3	6.7	6.1	
Fisheries	22.8	23.9	29.4	27.3	22.7	
Households	22.9	24.1	26.9	24.0	25.7	
Non-performing loans (in percent of total loans)	5.4	4.3	2.7	2.8	1.9	
Loan-loss provisions (in percent of non-performing loans)	24.2	23.2	35.9	35.5	35.7	
Leverage ratio (equity/total assets)	7.9	7.4	7.0	6.8	6.5	
Lending by deposit money banks (change in percent)	11.8	12.7	30.4	22.9	26.4	
Lending by the credit system (change in percent)	8.8	10.9	15.5	17.3	18.4	

Sources: Financial Supervisory Authority, Central Bank of Iceland, Statistics Iceland, and staff estimates.

1/ Staff estimate for end-2000.
2/ Based on freely usable reserves (excluding contigent credit lines) over short-term debt on an orginial maturity basis.
3/ Debt figures are based on end-of-period exchange values, while GDP is valued at average-of-period rates. The authorities, in valuating the debt stock on basis of the average-of-period exchange rate, report a gross external debt ratio of 99.1 percent of GDP for 2000.
4/ Spread between yields on Icelandic and trade-weighted foreign 3-month T-bills.

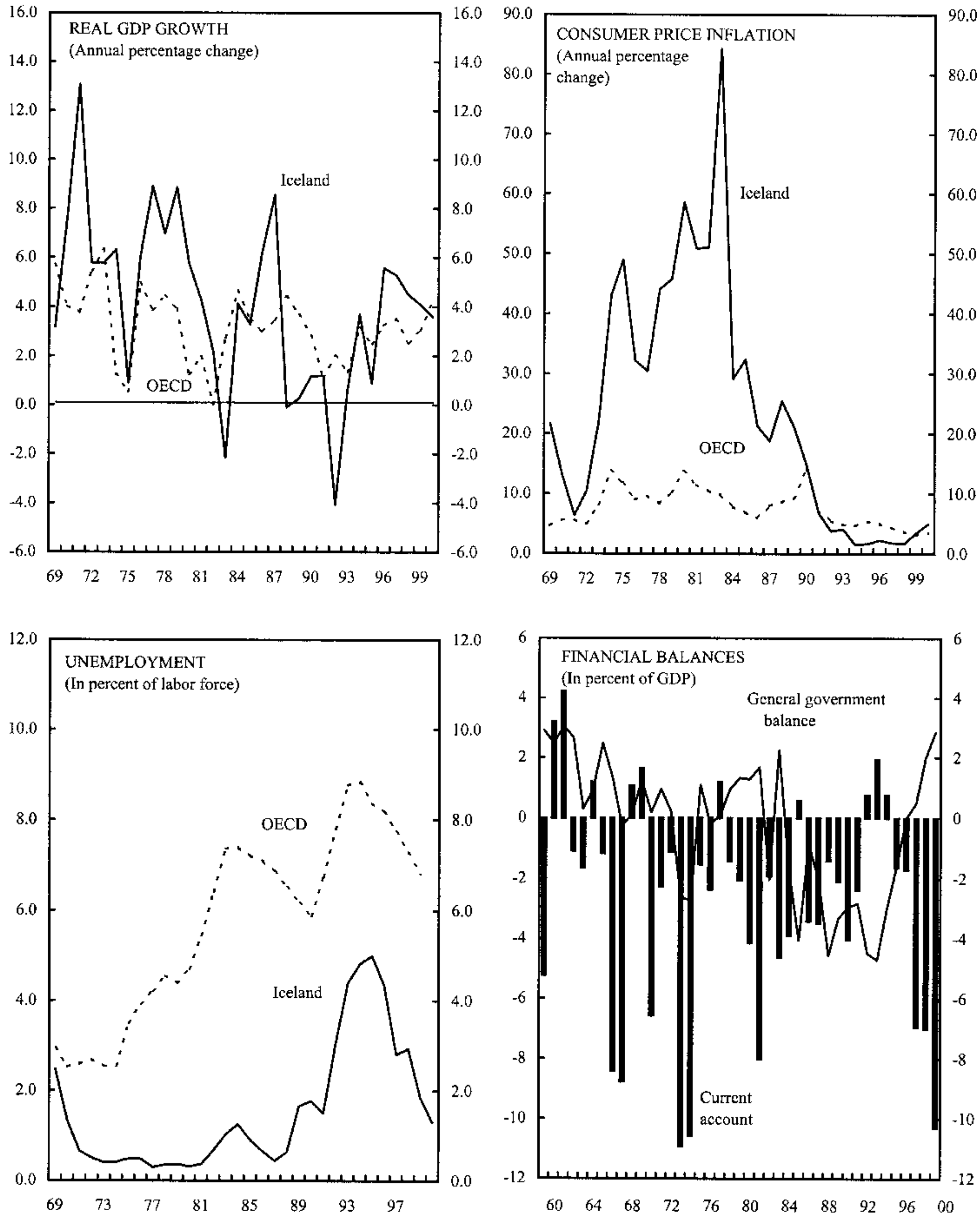
Table 5. Iceland: Medium-term Scenario

(Percentage change, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006
Real domestic demand	4.6	5.4	1.3	1.6	1.9	2.2	2.3	2.4
Private consumption	6.9	4.0	2.2	2.3	2.4	2.5	2.5	2.5
Public consumption	5.1	3.7	3.0	2.5	2.5	2.5	2.5	2.5
Gross fixed investment	-0.8	9.0	-2.4	-0.9	-0.1	1.3	1.7	2.0
Stocks	-0.2	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	4.4	5.0	0.3	2.6	3.0	3.1	3.1	3.1
Exports of goods	7.4	-0.7	-2.0	1.5	2.2	2.2	2.2	2.2
Exports of services	-1.7	17.9	4.5	4.5	4.5	4.5	4.5	4.5
Imports of goods and services	5.7	9.3	-0.9	1.3	2.5	3.0	2.9	3.0
Imports of goods	5.0	3.8	-2.2	0.4	1.8	2.5	2.4	2.5
Imports of services	7.5	23.2	2.0	3.0	4.0	4.0	4.0	4.0
Real GDP	4.1	3.6	1.9	2.1	2.0	2.2	2.3	2.4
Consumer price inflation	3.4	5.0	4.6	3.5	2.7	2.0	2.0	2.0
Unemployment rate (in percent)	1.9	1.3	1.8	2.1	2.2	2.3	2.5	2.5
	In percent of GDP							
General government								
Revenues	43.2	43.8	43.9	44.0	43.9	43.9	43.9	43.9
Expenditures	41.1	41.0	41.2	41.1	41.2	41.2	41.2	41.2
Financial balance	2.2	2.8	2.7	2.9	2.7	2.7	2.7	2.7
Memorandum items:								
Current account	-7.0	-10.3	-10.6	-8.2	-7.3	-5.9	-5.4	-5.0
Trade balance	-3.6	-5.7	-5.9	-4.9	-4.3	-3.5	-3.2	-3.0
Services balance	-1.1	-1.6	-1.6	-1.1	-0.8	-0.3	-0.1	0.1
Factor income balance	-2.2	-2.8	-3.1	-2.1	-2.1	-2.1	-2.1	-2.1
Net current transfers	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Capital and financial account	9.7	9.9	10.2	8.2	7.4	6.3	5.5	5.1
Capital transfers, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	9.7	9.9	10.2	8.2	7.5	6.3	5.6	5.2
Direct investment, net	-0.5	-2.3	0.7	1.2	1.2	1.1	1.1	0.9
Portfolio investment, net	6.8	5.2	3.1	2.3	1.5	1.5	1.6	1.6
Other investment, net	4.2	6.2	6.4	4.7	4.7	3.8	2.9	2.7
Reserve assets (-=increase)	-0.9	0.8	0.5	0.0	-0.1	-0.4	-0.1	-0.1
Net error and omissions	-2.7	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Gross external reserves in months of next year's imports	1.7	1.6	1.3	1.3	1.3	1.4	1.4	..
Net external debt 1/	72.5	100.0	103.0	103.7	104.4	103.9	103.3	102.5

