October 2005
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Iceland: 2005 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Iceland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 13, 2005, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 12, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of September 26, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 3, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Iceland.

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

Selected Issues Paper

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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INTERNATIONAL MONETARY FUND

ICELAND

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the
2005 Consultation with Iceland

Approved by Alessandro Leipold and Martin Fetherston

August 12, 2005

- The Article IV consultation discussions were held in Reykjavik during June 2 to 13, 2005. The mission comprised Mr. Hunt (head), Ms. Westin, and Mr. Tchaidze (all EUR). Messrs. Solheim (Executive Director) and Olafsson (Advisor) attended some of the meetings. The staff met with the Permanent Secretary in the Prime Minister's Office, the Governor of the Central Bank of Iceland, other seniors officials from a wide range of public institutions, the major banks, the stock exchange, the largest private pension fund, academia, and employer and employee federations. Staff presented drafts of their Selected Issues papers in a seminar during the consultation.

- Iceland has accepted the obligations of Article VIII, Sections 2, 3, and 4. The exchange rate is free of restrictions on payments and transfers for current international transactions (Appendix I).

- Iceland subscribes to the Special Data Dissemination Standard, and data provision is adequate for conducting surveillance (Appendix III).

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

- There will be a general election in 2007. The ruling coalition comprises the center-right Independence Party (IP) and its junior coalition partner, the centrist Progressive Party (PP).

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Executive Summary

Background

Although average economic growth has been high over the last decade, inflation and output have been volatile. In large part, this reflects the periodic episodes of major investment in the energy and aluminum-smelting sectors. Following the completion of the late 90s investment projects, output declined in 2002. However, new projects have subsequently rekindled rapid growth and the economy is now exhibiting signs of overheating, with imbalances evident in inflation, the current account, and external debt. Both monetary and fiscal policy have been tightening, although to this point in the cycle, monetary policy has done the largest share.

Key policy issues

Outlook and Risks: Growth is forecast to be close to 6 percent in 2005, moderating slightly and shifting toward net exports the following year. The current account deficit is expected to peak at 12 percent of GDP in 2005, improving only slightly in 2006 given the rapidly growing level of external debt. Inflation is anticipated to remain well above the 2½ percent target over the next two years. Views differed regarding the risks to the outlook, with staff and the central bank concerned that imbalances could widen more than forecast and then unwind sharply with a rapid contraction in demand. The finance ministry, however, saw both near- and medium-term risks contained by a substantial increase in the economy's supply capacity satisfying much of the expected growth, and rising household debt-servicing costs preventing above-forecast demand growth.

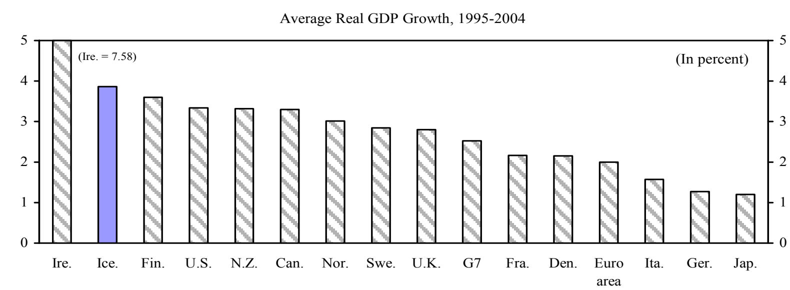
Fiscal policy: Given the different assessments of the risks, staff saw a stronger case than did the authorities for suggested measures to tighten the near-term fiscal stance. The authorities were receptive to staff's recommendations for strengthening the medium-term fiscal framework by defining the multiyear spending targets in nominal levels and deriving them from a rules-based system that would ensure a systematically countercyclical stance.

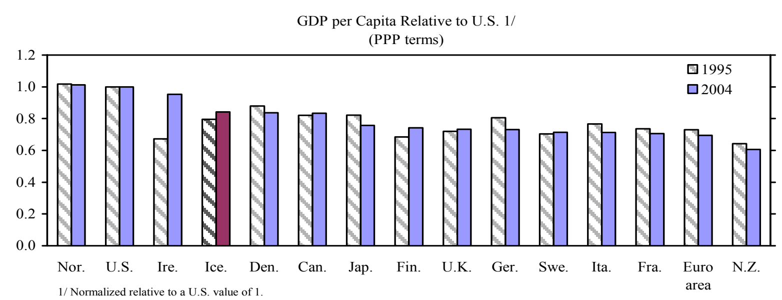
Monetary policy: The shared view was that monetary policy had responded appropriately to rising inflation and that persistent inflationary pressures would likely lead to further increases in interest rates. To more firmly anchor inflation expectations and thereby increase stability, staff made two, well-received, suggestions: the introduction of a pre-announced schedule for policy meetings that would conclude with a public statement regarding the bank's decision on interest rates; and publication of an interest rate path projected to return inflation to target.

Financial sector stability: Although stress tests and financial indicators suggested that the financial sector was sound, the financial supervisor is working toward implementing even more stringent stress tests as well as expanding their scope. There was agreement that the Housing Financing Fund could be reformed to allow banks a share of the mortgage market, which would increase financial stability, while retaining the benefits of the existing system.

I. Introduction

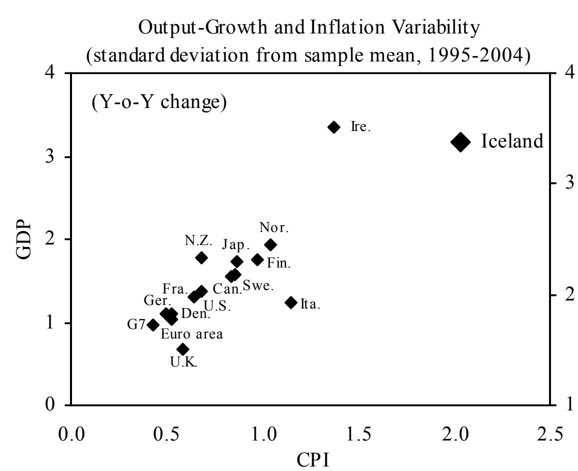
1. **Economic growth in Iceland has been impressive over the last decade.** GDP grew at an average rate of 3.8 percent between 1995 and 2004, second only to Ireland among industrial countries. As a result, Iceland's GDP per capita is now 84 percent of that in the United States. This success arises from a combination of factors that unfolded throughout the 1990s: major investment projects in the energy and aluminum-smelting sectors that helped diversify the economy and build export capacity; wide-ranging market liberalization and privatizations; and fiscal consolidation. The structural reforms implemented throughout the 1990s, the floating of the currency and the adoption of inflation targeting in 2001, and significant improvements in financial sector supervision introduced in the early 2000s have also helped improve the economy's resilience. This was illustrated by the relatively soft landing achieved in 2002, as the large imbalances from the investment boom of the late 1990s were resolved.





Source: World Economic Outlook.

