August 2003
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Iceland: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Iceland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 2, 2003,** 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 July 30, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 22, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Iceland.

The document listed below have been or will be separately released.

Financial System Stability Assessment Update

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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ICELAND

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with Iceland

Approved by Michael Deppler and Leslie Lipschitz

July 30, 2003

- The Article IV Consultation discussions were held in Reykjavik during May 21–June 2, 2003. The mission comprised Messrs. Escolano (Head), Lutz, and Ms. Moreno-Badia (EU1). Staff met with the Minister of Finance, Chairman of the Central Bank of Iceland's Board of Governors, and senior government officials; representatives of labor and employers unions, financial institutions, and academics.

- Iceland has accepted the obligations of Article VIII, Sections 2,3, and 4. The exchange system is free of restrictions on payments and transfers for current international transactions (Appendix II). Iceland has subscribed to the Special Data Dissemination Standard, and data provision is adequate for conducting surveillance (Appendix III).

- The authorities released the mission's concluding statement and intend to publish the staff report.

- The general elections of May 10, 2003 confirmed the parliamentary majority of the incumbent government coalition. The Prime Minister as well as the Ministers of Finance, and Industry and Commerce remained in their cabinet positions.

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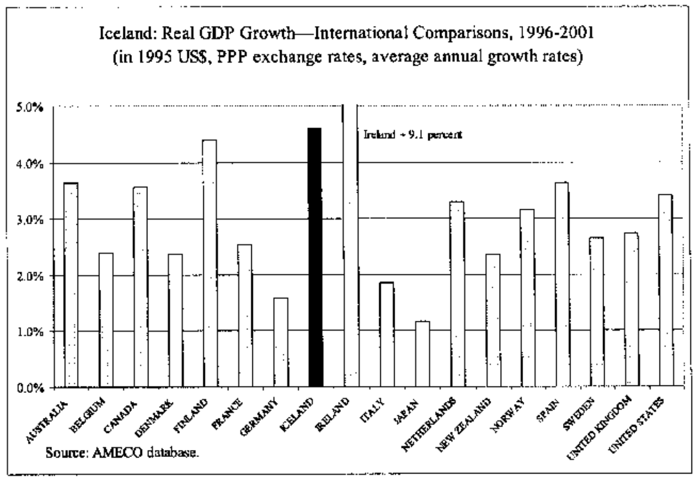
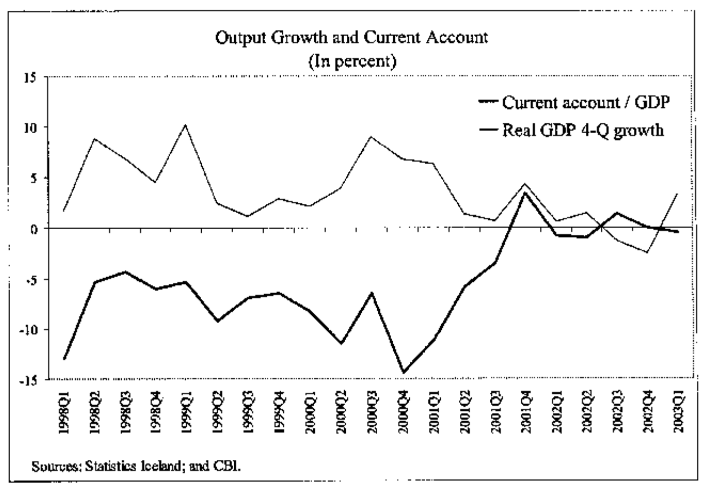
I. Introduction and Key Issues

1. **Rapid growth during the second half of the 1990s, led to overheating and the emergence of financial vulnerabilities by the end of the decade.** Fostered initially by economic liberalization and investment, the economic boom was accompanied by export diversification and buoyant incomes. Nevertheless, by 1998, it became increasingly driven by private consumption fueled by a rapid credit expansion—resulting in financial vulnerabilities reported in the 2001 Financial System Stability Assessment (FSSA)—and sustained by a current account deficit that widened to 10 percent of GDP in 2000.

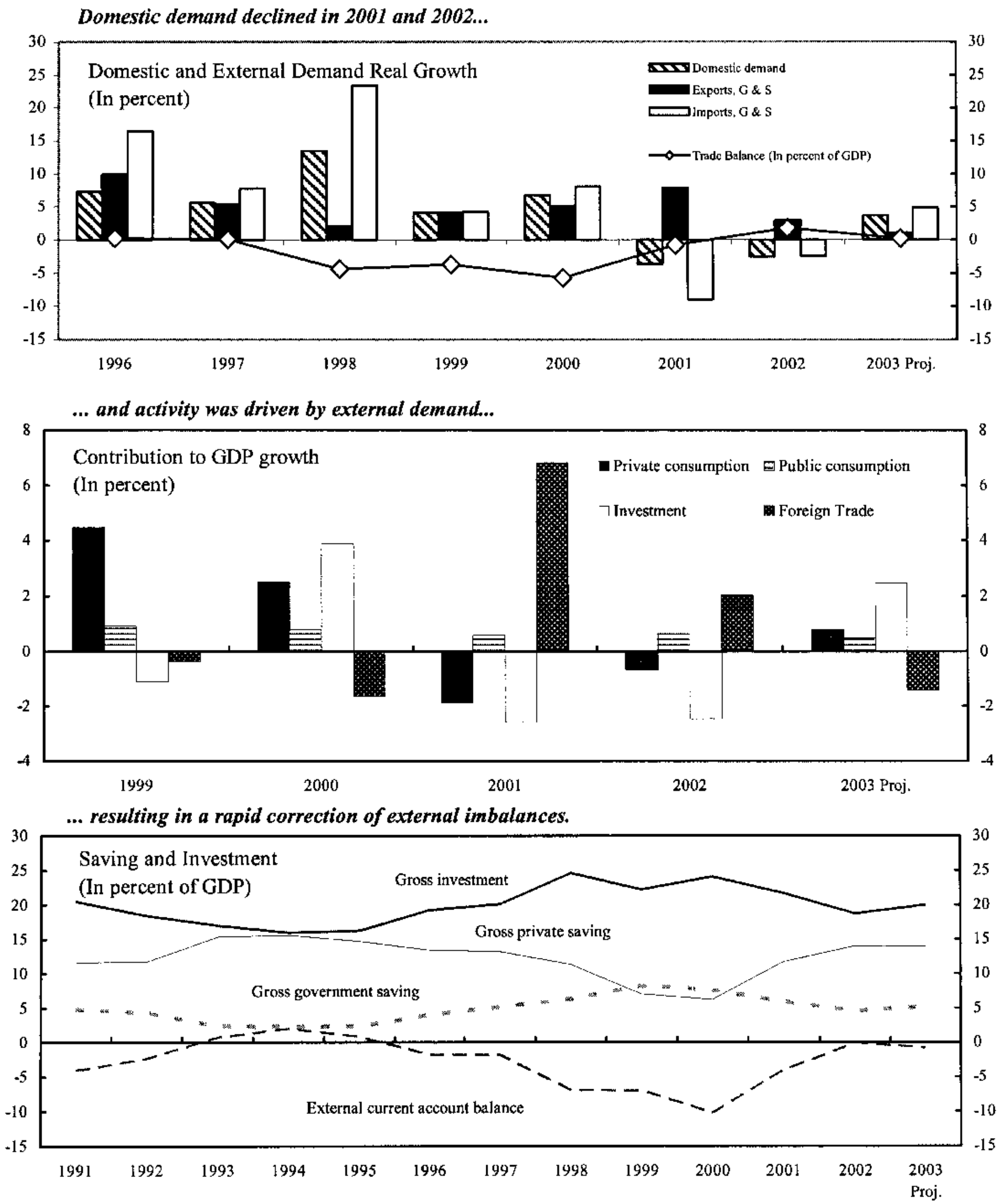


2. **The economy has stabilized since then, and appears poised for a resumption of growth (Table 1, Figure 1).** By mid-2000, a turn in sentiment and the deterioration in global economic conditions caused a reversal of capital flows, and the króna depreciated steeply through end-2001, triggering a domestic demand adjustment. This, combined with a dynamic export response, resulted in a rapid redirection of activity towards the external sector. The current account returned to broad balance in 2002, which contributed to a recovery of the króna (Table 2). Tight monetary conditions drove down inflation, which has remained close to the Central Bank of Iceland's (CBI) 2½ percent inflation target since November 2002. After a mild recession in 2002, most indicators point to a pickup in activity in 2003 and prospects are strong for investment-led growth over the medium term.



3. **The economy's soft landing owes much to the stability-oriented policies implemented by the authorities.** The adoption of inflation targeting, CBI independence, and a floating regime for the króna in March 2001 have resulted in an effective monetary policy framework that has successfully managed a difficult transition, anchoring inflation expectations. After an expansionary stance in 2001, fiscal policy has remained tight, helping to

Figure 1. Iceland: Soft Landing



Sources: Central Bank of Iceland; Statistics Iceland; and staff projections.

curb domestic demand. Financial vulnerabilities were addressed resolutely, including through a proactive supervision by the newly created Financial Supervisory Authority (FME), resulting in significant improvements in financial soundness indicators. From a broader perspective, the remarkable flexibility shown by the economy is, to a large extent, the consequence of structural reforms implemented since the early 1990s, including financial and external capital account liberalization undertaken in connection with membership in the European Economic Area (EEA), public finance consolidation, privatization, and other initiatives aimed at promoting robust and efficient markets (Figure 2).

4. The upcoming period, however, will pose significant policy challenges:

- **Large planned foreign investments in aluminum smelting and construction of associated power-generating facilities will complicate macroeconomic management (Box 1).** The investment projects, which will extend over 2003–10, amount to about 35 percent of 2003 GDP. They will substantially increase growth and export revenues, and by further diversifying the export base they will ultimately enhance the stability of the economy. But during the construction period, they will put pressure on limited resources. Policies will need to focus on avoiding economic overheating and an over-appreciation of the real exchange rate that could cause lasting damage to the export and import-competing sectors. To this end, the demand expansion will need to be countered primarily through a tight fiscal policy.

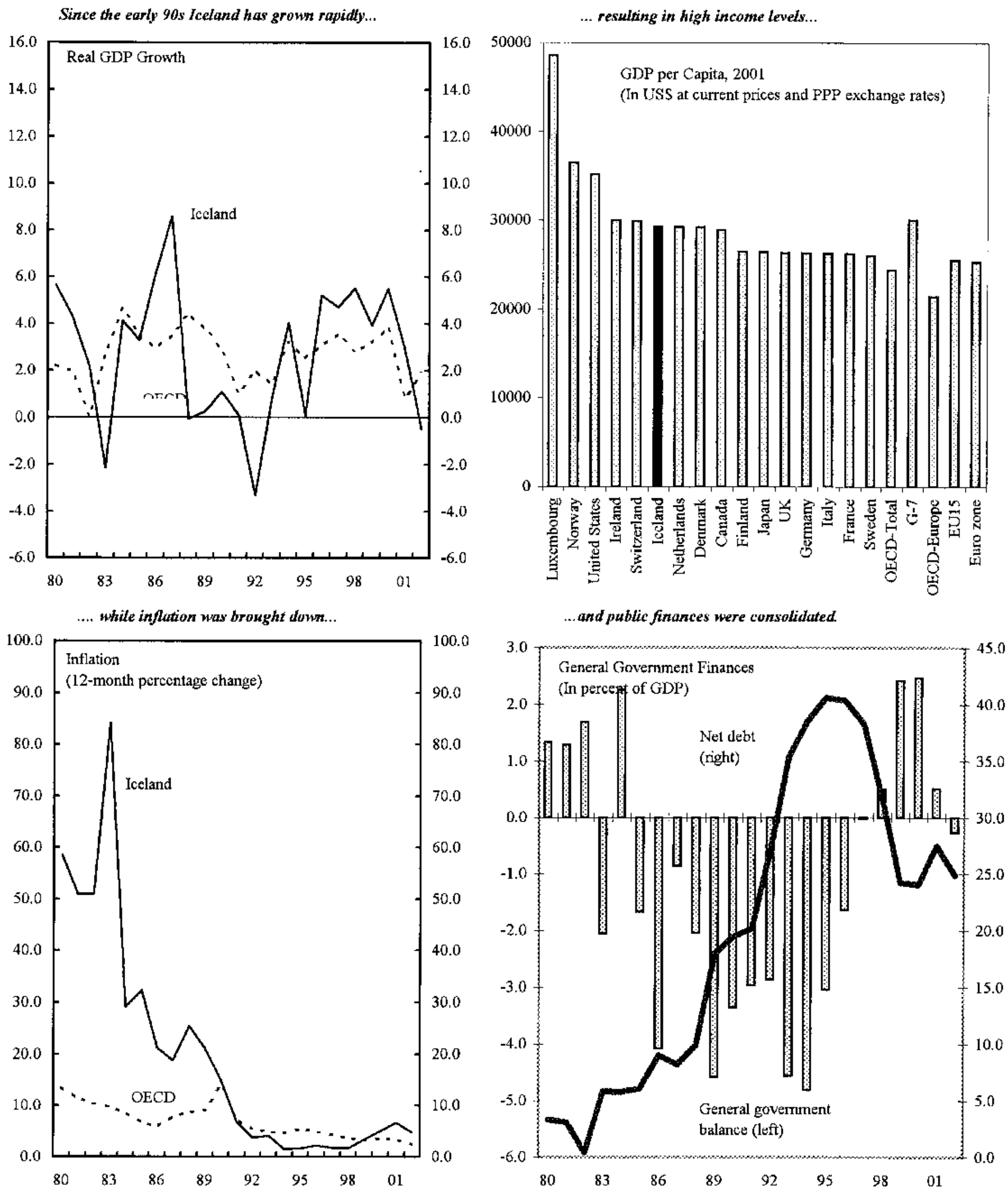
- **After increasing rapidly in recent years, the external liabilities of the Icelandic private sector are high.** This makes the economy vulnerable to external shocks and reinforces the case for a fiscal retrenchment aimed at increasing national saving.

- In this context, continued progress on **strengthening the institutional policy frameworks**, particularly in the fiscal area, and on **market-oriented structural reforms** will be crucial to seize the new growth opportunities and further increase the resilience and flexibility of the economy.

II. Recent Developments and Outlook

5. **Activity slowed sharply in 2002, as the 2001 impulse from net exports waned.** The 2001 depreciation of the króna triggered a swift reallocation of resources towards exports, which provided the main contribution to growth in 2001 and 2002. Simultaneously, private domestic spending and imports contracted. In addition to tight credit conditions and the depreciation of the króna, negative wealth effects had a further sobering effect on domestic demand. Labor markets softened although unemployment was contained at relatively low levels, peaking at 4.1 percent in February 2003, and the participation rate has remained high. While there is much uncertainty surrounding the level of potential output, staff agreed with the authorities that the output gap, if any, was small, with staff estimating it at a negative 1 percent of GDP in 2003.

Figure 2. Iceland: Economic Developments 1980–2002



Sources: Statistics Iceland; Central Bank of Iceland; OECD; and World Economic Outlook, IMF.

Box 1. Planned Aluminum and Power Plant Investments

During 2003–10, Iceland will undertake some of the largest investment projects in its history. Their cost is estimated at 281 billion krónur (US$3.7 billion or 35 percent of 2003 GDP) and they will result in aluminum production increasing almost three-fold. The projects comprise the expansion of the existing Nordural aluminum smelter; construction of a water reservoir and power-generating facilities for the Nordural plant; construction of an Alcoa aluminum smelter; and construction by Landsvirkjun of hydropower facilities to supply the Alcoa plant.[1]

Work on these projects will start in 2003 and peak in 2005–06. It is anticipated that 50 percent of the construction cost will be financed by foreign investors. Staff estimates that the current account will deteriorate during the construction period—including as a result of the induced consumption—reaching a deficit of 5.6 percent of GDP at the peak of activity.

Macroeconomic Impact of Power Intensive Projects 2003–08
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008
Total projects investment	2.1	4.0	7.7	7.7	5.3	1.3
Aluminum smelters	0.0	1.1	4.0	4.7	3.7	0.3
Hydropower station	2.1	2.9	3.7	3.0	1.6	1.0
Current account balance	-0.9	-2.1	-5.0	-5.6	-3.6	-0.2
of which imports from projects	-1.0	-2.0	-4.1	-4.1	-2.9	-0.6
Project-related labor demand (percent of labor force)	0.5	0.8	0.9	1.6	0.6	0.1
Output gap (percent of potential output)	-1.0	0.5	2.0	1.8	0.8	0.1

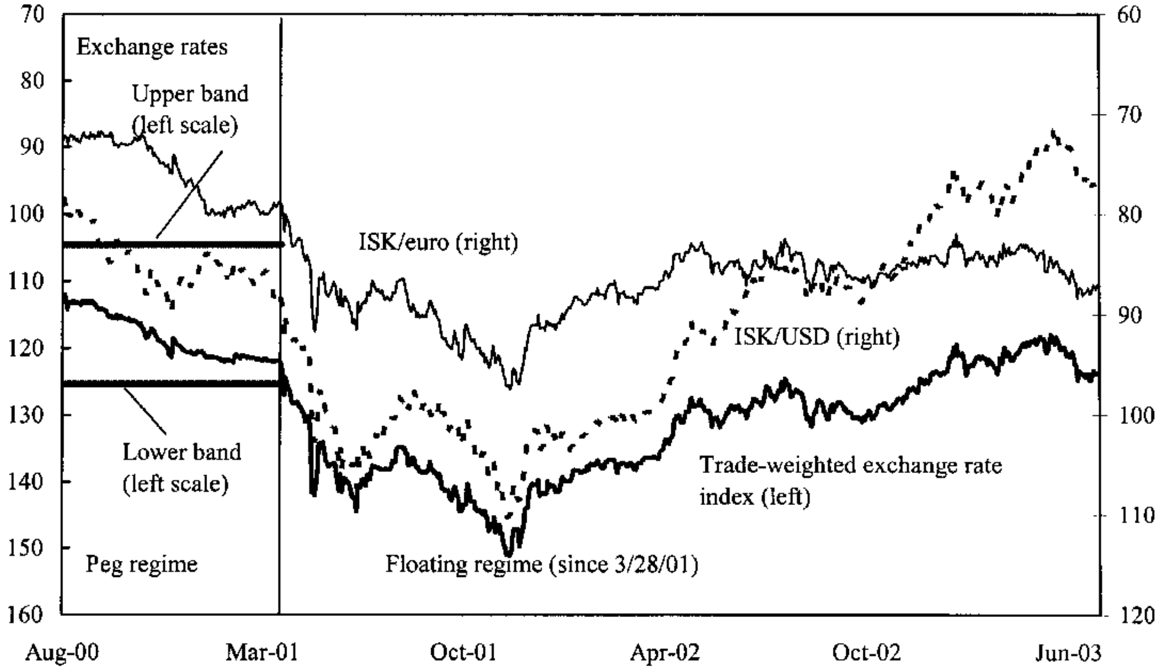
Sources: Central Bank of Iceland; Ministry of Finance; and staff estimates.
1/ Although the Nordural project is included in the official and staff projections, some decisions regarding this project are still pending.

6. **In 2002, the real exchange rate of the króna reverted to more normal levels from the lows reached in 2001 (Figure 3).** Since the 2001 depreciation, booming export earnings, flagging imports, interest rate differentials, and more recently, expectations of large foreign investment inflows, have sustained the recovery of the króna in nominal and real effective terms. By the time of the mission, the real exchange rate had regained a level consistent with its long-term average.