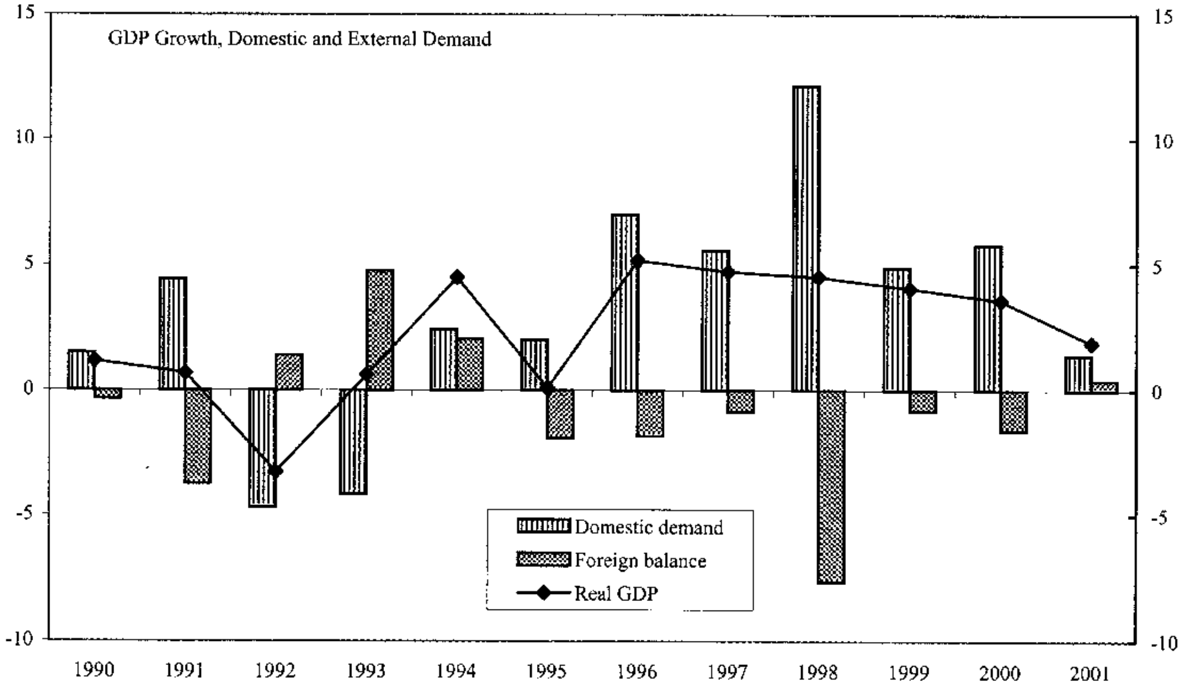
1/ Gross external debt net of foreign assets other than equity.
Source: Central Bank of Iceland; staff projections.

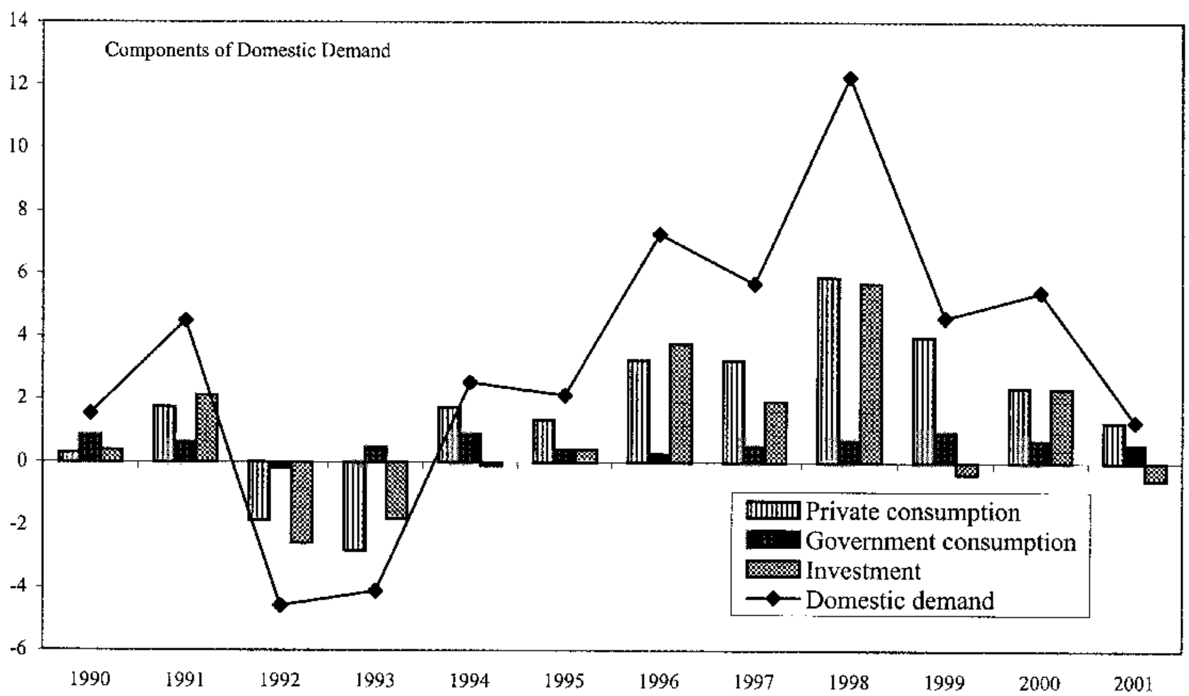
Figure 1. Iceland : Economic Developments 1960-2000



Source: National Economic Institute: Central Bank of Iceland, and IMF, World Economic Outlook

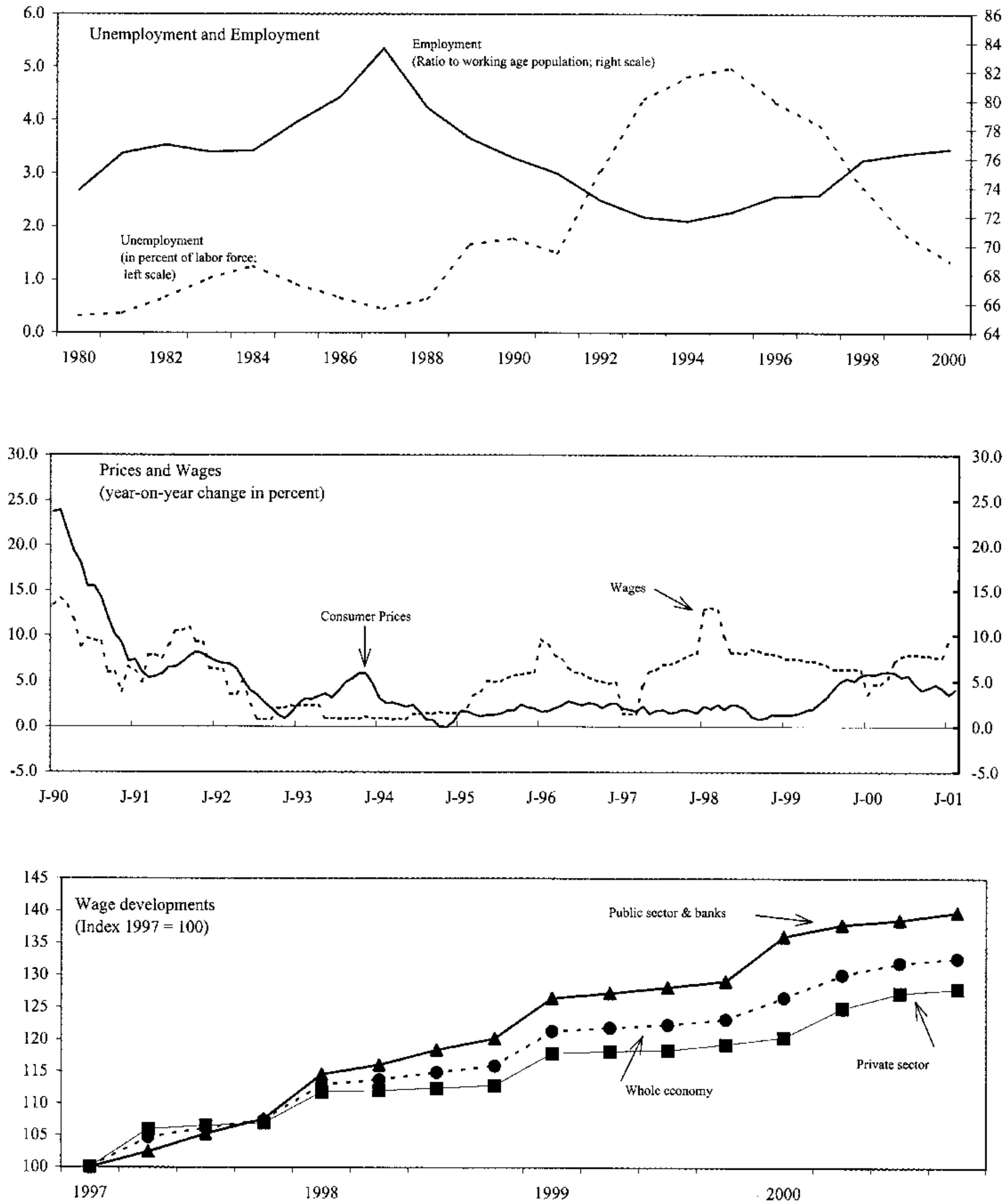
Figure 2. Iceland: Contributions to Growth
(in percent)