2. **While average growth has been strong, macroeconomic volatility has been pronounced.** Both inflation and output-growth variability in Iceland have been notably higher than in other industrial countries. The major investment projects have contributed both to the high growth rate and to overall macroeconomic volatility because of their size relative to that of the economy. In addition to their direct effect on investment spending, the income and employment effects stimulate consumption,



adding to upward pressure on the exchange rate and inflation. After the peak of the investment cycle has been passed, the unwinding of the built-up imbalances results in sharp adjustments in domestic demand, the demand for imports, the exchange rate, and inflation. These features of the Icelandic economy pose significant challenges for macroeconomic policy aiming for both growth and stability.[1]

3. **Following the recession in 2002, new investment projects have rekindled rapid economic growth and imbalances have reemerged.** After declining by 2.1 percent in 2002, GDP grew by 4.2 percent in 2003 and a further 5.2 percent in 2004. The direct effect of the investments and their indirect effect on consumer confidence generated total domestic demand growth of close to 8 percent in both 2003 and 2004. The extensive use of foreign labor in the construction phase of the projects helped to limit labor market pressures. In addition, the slack in the goods market initially accommodated growth. However, the slack was quickly exhausted, and imbalances have started to emerge in the current account, external debt and—albeit to a more modest extent than in previous episodes—inflation (Figure 1).

4. **After recovering to a small positive balance in 2002, large current account deficits have reemerged.** As the investment projects require significant imports of capital goods, the reversal in the current account was to be expected. However, the additional contribution of imported consumption goods has been stronger than anticipated. The current account deficit is now forecast to peak at 12 percent of GDP in 2005, double that forecast at the time of the last Article IV consultation. In part, the increase reflects an upward revision to the size of the projects and the share occurring during the peak year. However, a significant portion also reflects the buoyant response of households to their improved prospects.

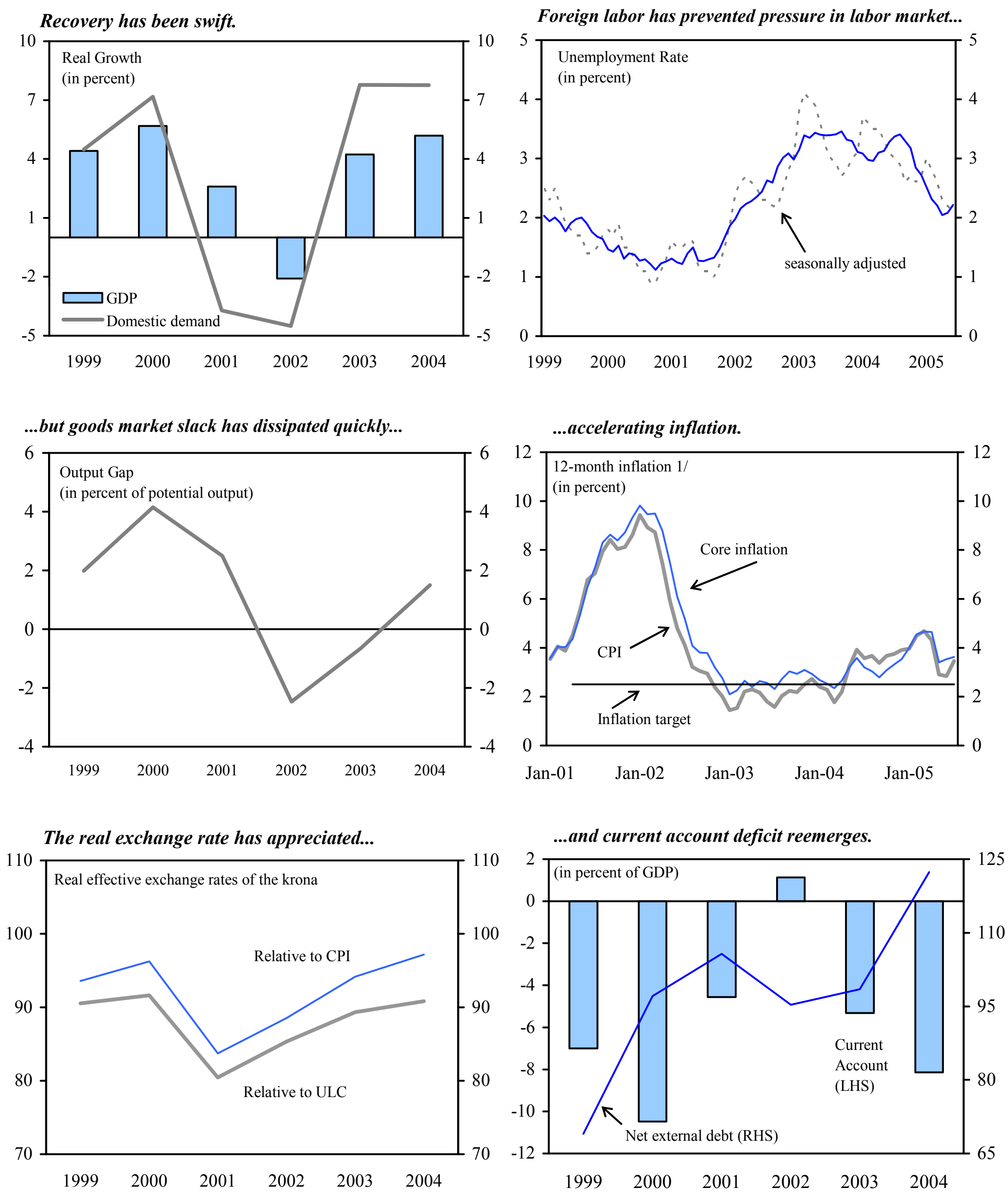
Decomposition of the Current Account in Percent of GDP

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Current Account	-7.0	-7.0	-10.5	-4.6	1.4	-5.1	-8.5
Balance on Goods	-4.4	-3.7	-5.7	-0.8	1.8	-2.0	-4.3
Merchandise exports f.o.b.	24.1	23.8	22.6	26.5	26.7	22.9	23.6
Merchandise imports f.o.b.	-28.5	-27.5	-28.3	-27.3	-24.8	-24.9	-27.8
Project related imports	-2.3	-1.2	-1.1	-1.0	-0.5	-1.2	-2.0
Balance on Services	-0.1	-1.1	-1.8	-0.2	0.0	-1.2	-1.7
Balance on Income	-2.2	-2.1	-2.9	-3.4	-0.5	-1.8	-2.4
Current Transfer, net	-0.2	-0.1	-0.1	-0.1	0.2	-0.1	-0.1

Sources: Central Bank of Iceland.

[1] This volatility also complicates economic projections as reflected in the large revisions and errors in both the staff's and the authorities' forecasts.

Figure 1. Iceland: Macroeconomic Indicators



Sources: Central Bank of Iceland; Directorate of Labor; Ministry of Finance; Statistics Iceland; and staff calculations.
1/ In May, the methodology for calculating the user cost of housing in the CPI changed. Moving to a 12-month moving average of interest rates from a 5-year moving average reduced y-o-y CPI inflation by roughly 0.5 percentage points.