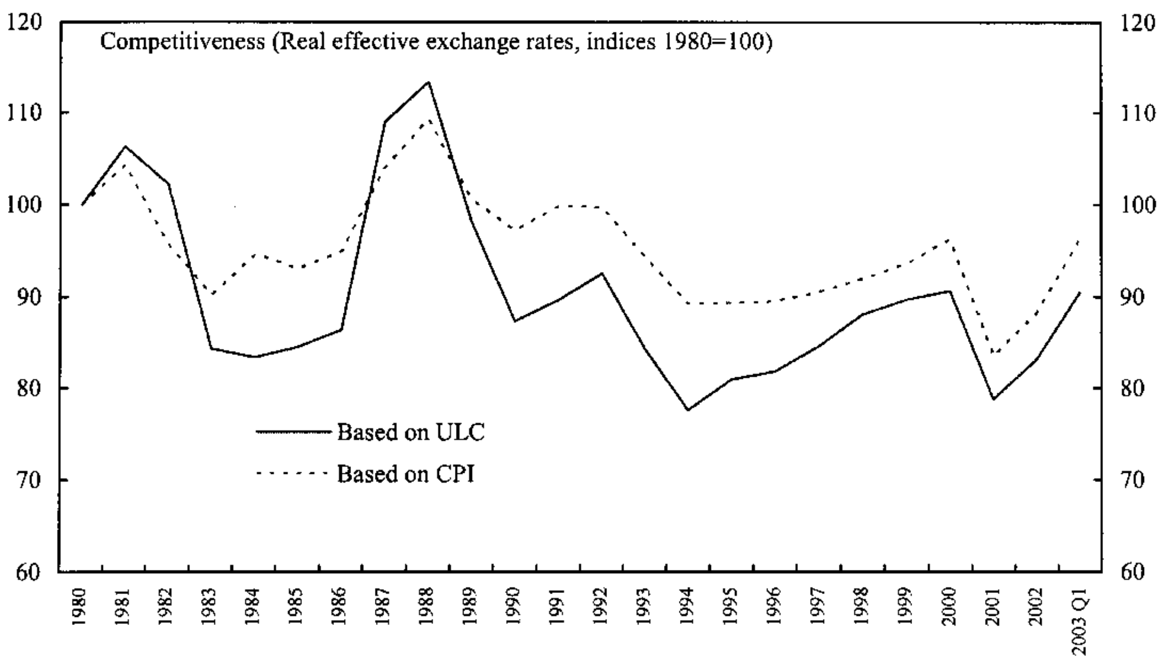
7. **Output growth is projected to recover to about 2¼ percent in 2003 and gather pace subsequently, as the investment projects in electricity generation and smelting take place.** The activity pick up is being spearheaded by a consumption upswing in 2003, as suggested by high frequency indicators and national accounts data for 2003Q1 (Figure 4). The output gap is expected to close by early 2004 as domestic demand growth takes hold,

Figure 3. Iceland: Exchange Rate and Competitiveness

The króna has appreciated...



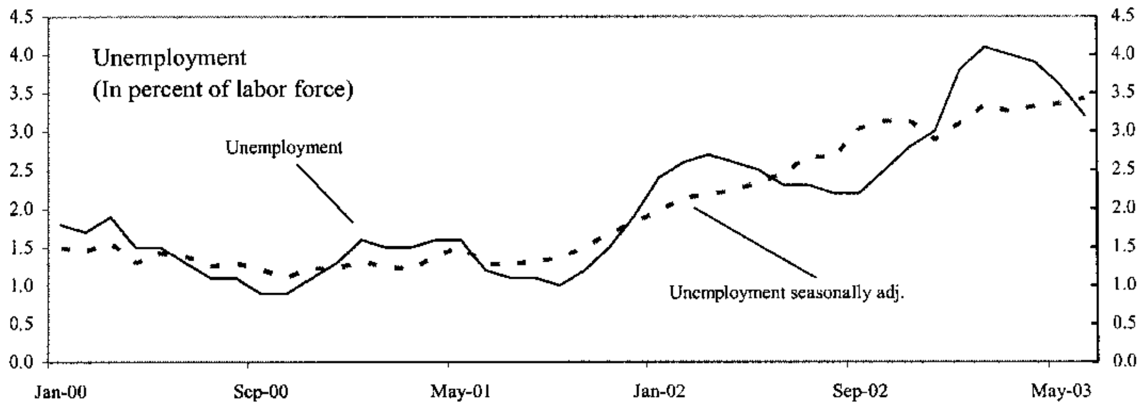
... but the real exchange rate remains around its historical levels.



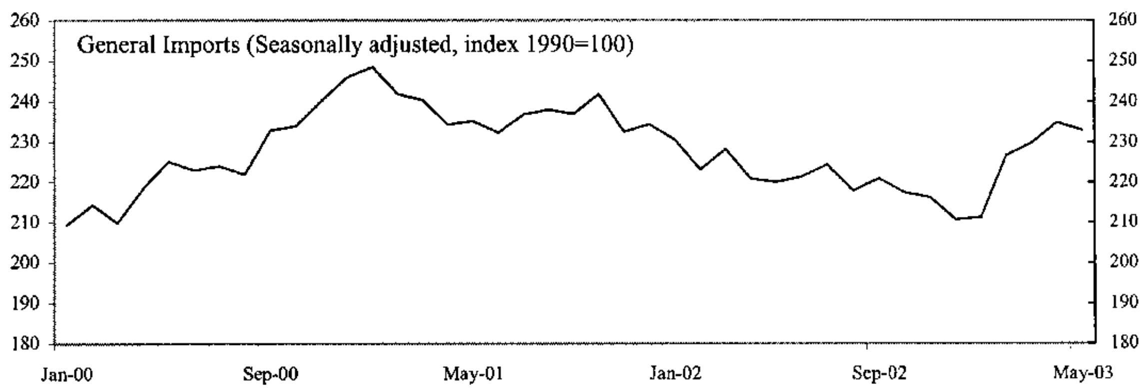
Source: Central Bank of Iceland.

Figure 4. Iceland: Activity Indicators

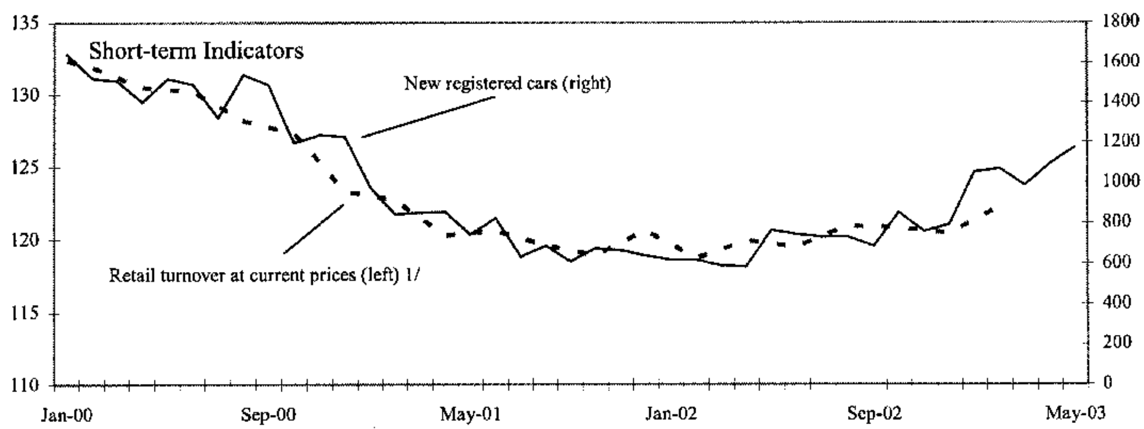
Although there is still slack in the labor market...



... consumption is starting to pick up as suggested by imports...



... and other short-term indicators.



Sources: Statistics Iceland; Directorate of Labor.
1/ Index, 1990=100.

buttressed by the start of power-generation and smelting construction projects in the second half of 2003.

8. **Over the medium term, the investment projects will impart a significant impetus to economic activity and output will grow for some years above its long-run trend pace (Table 3).** Staff's baseline projections indicate that capital inflows will temporarily widen the current account deficit to a peak of about 5½ percent of GDP in 2005–06. This deficit will be mainly driven by imports directly related to construction projects, and largely financed by foreign direct investment. Staff projections—postulated on the adoption of appropriately tight macroeconomic policies consistent with the authorities' intentions—also indicate that the demand push could be accommodated with only a moderate appreciation of the real exchange (most of which appears to have already taken place), while gross external debt could decline to below 100 percent of GDP by 2008.

9. **There are, however, significant upside risks to this medium-term central scenario.** While, at present, a weak global outlook and high levels of private sector indebtedness may temper the recovery, the investment demand push will soon gather momentum, including through forward-looking expectations. Thus, the main risks will increasingly be the emergence of overheating and loss of external competitiveness, particularly if an asset price boom or unrealistic expectations of income growth develop. In this connection, the upcoming wage round in early 2004 will provide a first test. Also, the high levels of external debt, particularly short-term liabilities, will continue to make the economy vulnerable to unexpected swings in sentiment and external financial conditions.

III. Policy Discussions

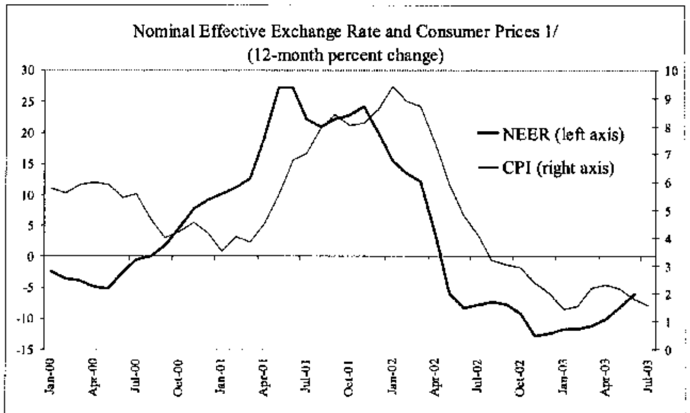
10. **The authorities have responded appropriately to the macroeconomic policy challenges identified in previous Article IV consultations and policies have been consistent with Board's recommendations.** At the conclusion of the last consultation (June 2002), Directors commended the authorities for progress in resolving macroeconomic imbalances and in overcoming financial vulnerabilities identified in the 2001 FSSA. While considering sound the underlying position of the public finances, Directors expressed concern on spending slippages and recommended strengthening the budgetary process and the medium-term orientation of fiscal policy. The introduction of inflation targeting and a floating regime for the króna was welcomed by the Board and financial supervisory reforms recommended by the 2001 FSSA have been implemented.

11. **The 2003 consultation discussions focused on the medium-term economic policies required to accommodate the envisaged acceleration of demand while maintaining external competitiveness and macroeconomic balance.** The authorities considered that tight fiscal and monetary policies would be essential to forestall a resurgence of imbalances as activity strengthened, spurred by the planned large investment projects. They attached high priority to stemming a potential real overvaluation of the króna, which could otherwise prompt a "Dutch disease" through attendant competitiveness losses. To this end, there was agreement that, given the size and extended duration of the expected demand shock, fiscal policy would

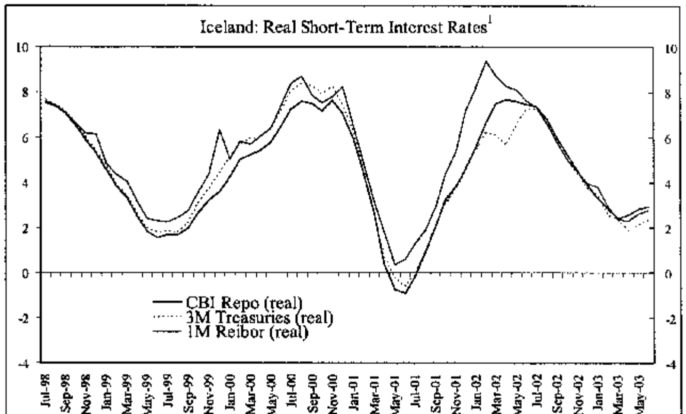
have to bear most of the burden of the necessary adjustment. In particular, the authorities saw a need for expenditure restraint and increasing structural fiscal surpluses following the profile of the envisaged investment activity. In this regard, staff welcomed the authorities' assurances of a prudent and gradualist approach to implementing some of the more potentially expansionary aspects of the coalition parties' electoral platforms—including tax cuts and increases in the loan-to-value ratios of the Housing Financing Fund (HFF).[1] Plans to expand labor immigration during the construction phase would also lessen resource strains. Although the economic program for the government's new period in office still awaited detailed development, it was apparent that the authorities faced an enviably broad consensus on the thrust of these policies among the private sector and social groups.

A. Monetary Policy

12. **Monetary policy, combined with recessionary conditions and the appreciation of the krόna, has successfully stabilized inflation close to its target level (Figure 5).** After an initial burst following the 2001 depreciation, the 12-month rate of inflation receded swiftly in 2002. As inflation came down, the CBI cut the policy rate gradually, while still maintaining a tight real stance until early-2003 (Figure 6). Short-term nominal market rates followed closely, while rates on inflation-indexed instruments experienced a lesser decline, partly reflecting their longer maturities but also suggesting that the fall in inflation expectations largely matched the rate cuts. Staff estimates that the ex post real policy rate, after dipping into negative territory in mid-2001, increased steeply in 2002, and has remained relatively high until recently.[2] The



Sources: Statistics Iceland; and Central Bank of Iceland.
1/ Nominal effective exchange rate measured as kronur per unit of foreign currency. An increase reflects depreciation.



Sources: CBI; Statistics Iceland; and staff estimates.
1/ Nominal rates less smoothed (HP-filtered) actual monthly inflation.

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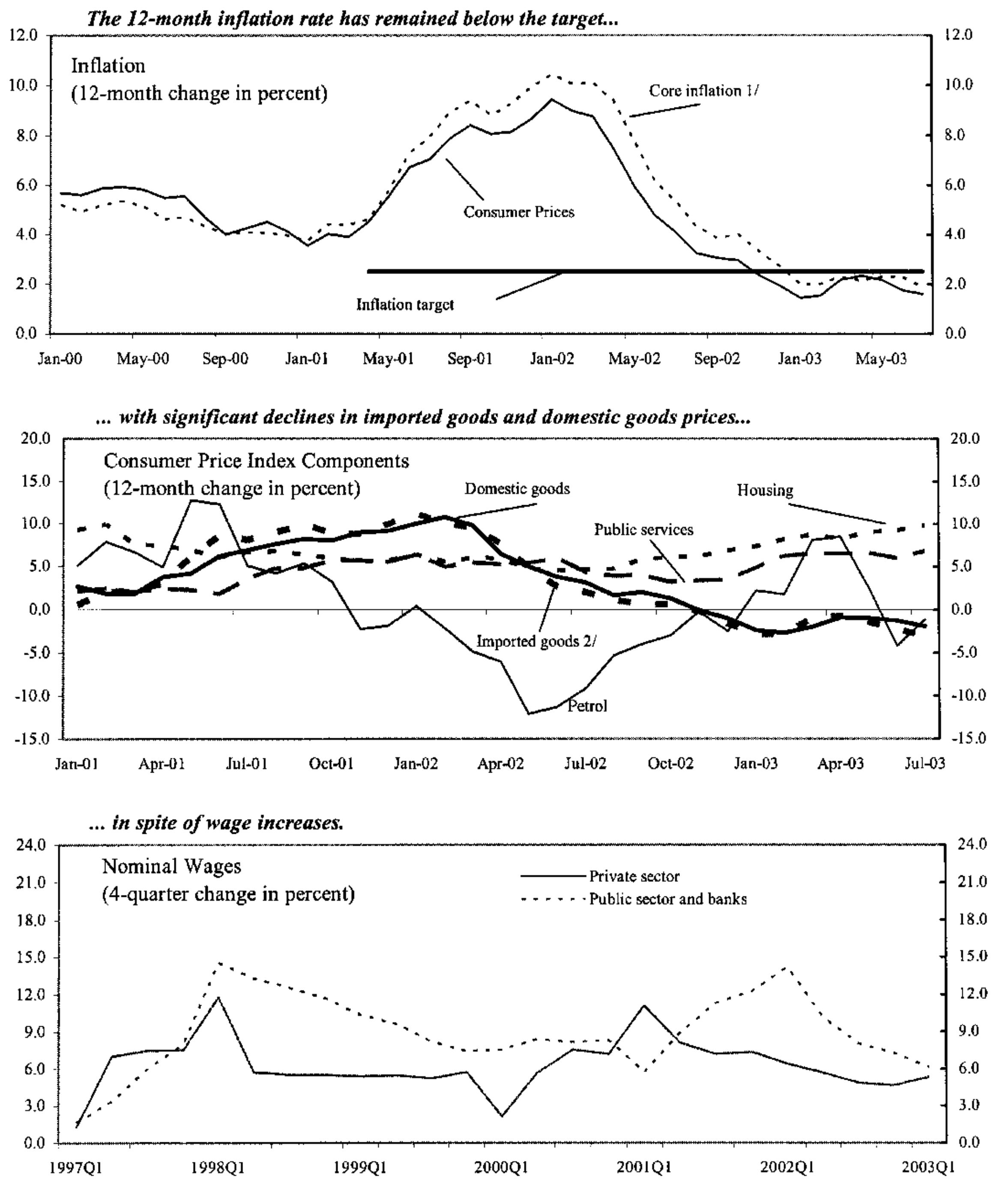
[1] The HFF is a public entity that provides mainly residential mortgages financed with government-guaranteed long-term inflation-indexed bonds. The HFF does not receive budget support, although it passes to borrowers the interest savings from lower risk premia.

[2] Staff estimates that the real policy rate was 2.9 percent in June 2003. The CBI typically gauges the real policy stance as the difference between the 14-day repo rate and the market-determined inflation premium on available up to 5-year Treasury maturities. On this measure, the real policy rate stood at 2.7 percent.