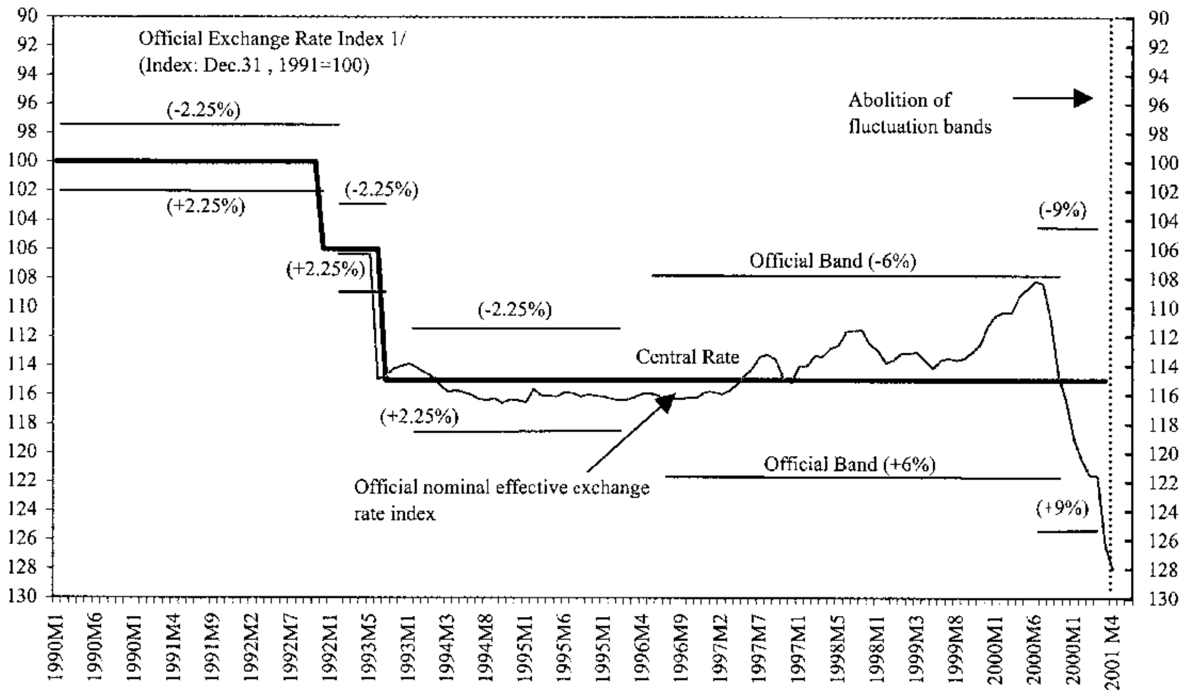
Source: National Economic Institute and IMF staff projections.

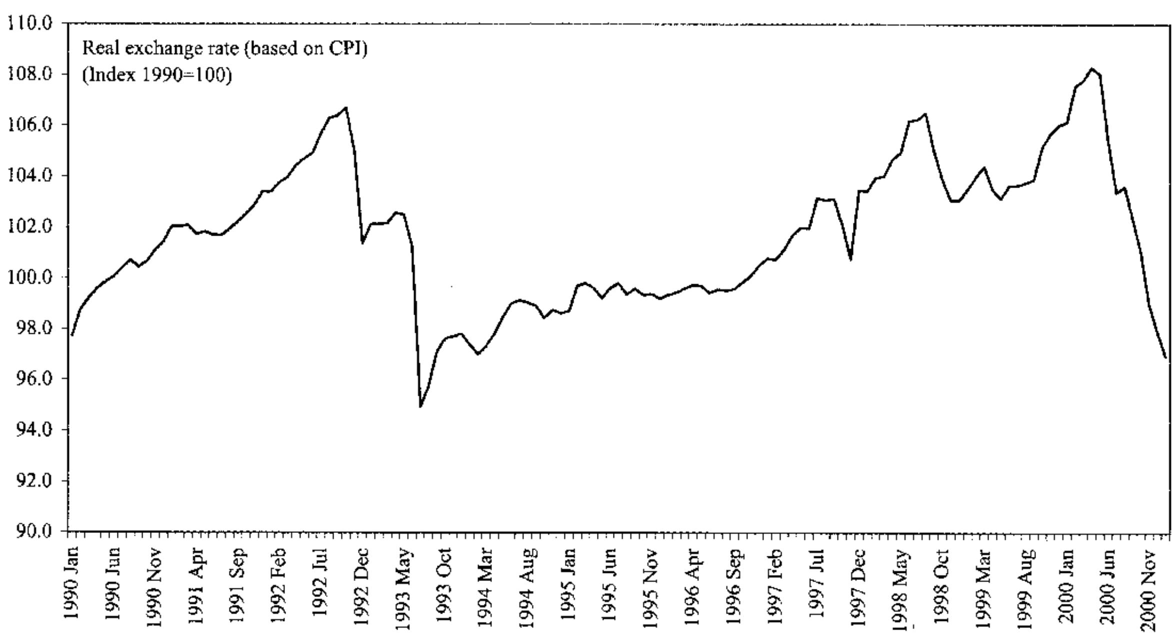
Figure 3. Iceland: Unemployment, Inflation and Wage Developments.



Source: National Economic Institute; Central Bank of Iceland; Statistics Iceland.

Figure 4. Iceland : Exchange Rate and Competitiveness.