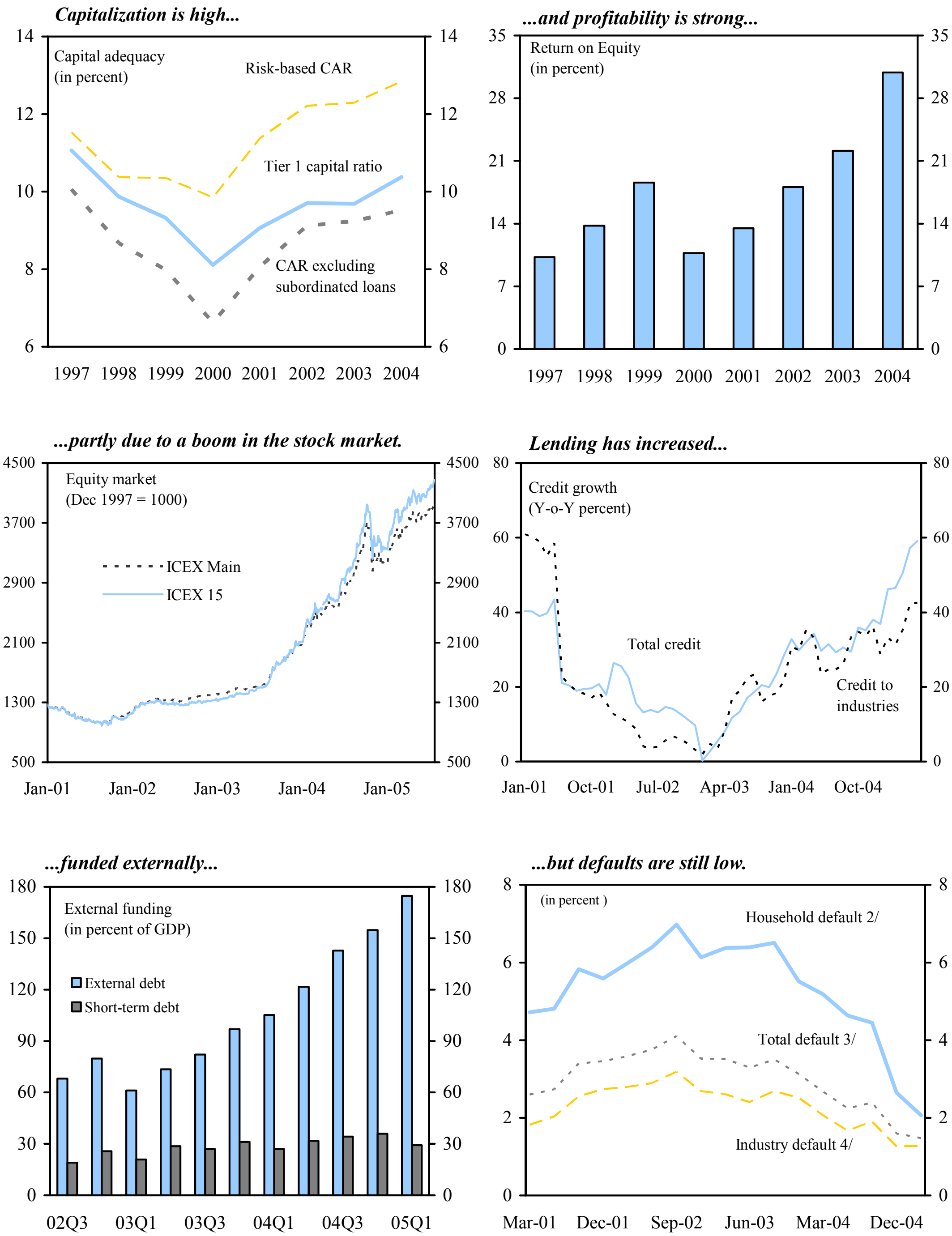
5. **External liabilities have increased sharply, primarily reflecting banks' use of foreign borrowing to fund domestic credit expansion.** Preliminary data show that the net external debt-to-GDP ratio increased from 98 percent in 2003 to 122 percent in 2004. In 2004, banks' lending to households grew by 98 percent and that to firms by 30 percent. Although banks' net external debt has risen sharply, limits are enforced on their open currency positions. Consequently, banks intermediate a large volume of foreign currency-denominated lending. While a significant portion of this goes to firms with foreign currency revenue streams, banks have also been increasingly extending foreign currency loans to domestic firms (although not in significant amounts to households) without such a natural hedge. The increase in banks' external liabilities also reflects their expansion abroad, principally to other Nordic countries and the United Kingdom. Encouragingly, banks' credit ratings have been improving over the last two years owing to their strengthening financial position. Capital adequacy ratios have been increasing well above required minimums, profitability has been high (in particular reflecting a stock market boom over the last year), and default rates are low and declining (Figure 2).

6. **In August 2004, banks began to compete with the Housing Financing Fund (HFF) for first mortgages, thereby accelerating the rate of expansion in household credit.** Prior to August 2004, the publicly guaranteed HFF dominated the first-mortgage market, and banks primarily provided the second mortgages required by households because of HFF lending limits. In the summer of 2004, banks saw an opportunity to enter the market when the HFF started issuing noncallable housing bonds directly to the market and offering mortgage loans at a fixed spread above the cost of finance. Given the increased transparency and the magnitude of the spread, banks matched loan rates, plus offered larger mortgages, higher loan-to-value limits, and the option to refinance existing mortgages, allowing equity withdrawal. Consequently, banks were able to quickly capture a large share of the market and HFF mortgages were prepaid in significant amounts. In response, the government accelerated reforms at the HFF to raise loan limits.

7. **Inflation exceeded the upper bound of the central bank's target range in early 2005, but has since moderated.** In February, with year-over-year CPI inflation at 4.5 percent, the central bank was obliged to submit a report to the government outlining why inflation had breached the 4 percent upper bound and the prospects for returning it to target (Figure 3). Domestic demand pressures, most notably in the housing market, were cited as the main factor underlying high inflation. In May, Statistics Iceland changed the methodology for calculating the user cost of housing in the CPI. The new methodology uses a 12-month moving average of real mortgage rates rather than the previous five-year moving average. With real mortgage rates declining between August and November 2004, this change, along with developments in food prices, resulted in year-on-year CPI inflation of 2.9 percent in May, considerably below the 4.3 percent reported in April.[2] However,