Figure 5. Iceland: Inflation and Wage Developments



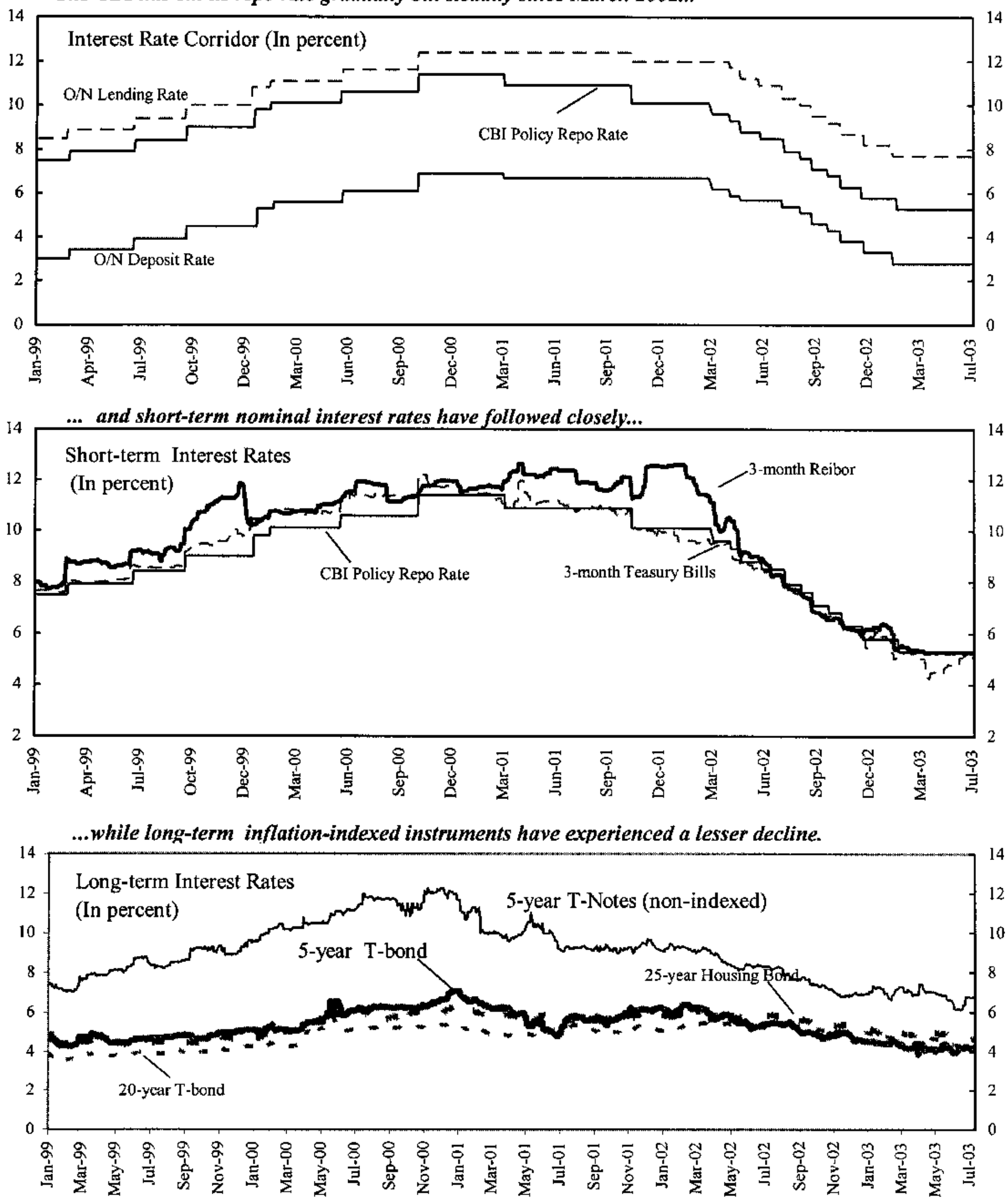
Source: Statistics Iceland.

1/ Consumer Price Index excluding agricultural products, fruits, vegetables, petrol and public services.

2/ Imported goods less alcohol and tobacco.

Figure 6. Iceland: Interest Rate Developments

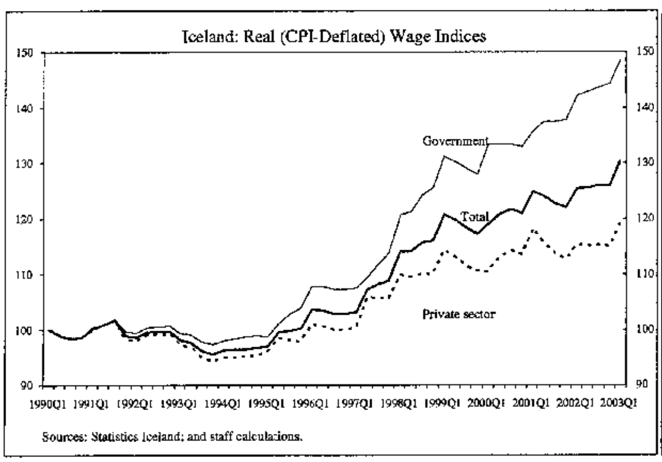
The CBI has cut its repo rate gradually but steadily since March 2002...

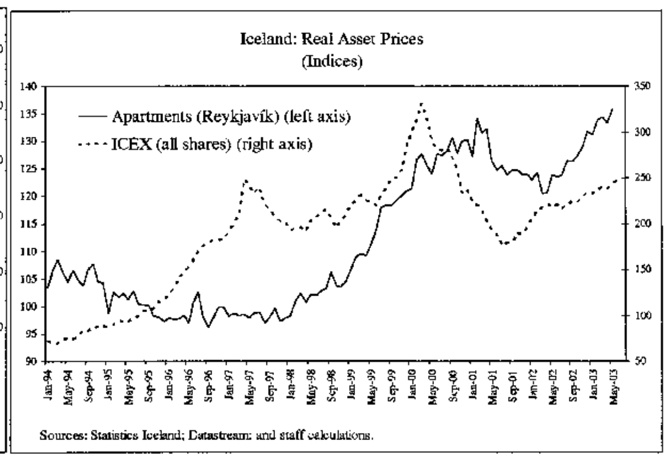


Source: Central Bank of Iceland.

12-month growth of credit to the private sector had declined to less than 5 percent by mid-2003—compared to rates in excess of 20 percent through mid-2001—owing mainly to demand conditions, but also to stricter lending criteria (Figure 7).

13. **Staff supported the CBI's broadly neutral policy stance, which struck a balance between incipient domestic demand pressures and the cooling effect of the appreciation of the króna.** On the demand side, consumption had edged up, although from low levels. Consumer confidence indicators were also firming, reflecting the announced investment projects, and real earnings and disposable income growth had been sustained during the recession, soft labor markets notwithstanding, owing partly to buoyant public wages (Figure 8). Both real housing and stock prices had resumed an upward trend in 2002—possibly mitigating negative wealth effects and the dampening impact of high private indebtedness. Finally, the lagged effects of earlier rate cuts and the recent reform of banks' reserve requirements would continue to impart a moderatetimulus.[3] However, although historical estimates would have indicated that the current policy stance was slightly accommodating, inflationary pressures had been countered by the increasing strength of the króna in 2002–03, which was expected to generate downward price pressures into 2004. As a result, core inflation indicators had shown little underlying inflationary pressure, with increases concentrated on imputed housing costs, petrol, and government-provided services, and with significant decreases in imported good prices. Inflation was 1.6 percent in July 2003 and the CBI projected that it would remain below target until end-2004.

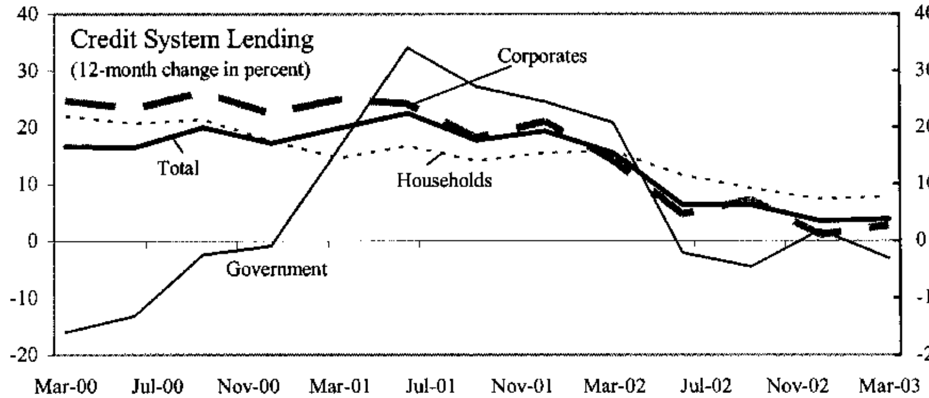




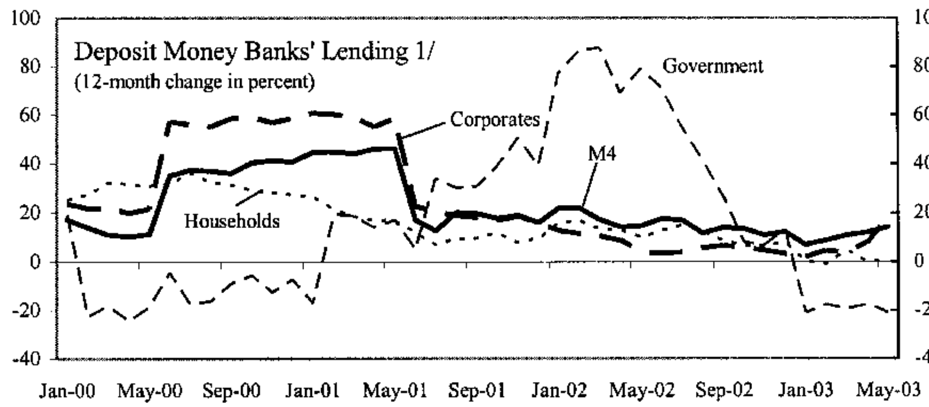
[3] In March and April, 2003, the CBI implemented changes in liquidity reserve requirements—aiming to bring them in line with international practices—equivalent to a release of banks' reserves of about 1 percent of GDP. This liquidity was offset by lower repo liquidity demand, but was expected to have an easing impact though lower lending rates and interest rate margins.

Figure 7. Iceland: Money, Credit and Liquidity Operations

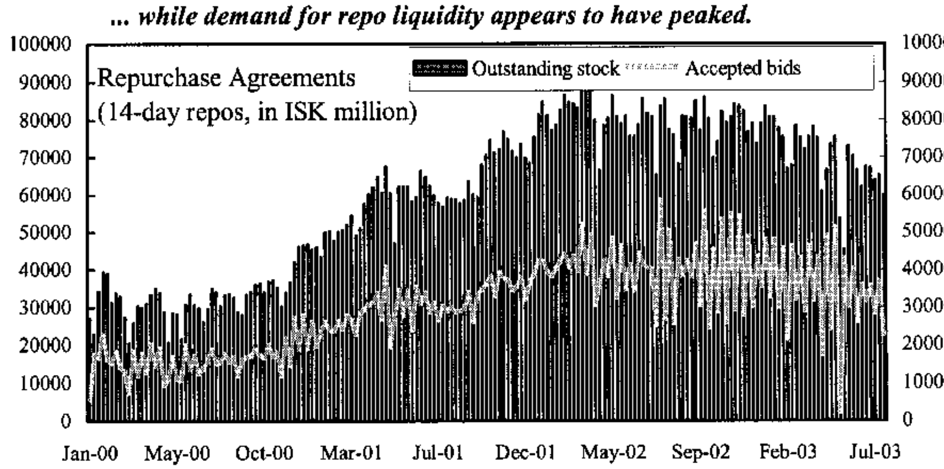
Overall lending to the private sector by the credit system declined during 2002...



... particularly household lending by deposit money banks...



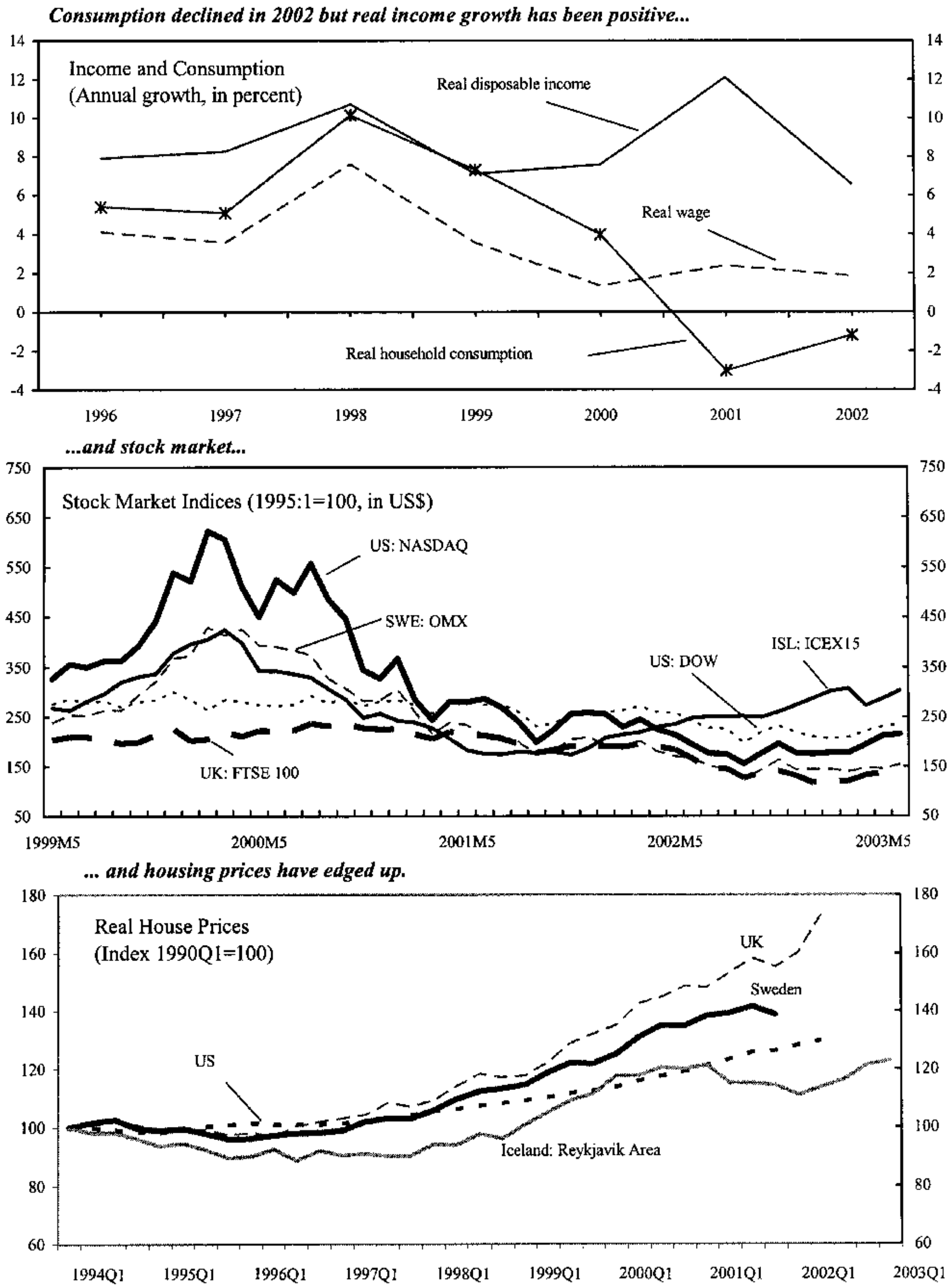
... while demand for repo liquidity appears to have peaked.



Source: Central Bank of Iceland.

1/ From January 2000, 12-month changes include lending by FBA investment bank. By way of its merger with commercial bank Íslandsbanki, FBA entered the Deposit Money Banks data set in June 2000.

Figure 8. Iceland: Income and Asset Prices



Sources: Statistics Iceland; Bloomberg; and IMF staff estimates.

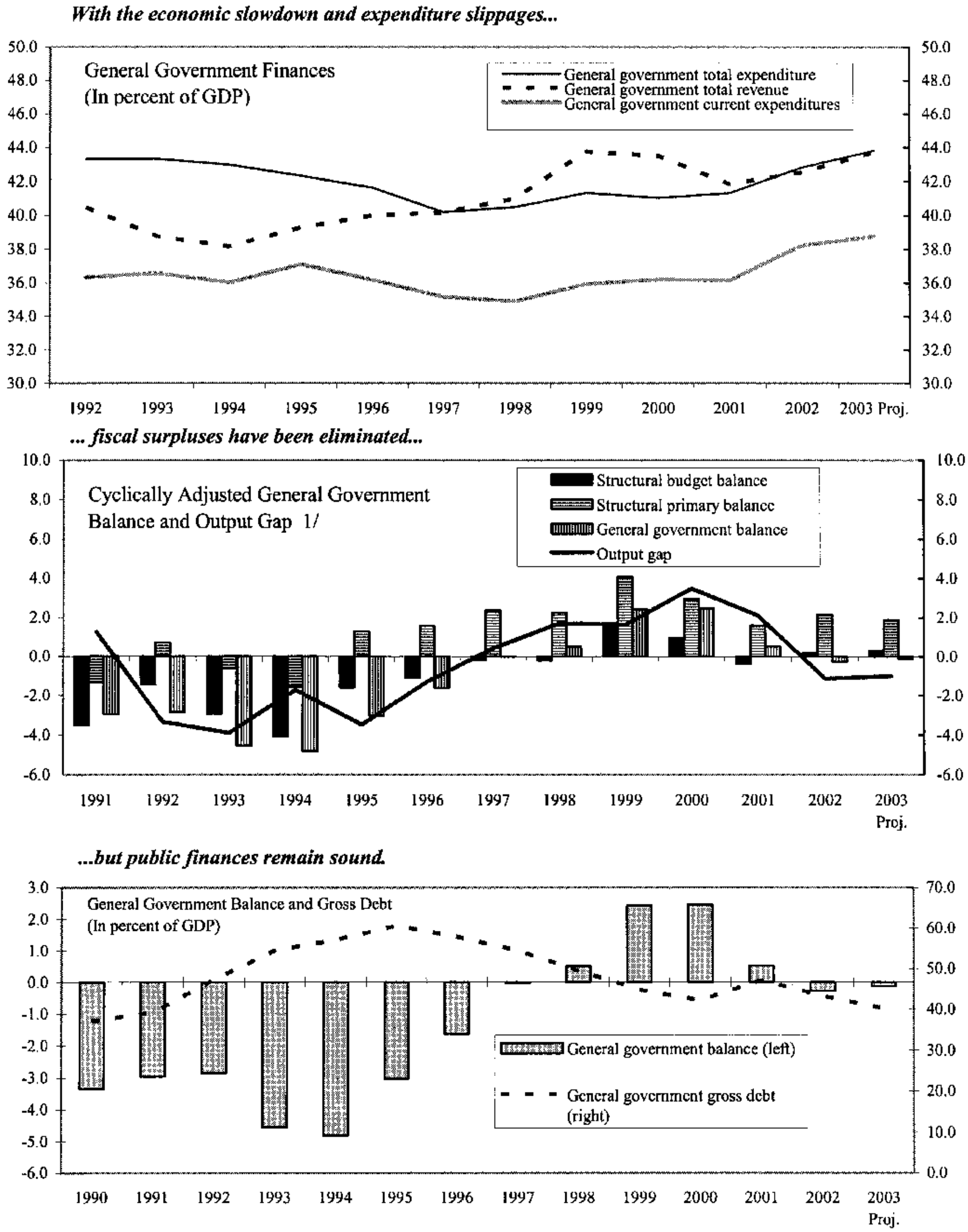
14. **As the upturn in activity takes hold, the CBI envisaged an interest rate tightening, with the rate remaining restrictive over the medium term.** This was also the expectation of market participants. The authorities agreed, however, that containing demand pressures over the extended period of project-related investments would mainly be the responsibility of fiscal and structural government policies, if Iceland's external competitiveness was to be safeguarded. This would allow monetary policy to remain the first line of defense against unexpected and short-term demand and external shocks. While welcoming this approach, staff expressed concern in this connection regarding plans to raise the loan-to-value ratios applied by the HFF in its mortgage lending—a measure included in the government's Policy Statement. The authorities agreed that this should be complemented with countervailing reforms to prevent a destabilizing expansion of HFF credit, which if not kept within strict limits could undermine CBI's liquidity management and contribute to higher real interest and exchange rates as well as to housing price increases.

15. **The successful stabilization of 2001–02 had consolidated confidence in the inflation targeting framework, which was being buttressed by market infrastructure reforms.** Through its policy actions, as well as through outreach activities and publications, the CBI had enhanced confidence in and understanding of the monetary policy framework by market participants, and inflation expectations—survey and market-based—appeared anchored around the CBI inflation target. Further in this direction, staff suggested consideration of holding regular rate-setting meetings of the CBI Board of Governors and publishing their minutes. Without ruling out such an approach in the future, the authorities indicated that the CBI quarterly bulletin was effectively used to explain policy decisions. The CBI was purchasing foreign currency through a pre-announced schedule to bolster its net foreign reserves, which should further cement confidence in its capacity to face unexpected liquidity shocks. The authorities had reformed the payments and securities settlement systems along best international practices, to increase their efficiency and safety. Staff recommend exploring reforms to promote the depth of domestic money markets, thus reducing banks' reliance on the CBI's repo facility and external borrowing for short-term funding needs.