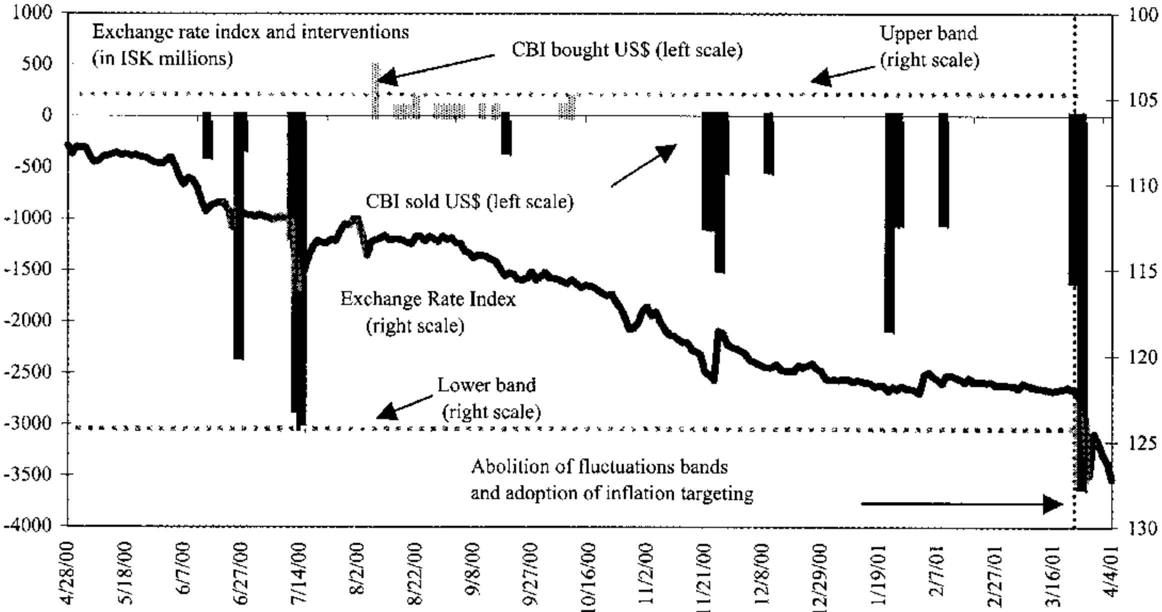


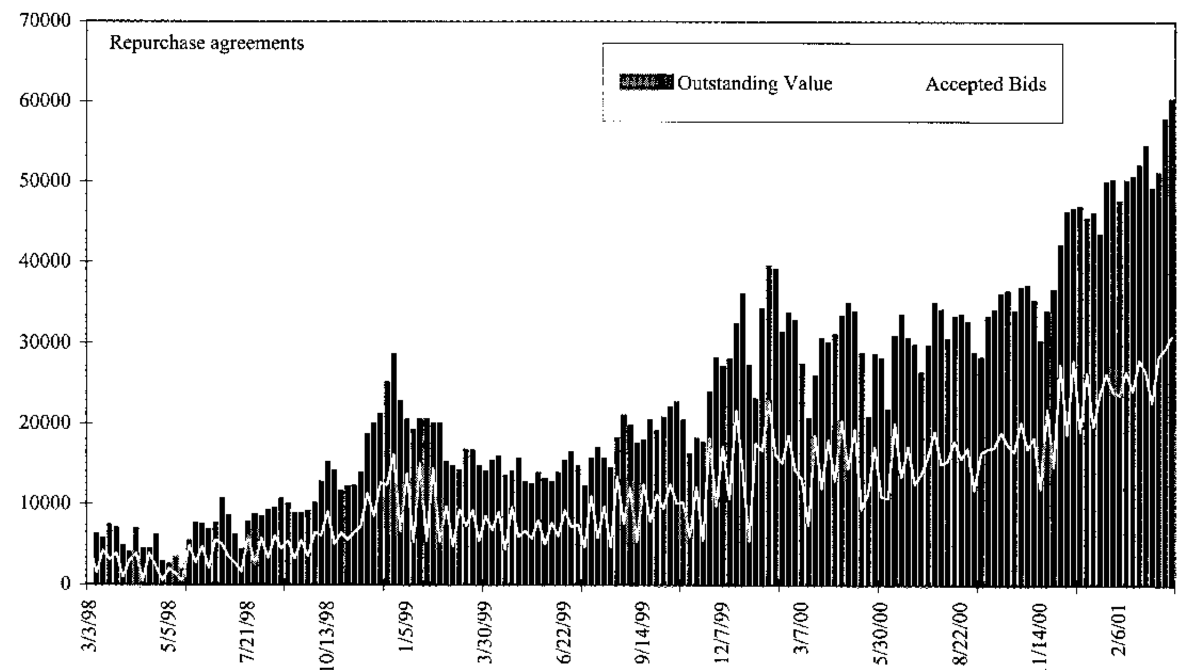


Source: National Economic Institute; Central Bank of Iceland; and IMF staff projections.

1/ Average of period; a decline indicates a depreciation. The current weights are based on 2000 trade shares.

Figure 5. Iceland: Scope of Interventions and Repurchase Agreements





Source: Central Bank of Iceland

Assessing the Sustainability of Iceland's External Balance

The continual widening of the current account deficit in Iceland has been due recently not to sustained foreign direct investment, but rather to buoyant private consumption growth. Moreover, the enlargement of the current account deficit has been accompanied by a significant increase in the private sector's external indebtedness. A question that is clearly important for policy makers is whether or not, on current policies and at prevailing exchange rates, the current account imbalance is unsustainable and, thus, poses risks of financial distress over time. This annex provides an assessment of the sustainability of the current account deficit using two different methodologies.

The macroeconomic balance approach

Iceland's current account deficit has widened sharply during the second half of the 1990s. The sustainability of the current account can be analyzed using the standard macroeconomic balance (MB) approach employed by IMF staff. The MB approach takes a medium-term perspective in terms of the underlying saving and investment patterns of the economy. The first step is to estimate the underlying current account balance that would prevail if all economies were operating at their potential and real exchange rates were to remain unchanged. The next step is to calculate the long-run saving-investment norm (S-I norm) for the economy. The S-I norm is an equilibrium value for the current account position determined by variables that are thought to influence saving and investment behavior in the long-run. The equation consists of three variables: (i) the structural fiscal position, (ii) the dependency ratio, and (iii) per capita income. Since, by accounting convention, the saving-investment (S-I) balance and the current account balance must be equal ex post, preliminary judgments about external sustainability can be reached if there exist substantial differences between the two estimates.

Interpretation of the results for Iceland is subject to considerable uncertainty, however. First, as the Icelandic export base (mainly marine products and aluminum) is subject to supply side constraints, the elasticities with respect to exchange rates and economic activity derived in the model may not be appropriate to illustrate the dynamics of Icelandic exports. Second, the S-I equation was approximated by using 1971–93 data from 21 industrialized countries *excluding Iceland*. As the structure of the Icelandic economy differs markedly from that of most industrial countries included in the sample, and there were no country-specific estimates available for Iceland, the S-I norm turned out to be a rather poor predictor of the current account balance over 1990–2000. Therefore, a country-specific constant term (that sets the S-I norm to be identical to the actual current account balance over 1990-2000) was introduced to ensure that the identity between S-I norm and the current account holds.

The MB approach points—at current exchange rates—to a substantial gap between Iceland's underlying current account position and that which would be consistent with equilibrium saving-investment balance. The underlying current account deficit is estimated at 7.8 percent of GDP in 2000, even after adjusting for the recent rise in oil price. By contrast, at prevailing exchange rates, a deficit of 2.5 percent of GDP would be consistent with the estimated S-I norm in 2000.

The net external liabilities approach

An alternative indicator of the sustainability of the current account is whether net external liabilities in relation to GDP (NEL) is stable, given reasonable assumptions about its determinants. The change in NEL depends on the nominal world interest rate, the nominal growth rate of the economy, and the ratio of the current account balance *adjusted* to exclude net factor income (i.e. balance of goods, services and transfers excluding net factor income) to GDP.[1] On the one hand, if the rate of return on net external liabilities exceeds the country's nominal growth rate, NEL will grow faster than GDP, unless a country runs *adjusted* current account surpluses to offset this difference. On the other hand, a country can have a permanent current account deficit if nominal GDP growth remains sufficiently positive. The stability of NEL is naturally sensitive to the external value of a country's currency.