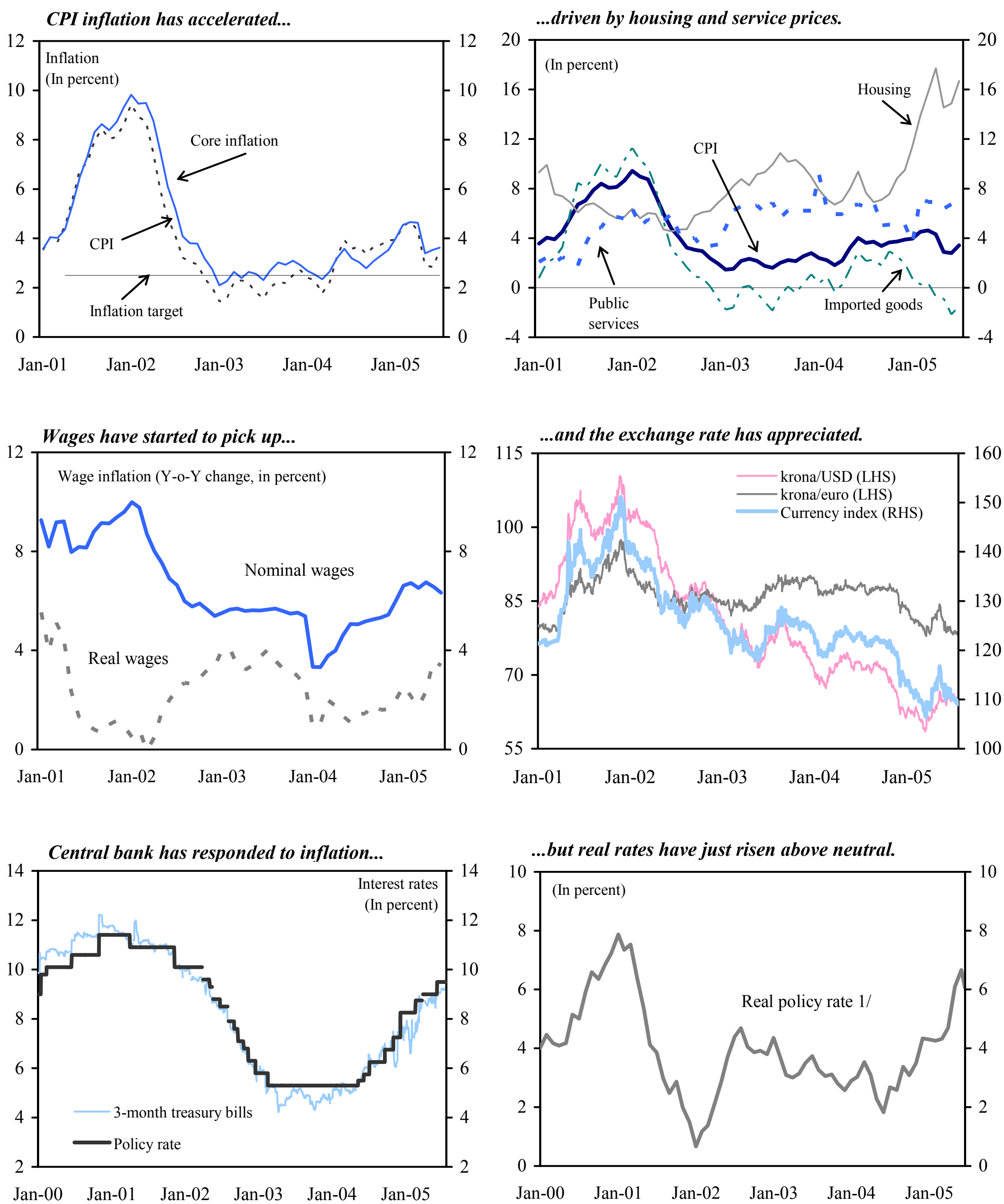
[2] The change in the CPI methodology reduced year-over-year inflation by 0.5 percentage points in May.

Figure 2. Iceland: Banking Sector Developments.



Sources: Bloomberg, Central Bank of Iceland, FME, and Statistics Iceland.
1/ICEX Main is an all-share index while ICEX 15 is calculated for the 15 largest and most traded companies.
2/ As a percent of loans to households.
3/ As a percent of total loans.
4/ As a percent of loans to industry.

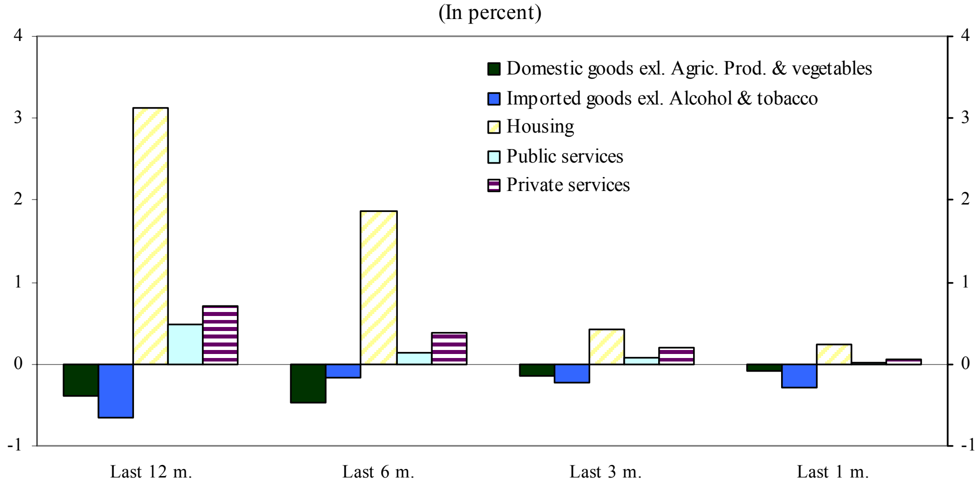
Figure 3. Iceland: Inflation



Sources: Central Bank of Iceland, Statistics Iceland, and staff estimates.
1/ Policy rate deflated by the CPI.

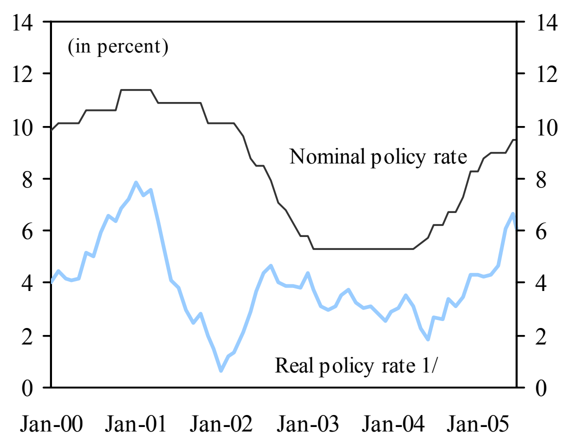
underlying inflationary pressures remain strong as reflected in year-on-year CPI inflation of 3.5 percent in July.

Components of Inflation as of July 2005
(In percent)



8. **The central bank has responded decisively to accelerating inflation.** Since May 2004, the policy rate has risen from 5.3 percent to 9.5 percent. However, because of the acceleration in inflation, the real policy rate has increased more slowly, only recently rising above the upper end of the range estimated for the neutral real rate. In spite of the policy tightening, increased competition and related developments in the mortgage market over the last year have led to a decline of roughly 150 basis points in effective long-term real mortgage rates. Although mortgages are indexed to the CPI, the resulting increase in servicing costs from higher inflation is small because the impact is spread over the remaining life of the mortgage.[3] The policy tightening has been reflected in the krona trade-weighted exchange rate index, which has appreciated by 10 percent over the last year.

Policy Rates



1/ Deflated by CPI.

9. **The fiscal stance has been tightened in 2004 and 2005, but the planned tax cuts will make for a broadly neutral stance going forward**. The general government balance

[3] The average duration of a mortgage loan in Iceland is roughly 22 years.

shifted from a deficit of 1 percent of GDP in 2003 to an estimated surplus of 0.4 percent in 2004. General government nominal expenditure growth exceeded that budgeted by 4 percentage points in the last year, with the largest slippages occurring at the local level. However, these slippages were more than offset by faster-than-budgeted revenue growth. For 2005, the budget contains additional restraint, with the most recent ministry forecast estimating a surplus of 0.9 percent of GDP, virtually the same as the staff's. Based on the multiyear spending targets, no significant further tightening will occur in 2006. A permanent reduction of 1 percentage point in labor income taxes took effect in January 2005, and additional reductions have been announced for 2006 and 2007. Permanent tax reductions can be introduced because of the extended period of prudent fiscal management, as illustrated by the low and declining ratio of general government debt to GDP, which stood at 23 percent at end–2004.

General Government, 2000-06
(in percent of GDP)

	2000	2001	2002	2003	2004	2005	2006
					prel.	proj.	proj.
Revenue	47.6	46.3	47.9	48.7	49.9	49.3	48.8
Expenditure	45.1	46.1	47.7	49.8	49.5	48.3	48.0
Overall balance	2.5	0.2	0.2	-1.0	0.4	1.0	0.8
Structural balance 1/	0.5	-0.8	1.4	-0.4	0.9	0.4	0.1
Net debt	24.0	26.9	23.8	24.2	22.9	21.0	18.9

Source: Ministry of Finance; and staff estimates.