B. Fiscal Policy

16. **Although the downturn in activity and expenditure slippages eliminated the fiscal surpluses experienced during the boom of the 1990s, the public finances remain sound with the budget close to balance and the debt burden low (Table 4, Figure 9).** The overall balance deteriorated from a 2½ percent of GDP surplus in 1999 to the broad balance expected for 2003. Staff estimates that about half of this change was the result of the automatic stabilizers. The remainder reflects hikes in health, education, and social spending—to a large extent, the result of wage increases. The cyclically-adjusted fiscal stance was somewhat restrictive in 2002–03 with revenue over-performance offsetting expenditure overruns—

Figure 9. Iceland: Fiscal Developments



Sources: Statistics Iceland; Ministry of Finance; and staff projections.
1/ Actual output minus potential output, in percent of potential GDP.

despite tax cuts passed in 2001.[4] General government debt has continued declining as privatization proceeds have been used to redeem debt and capitalize future pension liabilities.

17. **The authorities agreed that maintaining stability and competitiveness in the face of the upcoming demand expansion would require sustained budget surpluses over a number of years.** Based on the authorities' policy goals, staff discussed macroeconomic projections that limit the current account deficit to a level close to project-related imports, which could be mostly financed with envisaged foreign direct investment. These estimates suggest the need for increasing budget surpluses, peaking at about 3 percent of GDP in 2006, i.e., at levels similar to those experienced during the late-1990s economic upswing. This would require a structural retrenchment of about 2 percentage points of GDP, with the remainder contributed by the automatic stabilizers. Given the risks and uncertainties associated with the projections, staff emphasized that policies should be reassessed in the light of developments with a view to limit current account deficits. In particular, a more restrictive fiscal stance might be necessary if signs of overheating emerged. The authorities agreed with the thrust of this scenario, including the need to build up significant budget surpluses, but indicated that specific fiscal projections would not be developed until the 2004 budget discussions in Autumn 2003.

18. **The authorities explained that their focus would be on expenditure restraint and that the tax cuts announced during the elections would be implemented in a manner consistent with macroeconomic stability.** The authorities indicated that investment spending would be reduced, partly because some investment projects had been brought forward into 2003 to palliate unemployment. But cuts in current spending (as a percent of GDP) would also be necessary. Staff supported this view and pointed out that government wage increases had significantly outpaced those in the private sector for some time, which was not only unsustainable but particularly damaging in the run-up to the general 2004 round of private sector wage negotiations. In order to mitigate strains on the budget, staff suggested expanding the role of private provision of public services and of user fees and co-payments (which could be means-tested)—particularly in health and higher education. On other expenditure areas, the authorities indicated that the reduction in debt would prompt interest savings and that demographic prospects and a largely fully-funded pension structure insulated the public finances from the pressures anticipated in many other European economies (Annex I). The authorities explained that they intended to continue their tax reform agenda by lowering personal income tax, inheritance tax, and some VAT rates; eliminating wealth taxes; and possibly increasing saving incentives. But these were measures to be implemented over the government's period in office and their timing would be contingent, inter alia, on macroeconomic circumstances.

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[4] The 2001 tax reform covered cuts in personal and corporate income and wealth taxes, as well as a number of other smaller items, phased in during 2002–03 (SM/02/167).

19. **To facilitate fiscal consolidation, the authorities were intent on strengthening the medium-term orientation of the fiscal framework—a timely objective given the need to avoid an imbalanced policy mix and cement confidence in the stability of the economy.** The new government announced that the 2004 budget would be designed within an explicit multi-year context. The authorities were considering various possible medium-term fiscal rules and budget targets—which in their view should allow the unrestricted operation of automatic stabilizers. They also planned to switch to a national accounts-based budget formulation. Staff encouraged the authorities to advance in this direction and announce soon the details of a medium-term fiscal policy strategy that included ambitious budget balance targets buttressed by commitments to contain expenditure. Staff argued that, while confidence among market participants in the monetary policy framework was strong, considerable uncertainty still surrounded the intended fiscal path, particularly given the past reliance on supplementary budgets and the short-term horizon of the current budget process. This perceived risk of a lopsided policy mix might explain part of the still relatively high medium- and long-term interest rates.

C. Financial Sector

20. **Aided by a proactive supervisory response, the financial sector imbalances identified in the 2001 FSSA have subsided and Iceland's financial sector has returned to a more balanced risk profile (Table 5).** This was the main conclusion of this year's FSSA update. Icelandic banks recorded increased profits in 2001 and 2002, and encouraged by supervisory recommendations, bolstered their regulatory capital ratios, including through the issuance of new shares and qualifying subordinated debt. Savings banks experienced more difficult conditions than commercial banks, as their non-performing loans and credit losses were proportionately larger.

21. **The legal, regulatory, and supervisory frameworks have been significantly strengthened, and the new assessment found major improvements in the degree of compliance with Basle Core Principles (BCP).** The Financial Undertakings Act and other related pieces of financial legislation substantially extended the powers of the FME—including to mandate capital ratios in excess of 8 percent if warranted by a bank's risk profile—and FME resources had been appropriately increased. The FME implemented exhaustive bank-by-bank on-site examinations of loan classification, provisioning, and collateral valuation practices. As a result of the quick and comprehensive regulatory and supervisory changes implemented since the 2001 FSSA, Iceland is now compliant or largely compliant with all but one of the BCP—the exception owing to the lack of a country risk reporting system. Staff encouraged the authorities to remain vigilant in the coming years in light of the potential for emerging macroeconomic tensions, including from high levels of indebtedness.

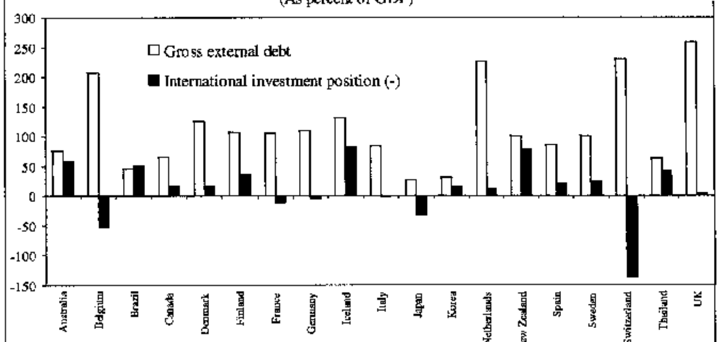
22. **The discussions also touched upon some areas that could benefit from additional improvement.** The HFF, although under the oversight of the Ministry of Social Affairs and Parliament, was exempt from regular prudential laws and regulations, such as capital requirements, provisioning rules, etc. The authorities agreed with the staff's recommendation that the HFF should be subject to explicit prudential guidelines regarding its operations. Also,

careful monitoring of some weaker savings banks would continue to be warranted to ensure improvements in their management and solvency position, notwithstanding their minimal systemic importance.

D. External Position

23. **The relatively high external debt of Iceland corresponds mostly to the private sector and, in the authorities' view, has its roots in low household savings (Annex II).** At end-2003Q1, Iceland's gross external debt amounted to about 127 percent of GDP and net external liabilities (as measured by the negative net international investment position) were 80 percent of GDP (Table 6). External debt rose rapidly during the 1998–2000 economic boom and its ratio to GDP was bolstered by the 2001 depreciation of the króna, edging down only recently. Most of this gross debt—95 percent of GDP—corresponds to the private sector, of which the banking sector accounts for 67 percent of GDP. The authorities considered that the main reason of the high external debt of Iceland vis-à-vis other comparable economies had been a rapid raise in household indebtedness following the financial liberalization of the mid-1990s. Household debt increased from 47 percent of GDP to 98 percent of GDP in 1990–2002. Non-financial corporations' debt had also increased substantially, although their debt-to-equity ratios had been relatively stable. With both a low supply of domestic savings and a high demand for credit, the banking sector had intermediated foreign savings—helped by the good credit ratings of Icelandic banks and the country as a whole. Banks, however, have limited open foreign currency positions and the exchange rate risk lies with the ultimate borrowers, which are mostly organically hedged corporations, such as fisheries and other exporters.

Iceland: Gross External Debt and Net International Investment Position
International Comparisons 1/
(As percent of GDP)



Sources: Central Bank of Iceland; International Financial Statistics; and Balance of Payments Statistics, IMF.
1/ Data for Australia, Iceland, Finland and the UK are as of end-2002; data for Sweden are end-2000; all others are end-2001. A positive gross external debt or a positive international investment position indicate a liability.

24. **As to underlying trends, the authorities explained that the increase in private sector debt was rooted in fundamentals.** Regarding the household sector, the age profile of the Icelandic population is younger than in most other European countries, which reduces aggregate saving due to life-cycle behavior.[5] Also, the pension system is mainly private and

[5] Staff's cross-country analyses supported the view that the deviation of Iceland's international investment position with respect to comparable economies was largely explained by demographic factors (Annex II).

highly capitalized, underpinning household confidence. When pension and other assets are included, the net worth of households has increased despite the parallel increase in indebtedness.[6] The increase in corporate debt corresponds to rapid asset growth during the past decade, including takeovers and expansion abroad.

25. **Moreover, external liabilities are well regulated and carefully monitored.** Iceland has strict reporting and prudential banking regulations regarding liquidity ratios and open foreign-currency positions—consistent with EU financial directives, which Iceland has adopted as part of the EEA. Moreover, the CBI monitors closely banks' short-term obligations on original and residual maturity bases, and liquid assets. On the asset side, banks' foreign currency-denominated portfolios are strong, as demonstrated by their good performance during the recent sharp depreciation of the króna.

26. **The authorities concurred that policies should aim to increase national saving, but did not expect a rapid reduction of private indebtedness.** The authorities noted that, although most of the external debt of Iceland corresponds to the private sector, fiscal retrenchment would help to increase national saving and contribute to curb external liabilities. Indeed, staff projections envisage a steady decline of gross and net external liabilities over the coming years. Still, the authorities argued that, since borrowing levels are not caused by market distortions, lax supervision, or weak public finances, but are possibly an equilibrium outcome, the policy levers available to affect credit and associated external borrowing directly are limited. They also argued that given these factors, and since private sector balance sheets are strong, the level of indebtedness is manageable and should not be a cause of systemic stress. Staff acknowledged these reasons and concurred that tight macroeconomic policies aiming to limit current account deficits and a strong prudential framework are the primary means to address the external exposure. Staff noted, however, that this exposure highlights the risks associated with a rekindling of external imbalances and narrows the room for policy slippages. These risks are confirmed by standard external sustainability stress tests analysis (Appendix IV). This analysis shows that, among the stress test scenarios, those that assume a pronounced depreciation or a repetition of the large current account deficits of the late 1990s result in the highest debt growth.[7]

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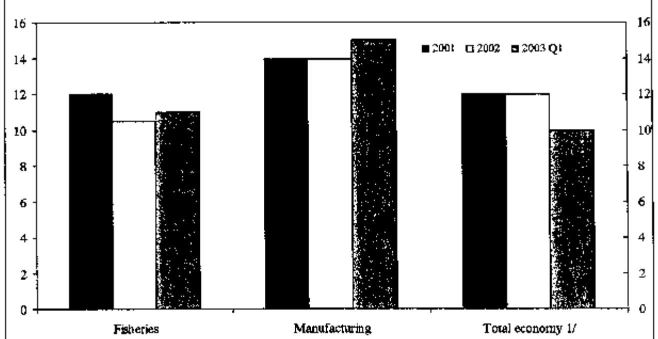
[6] In 1990–2002, household gross debt increased from 80 percent to 176 percent of disposable income, while net worth (including pension fund assets) increased from 287 percent to 298 percent. Households' leverage, however, also increased.

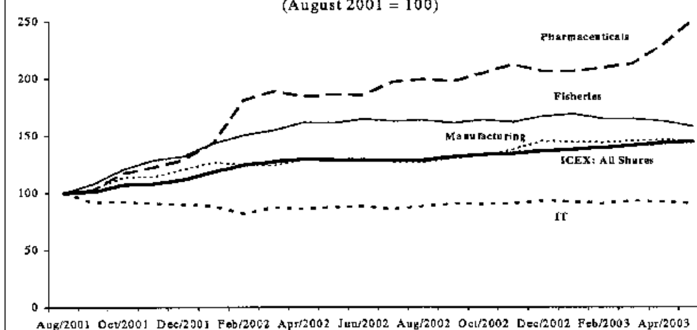
[7] The standard stress tests performed explore the evolution of external gross debt under relatively extreme, not necessarily likely scenarios.

27. **On the external side, the discussions also covered exchange rate developments, which had recently eroded the windfall export profits of 2001.** The pronounced 2001 depreciation of króna prompted unusually high profits in export-oriented activities. Conversely, the subsequent appreciation has caused a decline in export profitability—particularly among fisheries and the tourism industry. The impact of exchange rate volatility, however, was partly dampened by shifts in destination markets towards the euro area and by the foreign-currency denomination of most of the liabilities in export industries. Also, the built-in profit-sharing clauses in the wage arrangements of the fishing industry provided an additional buffer.

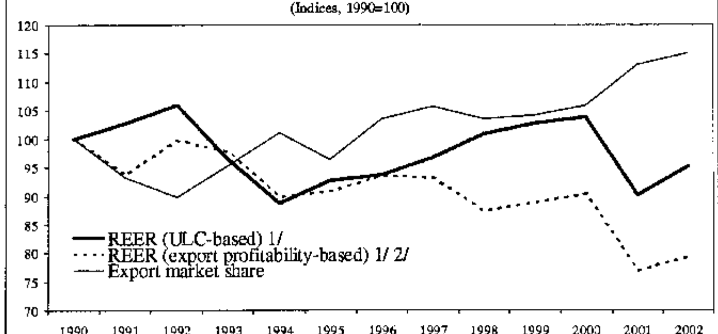


Sectoral Profitability
(Gross profits as percent of revenue)
Source: Ministry of Finance.
1/ Excluding finance and insurance.

28. **Looking forward, the authorities and private sector analysts considered that, at the exchange rate prevailing around the time of the mission (which has since then depreciated somewhat), export industries would remain competitive.** This assessment was born out by sustained export performance and by the stock prices of most listed exporting companies, which had generally recovered since the stock market trough despite the strengthening of the króna. This performance is consistent with the remarkable flexibility shown by export industries over the last decade, reflected in increased diversification towards high value-added export activities such as pharmaceuticals, high technology manufacturing, and financial and business services. Staff estimates of relative export profitability vis-à-vis trading partners and market share indicate a continual improvement since the mid-1990s. In particular, the fishing sector has undergone substantial consolidation over a number of years, seeking increased efficiencies and moving up



Iceland: Stock Market Indices
(August 2001 = 100)
Source: Datastream.



Iceland: Measures of Competitiveness
(Indices, 1990=100)
Sources: Central Bank of Iceland; Statistics Iceland; and staff estimates.
1/ Real effective exchange rates. A decline indicates more competitiveness.
2/ Ratio of the ULC share in Iceland's export prices relative to partner countries. See Lipschitz and McDonald: "Real Exchange Rates and Competitiveness" (Empirica-Austrian Econ. Papers, 1992).

in the value added chain.[8] Profitability prospects are also supported by an ongoing recovery in fish stocks, which resulted in a recent 11 percent increase in the total allowed fish catch for next year. Market analysts, however, expected that a stronger króna would cause stress in specific export sectors, forcing further consolidation and restructuring—particularly in fisheries.

E. Structural Reforms and Other Issues

29. **The privatization agenda had continued to advance rapidly, but progress in other structural reforms appeared more protracted.** In 2002–03, the government successfully divested its remaining stakes in banking, opening the door to efficiencies in the sector through mergers and acquisitions. Having passed all necessary enabling legislation, the authorities expected prompt privatization of the telecommunications company, which awaited favorable market conditions. Progress had been slower in the rationalization and liberalization of the electricity sector, where the authorities were in the process of introducing the relevant EU directives. The authorities agreed to consider reforms of the HFF, which in the staff's view should aim to limit gradually the HFF role to strictly social objectives and open the bulk of the mortgage market to banks.

30. **Staff encouraged faster progress on trade and agriculture liberalization in the context of the Doha round of multilateral world trade negotiations, although the authorities envisaged a more gradualist approach.** There had been a significant decline in the overall level of agricultural support in Iceland, from 5 percent of GDP in the late 1980s to 1.6 percent of GDP in 2001, and a partial shift away from quotas and other relatively more distorting trade barriers to direct budgetary income support payments. Nevertheless, agricultural protection remains among the highest in the OECD. The authorities pointed out a number of factors inhibiting bolder reform efforts, including possible rural poverty traps and regional inequality. Staff argued, however, that the current system unduly distorts resource allocation and burdens consumers—as suggested by the recent substantial decline in retail prices as tariffs on vegetables were replaced by direct budgetary support.

31. **Iceland conforms to the standards of the Anti-Bribery Convention, and has a comprehensive system to combat money laundering and the financing of terrorism.** Iceland was among the first to adopt the Anti-Bribery Convention and implement enabling legislation, which the OECD considers conforming to the standards of the Convention. It had additionally undertaken a Phase 2 review, and the authorities were considering its recommendations. Iceland was also among the first to complete the Fund's Anti-Money Laundering/Combating the Financing of Terrorism questionnaire. The Financial Action Task Force (FATF) considered that the Icelandic anti-money laundering system met most of the

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[8] The proportion of quota rights held by the largest 10 fishing companies increased from 27 percent in 1995 to 53 percent in 2002.

essential requirements of the initial 40 recommendations. Subsequently, Iceland had passed additional legislation to adopt the recent "40+8" FATF recommendations.

32. **Iceland grants duty-free access to imports from least developed countries and has increased Official Development Assistance (ODA).** Imports from least developed countries are afforded equal treatment to those from the EEA. Projected at 0.16 percent of GNP, ODA has continued to increase, albeit modestly.

IV. Staff Appraisal

33. **The Icelandic economy has overcome the macroeconomic imbalances that developed at the end of the 1990s and is beginning to rebound.** The 2001 depreciation of the króna prompted a redirection of activity toward exports and curtailed domestic demand. As a result, the large current account deficits of previous years were eliminated and the króna recovered in 2002–03, helped by tight interest rates. Simultaneously, the 12-month rate of inflation was swiftly brought down to the 2½ percent target. The real effective exchange rate has appreciated since early-2002, eroding the windfall profits of export industries. However, at the levels prevailing in mid-2003, it did not compromise external sustainability. Led by a pickup in consumption, output appears to be bottoming out after a ½ percent decline in 2002.

34. **The authorities are to be commended for the successful stabilization of the economy—to a great extent, the result of strong monetary and financial supervisory frameworks and stability-oriented structural reforms.** The adoption in March 2001 of inflation targeting, independence of the CBI, and a floating exchange rate regime was crucial in subduing inflationary pressures and cementing confidence. The FME, aided by the prompt passage of supporting legislation, proved instrumental in overcoming financial vulnerabilities reported in the 2001 FSSA. Overall, the remarkable economic adjustment of 2001–03 bears witness to the success of a decade of structural reforms focusing on market and external liberalization, public finance consolidation, privatization, and rationalization of the public sector.

35. **The prospects are for a resumption of growth of about 2¼ in 2003, accelerating through the medium term as large foreign investments take place—while risks will tilt to the upside.** The investment projects in smelting and associated energy-generating facilities will impart a significant demand stimulus. Associated capital inflows are expected to reopen a current account deficit broadly equivalent to direct project-related imports—peaking in 2005–07. In the near term, a hesitant global recovery and debt overhang may weaken somewhat the upswing in activity. But over the medium term, the main risks will remain a reemergence of earlier imbalances driven by excessive domestic demand growth. Pressure on resources could result in inflationary strains and a real over-appreciation of the króna, eroding export competitiveness and causing excessive current account deficits.