To analyze these dynamics for Iceland and estimate the level of the current account balance, which would be required to stabilize NEL at its current level (62.3 percent of estimated nominal GDP at end-2000), a simple simulation was conducted. The simulation is based on the following assumptions: (i) the economy grows at its estimated average rate of potential growth of 2.7 percent; (ii) inflation returns to and remains at the average rate of 2.8 percent achieved between 1992-2000; and (iii) the cost of capital on net external liabilities is 7 percent.[2]

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[1] The dynamics are described by the following equation:

$$\Delta NEL_{t+1} = \left(\frac{r-\gamma}{1+\gamma}\right) NEL_t - CA_t^{adj.}$$

where Δ indicates the change over the previous period, t indicates a time period, r is the cost of external capital and γ is the nominal growth rate of the economy, NEL is the net external liabilities to GDP ratio, and $CA^{adj.}$ is the *adjusted* current account balance excluding net factor income i.e. the cost of NEL to GDP.

[2] As the structure of Icelandic external liabilities comprises mainly debt, an estimate of a world interest rate plus a risk premium for Iceland was used as a proxy for the implicit cost of capital. The simulations are based on a world interest rate of 5.9 percent, the GDP-weighted average of nominal long-term bond yields for advanced economies in 2002–2005 presented in *World Economic Outlook*, October 2000. An estimate of the risk premium for Iceland was more problematic. Iceland borrows mainly in foreign currencies and yield spreads over euro-denominated government bonds have recently been trading at roughly 40 basis points above German levels. However, potential market concerns about the sustainability of the current account deficit and recent increases in the vulnerability of the financial system justify a somewhat higher risk premium. The simulation assumes the risk premium to be above 100 basis points, bringing r close to 7 percent.

The simulation results suggest that, to stabilize NEL at current levels, the *adjusted* current account has to post a surplus of 1 percent of GDP. This would correspond to a current account *deficit* of 3.8 percent of GDP. Each one percentage point change in the gap between the world interest rate and nominal GDP growth rate would raise the required *adjusted* current account at the margin by 0.7 percent of GDP to keep NEL constant. Thus, if Iceland were to face a period of slower economic growth and inflation, with nominal GDP growth averaging, for example 4 percent, the adjusted current account would have to post a surplus of 1.9 percent of GDP, which would correspond to an unadjusted current account *deficit* of 2.8 percent of GDP. Furthermore, if NEL would be brought back to a more sustainable level of 50 percent of GDP within the next 5 years, it would require an annual *adjusted* current account surplus of 4.3 percent of GDP. If an adjustment of similar magnitude would be done within the next 10 years, the required surplus in *adjusted* current account would be 2.6 percent of GDP.

Conclusion

Both of the analyses presented above—even though the macroeconomic balance approach is subject to a considerable margin of error—suggest that the current level of external imbalance is unsustainable. Correcting the imbalance requires a sizable increase in national saving. The recent depreciation of the króna is likely to contribute to slower growth of imports, and a gradual recovery of the fish catch and potential export earnings—especially from future projects in the energy intensive sector—is expected to improve the situation in the medium term. Furthermore, consumption growth is forecast to slow down markedly on account of higher debt service payments and negative wealth effects of the recent decline in asset prices. Implementation of measures aimed at reducing the vulnerability of the financial system—increasing capital adequacy ratios, improving loan-loss provisions, etc.—should also have the subsidiary effect of reducing credit growth and, in turn, demand growth.

Iceland: Basic Data

Demographic and other data

Area	103,000 square kilometers
Population (Dec. 2000)	282,845
Natural rate of increase (1992-00)	1.0 percent
Life expectancy at birth (1995)	
Males	76.7 years
Females	80.9 years
Infant mortality (per 1,000 live births)	3
Population per physician (1990)	357
GDP per capita (2000)	US$ 30,763

Composition of GDP in 2000, at current prices	In billions of kr¢nur	Distribution in percent
Private consumption	401.0	59.9
Public consumption	158.3	23.7
Total investment (including stockbuilding)	159.3	23.8
Total domestic demand	718.6	107.3
Exports of goods and services	229.4	34.3
Imports of goods and services	278.6	41.6
GDP at market prices	669.4	100

Selected economic data	**1998**	**1999**	**2000**
	(Annual percentage change)		
Output and unemployment:			
Real GDP at market prices	4.5	4.1	3.6
Manufacturing production	4.8	1.4	-0.7
Average unemployment (in percent)	2.7	1.9	1.3
Earnings and prices:			
Wage Index	9.4	6.8	6.7
Consumer Price Index	1.7	3.4	5.0
Money and interest rates			
M1 (end-period)	20.3	19.4	-10.5
M3 (end-period)	15.2	16.9	11.0
3-month Treasury bill yield (eop)	7.6	9.8	11.5
25-year indexed housing bond (real yield)	4.7	4.8	6.3
	(In billions of kr¢nur)		
Fiscal accounts:			
Treasury receipts	180.8	222.6	224.2
Treasury expenditure	189.6	199.0	201.4
Treasury balance	-8.8	23.6	22.8
(In percent of GDP)	-1.5	3.8	3.4
Balance of payments:			
Current account balance	-40.1	-43.6	-68.9
(In percent of GDP)	-6.9	-7.0	-10.3
Trade balance	-25.0	-22.4	-38.4
Exports	136.6	144.9	148.4
Imports	161.6	167.3	186.8
Services and transfers (net)	-1.3	-7.0	-10.8
Gross reserves, official basis			
(Millions of SDR, end-period)	408	360	310
Exchange rate (ISK/SDR, end-period)	97.6	99.6	110.4

Sources: National Economic Institute; Central Bank of Iceland; Ministry of Finance; and IFS.

ICELAND: Fund Relations

(As of February 28, 2001)

I. **Membership Status**: Joined 12/27/45; Article VIII

II. General Resources Account:	SDR Million	% Quota
Quota	117.60	100.0
Fund holdings of currency	99.02	84.2
Reserve position in Fund	18.58	15.8

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	16.41	100.0
Holdings	0.15	0.9

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

V. **Financial Arrangements**: None

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

	Overdue	Forthcoming				
	01/31/2001	2001	2002	2003	2004	2005
Charges/Interest	0.0	0.5	0.7	0.7	0.7	0.7
Total	0.0	0.5	0.7	0.7	0.7	0.7

VII. **Exchange Rate Arrangement**: Iceland adopted a floating exchange rate regime for the króna, effective March 28, 2001.

Iceland continues to maintain exchange restrictions pursuant to UN sanctions against Iraq (see EBD/90/242, 7/13/90). Residual restrictions are maintained against the Federal Republic of Yugoslavia (Serbia/Montenegro) (see EBD/92/148, 7/17/92) as concerns weapons and other military equipment.

VIII. **Last Article IV Consultation**:

Discussions for the 1999 Article IV Consultation were held in Reykjavik during January 20-28, 1999. The Staff Report (SM/99/90) was considered by the Executive Board on May 5, 1999 (EBM 99/51). Article IV consultations with Iceland are currently on the 24-month cycle.

IX. **Technical Assistance**: None

X. **FSAP:** An FSAP mission visited Reykjavik from November 8-22, 2000.

XI. **Resident Representative**: None

Iceland—Statistical Issues

Iceland's economic database is comprehensive and—notwithstanding the shortcomings noted below—sufficient for effective surveillance. Iceland has subscribed to the Special Data Dissemination Standard (SDDS) established by the Fund.