1/ In percent of potential GDP.

Box 1. Implementation of Past Fund Policy Advice

The authorities have generally followed policies consistent with Fund advice, most particularly in the structural and institutional areas (market liberalization, privatization, monetary policy framework, and financial sector reform). In particular, the 2001 Financial Sector Assessment Program (FSAP) served as the basis for strengthening the legal framework for the financial supervisory system and establishing standards for risk control and risk management for the payments system. On fiscal policy, introducing multi-year spending targets into the budget was consistent with Fund advice on strengthening the medium-term framework. However, there has at times been less agreement with the advice on the appropriate cyclical fiscal stance.

Regarding the effectiveness of Fund surveillance, the authorities noted that the enhanced transparency of the IMF and the publication of the concluding statements were welcome developments. At the same time, a slower turnover in mission team members would ease resource costs of consultations.

Public information notice (PIN) following 2003 Article IV consultation is available on the web at http://www.imf.org/external/np/sec/pn/2003/pn03105.htm

II. Report on the Discussions

10. **With large imbalances emerging and likely to grow, discussions centered on ensuring that appropriate policies were in place to help contain the imbalances and their associated risks, and limit their reemergence beyond the current cycle.** There was agreement that the flexibility arising from wide-ranging structural reforms, a profitable and well-capitalized financial sector, and sound public finances were likely to have increased the economy's resilience, as testified by the relatively smooth unwinding of imbalances in 2002. Nonetheless, staff stressed that enhancing macroeconomic stability should be a central policy objective and accordingly focused the discussions on the following:

- achieving a tighter fiscal stance than currently envisaged over the remainder of the cycle;
- ensuring that the rapid expansion in external liabilities and domestic credit does not intensify vulnerabilities that will amplify the downturn once investment slows; and
- modifying the inflation-targeting and the medium-term fiscal frameworks to help limit the extent to which imbalances develop when large shocks hit the economy.[4]

A. The Outlook and Risks

11. **There was broad agreement that growth will be robust and imbalances will persist throughout 2005–06.** Staff and the authorities forecast GDP to grow by roughly 6 percent in 2005, driven by domestic demand. Project-related investment will peak in 2005, with the associated confidence and income effects on consumption amplified by the easing in mortgage credit conditions and cuts in labor income taxes. The current account deficit is forecast to be 12 percent of GDP in 2005. In 2006, growth is expected to ease, in part reflecting an anticipated further tightening in monetary policy. Higher interest rates and rapidly rising household debt levels are expected to moderate consumption growth and investment is forecast to decline from its project-related peak—although the share of investment in GDP will remain well above normal. While the level of imports is expected to remain high, given investment and consumption demand, net exports will contribute positively to growth in 2006, as some of the aluminum sector investments become productive and the fishery sector continues to redirect its output toward

Contribution to Growth in Percent of GDP

	2003	2004	2005 Staff Forecast	2006 Staff Forecast
GDP	4.2	5.2	5.8	4.9
Domestic Demand	7.7	7.9	10.1	1.9
Private Consumption	3.9	4.5	4.6	2.8
Public Consumption	0.7	0.8	0.5	0.5
Investment	3.1	2.7	4.9	-1.4
Stock Changes	-0.1	-0.1	0.0	0.0
Net Exports	-3.5	-2.7	-4.3	3.0
Exports, goods and services	0.6	3.2	1.9	3.4
Imports, goods and services	-4.0	-5.9	-6.3	-0.4

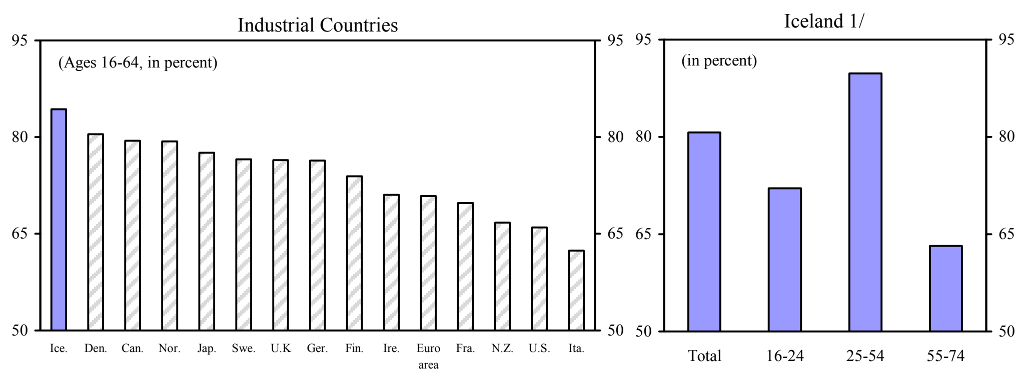
Source: staff estimates.

[4] Although some longer-term structural and trade issues are important for Iceland, they received less focus in this consultation because the current cyclical volatility and imbalance issues were jointly deemed to be more important.

higher-value-added products and markets. Little improvement is expected in the current account deficit in 2006, as the narrowing of the trade deficit will be partially offset by a deterioration in the income account, owing to the rapidly growing stock of foreign debt and the expected gradual rise of foreign interest rates.

12. **The authorities and staff both project inflation to remain well above the central bank's target through 2005–06.** Both the central bank and the staff forecast that strong growth will overheat the domestic economy and generate above-target inflation. The finance ministry, however, sees only modest excess demand pressures and attibutes inflationary pressure mainly to an expected gradual króna depreciation. This difference arises because the ministry forecasts a rapid increase in aggregate supply from a strong labor supply response to the tax cuts and the immediate addition of investment flows to the effective capital stock. Staff expect the labor supply response to be more modest because Iceland's labor force participation rate of 81 percent is high by all standards; furthermore, for the group aged 16 to 24, which has a relatively low participation rate, the tax cuts increase the incentives to acquire more education. Furthermore, it seems prudent to add investment flows to the capital stock only after the associated plant and equipment become fully productive.

Labor Force Participation Rates



1/ Total for ages 16-74.

13. **Beyond 2006, the shared outlook is for growth to slow to close to its potential rate, with staff, however, pointing to appreciable risks of a less benign outcome.** Although private consumption is expected to continue to be supported by strong income growth, investment will return to a normal level with the completion of the projects. More of the increased aluminum capacity will then be productive, and the reequilibration of the exchange rate is expected to stimulate exports and dampen imports. Consequently, the current account deficit is forecast to narrow sharply in 2007 and then exhibit a gradual improving trend beyond. The slowing in aggregate demand is forecast to result in modest excess supply, which, in combination with a slowing in house price appreciation due to the response of housing supply, will bring inflation back to target. This baseline view assumes that the increased flexibility in the Icelandic economy, not least of all in the exchange rate, will allow the built-up imbalances to be resolved in an orderly fashion. Staff, however, saw considerable risk of a less benign outcome, whose preemption provided the motivation for its policy advice.