36. **Consequently, although the public finances remain sound, the stability of the economy will require a medium-term plan for fiscal consolidation in the context of a strengthened fiscal policy framework.** Thus, the authorities' intention to build up budget

surpluses to counteract the envisaged demand push is welcome and should underpin the 2004 budget proposal. This would leave room for monetary policy to play its stabilization role while avoiding sustained high interest rates. Also, it would mitigate current account deficits, providing for a gradual decline in external debt. Specifically, the authorities' stability objectives will require focusing first on implementing the necessary restraint in current spending. The planned tax cuts should be introduced only once commensurate additional expenditure savings have been identified. In addition, increasing the scope of means-tested user fees and co-payments as well as the private provision of currently publicly-provided services would usefully reduce pressures on the budget. The authorities' plan to frame the 2004 budget within a multi-year horizon is welcome. In this regard, explicit cyclically-adjusted balance targets and expenditure limits would crucially contribute to the predictability and credibility of budget policies. Fiscal transparency will be enhanced by the planned budget adoption of national accounts methodology.

37. **The current broadly neutral monetary stance is appropriate, but will need to tighten over the medium term.** The sustained reduction in interest rates over the past year was appropriate in light of the easing of activity, the firming of the króna, and the drop in inflation. But as the recovery takes hold, the monetary stance will need to tighten and remain restrictive over the coming period, as is the policy intention of the authorities. A destabilizing expansion of HFF credit, which could be prompted by the planned relaxation of its lending criteria, should be avoided.

38. **The recent successful stabilization has consolidated confidence in the monetary policy framework and anchored inflation expectations.** Further, market infrastructure has been reinforced by the adoption of reforms aiming to minimize risk in payment systems and bring them in line with international practices. And the ongoing CBI program of pre-announced foreign exchange purchases to shore up net reserves will strengthen the capacity to deal with unexpected shocks. Further along this lines, the transparency of monetary policy would be enhanced by setting regular rate-setting meetings and publishing their minutes. Also, the authorities could consider reforms to deepen money markets, thus minimizing the need for banks' resort to the CBI repo facility and short-term foreign funding.

39. **Financial vulnerabilities identified in the 2001 FSAP have substantially subsided.** The banking sector increased profits in 2001–02 and bolstered its capital base. The authorities took determined steps to strengthen the prudential supervisory framework and implemented many of the 2001 FSSA recommendations. As a result, the FSAP follow-up assessment found major improvements in BCP compliance.

40. **Iceland's high private external debt levels, while not a cause of systemic concern at this point, pose potential medium-term vulnerabilities.** Private sector borrowing appears rooted in demographic trends and the buildup of substantial private assets—rather than weak public finances or market distortions. In this respect, the authorities' approach, emphasizing macroeconomic policies that limit current account deficits, strict prudential supervision, and close monitoring of banks' liquidity positions, is appropriate. The high external liability

position, however, underscores the risks associated with potential external imbalances and reduces the room for policy slippages.

41. **The authorities have made commendable progress on their privatization program, but agricultural liberalization could be accelerated.** The swift divestment of the public stake in banking has already prompted increased sectoral efficiencies and the prospect of telecommunications privatization is welcome. The authorities are encouraged to intensify efforts at agricultural trade liberalization, where distortions, as well as potential efficiency and welfare gains are large.

42. Staff welcomes the **duty-free access** accorded to imports from least developed countries and encourages the authorities to continue increasing **ODA** towards to U.N. target of 0.7 percent of GNP. Iceland enjoys a well-recognized international standing for its efforts to fight **money laundering, the financing of terrorism, and other financial crime**.

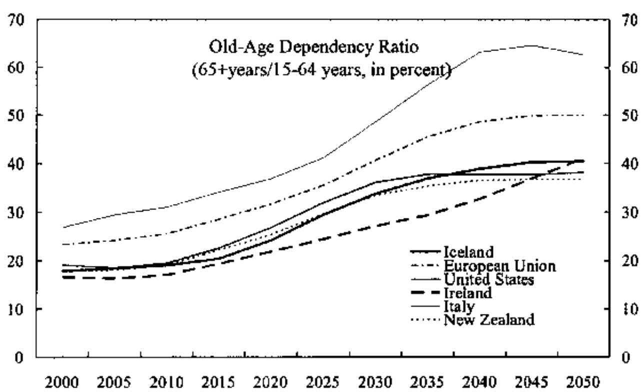
43. Given the positive assessment of the FSAP follow-up and the successful correction of earlier macroeconomic imbalances, it is recommended that Iceland return to a 24-month cycle for Article IV consultations.

Iceland's Demographic and Pension Prospects[1]

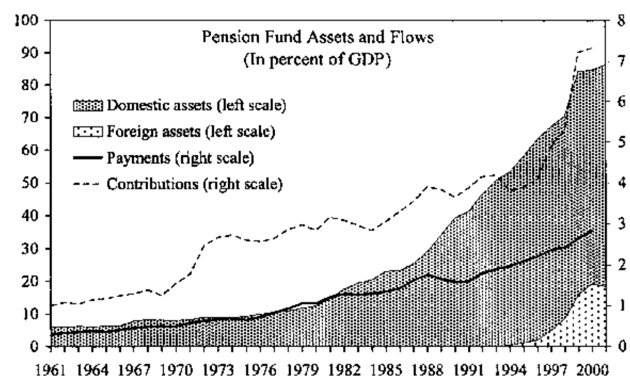
Demographic and pension prospects in Iceland are relatively benign, in comparison to most continental European economies. This largely reflects two factors: the projected increase in Iceland's old-age dependency ratio is lower than in other economies; and the pension system is firmly based on compulsory fully-funded defined-contribution private pension schemes. Thus, the expected budgetary impact of population aging is expected to be quite limited.[2]

Iceland's population is comparatively young, with an old-age dependency ratio below most other European countries, and more similar to those in Ireland, New Zealand, and the United States. Moreover, the projected increase in this ratio is relatively small and is of less consequence in Iceland than in economies with pay-as-you-go pension systems. Additionally, Iceland has relatively high elderly labor force participation rates, reflecting both a high statutory retirement age (67 years for most workers) and high effective retirement ages.

Of equal or more importance is Iceland's use of a three pillar system. The government provides a basic pension equivalent to about 10 percent of average earnings, and a means-tested supplementary pension, both financed out of tax revenues. The second pillar comprises mainly private pension funds, with mandatory contributions of at least 10 percent of wages, invested in a variety of assets, including an increasing share of foreign claims. Contributions into these (and optional tax-advantaged third pillar supplementary pensions) are presently more than double the pension payments from these funds, resulting in a rapid accumulation of assets, currently in excess of 80 percent of GDP.[3] Once these schemes mature, total assets are anticipated to exceed 150 percent of GDP, with pensions equivalent to 50–60 percent of full-time earnings (in addition to the basic pension), thereby leading to a phasing out of public supplementary pensions.



Source: International Bank for Reconstruction and Development.



Source: Central Bank of Iceland

[1] Prepared by Mark Lutz.

[2] Health care expenditures, however, may face aging-related pressures.

[3] The government has made additional contributions in recent years to fund projected liabilities to the old, pay-as-you-go public sector pension system, while newly hired employees (and those opting to switch from the old system) pay into a fully-funded scheme. It is expected that 25 percent of government liabilities will be funded by the end of 2003.

What Explains Iceland's High Levels of External Indebtedness?[1]

1. Iceland's external liabilities and short-term debt has increased rapidly in the past years. Ultimately, low household's saving rates explain these levels of indebtedness. During the boom years banks resorted to foreign borrowing in other to extend credit to the corporate sector while domestic liabilities were increasingly devoted, directly or indirectly, to household lending.

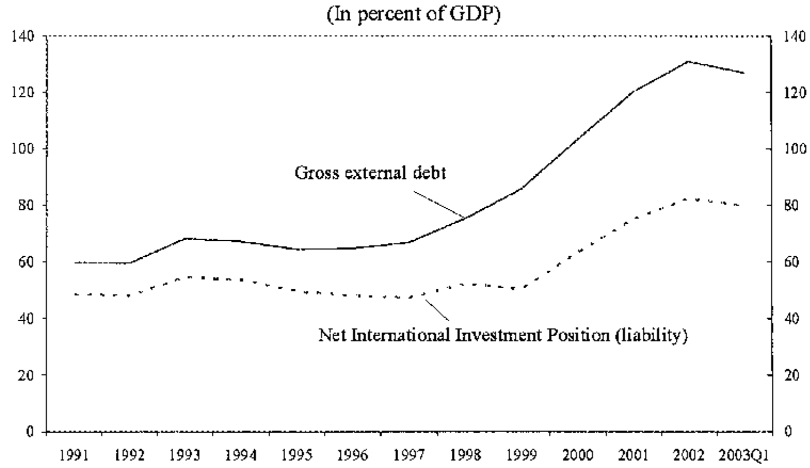
2. Although as a result Iceland's external vulnerability has increased, there are some mitigating factors that make external risks manageable. Currency risk lies mainly with organically hedged non-financial corporations—either through direct borrowing or intermediated by banks. Most banks' foreign borrowing is on-lent to these corporates or invested in foreign assets. Household debt, on the other hand, is denominated mainly in domestic currency and, when in long-term maturities, it is indexed to inflation.

3. This note takes a closer look at the factors behind Iceland's high levels of indebtedness and provides a brief assessment of the balance sheets of households, and of the corporate and banking sectors.

What do the data tell us?

4. **Iceland's gross external debt has risen sharply since the mid-1990s, more than offsetting the increase in foreign assets** (Figure 2.1). As a result, both external debt and net liabilities remain high by historical and international standards representing about 127 and 80 percent of GDP respectively, at end-March 2003.[2] Only 2 percent of Iceland's external debt is denominated in Icelandic krónur.

Figure 2.1 Iceland: External indebtedness
(In percent of GDP)



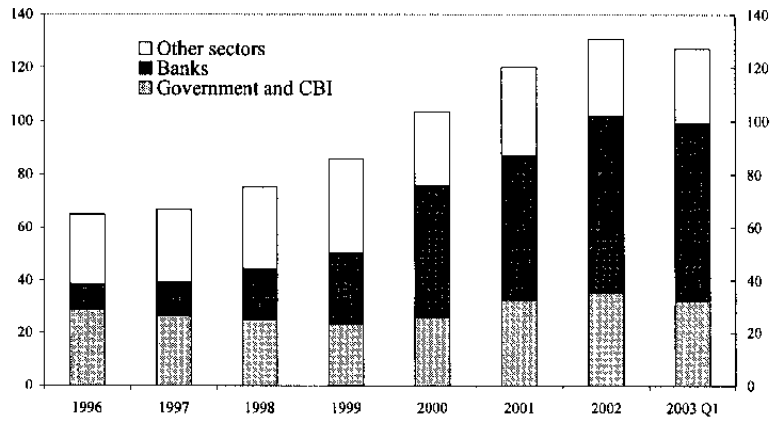
Source: Central Bank of Iceland.

[1] Prepared by Marialuz Moreno Badia.

[2] Net liabilities are measured as the negative of the net international investment position (IIP).

5. **Most of Iceland's gross external debt growth relate to the banking sector** (Figure 2.2). External debt of banks has increased more than twofold since end-1999, rising to 67 percent of GDP at end-March 2003, and accounting for about half of total gross external debt. Banks' foreign currency risk is limited by prudential regulation on open positions and the application by banks of selective criteria for qualifying borrowers, like restricting foreign currency loans to borrowers who are organically hedged.[3] By contrast, public external debt has declined as a result of fiscal surpluses and the use of privatization receipts to retire external debt and stood at 31 percent of GDP at end-March 2003. Corporate external indebtedness has also declined, accounting for 28 percent of GDP.

Figure 2.2 Estimated External Debt by Sector
(In percent of GDP)



Sources: Central Bank of Iceland; and staff estimates.

6. **Short-term debt has increased sharply as percent of GDP, pari passu with total debt, keeping the maturity structure broadly stable** (Table 2.1). As of end-2002, Iceland's short-term debt (on a residual maturity basis) was estimated at 52 percent of GDP against 27 percent three years earlier. The highest increase in short-term financing resides within the financial sector where banks owed about 36 percent of GDP in short-term maturities at end-2002 reflecting the increased intermediation of flows facilitated by banks' access to

Table 2.1 Iceland: Gross External Debt 1/
(In percent of GDP)

	1997	1998	1999	2000	2001	2002	2003 Q1
Total gross external debt	66.8	75.3	85.7	103.4	120.3	131.0	127.1
By (residual) maturity							
Short-term	18.7	19.5	26.7	35.3	39.7	51.5	...
Medium and long-term	48.1	55.8	59.1	68.1	80.6	79.5	...
By (original) maturity							
Short-term	12.8	11.9	15.6	18.9	22.9	30.2	34.5
Medium and long-term	54.0	63.4	70.1	84.5	97.4	100.8	92.6
By currency							
Domestic	0.4	0.4	1.6	0.8	1.3	2.9	...
Foreign	66.4	75.0	84.2	102.6	119.0	128.1	...

Source: Central Bank of Iceland
1/ Partly estimated using Central Bank of Iceland data.

[3] Total foreign exchange exposure is capped at 30 percent of capital by regulation. For each currency, the exposure is limited to 15 percent, except for the U.S. dollar and the euro which have a limit of 20 percent. Moreover, regular capital charges also apply.

international capital markets owing to high credit ratings (Table 2.2).

Table 2.2. Iceland: Banks' Ratings

	Moody's 1/			Fitch 2/	
	Long-term	Short-term	Financial strength	Long-term	Short-term
Íslandsbanki-FBA hf.	A1	P-1	B-	A	F-1
Landsbanki Íslands hf.	A3	P-1	C	A	F-1
Kaupthing Búnadarbanki hf	A3	P-1	C	...	...

Sources: Moody's; and Fitch.

1/ Maximum rating on long-term is Aaa. Maximum rating on short-term is P-1. Maximum rating on financial strength is A+.

2/ Maximum rating on long-term is AAA+. Maximum rating on short-term is F1+.

7. **Iceland's young population seems to be a key factor explaining its relatively higher levels of indebtedness.** Staff estimates—based on work by Lane and Milesi-Ferretti (2001)—suggest Iceland's age structure alone can account for 60 percent of its higher external liabilities relative to other industrial countries.[4] In theory there are several channels through which a younger population can affect net foreign asset positions. For example, countries with younger workforce may save less, given that retirement is still far away, to smooth consumption and invest more, among other things in housing.

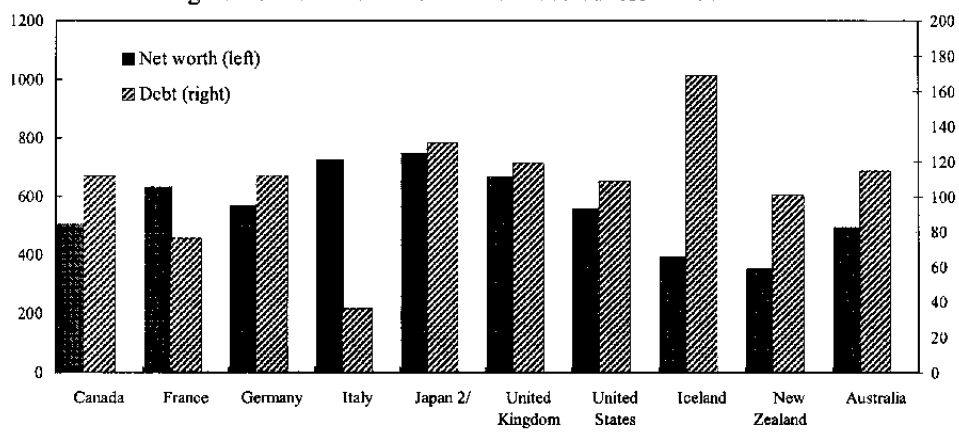
Balance Sheets

8. ***Households.* Over the last decade, household balance sheets have changed dramatically, influenced by the spread of indexation of financial instruments and housing benefits.** Household debt to the financial system increased from about 80 percent of disposable income at the beginning of the 1990s to an estimated 176 percent at end-2002. Mortgage debt remains the major household liability (around 70 percent of the stock), and although it is indexed, debt servicing costs are still relatively low due to the preferential rates offered by the housing system and pension funds to their members. Correspondingly, housing is the main household asset representing about 66 percent of household's net worth. Although household debt is relatively high and net worth relatively low compared to other countries (Figure 2.3), household default rates in Iceland have been relatively low in the past, even in times of high nominal interest rates, and income prospects for the near term are positive. A possible factor explaining household balance sheets is the build up of pension

[4] Lane, Philip R., and Milesi-Ferretti, Gian Maria, 2001, "Long-term Capital Movements," IMF Working Paper 01/107 (Washington: International Monetary Fund Working Paper). In their model, shifts in relative output levels, the stock of public debt and demographic factors explain the evolution of net foreign asset positions. If all these factors are considered, Iceland's actual data fall within the 95 percent confidence interval of the simulated model.

assets, representing 88 percent of GDP as of end-2002, which may have induced an increase in household's leverage.

Figure 2.3 Household Wealth and Indebtedness in 2001 1/



Sources: OECD Economic outlook, December 2002; Reserve Bank of New Zealand, Reserve Bank of Australia; and Central Bank of Iceland.
1/ As percent of disposable income excl. pension assets.
2/ 2000 data.
3/ Data on net worth is net financial wealth.
4/ Data on debt is house loans.

9. ***Non-financial corporations.*** **Balance sheets indicators for the non-financial corporate sector are good despite the distress experienced by some companies during 2002** (Table 2.3). During the second half of the 1990s, corporate leverage increased. In fact, measured as percentage of GDP, corporate debt went from 80 percent in 1997 to 120 percent in 2001. However, net worth increased at the same time, and debt-to-equity ratios for listed non-financial sector firms declined in 2002 to levels unseen since 1996. Profitability has continued to be high except for the retail and service sectors, where there has been an increase of corporate bankruptcies reflecting weak economic conditions.

Table 2.3. Iceland: Corporate Balance Sheet Indicators

	1997	1998	1999	2000	2001	2002
Debt as percentage of equity[1]	1.96	1.85	1.96	2.21	2.27	1.72
Profitability (EBITDA/turnover)[1 2]	8.0	8.2	7.3	9.2	10.2	10.2
Fisheries sector	16.5	17.8	14.7	17.2	27.1	23.3
Retail, construction and services	9.3	4.7	5.6	14.7	5.6	(1.0)
Manufacturing and production	10.7	9.3	7.5	13.2	13.4	13.6
Information technology	.	6.1	8.7	9.6	17.4	18.4
Number of private bankruptcy rulings	197	248	253	298	361	565

Sources: Central Bank of Iceland; and Lánstraust credit rating agency.
1/ Publicly listed companies (excluding banks).
2/ Earnings before interest, taxes, depreciation, and amortization

10. ***Banks.*** **Icelandic banks balance sheets are strong:**

- In spite of the economic slowdown banks were profitable in 2002, registering a return on total assets of 1.1 percent and return on equity of 18.1 percent.

- Banks are also well capitalized and, after bolstering their regulatory capital ratios in 2001 and 2002, they maintain total capital of 12.1 percent and tier-one capital of 9.7 percent of risk-weighted assets.

- As anticipated, asset quality has deteriorated since 2000, especially in the consumer and retail sector as a result of a weak domestic demand. However, there are signs that the loss phase of the credit cycle may have reached its peak. The accuracy of reported NPLs and the adequacy of loan loss provisions has been verified by the FME through focused on-site examinations that reviewed the loan performance, collateral valuation and provisions in all deposit taking institutions.