Data on a wide range of economic and financial variables are provided to the Fund in a timely manner during and between consultations through regular publications, mail correspondence, and electronic transmission. In addition to periodic press releases, statistical information is disseminated to the public through a range of monthly, quarterly and annual publications by four main institutions (The Central Bank of Iceland (CBI), the National Economic Institute (NEI), the Ministry of Finance (MOF), and Statistics Iceland (SE)), and is increasingly available on their internet sites. Electronic data are still only rarely available in English so far, and there is a clear need to improve the labeling of the data. The Central Bank introduced major changes to the presentation of the balance sheet in December 1999, causing a temporary discontinuity in the publication of data for the monetary authorities' accounts in *IFS*. STA is working with the authorities to reconstruct a revised and consistent data presentation. Also, as regards dissemination of financial sector data, the Central Bank and the Financial Supervisory Authority (FSA) need to improve coordination to ensure internal consistency of disclosed data. Progress in this regard has been achieved, with the creation of a new financial stability department at the CBI, which is charged with, inter alia, coordinating with the FSA on data matters.

As to Iceland's subscription to the SDDS, a letter was sent to the authorities by the First Deputy Managing Director of the IMF on December 28, 2000 to alert the authorities of Iceland's incomplete compliance with some of the requirements of the SDDS. The shortcomings related to the expiration of four transition plans for data coverage, timeliness and periodicity, and 12 transition plans for advance release calendars. In response, the authorities emphasized that progress was well underway in many areas, and they expected to be in full compliance with the requirements of the SDDS in the near future. The NEI plans to disseminate quarterly national accounts data with SDSS prescribed timeliness before end-June 2001, including quarterly data for the period 1997-2000 and the first quarter of 2001. Quarterly employment data are also being developed by June 2001 and will be produced and published on the basis of a continuous labor market survey from 2003 onward. In the interim, beginning in June 2001, quarterly estimates will be based on actual data for only the first and third quarters of the year. Only a few components of a producer price index (PPI) are available at this stage. The NEI provides data on export prices, import prices, and produces a marine products price index. These figures are disseminated on a revised draft National Summary Data Page (NSDP). It is intended that SE will take over the development of a proper PPI from the NEI, and SE is expecting to disseminate these data in accordance with SDDS requirements no later than 2003. Annual data on general government operations are available for 1999 on the revised draft NSDP; however, a breakdown of financing data (domestic (with bank/non-bank) and foreign financing) is to be disseminated only in June 2001 at the time fiscal data on general government operations for the year 2000 are released.

As regards central government data, coverage and timeliness of the data has been brought into observance with the SDDS guidelines. A general release calendar for all releases of the NEI is being developed, while the advance release calendars for national accounts, production index, employment, produce price index, and general government operations are being prepared. Finally, the authorities have also provided revisions to the base-page metadata, which have been posted on the IMF's Dissemination Standards Bulletin Board (DSBB).

The authorities have made considerable efforts to prepare the NSDP in accordance with the NSDP Guidelines and have sent a revised draft NSDP to the IMF for comments. As of March 27, 2001, after having incorporated the staff's comments for improving the coverage and presentation, Iceland's NSDP that is accessible at: http://www.eskill.is/si/web/ has been hyperlinked to the IMF's DSBB, including an announcement on the "What's New" page at: http://www.dsbb.imf.org/whatsnew.htm.

The authorities started to provide information on international reserves on basis of the new reserve template in November 2000. The template data submitted by authorities are internally consistent and also in line with other data sources that are available. A decision has been made in January 2001 to disseminate this template data through the Central Bank's website in English and Icelandic, although the latter has not yet been posted. Furthermore, the authorities have provided to the IMF detailed information about the contractual arrangements of the CBI's contingent credit lines and the composition of short-term external debt.

As regards the national accounts data, the authorities shifted to ESA95 in August 2000 and revised the corresponding time series back to 1990. However, at present it is not clear when the data revision will be extended. The authorities have provided assurances, however, that the quality of national accounts time series would not suffer from a structural break due to the transition to ESA95 and annual growth rates could be applied to earlier years to expand the ESA95-based time series backwards.

Following a methodology applied by the European Central Bank (ECB) for the calculation of income payable by collective investment institutions (e.g., mutual funds), the NEI recently deviated from the methodology set out in the fifth edition of the Fund's *Balance of Payments Manual* (BPM50). According to the ECB, all income raised on the assets side of a mutual fund is attributed to the holders of the units over the period under review. This means that all income is assigned to investors, regardless of whether it is distributed or not. Consequently, the reinvested part of earnings, notably the non-distributed earnings of mutual funds, are estimated and then added to income payable. According to BPM5 however, portfolio investors' shares of retained earnings are not included in the balance of payments statement. This discrepancy in methodology has been subject of written communication between the IMF's Statistics Department (STA) and the ECB, and the matter has yet to be resolved.

Iceland: Core Statistical Indicators
as of April 11, 2001

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	04/11/01	03/31/01	03/31/01	03/31/01	02/28/01	03/31/01	Apr. 2001	Feb.2001	2000 Q4	1999	1999	1999
Date Received	04/11/01	04/05/01	04/05/01	04/05/01	03/26/01	04/09/01	04/11/01	03/30/01	03/12/01	Dec. 00	Oct. 00	Oct. 00
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Annual	Annual	Annual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Source of Update	TRE and CBI	CBI	CBI	CBI	CBI	CBI	Statistics Iceland	Statistics Iceland	CBI	Ministry of Finance and NEI	NEI	NEI
Mode of Reporting	Electronic	Electronic and Internet	Electronic and Internet	Electronic and Internet	Electronic and Internet	Electronic and Internet	Electronic and Internet	Electronic and Internet	Electronic and Internet	Electronic and Internet	Internet and Publication	Internet and Publication
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly

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IMF Concludes Article IV Consultation with Iceland

On May 2, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iceland.[1]

Background

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

During the past two years, the economic expansion continued apace, accompanied by further income and employment gains. Output remained above the economy's capacity for the fourth year in a row, driven mainly by excessively rapid domestic demand growth, which in turn was fueled by brisk private credit growth generated by banks' borrowing overseas for domestic onlending. Inflation picked up markedly despite repeated increases in interest rates, reaching 6 percent in April 2000, and has shown initial signs of subsiding only recently. The labor market has become increasingly tight, and the current account deficit, reflecting fully a decline in the private sector saving-investment balance, rose to 10.3 percent of GDP in 2000.

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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. This PIN summarizes the views of the Executive Board as expressed during the May 2, 2001 Executive Board discussion based on the staff report.

Public finances have improved considerably in recent years on account of both the sustained economic expansion and discretionary actions. The rising general government surplus, which reached 2.8 percent of GDP in 2000, has allowed a significant and steady decline in the ratio of gross public debt to GDP. The mildly contractionary stance of fiscal policy has been weakened somewhat by expenditure overruns in non-interest categories of spending. Public sector wages have posed a particular problem, partly due to front-loaded pay reforms.

Monetary policy has been guided by the desire to maintain price stability while keeping the exchange rate within its fluctuation bands. The Central Bank of Iceland raised its policy interest rate by 390 basis points in seven steps during 1999-2000, which required a widening of the fluctuation bands of the exchange rate from ±6 percent to ±9 percent in early 2000. The króna subsequently appreciated during the first four months of 2000. Following an announcement in May that the allowable cod catch for the 2000/01 fishing season should be reduced by 20 percent, however, the króna came under sustained downward pressure. By end-March 2001, the effective exchange rate index of the króna had depreciated by almost 15 percent since end-April 2000, to about 1½ percent above its lower fluctuation band. On March 27, 2001, the government and the Central Bank jointly announced the adoption of a floating exchange rate regime for the króna, accompanied by an inflation targeting framework for monetary policy.

The increased openness of Iceland's financial markets, together with the emergence of large positive interest rate differentials and the prevalence of a soft exchange rate peg until end-March 2001, led to a surge in foreign borrowing by banks for domestic onlending, which in turn fueled domestic credit and demand growth. Indicators of external and financial vulnerability suggest that the financial system's risk exposure has increased, while indicators of the robustness of the financial system point to a decline in the system's capacity to absorb shocks.