14. **While there was broad agreement on the central scenarios, there was a different appreciation of the balance of risks.** In the near term, staff viewed the risks to be on the upside, in terms of persistent overheating pressures, with—in contrast—considerable downside risk of slower growth later on. Staff argued that, given the easing in credit conditions, households could respond more than forecast to their improved income and wealth positions, thereby widening the imbalances—a concern shared by the central bank. In addition, staff stressed that relying primarily on monetary policy to contain demand pressures, as the currently expected policy mix does, risks further exchange rate appreciation and a greater-than-forecast widening of the external imbalances. Staff observed that once the investment projects have been completed, the extent of the downside risk would be related to the magnitude of the built-up imbalances. A sharp correction in the currency, possibly sparked by the scale of the imbalances or disorderly conditions in international capital markets, could then produce a much larger retrenchment than expected in domestic demand, particularly in light of the high and rapidly growing level of foreign indebtedness. The finance ministry contended that the increase in debt-servicing costs from the growing household debt burden would provide a natural brake on consumption, limiting risks in both the near and long term.

B. Fiscal Policy

15. **Although the fiscal stance has tightened as growth has accelerated, no additional tightening relative to the multiyear plan in the 2005 budget is currently envisaged.** With projections of general government surpluses during 2005–06 of less than half of the average achieved over 1999–00, the peak years of the previous investment-led boom, staff called for a tighter fiscal stance, as outlined in the text table. With the forecast for higher growth and wider imbalances than when the 2005 budget was drawn up, staff saw a strong case for additional fiscal restraint. The authorities' view was that the fiscal stance did not need to be as tight because the structural change in the economy since the previous boom had increased its resilience. In addition, the authorities noted that the 2005 fiscal surplus would likely be larger than the most recent projection because tax receipts were running above forecast. Given that the main surprises were in value-added tax receipts and stamp duties on housing transaction, staff suggested that this could point to greater-than-projected demand pressures.

General Government, 2005-06 - Suggested Measures
(in percent of GDP)

	2005	2006
Revenue measures		
Delay reduction in personal income tax	...	0.4
Enhance use of co-payments and user fees	...	0.4
Expenditure measures		
Contain publ. exp. growth to 7% and 6%, resp.	0.2	0.7
Contain public investment to 2.5% of GDP	0.8	0.7
Total impact of measures	1.0	2.2
Overall balance without measures	1.0	0.8
Overall balance with measures	2.0	3.0
Structural balance with measures 1/	1.4	2.4

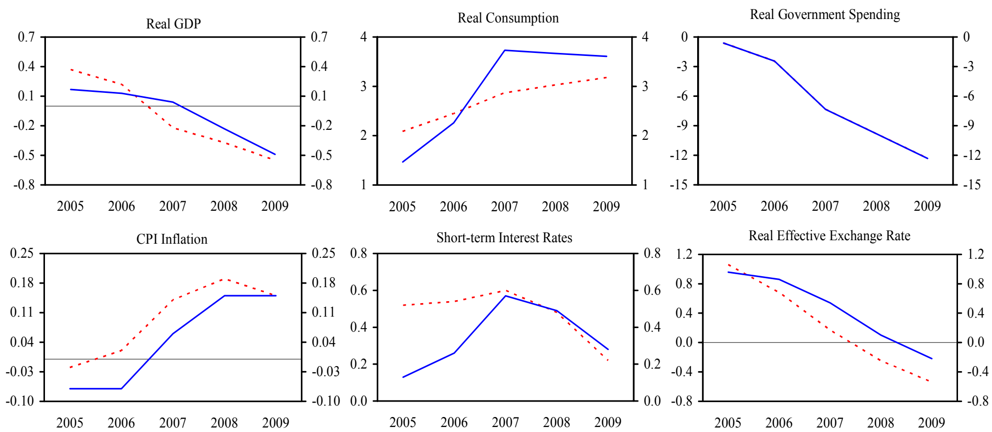
Source: Staff estimates.
1/ In percent of potential GDP.

16. **Views differed on whether the labor supply response to the tax cuts would prevent them from adding to the overheating.** The staff advised that the tax cuts planned for 2006 and beyond be postponed until it was clear that excess demand conditions had dissipated fully. Staff reasoned that the tax cuts would contribute to overheating, particularly in light of the increased availability of low-cost finance (Box 2). The authorities expected that a strong labor supply response to the tax cuts, estimated at 800 people a year through

2005–07, would satisfy the additional demand. Staff expected, however, that the labor supply response would be more modest.[5]

Box 2. The Effect of Permanent Tax Cuts

MULTIMOD Simulation: Permanent Reductions in Labor Income Taxes
(percent or percentage point deviation from baseline)



A permanent reduction in labor income taxes is simulated in MULTIMOD under two assumptions about the proportion of liquidity-constrained households (solid line 40 percent and dotted line 10 percent).[1] The path for the tax cut replicates that announced for Iceland starting in 2005 (1 percentage point in 2005,1 percentage point in 2006, and 2 percentage points in 2007). Government spending is permanently reduced to sustain the tax cut. These simulations illustrate how the tax cut may contribute to the projected short-term overheating in the economy, and how the developments in the mortgage market in Iceland, which have reduced the proportion of liquidity-constrained households, may amplify these effects.

[1] Selected issues paper, "Some Illustrative Simulations of the Potential Impact of Income Tax Cuts in Iceland".

17. **There was more agreement on the scope for reducing government expenditures, particularly public investment.** The authorities noted that public investment projects scheduled for 2005–06 could be postponed without impeding the economy's supply capacity. Because the multiyear spending targets for public consumption are formulated in real terms and then converted to nominal terms using the CPI forecast, nominal public consumption is

[5] In addition, staff analysis presented in the selected issues chapters suggests that, even if the labor supply responds as the authorities expect, it will not prevent overheating. In the staff's MULTIMOD-based simulations, the increased production capacity would be quickly absorbed because those entering the labor force would demand consumption goods and firms would increase investment demand in response to the additional labor supply growth.

projected to grow at above 7 percent in 2005–06. Staff argued that more modest increases would be both possible and advisable, pointing to the introduction or expansion of user fees in health care and education as a possible option. In addition, staff noted that the risk of stronger-than-expected municipal spending in the run-up to the local elections in early 2006 strengthened this case. Without agreeing on the specific measures, the authorities concurred that reducing the growth in public consumption could be considered, especially if economic indicators suggested more overheating than currently forecast.

18. **The authorities were receptive to staff recommendations for strengthening the medium-term fiscal framework.** Although the debt sustainability analysis presented in Appendix II indicates that fiscal policy is on a sound footing from a medium-term perspective, staff saw a stronger role for fiscal policy in supporting monetary policy and helping to reduce overall macroeconomic volatility. It recommended that the multiyear pending targets be specified in nominal—rather than real—terms at the general government level and that central and local governments cooperate more closely to ensure that slippages do not occur. Nominal spending targets, it noted, were more transparent, enforceable, and consistent with the inflation-targeting framework. The authorities agreed that closer cooperation between levels of governments would be beneficial, but noted that local governments highly valued their independence and would resist spending constraints imposed by the central government. They noted that although nominal spending targets had several positive features, the indexing culture was strong in Iceland because of the experience of high inflation in the 1970s and in the 1980s and that such a change would need to be implemented gradually. Staff also called for the introduction of a rules-based system to derive the multiyear spending targets to ensure the simultaneous achievement of the government's medium-term debt target and a consistently countercyclical fiscal stance.[6] The authorities saw merit in introducing such a system to guide the medium-term fiscal framework.

19. **The authorities noted that the privatization of Iceland Telecom was proceeding as planned.** They indicated that they had strived to ensure an open and transparent process. Proceeds from the sale, a significant portion of which the authorities anticipate will go to debt reduction, are expected to be higher than the ISK 35–40 million sought in 2001. Staff encouraged the authorities to use the entire proceeds for debt reduction.