- Foreign currency loans—78 percent of which are to the corporate sector—have performed better than anticipated because of the transitory nature of the depreciation experienced in 2000–01 and the banks' strict lending criteria.

- Liquidity risk is limited given the restrictive central bank regulations based on a maturity ladder and involving an overall assessment of the payment structure of all assets and liabilities, including off-balance sheet items.[5] The ratio of short-term assets to liabilities with maturity shorter than 3 months was 1.2 as of April 2003.

[5] Four time bands are defined: liquid within 1 month, 1–3 months, 3–6 months and 6–12 months. Banks must evaluate all assets and liabilities within each bracket with respect to the ease and security of liquidating them. The requirement is that liquid claims shall be greater than liquid liabilities in the first two brackets. Liquidity of 3–12 months is monitored but no special levels are required.

Table 1. Iceland: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002 Estimate	2003 Q1	2003 Staff Forecast
	(Percentage change, unless otherwise noted)							
National Accounts (constant prices)								
Gross domestic product	4.7	5.5	3.9	5.5	2.9	-0.5	3.3	2.3
Total domestic demand	5.5	13.5	4.0	6.7	-3.6	-2.5	1.2	3.7
Private consumption	5.1	10.1	7.3	4.0	-3.0	-1.2	4.6	1.3
Public consumption	2.5	3.4	4.6	3.8	2.9	3.1	3.8	2.3
Gross fixed investment	10.0	33.0	-3.7	14.7	-6.9	-12.4	-9.4	12.4
Export of goods and services	5.4	2.0	4.0	5.0	7.9	2.9	4.8	1.1
Imports of goods and services	7.7	23.4	4.2	8.0	-9.0	-2.4	-0.5	4.9
Output gap 1/	0.4	1.7	1.6	3.5	2.1	-1.1	...	-1.0
Selected Indicators								
Fish catch (at constant prices)	-9.7	-4.8	9.8	-14.7	7.9	3.4	-1.0	...
Unemployment rate 2/	3.9	2.8	1.9	1.3	1.4	2.5	4.0	3.0
Real disposable income per capita	4.7	6.4	2.6	2.0	1.5	0.9	...	...
Consumer price index	1.8	1.7	3.4	5.1	6.6	4.8	1.7	2.2
Nominal wage index	5.4	9.4	6.8	6.6	8.9	7.1	5.6	5.0
Nominal effective exchange rate 3/	1.3	1.6	0.2	-0.1	-16.7	3.0	7.2	...
Real effective exchange rate (CPI) 3/	1.1	1.6	1.8	2.8	-13.2	5.6	9.0	...
Terms of trade	2.2	5.6	-0.8	-2.6	0.3	0.8	...	0.1
Money and Credit								
Deposit money bank credit (end-period)	12.7	30.4	26.7	22.7	19.7	1.9	4.8	...
Domestic credit (end-period)	15.9	28.0	25.1	25.4	21.2	2.0	6.1	...
Broad money (end-period)	8.7	15.2	16.9	11.2	14.9	15.6	12.8	...
CBI policy rate (period average)	6.9	7.3	8.4	10.5	10.9	8.3	5.6	...
	(In percent of GDP, unless otherwise noted)							
Public Finance								
General government 4/								
Revenue	40.2	41.0	43.8	43.5	41.8	42.5	...	43.7
Expenditure	40.2	40.5	41.3	41.0	41.3	42.8	...	43.8
Balance	0.0	0.5	2.4	2.5	0.5	-0.3	...	-0.1
Balance of Payments								
Current account balance	-1.8	-7.0	-7.0	-10.2	-4.0	-0.1	-0.5	-0.9
Trade balance (goods)	0.0	-4.4	-3.7	-5.7	-0.8	1.8	3.5	0.2
Financial and capital account	3.4	8.1	9.4	10.9	2.3	1.8	7.2	0.9
o/w: reserve assets 5/	0.6	-0.4	-0.9	0.9	0.7	-0.7	-0.1	-2.1
Net errors and omissions	-1.7	-1.1	-2.4	-0.7	1.7	-1.7	-6.8	0.0
Gross external debt 6/	66.8	75.3	85.7	103.4	120.3	131.0	127.1	110.6
Debt service ratio 7/	19.2	21.6	26.9	37.2	46.7	48.1	...	...
Central bank gross reserves (in months of imports of goods and services) 8/	1.8	1.5	1.8	1.5	1.4	1.5	2.2	2.4

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

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ National accounts basis.
5/ A positive (negative) sign indicates a decrease (increase) in gross official foreign reserves.
6/ External liabilities minus equity investment.
7/ Ratio of long-term external debt service payments to exports of goods and services.
8/ Excluding imports from the construction of hydropower facility and smelters in 2003.

Table 2. Iceland: Balance of Payments

(In millions of US dollars 1/, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003 2/ Q1
Current account	-129	-555	-588	-851	-304	-9	-12
Balance on goods and services	46	-363	-405	-596	-37	161	51
Exports of goods and services	2690	2871	2930	2937	3106	3370	903
Goods, fob	1849	1921	2001	1893	2011	2234	630
Marine products	1319	1395	1349	1198	1248	1396	378
Other goods	529	525	652	694	762	838	252
Services	842	951	928	1044	1095	1136	274
Imports of goods and services	-2645	-3235	-3334	-3533	-3143	-3209	-852
Goods	-1845	-2272	-2310	-2368	-2072	-2085	-544
Services	-800	-962	-1024	-1165	-1072	-1124	-308
Income balance	-171	-178	-174	-245	-257	-184	-58
Receipts	100	120	129	147	172	178	55
Expenditures	-271	-297	-302	-392	-429	-361	-113
Current transfers, net	-3	-14	-10	-10	-10	13	-5
Capital and financial account	248	644	789	912	177	156	180
Capital transfers, net	0	-5	-1	-3	4	-1	1
Financial account	248	648	789	915	174	157	179
Financial account, excl. reserves	203	680	863	841	124	219	182
Direct investment, net	92	74	-57	-222	-206	-41	88
Abroad	-56	-74	-123	-393	-355	-176	4
In Iceland	148	148	67	170	149	135	84
Portfolio investment, net	-242	-236	587	500	622	224	61
Assets	-203	-302	-447	-639	-58	-308	-93
Equity Securities	-180	-252	-370	-633	-59	-260	-85
Debt Securities	-22	-50	-77	-5	2	-49	-7
Liabilities	-40	66	1034	1138	680	533	154
Equity Securities	-1	14	56	-42	44	17	-31
Debt Securities	-39	52	978	1181	636	516	185
Financial derivatives, net	-1	-1	2	-1	0	0	0
Other capital, net	355	843	331	565	-292	35	33
Assets	-163	4	-175	-90	-482	-368	-81
Liabilities	518	839	506	655	189	403	115
Reserve assets (-= increase)	45	-32	-74	73	49	-62	-3
Net errors and omissions	-120	-88	-200	-61	127	-146	-168
Memorandum items:							
Current account (in percent of GDP)	-1.8	-7.0	-7.0	-10.2	-4.0	-0.1	-0.5
Gross foreign reserves of the Central Bank (end of period)	386	427	495	405	355	462	469
Net foreign reserves of the Central Bank (end of period)	387	376	446	221	212	259	339
Exchange Rate: ISK/US$ (period average)	71.0	71.1	72.4	78.9	97.8	91.5	78.4

Sources: Central Bank of Iceland; and International Financial Statistics, IMF.

1/ Based on official estimates in domestic currency converted into US$ at current exchange rates.

2/ Preliminary figures.

Table 3. Iceland: Medium-Term Scenario

	2001	2002	2003	2004	2005	2006	2007	2008
				(Percentage change)				
Real domestic demand	-3.6	-2.5	3.7	4.9	7.9	2.8	-0.2	-2.3
Private consumption	-3.0	-1.2	1.3	2.7	4.3	2.9	2.1	1.7
Public consumption	2.9	3.1	2.3	2.0	2.0	2.0	2.0	2.0
Gross fixed investment	-6.9	-12.4	12.4	13.2	21.4	3.2	-6.4	-14.5
Public fixed investment	-1.5	-8.3	14.3	-6.7	-8.1	-4.0	6.0	6.0
Private fixed investment	-7.9	-13.2	12.0	17.1	26.0	4.1	-7.7	-16.9
Exports of goods and services	7.9	2.9	1.1	3.5	4.9	4.0	5.9	8.9
Exports of goods	7.2	6.1	0.9	4.2	5.3	4.0	6.8	11.2
Exports of services	9.1	-3.0	1.5	2.0	4.0	4.0	4.0	4.0
Imports of goods and services	-9.0	-2.4	4.9	6.4	12.7	4.0	0.1	-1.1
Imports of goods	-10.0	-3.2	7.0	8.2	16.7	4.2	-1.2	-3.0
Imports of services	-6.9	-0.7	0.5	2.3	3.5	3.5	3.5	3.5
Real GDP	2.9	-0.5	2.3	3.7	4.8	2.8	2.0	1.8
Output gap (in percent of potential GDP)	2.1	-1.1	-1.0	0.5	2.0	1.8	0.8	0.1
Consumer price index	6.6	4.8	2.2	2.1	3.3	3.5	2.9	2.7
Unemployment rate	1.4	2.5	3.0	2.5	1.5	1.0	1.5	2.1
				(In percent of GDP)				
Current account	-4.0	-0.1	-0.9	-2.1	-5.0	-5.6	-3.6	-0.2
Trade balance	-0.8	1.8	0.2	-0.6	-3.2	-3.3	-1.5	1.8
Services balance	0.3	0.1	0.2	0.2	0.2	0.2	0.3	0.3
Factor income balance	-3.4	-2.2	-1.5	-1.8	-2.1	-2.6	-2.6	-2.5
Net current transfers	-0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Capital and financial account	2.3	1.8	0.9	2.1	5.0	5.6	3.6	0.2
Capital transfers, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account	2.3	1.9	0.9	2.1	5.0	5.6	3.6	0.3
Memorandum items (in percent of GDP):								
International investment position	-75.2	-82.4	-65.3	-62.2	-63.0	-65.6	-66.8	-64.6
Gross external debt	120.3	131.0	110.6	105.2	101.9	100.2	98.0	96.3
Gross reserves in months of imports 1/	1.4	1.5	3.5	3.5	3.5	3.5	3.5	3.5
General government balance	0.5	-0.3	-0.1	0.7	2.1	3.1	2.7	2.3
General government structural balance 2/	-0.4	0.2	0.3	0.5	1.3	2.4	2.4	2.3
General government gross debt	47.2	43.2	40.2	37.3	32.4	27.3	23.2	19.8
Domestic debt	18.5	17.8	16.5	15.3	13.3	11.2	9.5	8.1
Foreign debt	28.7	25.5	23.7	22.0	19.1	16.1	13.7	11.7
General government net debt	27.5	24.9	22.4	21.7	18.0	13.8	10.3	7.5

Sources: Statistics Iceland; Central Bank of Iceland; and staff projections.

1/ Imports of goods excluding temporary direct imports for the energy intensive investment projects that are financed through foreign direct investment.

2/ In percent of potential output.

Table 4. Iceland: Summary Operations of the General Government 1/

	1997	1998	1999	2000	2001	Prelim. 2002	Forecast 2003 2/	Forecast 2003 3/
				(In percent of GDP)				
Total revenue	40.2	41.0	43.8	43.5	41.8	42.5	43.4	43.7
Current revenue	38.0	38.9	41.7	41.4	39.8	40.4	41.2	41.5
Capital revenue	2.2	2.1	2.1	2.0	2.0	2.1	2.1	2.1
Total expenditure	40.2	40.5	41.3	41.0	41.3	42.8	43.5	43.8
Current expenditure	35.2	34.9	35.9	36.2	36.2	38.2	38.5	38.8
of which:								
Interest expenditure	3.8	3.7	3.7	3.5	3.9	3.6	3.3	3.3
Capital expenditure	5.0	5.6	5.4	4.8	5.1	4.6	5.0	5.0
Primary balance	3.8	4.2	6.2	5.9	4.4	3.3	3.1	3.2
Overall balance	0.0	0.5	2.4	2.5	0.5	-0.3	-0.1	-0.1
Debt position								
General government gross debt	54.5	49.4	44.8	42.2	47.2	43.2	40.0	40.2
Domestic Debt	28.3	27.0	23.4	19.0	18.5	17.8	...	16.5
Foreign Debt	26.2	22.4	21.4	23.2	28.7	25.5	...	23.7
General government net debt	38.3	31.8	24.2	24.1	27.5	24.9	23.6	22.4
Cyclically adjusted								
			(In percent of potential GDP, unless otherwise indicated)					
Primary revenue	38.9	39.6	42.3	41.8	39.8	40.9	41.7	42.0
Primary expenditure	36.5	37.4	38.2	38.9	38.2	38.8	40.0	40.1
Primary balance	2.4	2.2	4.1	2.9	1.6	2.2	1.7	1.9
Total revenue	40.2	41.0	43.7	43.4	41.8	42.5	43.4	43.7
Total expenditure	40.4	41.2	42.0	42.4	42.2	42.3	43.3	43.4
Overall balance	-0.2	-0.2	1.7	1.0	-0.4	0.2	0.1	0.3
Memorandum items:								
Real expenditure change 4/	1.1	6.3	6.1	4.7	3.6	1.3	4.4	4.7
Output Gap 5/	0.4	1.7	1.6	3.5	2.1	-1.1	-0.6	-1.0

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

1/ Accrual basis.
2/ Official forecast of the Ministry of Finance as of April 2003.
3/ Staff forecast.
4/ Change in percent.
5/ Actual output less potential in percent of potential.

Table 5. Iceland: Financial Soundness Indicators

	1997	1998	1999	2000	2001	2002	2003	as of
				(In percent, unless otherwise indicated)				
Capital adequacy								
Risk-based capital adequacy ratio (CAR) 1/	11.6	10.4	10.6	9.7	11.3	12.2	...	
CAR excluding subordinated loans	10.2	8.8	8.2	6.6	8.0	9.1	...	
Tier 1 capital ratio	11.3	10.0	9.6	8.0	9.0	9.7	...	
Equity as percent of regulatory capital	92.9	86.7	82.9	79.7	62.0	66.2	...	
Asset quality								
Credit institutions								
Total lending (in ISK billion) 2/	308.5	385.7	475.8	601.5	704.3	740.2	793.0	May
thereof foreign currency loans (in percent)	31.8	34.4	36.5	41.6	44.3	39.6	40.7	May
Sectoral credit concentration								
Real estate loans (as percent of total loans)	6.7	6.3	6.8	6.6	5.8	5.4	5.0	May
Loans to fisheries (as percent of total loans)	29.4	27.7	24.8	22.9	21.2	17.1	16.1	May
thereof foreign currency loans (in percent)	79.1	83.3	83.9	86.5	86.8	87.0	86.9	May
Loans to households (as percent of total loans) 3/	26.6	27.9	27.3	27.5	25.5	26.3	24.0	May
thereof foreign currency loans (in percent)	0.5	1.8	4.8	8.1	10.4	8.6	7.2	May
Loans to businesses (as percent of total loans)	65.2	64.8	65.7	65.2	64.2	62.6	65.3	May
thereof foreign currency loans (in percent)	46.8	49.8	50.6	55.6	54.7	49.4	50.1	May
Loans to retail and services (as percent of total loans)	19.8	24.8	28.6	29.4	30.0	32.7	37.6	May
thereof foreign currency loans (in percent)	15.2	19.5	29.5	37.0	36.1	33.7	38.8	May
Loans to manufacturing et. al. (as percent of total loans)	16.0	12.3	12.2	12.9	13.0	12.7	11.6	May
thereof foreign currency loans (in percent)	26.7	35.5	32.4	43.0	45.3	39.2	36.0	May
Non-performing loans (NPL) as percent of total loans 4/	3.8	2.4	2.5	2.0	2.8	3.4	...	
Loan-loss provisions as percent of NPL 5/	45.6	51.9	50.5	52.5	46.8	43.7	...	
Off-bal. sheet exposure (w/out OTC deriv.) as percent of reg. capital	143.8	159.7	135.5	127.3	74.0	...	...	
Off-bal. sheet exposure (with OTC deriv.) as percent of reg. capital	147.1	163.4	140.4	143.4	85.5	...	...	
Foreign-currency den. assets as percent of total assets	30.0	27.0	31.1	49.4	50.1	48.7	...	
Foreign-currency den. liabilities as percent of total assets	29.6	27.4	31.6	49.9	50.0	48.2	...	
Leverage ratio (equity as percent of total assets)	7.4	7.0	6.8	6.4	6.6	6.3	...	
Borrowing entities								
Debt-equity ratios								
All listed companies (except financial companies)	1.96	1.85	1.96	2.21	2.27	1.72	...	
Fisheries companies	1.67	1.75	1.87	2.57	2.59	1.97	...	
Manufacturing companies	0.41	1.11	1.40	1.62	1.68	1.35	...	
IT companies		2.80	2.28	1.90	1.43	1.32	...	
Retail, services, and construction companies	2.10	2.39	2.28	1.94	1.99	1.52	...	
Corporate profitability (EBITDA/turnover)							...	
All listed companies (except financial companies)	8.0	8.2	7.3	9.2	10.2	10.2	...	
Fisheries companies	16.5	17.8	14.7	17.2	27.1	23.3	...	
Manufacturing companies	10.7	7.2	7.5	13.2	13.4	13.6	...	
IT companies		6.1	8.7	9.6	17.4	18.4	...	
Retail, services, and construction companies	9.3	2.2	5.6	14.7	5.6	-1.0	...	
Household indebtedness (debt/disposable income)	134.7	138.7	145.8	158.5	171.1	175.9	...	
Management soundness 1/								
Expense ratios								
Operating expenses as percent of gross income	65.3	67.1	60.4	65.6	64.2	59.4	...	
Operating expenses as percent of average total assets	4.4	4.1	3.7	3.1	2.8	3.0	...	
Staff costs as percent of avg. bal. sheet total	2.3	2.1	1.9	1.5	1.5	1.6	...	
Staff costs as percent of gross income	33.6	35.2	31.2	33.0	32.9	30.9	...	
Earnings per employee (gross inc./employees) (Kr. Millions)	8.3	8.9	10.9	11.0	12.5	18.1	...	
Earnings per branch (gross inc./branches) (Kr. Millions)	119.0	131.9	171.4	238.2	280.2	406.0	...	