Against the backdrop of declining equity values, a reduction in wage growth, and rising household debt burdens, economic growth is projected to slow to 2 percent in 2001, contributing to a moderation in the inflation rate to 4¼ percent. Since Iceland's merchandise exports are mainly supply-side constrained, repercussions of a global economic slowdown are more limited than elsewhere. However, the current account deficit is projected to increase slightly to 10.6 percent of GDP, not least because of higher debt service payments following the recent decline in the króna.

Executive Board Assessment

Executive Directors commended the Icelandic authorities for the success achieved during the past decade, as reflected in fiscal consolidation, rapid disinflation, job creation, solid income gains, and production diversification.

Directors noted, however, that above potential growth during the past five years had resulted in a sustained overheating of the economy. Growth had been driven predominantly by buoyant domestic demand, fueled by a fall in private saving that more than offset increases in public saving and, especially, by excessive private credit growth. The economic boom, in turn, had been accompanied by rising inflation and a deterioration of macroprudential indicators—namely, the further widening of the current account deficit in 2000 and an accompanying rise in external debt. Directors stressed that reducing the large external imbalances in an orderly fashion would require concerted policy action.

Directors agreed that a number of factors had contributed to rapid credit growth. The increased openness of Iceland's financial markets, together with the soft exchange rate peg and the widening of interest rate differentials as the central bank raised its policy rate to slow growth and counter inflation, had led to a surge in foreign borrowing by banks for domestic onlending.

Against this background, Directors welcomed the authorities' March 27, 2001 decision to allow the currency to float, accompanied by the adoption of inflation targeting. They noted that a flexible exchange rate was a natural extension of the gradual widening of the fluctuation bands during the past decade, and judged Iceland to be well placed to adopt an inflation targeting framework. Directors urged that the new Central Bank Act be enacted rapidly to provide instrument independence to the monetary authorities.

Directors noted, however, that the recent decision to reduce the policy interest rate had been ill-advised, especially in the early stages following the introduction of an inflation targeting regime. They noted that the ensuing surge in domestic liquidity had contributed to further depreciation of the króna, adding to inflationary pressures and the accumulation of financial risks. Directors therefore called on the authorities to take action to rein in liquidity growth.

Against this backdrop, Directors noted the timeliness of Iceland's participation in the Financial Sector Assessment Program. They agreed with the assessment that, although the Icelandic financial system was well developed and responding to market signals, its capacity to absorb shocks needed to be strengthened. In this context, they welcomed the authorities' willingness and resolve to address the existing vulnerabilities. Directors urged that direct measures be taken to lower the risk exposure of the financial system. In this regard, most Directors recommended that the authorities move swiftly to raise the minimum capital adequacy requirements of domestic banks, and that clear legal authority be assigned to the financial supervisory authority to mandate increased capital requirements. Directors also urged the authorities to take regulatory and legislative steps needed to improve asset classification and loan-loss provisioning arrangements. Most Directors suggested that the authorities move swiftly—and not hold off until the EU task force review of loan-loss provisioning is finalized. They welcomed the recent increases in staffing at the financial supervisory authority.

Directors agreed that fiscal policy was on a sound medium-term footing. Although fiscal policy had not been the cause of the overheating, Directors considered that it had to play a supporting role to address domestic and external imbalances. In this context, Directors stressed the importance of implementing effective spending control mechanisms and putting in place a medium-term budgetary framework.

On the structural front, Directors commended the Icelandic authorities for the planned re-invigoration of the privatization program, which had slowed somewhat during the past two years. They welcomed the plan to sell shares of the state-owned telecommunications company, and stressed the importance of carrying through with the sale of the two remaining state-owned banks. Directors encouraged the authorities to use the proceeds from privatization to reduce further the government's unfunded public pension liability, which had increased with recent public sector pay reforms. They welcomed the government's recent initiative to work on reform of fisheries management, noting the difficulties involved in reaching consensus.

Directors considered that Iceland's trade policies could be further improved, notably through a reduction of tariff and non-tariff barriers on farm products.

Directors welcomed Iceland's budgeted increase in official development assistance, but encouraged the authorities to raise the level toward the United Nations target.

While Iceland's economic and financial statistics are broadly adequate for surveillance purposes, Directors welcomed the authorities' intention to further improve their coverage and timeliness to achieve full compliance with Special Data Dissemination Standard requirements.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Iceland: Selected Economic Indicators

	1997	1998	1999	2000 1/	2001 2/
Real Economy (change in percent)					
Real GDP	5.3	4.5	4.1	3.6	1.9
Domestic demand	6.2	12.1	4.7	5.4	1.3
CPI	1.8	1.7	3.4	5.0	4.6
Unemployment rate (in percent)	3.9	2.7	1.9	1.3	1.8
Gross national saving (percent of GDP)	19.1	17.9	15.8	13.5	12.2
Gross domestic investment (percent of GDP)	12.3	26.6	-0.8	9.0	-2.4
General Government Finances (in percent of GDP)					
Financial balance	0.0	0.4	2.2	2.8	2.7
Structural primary balance	2.1	1.9	2.5	2.4	2.8
Structural balance	-0.4	-0.5	0.4	0.9	1.2
Gross debt	53.2	48.6	436.	42.2	40.2
Money and Credit (change in percent)					
Deposit money bank credit (end of period)	12.7	30.4	23.2	26.4	..
Domestic credit (end of period)	15.5	27.6	22.3	18.4	..
Broad money (end of period)	8.7	15.2	16.9	11.0	..
Repurchase rate (period average, in percent)	6.9	7.3	8.4	10.5	..
Balance of Payments (in percent of GDP)					
Trade balance	0.0	-4.3	-3.6	-5.7	-5.9
Current account balance	-1.7	-6.9	-7.0	-10.3	-10.6
Financial and capital account	3.2	7.9	9.7	9.9	..
Gross external debt	66.0	71.9	83.2	109.1	..
Reserves cover (in months of imports) 3/	1.8	1.6	1.8	1.5	..
Fund Position (as of February 28, 2001)					
Holdings of currency (in percent of quota)					84.2
Holdings of SDRs (in percent of allocation)					0.9
Quota (in millions of SDRs)					117.6
Exchange Rate					
Exchange rate regime			Floating exchange rate		
Present rate (April 11,2001) 4/			ISK index = 128.19		
Nominal effective rate (change in percent)	-1.3	-1.6	0.1	0.0	..
Real effective rate (change in percent)	2.5	-0.2	6.7	-7.0	..

Source: National Economic Institute; Central Bank of Iceland; Ministry of Finance; and IMF staff estimates.

1/ Official estimates.

2/ Staff projections.

3/ In months of imports of goods and services.

4/ Trade-weighted exchange rate index of the króna (12/31/1991=100).

Statement by Åke Törnqvist, Alternate Executive Director
for Iceland
May 2, 2001

My Icelandic authorities would like to extend their thanks to Mr. Hagemann and his team for their report. They would also like to thank the FSAP team under the leadership of Mr. Alexander for their thorough report on the financial system in Iceland.

Recent developments

The strong upswing that began in 1995 continued at a robust pace in 2000, due to increased investment and somewhat lower savings rate, partly fuelled by credit-driven private demand growth. GDP growth was still above trend, and unemployment continued to fall. Consumer price inflation accelerated early in the year, before easing substantially as the year progressed. The current account deficit widened due to buoyant investment and the lower savings rate. With public finances running substantial surpluses, the current account deficit is primarily financed through private sector borrowing from abroad, channeled through the banking system.

My authorities' baseline forecast for 2001 is, in many ways, similar to that of the IMF. GDP growth is expected to ease to 2 percent - well below the economy's potential growth rate - largely due to a reduction in fish catches. A further slowdown is anticipated in private consumption growth, as well as a contraction in the level of private sector investment. As a consequence, imports of goods are expected to fall in real terms. Unemployment is expected to rise marginally to an average of 1½ percent.