C. Monetary Policy

20. **The shared view was that the pace of monetary tightening over the last year has been appropriate.** Although overheating in the housing market has been one of the main reasons for above-target headline inflation, the decisive monetary policy response was

[6] Such a rules-based approach could be broadly patterned after that used in the United Kingdom which includes both a target for the deficit over the cycle as well as a target for net government debt. The approach would need to be customized for Iceland to achieved the desired magnitude of the countercyclical stance.

appropriate for several reasons. First, the central bank's mandate specifies the inflation objective in terms of headline CPI including housing. Second, because headline CPI is used to index mortgages, house price inflation has important long-term implications for household welfare. Third, excess demand conditions in the housing market are often a leading indicator of general demand conditions, and forward-looking monetary authorities need to respond to such indicators.

21. **There was agreement that, although temporary factors had recently lowered CPI inflation, persistent inflationary pressures were still strong and further increases in the policy rate were likely.** Three key factors that had temporarily lowered CPI inflation were pointed out: revisions to the methodology for computing the user cost of housing (see para 7);[7] a price war among discount food stores; and the pass-through of the exchange rate appreciation. The revision to the CPI methodology—given base effects—is not expected to have a downward impact on inflation beyond November 2005. While the food price competition effect was expected to be short-lived, the exchange rate pass-through could continue for the remainder of the year. However, the central bank expected that despite these temporary factors, excess demand conditions would continue to exert upward pressure on inflation.

22. **The developments in the mortgage market were seen by all to be forcing the central bank to rely more heavily on the exchange rate channel for monetary transmission.** The monetary authorities emphasized that even though long-term mortgage rates had been falling and credit availability increasing while the policy rate was rising, monetary policy was not impotent. At the same time, they recognized the increase in downside risk further out, inherent in relying heavily on the exchange rate channel, especially in the absence of a tighter fiscal stance.

23. **Staff suggestions for improving the monetary policy framework were well received.** The authorities noted that inflation expectations continue to be based heavily on actual outcomes. Staff suggested two changes that could help anchor inflation expectations. First, in addition to the current practices associated with the publication of the quarterly *Monetary Bulletin,* a preannounced schedule for the intervening monetary policy meetings could be introduced. These meetings would also conclude with a public statement of the central bank's decision regarding interest rates. This would increase the public profile of monetary policy, enhance transparency, and help formalize the communications and decision-making process within the central bank. Second, the Monetary Bulletin could include a scenario based on an interest rate path that the central bank viewed as necessary to return inflation to target. In response, the central bank noted that they did conduct regularly scheduled monetary policy meetings; however they agreed that the staff recommendations could prove helpful.

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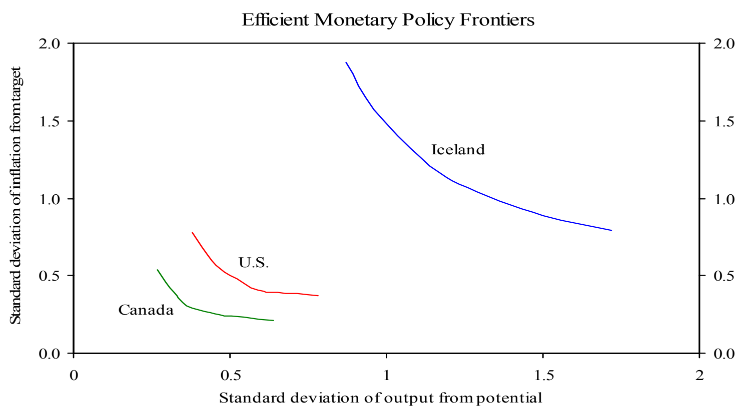
[7] Regarding the revisions to the CPI, the central bank noted that with shorter moving average of interest rates in use, changes in monetary policy could have a perverse impact on CPI inflation in the short term.

24. **The authorities and staff concurred that controlling inflation was more difficult in Iceland than in many other inflation-targeting countries and discussed possible measures to address this.** Empirical analysis presented by staff suggested that inflation was more likely to be outside the Icelandic central bank's tolerance band than for a larger inflation-targeting country like Canada (Box 3). The staff discussed with the authorities the relative costs to credibility of being outside the band versus operating within a wider band. The authorities felt that the recent episode of inflation outside the band had not been costly to credibility and were reluctant to risk the potential cost of widening the range, especially given the relative newness of the framework. Staff suggested that targeting a price index that removed some volatile components—such as food and energy prices, as has been done in other countries—could help address the issue. The authorities agreed, but noted that it would be important to wait until headline inflation had been firmly reanchored to the target before changing the targeted index.

Box 3. Achievable Inflation and Output Variability in Iceland



The efficient policy frontiers for Iceland, the United States and Canada suggest that the inflation-output variability tradeoff faced by the monetary authorities in Iceland is considerably less favorable than that faced by either Canadian or U.S. authorities. This reflects the small size of the Icelandic economy relative to the magnitude of the economic shocks to which it is subjected.

The frontiers are constructed by using estimated macroeconomic models of these countries to examine simple efficient monetary policy rules for Iceland.[1]

[1] Selected issues paper, "Simple Efficient Policy Rules and Inflation Control in Iceland."

D. Competitiveness

25. **Even allowing for the uncertainty about its equilibrium level, there was broad agreement that the real effective exchange rate was modestly overvalued.** Expectations were that the overvaluation, which long-term averages suggest is in the 10 to 15 percent range, would gradually dissipate as investment and interest rates returned to more normal levels. The authorities noted that, although the level of the exchange rate was squeezing

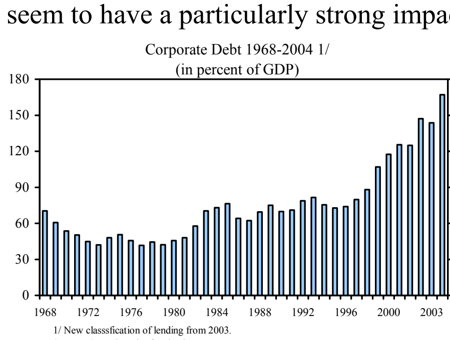
profits in some sectors, most export-oriented companies were becoming adept at adjusting to exchange rate fluctuations. For example, the fisheries have been very effective at adopting processing techniques that increase value added and allow them to direct their output toward markets where prices were high. There have been some fish-processing plant closures, but the authorities saw this as a required rationalization that was being accelerated by the current exchange rate level. Furthermore, these closures were not raising employment concerns as there will be job opportunities in some of the affected areas at the new aluminum facilities. Regarding economywide competitiveness, discussions with labor and employer federations suggested that the parties to the private sector wage agreements will act responsibly, as they have in the past, when deciding whether the current multiyear wage agreements should be reviewed in November 2005.