Table 5. (continued) Iceland: Financial Soundness Indicators

	1997	1998	1999	2000	2001	2002	2003	as of
Earnings and profitability:								
Return on assets	0.9	0.9	1.3	0.6	0.8	1.1	...	
Return on equity	10.3	13.5	19.3	9.7	13.4	18.1	...	
Interest income (as percent of total revenue)	58.9	56.0	52.4	60.7	73.8	51.4	...	
Non-interest income (net) as percent of gross income				39.3	26.2	48.6		
Fees and commissions (as percent total revenue)	24.8	23.1	23.1	24.9	27.7	26.2	...	
* Fees and commiss. payable as percent gross income	-2.15	-3.05	-3.58	-6.5	-5.7	...		
Net profit or loss on financial operations (as percent of total revenue)	7.5	15.0	12.0	-2.2	-8.5	12.1	...	
Dividends from shares and other holdings (as percent of total revenue)	6.1	3.9	9.6	6.2	2.5	2.7	...	
Other income (as percent of total revenue)	3.1	1.9	2.9	10.4	4.4	7.6	...	
Liquidity:								
Central bank credit to banks (end of period, in ISK billion)	...	22.8	36.0	46.9	68.7	73.7	64.1	July
Deposits to M3 ratio	0.97	0.97	0.97	0.98	0.98	0.98	0.98	May
Loans-to-deposits ratio	1.29	1.46	1.53	2.07	2.09	1.91	1.87	May
Liquidity ratio (cash and short-term assets/ demand and short-term liabilities)	...	...	...	1.2	1.2	1.2	1.2	May
Measures of secondary market liquidity:								
Interbank FX market turnover (Kr. Billions)	162.2	401.7	468.0	768.0	1,218.0	834.4	572.5	Jan-June
Interbank domestic market turnover (Kr. Billions)	...	447.7	502.9	524.3	426.1	420.8	332.1	Jan-June
Indicators of segmentation of the money market (difference between interbank lending rates)	...	...	5.8	...	...	...	...	
Market-based indicators:								
Stock market index (ICEX-15; y-o-y change)	14.7	9.8	47.4	-19.3	-11.2	16.7	11.0	Jan.-June
Equity prices of financial institutions (y-o-y increase)	82.9	11.7	70.8	...	...			
Residential housing prices (y-o-y increase)	2.7	7.3	21.9	13.5	3.3	6.5	5.2	Dec.-June
Commercial property prices (y-o-y increase) (between yearly averages)	0.7	19.8	25.2	19.5	-7.09	-12.01	...	
Price/earnings ratio	...	19.3	21.7	...	...	...	...	
Market capitalization at year-end/GDP 6/	28.5	39.9	57.6	59.5	57.0	68.2	68.0	June
Turnover rate (trading/market capitalization) (12 month trading)	15.6	17.2	32.4	50.0	32.4	60.8	70.5	June
Interest rate spreads on borrowing (average)	6.3	5.1	4.3	...	...	...	...	
Credit ratings								
Moody's short-term	...	P1-P2	P1-P2	P1-P2	P1-P2	P1-P2	P1	June
Moody's long-term	...	A2-A3	A2-A3	A2-A3	A2-A3	A2-A3	A1-A3	June
Fitch short-term	...	...	...	...	F1	F1	F1	June
Fitch long-term	...	...	...	...	A	A	A	June
Sovereign yield spreads (spread between yields on Icelandic and foreign trade-weighted 3-month T-bills)	2.7	3.4	5.7	6.3	7.9	3.1	3.2	June
Financial market structure:								
Concentration ratios in the banking sector								
Number of banks accounting for 25 percent of total assets	1	1	1	1	1	1	1	June
Number of banks accounting for 75 percent of total assets	3	3	3	3	3	3	3	June
Number of financial institutions	31	30	29	29	28	29	28	June

Sources: Financial Supervisory Authority; and Central Bank of Iceland.

1/ Deposit money banks, i.e., commercial banks and savings banks. Consolidated accounts
2/ Deposit money banks. In the year 2000 FBA was merged to Íslandsbanki which partly explain considerable increase in figures.
3/ Includes private business operations of individuals.
4/ Net of specific provisions and including appropriated assets. Commercial banks and savings banks. FBA and its predecessors included..
5/ Stock of general and specific provisions over stock of non-performing loans. Commercial banks and savings banks. FBA and its predecessors included.
6/ Including equity mutual funds.

Table 6. Iceland: Indicators of External and Financial Vulnerability

	1997	1998	1999	2000	2001	2002	2003 Q1 1/
External indicators							
Exports of goods and services (annual percentage change, in U.S. dollars)	1.4	6.7	2.0	0.2	5.8	8.5	20.1
Imports of goods and services (annual percentage change, in U.S. dollars)	1.5	22.3	3.1	5.9	-11.0	2.1	21.0
Terms of trade (annual percentage change)	2.2	5.6	-0.8	-2.6	0.3	0.8	...
Current account balance (in percent of GDP)	-1.8	-7.0	-7.0	-10.2	-4.0	-0.1	-0.5
Capital and financial account balance (in percent of GDP)	3.4	8.1	9.4	10.9	2.3	1.8	7.2
Foreign direct investment, net (in percent of GDP)	1.3	0.9	-0.7	-2.7	-2.7	-0.5	3.5
Portfolio investment, net (in percent of GDP)	-3.4	-3.0	7.0	6.0	8.2	2.6	2.5
Other investment, net (in percent of GDP)	4.9	10.6	4.0	6.8	-3.9	0.4	1.3
Gross official reserves (in millions of U.S. dollars)	427.6	400.9	409.4	423.7	332.5	453.9	485.2
in months of imports 2/	1.8	1.5	1.8	1.5	1.4	1.5	2.2
Net official reserves (in millions of U.S. Dollars)	387.0	376.0	445.6	221.1	212.2	259.1	338.6
over short-term debt (ratio) 3/	0.4	0.4	0.3	0.1	0.1	0.1	0.1
over short-term debt corrected for current account deficit net of FDI (ratio) 3/	0.4	0.3	0.2	0.1	0.1	0.1	0.1
over broad money (ratio)	0.1	0.1	0.1	0.1	0.1	0.1	0.1
over reserve money (ratio)	1.8	1.3	0.9	0.6	0.8	0.6	0.7
Gross external debt (in percent of GDP) 4/	66.8	75.3	85.7	103.4	120.3	131.0	127.1
Net external liabilities (in percent of GDP)	47.4	52.3	50.4	63.5	75.2	82.4	79.8
Real effective exchange rate (CPI) (cumulative yoy-change; (+) appreciation)	1.1	1.6	1.8	2.8	-13.2	5.6	9.0

Sources: Financial Supervisory Authority; Central Bank of Iceland; and Statistics Iceland.

1/ Preliminary figures

2/ Imports of goods and services

3/ Based on freely usable reserves (excluding contingent credit lines) over short-term debt on an original maturity basis.

4/ Debt figures are based on end-of-period exchange values, while GDP is valued at average-of-period rates.

Iceland: Basic Data

Demographic and other data

Area	103,000 square kilometers
Population (Dec. 2002)	288,471
Natural rate of increase (1992–00)	1.9 percent
Life expectancy at birth (2002)	
Males	78.2 years
Females	82.2 years
Infant mortality (per 1,000 live births)	2.2
Population per physician (1997)	308
GDP per capita (2001, PPP exchange rate)	US$ 29,300

Composition of GDP in 2002, at current prices	In billions of kronur	Distribution in percent
Private consumption	419.5	54.2
Public consumption	194.7	25.1
Total investment (including stockbuilding)	145.4	18.8
Total domestic demand	759.6	98.1
Exports of goods and services	308.2	39.8
Imports of goods and services	293.5	37.9
GDP at market prices	774.4	100

Selected economic data	**2000**	**2001**	**2002**
	(Annual percentage change)		
Output and unemployment:			
Real GDP at market prices	5.5	2.9	-0.5
Average unemployment (in percent)	1.3	1.4	2.5
Earnings and prices:			
Wage Index	6.6	8.9	7.1
Consumer Price Index	5.1	6.6	4.8
Money and interest rates			
M1 (end-period)	4.4	-2.3	25.8
M3 (end-period)	11.2	14.9	15.6
3-month Treasury bill yield (eop)	11.8	10.0	5.9
25-year indexed housing bond (real yield)	6.1	5.9	5.2
	(In billions of kronur)		
Fiscal accounts:			
General government receipts	286.3	309.8	329.4
General government expenditures	270.0	305.9	331.5
General government balance	16.3	3.9	-2.1
(In percent of GDP)	2.5	0.5	-0.3
Balance of payments:			
Current account balance	-67.1	-29.7	-0.8
(In percent of GDP)	-10.2	-4.0	-0.1
Trade balance	-37.5	-5.9	13.6
Exports	149.3	196.6	204.3
Imports	186.8	202.5	190.7
Services and transfers (net)	-9.5	2.3	1.1
Gross reserves, official basis			
(Millions of SDR, end-period)	310.2	282.7	339.5
Exchange rate (ISK/SDR, end-period)	110.4	129.4	109.6

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and International Financial Statistics, IMF.

ICELAND: Fund Relations

(As of April 30, 2003)

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

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	117.60	100.00
Fund holdings of currency	99.02	84.20
Reserve position in Fund	18.58	15.80

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	16.41	100.00
Holdings	0.08	0.51

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

V. **Financial Arrangements**: None

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

	Forthcoming				
	2003	2004	2005	2006	2007
Charges/Interest	0.21	0.29	0.29	0.29	0.29
Total	0.21	0.29	0.29	0.29	0.29

VII. **Exchange Rate Arrangements**: 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).

VIII. **Last Article IV Consultation**:

Discussions for the 2002 Article IV Consultation were held in Reykjavik during March 18-27, 2002. The Staff Report (SM/02/158) was considered by the Executive Board on June 21, 2002 (SUR/02/70). Article IV consultations with Iceland are currently on the 12-month cycle.

IX. **Technical Assistance**: None

X. **Resident Representative**: None

Iceland—Statistical Issues

Iceland's economic database is comprehensive and sufficient for effective surveillance. Iceland has subscribed to the Special Data Dissemination Standard (SDDS).

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

Iceland is not yet fully compliant with all SDDS requirements. Non-compliance stems from inadequate coverage of the producer price index. Iceland's authorities have expressed their intention to address this issue and become fully compliant.

As regards the national accounts data, the authorities shifted to ESA95 in August 2000 and revised the corresponding time series back to 1990. Another revision was carried out in 2002 going back only to 1997.

Iceland's balance of payments data deviate from the IMF's Balance of Payments Manual, fifth edition. In particular, the CBI follows the methodology applied by the European Central Bank (ECB) for the calculation of income payable by collective investment institutions (e.g., mutual funds). Unlike the fifth edition of the Fund's Balance of Payments Manual , the ECB's methodology includes portfolio investors' shares of retained earnings in the balance of payments statement.

Iceland: Core Statistical Indicators
(As of July 17, 2003)

	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	07/17/03	05/31/03	05/31/03	05/31/03	05/31/03	07/17/03	Jul. 2003	May 2003	2003 Q1	2002	2003 Q1	2003 Q1
Date Received	07/17/03	06/19/03	06/10/03	06/10/03	06/23/03	07/17/03	07/10/03	06/27/03	06/05/03	04/17/03	06/20/03	06/10/03
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly
Source of Update	CBI	CBI	CBI	CBI	CBI	CBI	Statistics Iceland	Statistics Iceland	CBI	Ministry of Finance and Statistics Iceland	Statistics Iceland	CBI
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 Public-ation	Internet and Public-ation
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Annual	Quarterly	Quarterly

Iceland—Sustainability Exercise

External Sustainability

Iceland's external debt level is high both by historical and international standards—specially in regard to the net international investment position—with the bulk of it corresponding to the private sector. Gross external debt stood at 131 percent of GDP at end 2002 (in US dollars), with government debt accounting for about 33 percent of GDP (Table A1). A significant part of the volatility of the debt-to-GDP ratio in 2000–02 was due to valuation effects (as the krona first depreciated steeply and then partly recovered)—which illustrates Iceland's vulnerability during an episode of exchange rate volatility. The likelihood of a repetition of such a pronounced exchange rate correction was diminished with the adoption of inflation targeting and a floating regime in 2001. Stabilization of the krona in 2003 at close to current levels is envisaged to result in a significant year-on-year appreciation and, with the projected small current account deficit, a decline of the gross debt-to-GDP ratio to about 111 percent by end-2003.

Under the baseline projection, staff expects that the external debt-to-GDP ratio will continue declining to about 96 percent by 2008. This evolution is the result of high output growth rates—in turn, stemming from large investment projects financed mainly through non-debt creating foreign direct investment—and a stabilization of the private sector saving ratio around its historical level, to which it recovered in 2002.

The external debt sustainability exercise was performed following standard cross-country methodology. In this context, the stress tests should be understood as representing extreme situations and not necessarily likely scenarios. The results show that among the standard stress tests, those that set variables at their historical averages or postulate a large and sustained depreciation have the most negative consequences in debt levels. The former result is not surprising, as most of the outstanding debt was in fact built up during the last five years, which dominate the averages. The result indicates that a repetition of the trends that prevailed during the past consumption boom would have seriously deleterious effects on the external debt position. Finally, the relatively lesser impact of a raise in interest rates of two standard deviations reflects the high credit ratings of Iceland, which have allowed it to borrow at a minimal premium over LIBOR and therefore, at low and stable rates.

Fiscal sustainability

The solvency of the public finances in Iceland has not been a cause of concern. Past budgetary surpluses and allocation of privatization proceeds to retire public debt have resulted in gross general government debt of 43 percent of GDP at end-2002, with net debt at 25 percent. The fiscal sustainability exercise confirms this benign assessment with the stress tests indicating quite manageable debt levels, even in extremely adverse scenarios (Table A2).

Table A1. Iceland: External Debt Sustainability Framework, 1993–2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
							I. Baseline Medium-Term Projections					
1 **External debt**	66.8	75.3	85.7	103.4	120.3	131.0	**110.6**	**105.2**	**101.9**	**100.2**	**98.0**	**96.3**
2 Change in external debt	2.0	8.5	10.4	17.7	16.9	10.7	-20.4	-5.5	-3.2	-1.7	-2.2	-1.7
3 Identified external debt-creating flows (4+8+11)	2.6	1.9	7.7	21.1	15.9	-8.6	-24.5	-6.7	-4.9	-3.0	-3.2	-2.9
4 Current account deficit, excluding interest payments	-1.5	3.7	3.6	5.9	-1.5	-3.8	-2.4	-1.5	1.1	1.2	-0.7	-4.0
5 Deficit in balance of goods and services	-0.6	4.6	4.8	7.1	0.5	-1.9	-0.5	0.5	3.0	3.1	1.2	-2.1
6 Exports	37.2	36.0	35.0	35.2	41.0	39.8	34.8	33.3	32.6	32.5	33.4	35.4
7 Imports	36.6	40.5	39.8	42.3	41.5	37.9	34.4	33.8	35.6	35.6	34.6	33.3
8 Net non-debt creating capital inflows (negative)	1.8	1.2	4.2	10.7	1.6	3.8	2.6	0.0	-2.8	-3.8	-3.0	0.4
9 Net foreign direct investment, equity	0.7	1.8	-0.5	-2.6	-1.4	-1.0	-0.1	1.1	3.9	4.6	3.7	0.3
10 Net portfolio investment,equity	-2.5	-3.0	-3.8	-8.1	-0.2	-2.9	-2.5	-1.1	-1.1	-0.9	-0.7	-0.7
11 Automatic debt dynamics 1/	2.2	-3.1	-0.1	4.5	15.9	-8.6	-24.7	-5.3	-3.2	-0.4	0.5	0.6
12 Contribution from nominal interest rate	3.3	3.3	3.4	4.3	5.5	3.9	3.3	3.6	3.9	4.4	4.3	4.2
13 Contribution from real GDP growth	-3.0	-3.3	-2.8	-4.7	-3.3	0.5	-2.3	-3.8	-4.7	-2.7	-2.0	-1.7
14 Contribution from price and exchange rate changes 2/	2.0	-3.0	-0.7	4.9	13.6	-13.1	-25.7	-5.0	-2.5	-2.1	-1.9	-1.9
14 Residual, incl. change in gross foreign assets (2-3)	-0.5	6.7	2.7	-3.4	0.9	19.3	4.2	1.3	1.7	1.2	1.0	1.2
External debt-to-exports ratio (in percent)	179.4	209.3	245.1	293.9	293.5	329.1	317.4	315.5	312.5	308.6	293.4	271.8
Gross external financing need (in billions of US dollars) 3/	1.3	1.9	2.1	3.0	3.1	3.2	4.2	4.6	5.2	5.4	5.3	4.9
in percent of GDP	18.0	24.0	25.3	36.1	40.5	37.6	38.9	39.2	40.9	41.0	38.6	34.5
Key macroeconomic and external assumptions												
Real GDP growth (in percent)	4.7	5.5	3.9	5.5	2.9	-0.5	2.3	3.7	4.8	2.8	2.0	1.8
Exchange rate appreciation (US dollar value of local currency, change in percent)	-6.1	-0.2	-1.8	-8.2	-19.3	6.9	22.7	2.7	-0.5	-1.5	-1.3	-1.0
GDP deflator in US dollars (change in percent)	-3.0	4.7	1.0	-5.6	-11.8	12.3	25.0	4.8	2.4	2.1	1.9	2.0
Nominal external interest rate (in percent)	5.1	5.4	4.8	5.0	4.9	3.7	3.2	3.5	4.0	4.5	4.5	4.5
Growth of exports (US dollar terms, in percent)	1.4	6.7	2.0	0.2	5.8	8.5	11.9	4.0	4.9	4.4	7.0	10.0
Growth of imports (US dollar terms, in percent)	1.5	22.3	3.1	5.9	-11.0	2.1	15.9	6.9	13.1	4.7	1.2	0.0
							II. Stress Tests for External Debt Ratio					
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2004–08							**110.6**	**116.4**	**122.7**	**128.6**	**134.5**	**140.7**
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005							**110.6**	**108.5**	**107.9**	**106.2**	**104.1**	**102.4**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005							**110.6**	**110.6**	**113.8**	**112.1**	**110.0**	**108.3**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005							**110.6**	**133.8**	**161.2**	**159.2**	**157.4**	**156.0**
5. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005							**110.6**	**113.7**	**116.3**	**114.5**	**112.4**	**110.7**
6. Combination of 2–5 using one standard deviation shocks							**110.6**	**132.3**	**154.8**	**152.8**	**150.9**	**149.5**
7. One time 30 percent nominal depreciation in 2004							**110.6**	**153.2**	**148.5**	**146.6**	**144.7**	**143.2**

Historical statistics for key variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Current account deficit, excluding interest payments	-1.1	4.1	-1.1
Net non-debt creating capital inflows	-2.6	3.2	1.1
Nominal external interest rate (in percent)	5.3	0.8	4.0
Real GDP growth (in percent)	3.2	2.3	2.9
GDP deflator in US dollars (change in percent)	-0.7	8.5	6.4