My authorities are in broad agreement with the staff report on the overall assessment of the macroeconomic situation. It is possible, nevertheless, that domestic demand growth will be lower than in official predictions, leading to a more rapid improvement in the external balance. There are already strong signs that domestic demand is receding, e.g., a strong downturn in automobile registration, a leveling off of demand for imported consumer goods, and a fall in retail turnover in real terms. Also, there are increasing signs that the corporate sector is in the process of scaling down investment in order to adjust to the lower than expected demand growth.

Fiscal policy

Fiscal policy has contributed to economic stability by maintaining a tight policy stance as measured by the overall structural balance, as well as through a re-orientation of policies with a strong emphasis on liberalization and privatization.
My authorities share the appraisal of the 2001 staff report that this change has enhanced the dynamism of the Icelandic economy. Also, they are in full accord with the staff's appraisal that, given the present situation, in particular with respect to the current external imbalance, fiscal policy needs to play a supporting role in the short and the medium term. In this respect,

strengthening the medium-term fiscal framework, with emphasis on pre-set fiscal targets, could be advantageous.

The Government has based its medium-term fiscal framework on a baseline scenario in which the external balance will be gradually restored and the current fiscal stance will be maintained. Continued emphasis on privatization, and the further reduction of the unfunded liability of the state employee pension scheme, will strengthen the medium- to long-term position of public finances while, at the same time, supporting the short-term objective to minimize the pressure on the domestic currency. In this regard, the government put forward a bill last week to sell 49% of the state-owned telecommunication company before the end of this year. Earlier, a bill was submitted to Parliament permitting the government to sell its remaining stake in the two banks before the end of the Government's term in office.

With regard to incomes policy, recent wage contracts with public employees have been in line with private sector contracts, and have in no way undermined the overall framework for pay settlements in Iceland.

Monetary policy

On March 27th, in a joint declaration of the government and the Central Bank, my authorities announced major changes in the framework of monetary policy that came into force on the next day. The change is described in the papers prepared by the staff. The only point that my authorities would want to make is to emphasize that the tolerance limits are not to be interpreted to indicate that inflation shall be 1-4 per cent. Instead, monetary policy shall aim at keeping inflation close to 2½ per cent. If inflation goes outside the tolerance limits, the Central Bank shall submit a report to the government as explained by staff in the Selected Issues paper. However, were the economy to be hit by significant supply shocks, it might be appropriate to allow inflation to temporarily go outside the limit.

It is important to stress that the regime switch was not based on a hastily taken decision owing to the current conditions in the foreign exchange market. The Central Bank had become convinced that the new regime would better suit Iceland than the soft exchange rate peg, and had been preparing for this change with increasing force since the widening of the exchange rate band in February last year. At that time, the Icelandic króna was appreciating. The exact timing of the change was prompted by the intention of the government to make its draft legislation on the Central Bank public at the Bank's annual meeting. It includes instrument independence and explicit permission to adopt an inflation target. At the time, there was a possibilty that market participants would expect that such a change was imminent, making it difficult and somewhat risky for the Central Bank to continue defending the existing exchange rate band.

The Central Bank decided to lower its main policy rate, the repo rate, by ½ percentage point to 10.9 percent, at the same time as changes in the monetary regime came into force. As monetary policy was no longer constrained by the exchange rate band, interest rates could be set on the basis of a forward-looking assessment of inflation prospects. In February, the

Central Bank had forecast a 4½ per cent inflation in the course of 2001 and 2.7 per cent in the course of 2002. The exchange rate had weakened somewhat since that prediction was made, but the inflationary effects of that weakening would be mostly out of the system by 2003, provided that wages do not react. Furthermore, as mentioned earlier, signs have begun to emerge that the economy is cooling, such as falling indirect tax collection in real terms and a flattening out of real merchandise imports. While recent figures of domestic credit have been inflated by the depreciation of the króna (part of the lending is denominated in foreign currency) the Central Bank has indications that there is a marked slowdown in domestic bank lending. The Central Bank therefore assessed lower interest rates to be compatible with the inflation target. It also has to be borne in mind that monetary conditions continue to be very tight, in spite of the recent cut, as demonstrated by the high interest rate differential vis-á-vis trading partners and a real repo rate of around 6 per cent.

The staff report criticizes the recent interest rate cut, citing a surge in liquidity in its wake, and arguing that it would have been prudent to wait for additional signs of decelerating inflation. This criticism lacks foundation, since there has actually been a liquidity squeeze in the Icelandic money market in recent weeks. This is reflected in the two week REIBOR, which is currently 180 basis points above the Central Bank repo rate. The recent increase in the outstanding repos cannot be taken as an indication of a liquidity surge, as it is largely the result of the withdrawal of króna liquidity through the interventions of the Central Bank in the foreign exchange market prior to the float. Base money has been more or less flat so far this year.

The exchange rate of the króna has depreciated by 19 per cent from its peak last year and by over 9 per cent from the beginning of this year. Of this, over 7 percentage points occurred after the regime shift. If not reversed, this depreciation will add to inflation in the months to come. Against the proposition of the staff that the króna is overvalued, my authorities have pointed out that the real exchange rate is now well below its historical average, export sectors that are not supply constrained have been expanding briskly, and the fall in the profitability of listed companies last year was mostly due to higher financing costs, partly because of the fall in the exchange rate. It is the assessment of my authorities that the current account deficit is mainly a demand management and private savings problem rather than a problem of misaligned relative prices.

To conclude the discussion on monetary policy, my authorities do not agree with the staff that the framework for monetary operations played a significant role in credit growth and the increased vulnerability of the financial system. Credit growth was mainly financed by foreign borrowing, and the contribution of central bank liquidity has been small. It is possible that a volume-based system would have had somewhat different effects on the behavior of bank fund managers, but it is difficult to see how this could have been more than a short-term effect. Experience shows that the present system is effective in signalling the Central Bank's intentions to the market. Central Bank rates have, until the last rate cut, been transmitted very strongly into money market and bank rates. In any case, a volume-based approach would have required a more sophisticated system for predicting liquidity than the Central Bank commands at present. My authorities agree that the spread between the overnight lending rate and the repo rate might, on occasions, have been too narrow. When the Bank cut the repo rate at the end of March, the overnight lending rate was kept unchanged, moving the repo rate toward the middle of the corridor.

Financial stability, FSAP and FSSA

The IMF assessment of the Financial System Standards and Codes reveals certain vulnerabilities in the regulatory and supervisory framework. The assessment is broadly in line with my authorities' views. Improvements needed to meet the IMF's recommendations are already included in the working program of my authorities. By establishing the Financial Supervisory Authority (FME) at the beginning of 1999, the government and Parliament expressed their clear intention to strengthen official supervision of financial activities. The IMF's assessment will help ongoing work in that direction.

Several weaknesses in the regulatory and supervisory framework need to be addressed through changes in legislation. The recommendations put forward by the Fund will be taken into account in a committee currently reviewing the legislative acts on credit institutions, securities transactions and insurance activities. Proposals for amendments are scheduled to be finalized later this year.

Amendments to supervision are being made in line with the IMF's recommendations. This applies to recruitment of new staff within the FME, improvements in data collection, clearer focus on on-site inspections, and further developments of supervisory guidelines, such as those regarding internal control and fitness and propriety.

Vulnerabilities in connection with the capital adequacy of banks and in the regulatory framework of loan classification and loan-loss provisioning are of special importance. My authorities acknowledge the recommendation to provide the FME with clear legal authority to mandate increased capital requirements for banks at particular risk. The strengthening of the FME's legal authority in this field will be discussed in the work of the aforementioned committee. The FME has repeatedly warned against the lowering of CARs, and has been developing tools to systemically evaluate the capital position of individual banks, as a part of its supervision of the banks' risk management.

My authorities acknowledge that the rules relating to asset classification and loan-loss provisioning requirements should be improved, and a process of such improvements has commenced. However, they believe that Basel Core Principle 8, concerning loan evaluation and loan loss provisioning, is largely complied with, as an overall evaluation of the regulatory framework and the banks' practices of the rules point to that conclusion.