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table A2. Iceland: Public Sector Debt Sustainability Framework, 1993–2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
							I. Baseline Medium-Term Projections					
1 Public sector debt 1/	54.5	49.4	44.8	42.2	47.2	43.2	**40.2**	**37.3**	**32.4**	**27.3**	**23.2**	**19.8**
o/w foreign-currency denominated	27.1	23.7	20.4	20.2	26.0	26.3	23.5	21.7	18.9	15.9	13.5	11.5
2 Change in public sector debt	-3.4	-5.1	-4.6	-2.7	5.0	-3.9	-3.0	-2.9	-4.9	-5.1	-4.1	-3.4
3 Identified debt-creating flows (4+7+12)	-2.1	-6.7	-6.5	-2.6	-0.6	-9.8	-3.7	-2.5	-4.8	-5.1	-4.0	-3.7
4 Primary deficit	-3.8	-4.2	-6.2	-5.9	-4.4	-3.3	-3.2	-3.8	-4.9	-5.6	-4.8	-4.1
5 Revenue and grants	40.2	41.0	43.8	43.5	41.8	42.5	43.7	43.5	43.7	43.9	43.4	43.2
6 Primary (noninterest) expenditure	36.4	36.8	37.6	37.6	37.4	39.2	40.5	39.7	38.8	38.2	38.6	39.1
7 Automatic debt dynamics 2/	1.7	-2.5	1.5	3.4	3.9	-4.7	0.5	1.3	0.2	0.5	0.8	0.5
8 Contribution from interest rate/growth differential 3/	-0.5	-1.5	0.6	-0.1	-0.8	1.5	1.6	0.9	-0.1	0.4	0.7	0.3
9 Of which contribution from real interest rate	2.0	1.2	2.4	2.2	0.3	1.3	2.5	2.3	1.7	1.3	1.3	1.1
10 Of which contribution from real GDP growth	-2.5	-2.7	-1.8	-2.3	-1.1	0.2	-0.9	-1.4	-1.9	-1.0	-0.6	-0.8
11 Contribution from exchange rate depreciation 4/	2.2	-0.9	1.0	3.5	4.8	-6.2	-1.1	0.4	0.3	0.2	0.2	0.1
12 Other identified debt-creating flows	0.0	0.0	-1.8	-0.1	-0.1	-1.9	-1.1	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	0.0	0.0	-1.8	-0.1	-0.1	-1.9	-1.1	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-1.3	1.6	1.9	-0.1	5.5	5.9	0.7	-0.5	-0.1	-0.1	-0.1	0.3
Public sector debt-to-revenue ratio 1/	135.6	120.5	102.5	97.0	112.7	101.6	92.1	85.7	74.2	62.2	53.4	45.8
Gross financing need 5/	3.1	1.7	0.1	-1.0	0.3	1.8	3.5	1.6	-0.3	-2.8	-2.7	-2.3
in billions of U.S. dollars	0.2	0.1	0.0	-0.1	0.0	0.2	0.4	0.2	0.0	-0.4	-0.4	-0.3
Key macroeconomic and fiscal assumptions												
Real GDP growth (in percent)	4.7	5.5	3.9	5.5	2.9	-0.5	2.2	3.6	5.4	3.2	2.2	3.5
Average nominal interest rate on public debt (in percent) 6/	7.1	7.6	8.1	8.4	10.3	7.9	7.9	8.1	8.1	8.1	8.1	8.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.9	2.7	5.3	5.5	0.9	2.9	6.0	6.0	5.1	4.5	4.9	5.1
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.3	3.8	-4.2	-14.3	-18.0	27.8	4.4	-1.6	-1.5	-1.0	-1.0	-1.0
Inflation rate (GDP deflator, in percent)	3.3	4.9	2.8	2.9	9.3	5.0	1.9	2.1	3.0	3.6	3.2	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	1.5	6.7	6.2	5.5	2.6	4.3	5.6	1.7	2.3	1.4	3.0	3.0
							II. Stress Tests for Public Debt Ratio					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2004-2008							**40.2**	**37.5**	**35.0**	**32.5**	**29.8**	**27.5**
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005							**40.2**	**38.1**	**34.3**	**29.2**	**25.2**	**22.0**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005							**40.2**	**39.2**	**36.4**	**30.7**	**26.2**	**22.5**
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005							**40.2**	**42.7**	**44.5**	**39.6**	**36.0**	**32.9**
5. Combination of 2-4 using one standard deviation shocks							**40.2**	**41.6**	**43.3**	**35.5**	**29.0**	**23.8**
6. One time 30 percent real depreciation in 2004 7/							**40.2**	**47.9**	**43.1**	**38.2**	**34.5**	**31.4**
7. 10 percent of GDP increase in other debt-creating flows in 2004							**40.2**	**47.3**	**42.5**	**37.5**	**33.7**	**30.5**

Historical statistics for key variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Primary deficit	-3.1	2.4	-4.4
Real GDP growth (in percent)	3.2	2.3	3.3
Nominal interest rate (in percent) 6/	8.2	0.9	8.1
Real interest rate (in percent)	4.5	1.8	5.3
Inflation rate (GDP deflator, in percent)	3.7	2.2	2.8
Revenue to GDP ratio	40.9	2.0	43.6

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND
Public Information Notice
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Iceland

On August 22, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iceland.[1]

Background

Economic developments since early 2001 have resulted in the correction of the external and domestic macroeconomic imbalances that emerged during the boom of the late 1990s. The 2001 depreciation of the króna sparked a redirection of activity towards the external sector. Domestic demand, which had grown well in excess of GDP, contracted in 2001-2002 at an annual average of 3 percent, while net exports soared. Booming export revenue and faltering import demand brought the external current account into broad balance in 2002, compared to a 10 percent of GDP deficit in 2000. This, in turn, contributed to the rebound of the króna, which appreciated since 2002, aided by high real interest rates and a recovery in confidence. Output grew 2.9 percent in 2001, supported by buoyant exports, and declined ½ percent in 2002, opening some slack on the labor market. High frequency indicators suggest that activity has started to edge up in 2003. In early 2003, agreements were reached with foreign investors to undertake large projects in smelting and associated power generation, covering the 2003-10 period and with a total value equivalent to 35 percent of 2003 GDP.

After an initial surge reflecting depreciation pass-through effects, inflation declined rapidly in 2002, responding to the effects of high real interest rates, weak domestic demand, and the recovery of the exchange rate. The 12-month inflation rate, at 1.6 percent in July 2003, has

[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.

been slightly below the Central Bank of Iceland's (CBI) inflation target of 2½ percent since November 2002. Credit and M4 liquidity growth has also moderated to low levels. Since early 2002, the CBI has reduced gradually its policy rate by 480 basis points to 5.3 percent in April 2003, and the policy stance is broadly neutral at this juncture. Although domestic demand has started to pick up, labor market slack and the króna's appreciation have dampened inflationary pressures. The CBI projects that inflation will remain slightly below its target through the fourth quarter of 2004.

The public finances are in broad balance, and the debt burden is low, although expenditures increased significantly in recent years. The overall budget balance declined by about 2½ percent of GDP since 1999, to an expected broad balance in 2003. It is estimated that about half of this deterioration resulted from automatic stabilizers, while the remainder reflected sizable expenditure hikes in health, education, and social affairs, due, in part, to wage increases. Owing to buoyant revenue performance, however, the fiscal stance was slightly contractionary in 2002. The general government debt ratio has declined substantially in past years, as fiscal surpluses and privatization proceeds were devoted to debt redemption. Net government debt represented 25 percent of GDP in 2002.

The 2003 Financial System Stability Assessment (FSSA) update concluded that financial sector imbalances identified in the initial 2001 FSSA have subsided. Icelandic banks recorded increased profits in 2001-02, and boosted their regulatory capital ratios, aided by a proactive supervision. A package of financial legislation was adopted that strengthened the powers of the supervisory authority, and implemented regulatory reforms recommended in the 2001 FSSA. As a result of these efforts, Iceland became compliant with all but one of the Basle Core Principles (BCP).

Iceland's external debt has grown rapidly in recent years and is high in relation to comparable economies. This is largely the result of economic fundamentals, including a relatively young population, rising household assets (including fully-funded pension assets), and improved access to foreign capital markets. Banks' liquidity and foreign open positions are strictly regulated and adeptly monitored.

The government has continued pursuing its privatization agenda, most recently with the sale of remaining state-held shares in two commercial banks. Progress in reducing agricultural protection, which remains among the highest in the Organization for Economic Cooperation of Development, and in liberalizing the energy sector is less advanced.

Executive Board Assessment

Directors commended the authorities for rapidly overcoming macroeconomic imbalances and financial vulnerabilities that had developed at the end of the 1990s, through the sustained implementation of stability-oriented policies—including the introduction of inflation targeting, central bank independence, a floating exchange rate regime, and a substantial strengthening of the financial supervisory framework. They noted that the resilience shown by the Icelandic economy during the recent recession was also due to the underlying flexibility afforded by a decade of structural reforms aimed at enhancing long-term economic performance through improved competitiveness and more diversified exports.

Directors agreed that there were good prospects for a resumption of growth in the near term, accelerating over the medium term as the large planned foreign investments in aluminum smelting and associated power-generating facilities gather pace. They warned, however, that while these investments will ultimately expand the export base and thus buttress economic stability, they will also generate a significant demand impetus during the construction phase that will strain resources and increase upside risks, thus complicating macroeconomic management.

Against this background, Directors agreed that the main policy challenge for the period ahead will be forestalling a re-emergence of overheating and containing external imbalances given the already high private external debt level. In this regard, Directors supported the authorities' view that macroeconomic policies would have to remain restrictive to counteract the expected demand pressures over the medium term. In particular, they agreed that fiscal policy would need to bear most of the burden of adjustment, leaving room for monetary policy to respond to unexpected shocks while avoiding an extended period of high interest rates and possible real over-appreciation of the króna. Directors stressed the need for appropriately tight policies to contain the external current account deficit at a level commensurate to direct project-related imports and compatible with a gradual decline in Iceland's net external liabilities as a share of GDP.

While noting that the public finances remain fundamentally sound, Directors welcomed the authorities' intention to build up significant budget surpluses to counteract the envisaged demand push, and urged that this be reflected in the 2004 budget proposal. This would require an early focus on restraining current spending, particularly the public wage bill, an area where repeated slippages have occurred in recent years. Directors also recommended increasing the scope for private sector participation and the use of means-tested fees and co-payments in the provision of public services. Moreover, Directors generally cautioned that the announced tax reductions should be introduced cautiously, and only when countervailing expenditure cuts have been identified.

Directors welcomed the authorities' decision to cast the 2004 budget in a transparent multi-year policy framework, which would facilitate efforts at fiscal consolidation. Directors thought that firm expenditure limits would contribute to the predictability and credibility of budgetary policies and reinforce market confidence. Directors also noted that the planned adoption of national accounts methodology for budgeting purposes would further enhance fiscal transparency.

Directors considered the current Central Bank of Iceland's (CBI) broadly neutral monetary stance to be appropriate. They concurred with the authorities that this stance would have to be tightened as the recovery strengthened, remaining moderately restrictive over the investment projects' implementation period. Directors cautioned against a destabilizing expansion of credit by the Housing Financing Fund (HFF) that could be prompted by the relaxation of its lending criteria.

Directors commended the authorities for their success in implementing the inflation-targeting monetary policy framework introduced in 2001, as evidenced by the swift decline in inflation to the CBI's target. They also noted that recent reforms had improved the operation and safety of the payments systems infrastructure, and that the ongoing net foreign reserve accumulation would enhance confidence and policy flexibility. Some Directors suggested that, to further promote monetary policy transparency, consideration be given to holding regular rate-setting meetings of the CBI Board of Governors and publishing their minutes.

Directors welcomed the positive conclusions of the Financial Sector Stability Assessment update, reflecting the authorities' forceful efforts in addressing financial system vulnerabilities identified in the 2001 FSSA. They noted that the banking sector had increased its profitability and capital base, returning to a more balanced risk profile. Directors commended the authorities for the strengthening of the legal and supervisory prudential framework, including the increased powers and resources granted to the Financial Supervisory Authority, as well as the major improvements in compliance with Basel Core Principles of Effective Banking Supervision. Directors nevertheless advised that continued vigilance would be required in the upcoming period of possible macroeconomic tension. They recommended applying explicit prudential rules to the HFF, and carefully monitoring the weaker savings banks.

Directors expressed concern that private sector external liabilities, including short-term maturities, had risen to high levels in recent years while the net international investment position was in deficit, but noted that this might in part be rooted in demographic factors as well as in the buildup of private assets, including through fully-funded pension schemes. Directors considered that banks' foreign exchange open positions, and liquid assets and liabilities were well regulated and carefully monitored, while a significant part of the exchange rate risk was borne by naturally hedged borrowers. Nevertheless, Directors cautioned that the level of external liabilities, while not a cause of immediate systemic concern, posed medium-term vulnerabilities and reduced the room for policy slippages. They supported, in this connection, the authorities' objective of raising domestic saving, including through fiscal consolidation, and urged them to carefully monitor the debt levels of households and non-financial corporate borrowers.

Directors commended the authorities' continued progress in privatization, as evidenced by the recent divestment of the remaining public stake in the banking sector, and encouraged them to privatize telecommunications as early as feasible. They also encouraged them to press forward with liberalization of the electricity sector, and of agricultural trade, where distortions and welfare losses remained large.

Directors welcomed the duty-free access accorded to imports from least developed countries and encouraged the authorities to increase official development assistance toward the U.N. target of 0.7 percent of GNP. They also supported the authorities' efforts at combating money laundering, the financing of terrorism, and other financial crime.

Iceland publishes statistical data on a sufficiently timely and comprehensive basis to permit effective surveillance.

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. The Staff Report for the 2003 Article IV Consultation with Iceland is also available.

Iceland: Selected Economic Indicators

	1999	2000	2001	2002	2003 1/
Real Economy (change in percent)					
Real GDP	3.9	5.5	2.9	-0.5	2.3
Domestic Demand	4.0	6.7	-3.6	-2.5	3.7
CPI	3.4	5.1	6.6	4.8	2.2
Unemployment Rate (in percent of labor force)	1.9	1.3	1.4	2.5	3.0
Gross domestic investment (in percent of GDP)	-3.7	14.7	-6.9	-12.4	12.4
General Government Finances (percent of GDP)					
Financial Balance 2/	2.4	2.5	0.5	-0.3	-0.1
Structural Overall Balance	1.7	1.0	-0.4	0.2	0.3
Gross Debt	44.8	42.2	47.2	43.2	40.2
Money and Credit (change in percent)					
Deposit money bank credit (end of period)	26.7	22.7	19.7	1.9	...
Domestic credit (end of period)	25.1	25.4	21.2	2.0	...
Broad money (end of period)	16.9	11.2	14.9	15.6	...
CBI policy rate (period average, in percent)	8.4	10.5	10.9	8.3	...
Balance of Payments (in percent of GDP)					
Trade balance	-3.7	-5.7	-0.8	1.8	0.2
Current account balance	-7.0	-10.2	-4.0	-0.1	-0.9
Financial and capital account	9.4	10.9	2.3	1.8	0.9
Gross external debt	85.7	103.4	120.3	131.0	110.6
Reserve Cover (in months of imports) 3/	1.8	1.5	1.4	1.5	2.4
Fund Position (as of April 30, 2003)					
Holdings of currency (in percent of quota)					84.2
Holdings of SDRs (in percent of allocation)					0.5
Quota (in millions of SDRs)					117.6
Exchange Rate					
Exchange Rate Regime		Floating Exchange Rate			
Present Rate (July 14, 2003) 4/		123.74			
Nominal effective rate (change in percent)	0.2	-0.1	-16.7	3.0	...
Real effective rate (change in percent)	1.8	2.8	-13.2	5.6	...

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

1/ Projection

2/ National accounts basis.

3/ In months of imports of goods and services

4/ Trade weighted index of the exchange rate as krónur per unit of foreign currency (12/31/1991=100).

Statement by Vilhjálmur Egilsson, Executive Director for Iceland
August 22, 2003

Introduction

My Icelandic authorities would like to thank Mr. Escolano and Mr. Kupiec and their teams for their consultations in Reykjavík and thank them for the well balanced Staff Report and a very useful FSSA update. My authorities are in broad agreement with the main conclusion of the Staff Report and the views on the challenges ahead. Moreover, the FSSA Update report contains an excellent evaluation of the changes in the Icelandic financial sector in the past three years.

Economic prospects

The Icelandic economy experienced growth rates above the industrialized countries' average during the years 1996-2001. This led to a period of overheating that peaked in the year 2000 when the current account deficit exceeded 10% of GDP. These imbalances have now been corrected with only a relatively mild recession and in 2002 the current account had returned to balance. We fully agree with Staff that the stability-oriented policies implemented during the 1990s played a large part in this achievement. This includes the adoption of inflation targeting, the floating of the exchange rate, the independence of the Central Bank and prudent fiscal policies. Moreover, significant improvements were undertaken in the financial sector to address vulnerabilities, including some that were identified in the 2001 FSAP.

Growth is now picking up again after a standstill in 2002. GDP growth is now expected to be 2 ½ - 3% for this year and at or above 3½% for the next year. The outlook for the medium-term indicates that the economy is entering a period of strong growth led by investment in hydro-power facilities and energy-intensive industries.

My authorities agree with the Staff analysis on the policy challenges that lie ahead. The greatest challenge will be to avoid overheating and an unsustainable appreciation of the Icelandic króna during the period of investment-led growth that is expected to last until the end of this decade. The cumulative investment in the projects decided so far is expected to amount to about 35% of GDP.

While risks of overheating should not be underestimated, the economy is in many respects better equipped than in recent years to take on the challenges associated with these investment projects. Moreover, the investments will contribute to increased export revenues and further diversify the economy. My authorities, however, acknowledge that an appropriate policy mix will be necessary to prevent overheating.

Monetary Policy

The inflation rate has been low and below the Central Bank's target of 2½% for the whole of this year. This can be partly explained by the appreciation of the króna towards the end of last year and in the early part of this year and lower-than-expected global inflation. Assuming an unchanged monetary stance inflation is now forecast below the target for the whole of next year, but will reach the target in early 2005.

The most likely outlook is still that interest rates will remain unchanged for the time being, then rise as the peak of aluminium-related investments approaches. However, the point at which it may be necessary to raise interest rates could be further away than was foreseen earlier this year, since inflation has been very low recently and will most likely continue to be so, for reasons including low global inflation and greater slack in the economy. As always, the outcome will depend on future developments as well as fiscal policy. In light of the present low rate of inflation, however, it cannot be ruled out that negative shocks to domestic demand and to imported inflation might call for a temporary reduction in interest rates from their present level.

The Central Bank has since September 2002 made regular purchases of currency in the domestic inter-bank market on the basis of a pre-announced plan. The purpose of these purchases is to increase the Bank's reserves. It is taking advantage of the current conditions in the foreign exchange market, which strengthened markedly as plans for the investment projects in the energy sector emerged. Since beginning regular currency purchases in September last year the Central Bank has significantly built up its net foreign exchange reserves, thereby strengthening its capacity to meet the need for liquidity.

Fiscal Policy

The Icelandic authorities have pursued a policy of fiscal consolidation during the last decade. As a result, the Treasury budget has registered a surplus since 1997, enabling debt reduction and funding of pension obligations. This effort has continued despite the slowdown in the economy as the cyclically adjusted fiscal stance has been restrictive in the past two years. The outcome for 2003 is expected to be broadly in balance. My authorities agree with the Staff Report that fiscal policy should remain restrictive and that it will be necessary to further increase the budget surplus in light of the upcoming demand pressures from the investment projects. My authorities therefore acknowledge that fiscal policy will play a major role in preventing overheating of the economy in the next few years.

Furthermore, we agree with Staff that a medium-term fiscal framework is important in order to facilitate fiscal consolidation. In this context the Government intends to strengthen the medium-term orientation of the fiscal framework along the lines proposed by the IMF with particular emphasis on expenditure restraint and implementation of tax reforms consistent with macroeconomic stability. This undertaking will confirm the authorities' intention to meet the challenges ahead with appropriate measures.

Structural issues

The privatization program of recent years was stepped up after a short interlude and last year marked a milestone when the government sold its remaining stake in two commercial banks. The banking sector has now been fully privatized and this recent move facilitated a restructuring of the banking sector through mergers. The proceeds of the privatization of the banks have been used to pay down government debt. Further privatization is on the agenda and the government plans to privatize the state- owned telecommunications company, which will be the largest privatization project to date.

External imbalances
My authorities generally concur with the Staff's assessment of the external position in that it can be explained *inter alia* by demographics and a well funded pension system. Furthermore, the buildup in private sector gross debt is at least partly matched by strong growth of assets. The rapid increase in indebtedness followed financial liberalization and an investment boom in the mid-nineties. Most of the debt rests with the private sector. The banks have intermediated this flow of external debt and their external positions are under prudential supervision.

Nevertheless, my Icelandic authorities acknowledge that this trend should be contained to the extent possible and that policies should be pursued that aim at increasing national savings in the medium term.

Financial sector
My authorities warmly appreciate the efforts of the FSAP update team and generally agree with the findings of the FSSA Update Report. This effort will play a part in the authorities' continuing efforts to strengthen further the robustness of the Icelandic financial system. The draft Report confirms the significant improvements made to maintain economic and financial stability and to improve the regulatory framework since the initial FSAP was conducted in late 2000 and early 2001. Also, the importance of the initiatives taken by the Central Bank regarding the safety of payment systems is recognized. Furthermore, it includes observations and recommendations which my Icelandic authorities consider helpful.