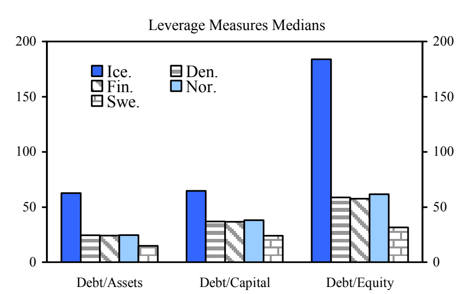
E. Financial Sector

26. **Financial Supervisory Authority (FME) officials observed that stress tests and other indicators suggested that the financial sector was sound, despite the rapid pace of credit expansion.** In aggregate and by institution, the major banks would continue to meet minimum capital adequacy standards if bond and equity prices were to fall sharply and defaults increased substantially. Given the recent large increase in equity and house prices, FME officials also noted that they would be implementing more stringent tests in these areas. Staff asked about progress on the ongoing work related to exchange rate and interest rate stress tests, which are becoming increasingly important because of the rapidly growing levels of external, household, and firm debt, a large portion of which is foreign-currency denominated (Box 4, Figure 4). Regarding exchange rate stress tests, FME officials noted

Box 4. Iceland's Corporate Leverage

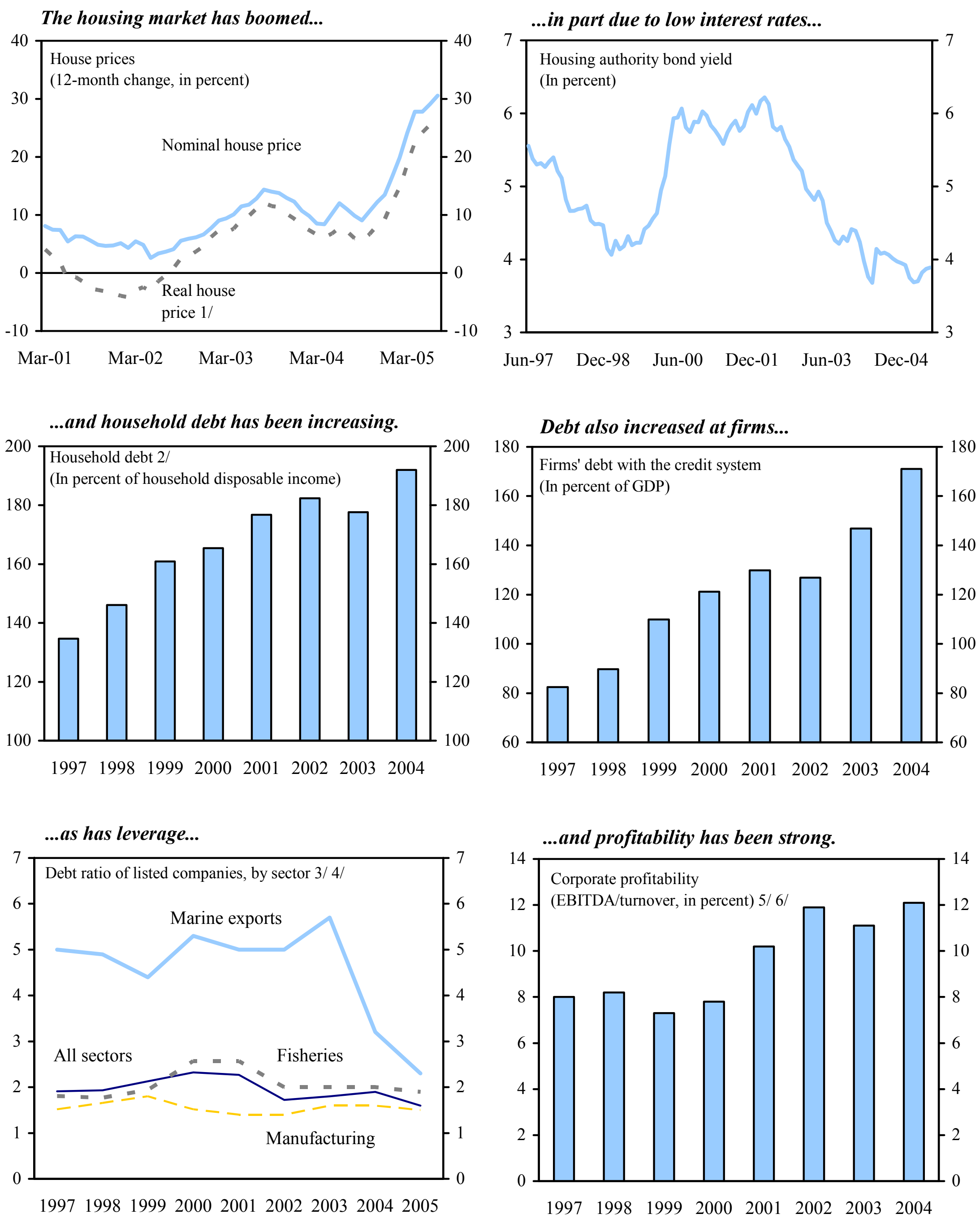
Icelandic firms' debt has risen sharply since the mid-1990s, reaching more than 160 percent of GDP in 2004. Since high leverage can contribute significantly to corporate distress in the presence of macroeconomic shocks, it is important to verify whether these rates are Iceland-specific and identify driving forces. Using a unique data set on corporates, the staff finds that, irrespective of the measure of leverage used, Icelandic firms are more leveraged than in other Nordic countries, both throughout the sample (1995-2003) and across industries.[1] Further analysis shows that there may be fundamental reasons for this finding. Specifically, the tax regime, which until recently has been more beneficial to debt than to equity issuance, and the industrywide degree of internationalization, as measured by the ratio of exports to production, seem to have a particularly strong impact on leverage in Iceland.





[1]Selected issues paper, "Corporate Leverage: How Different is Iceland?"

Figure 4. Iceland: Households and Firms' Balance Sheets



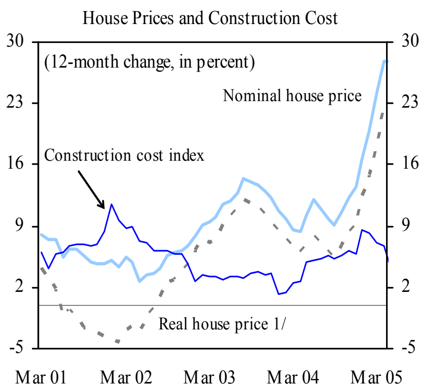
Sources: Central Bank of Iceland.
1/ Deflated by CPI.
2/ Household debt decreased in 2003 as a result of loan reclassification. Adjusted data not available prior to 2003.
3/ Debt as percentage of equity.
4/ 2004 data as of June.
5/ Listed companies.
6/ Earnings before interest, taxes, depreciation, and amortization.

that, in cooperation with the central bank, they had compiled a preliminary data set that would allow them to examine the vulnerabilities presented by banks' indirect exchange rate exposure. Work on interest rate stress tests was still in a preliminary phase. FME officials expressed some concern about recent developments at the HFF, which they now supervised. With the HFF relying extensively on noncallable bonds for funding and prepayments running high as a result of banks' entry into the mortgage market, the HFF is lending excess funds to banks. This is not a legislated core activity for the HFF, and its capital adequacy requirements do not reflect the risk of such activities. FME officials stressed the need for the government to quickly address this issue.

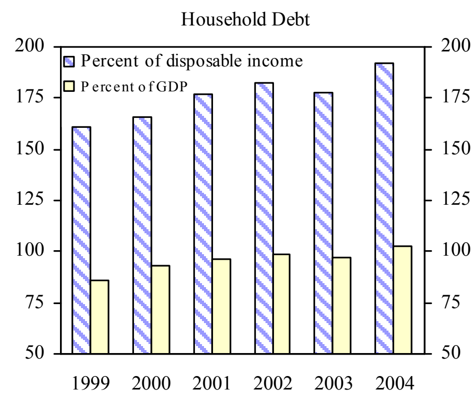
27. **It was agreed that the entry of banks into the mortgage market was a positive development, and that the HFF should be reformed to ensure that this presence could be sustained.** To diversify their assets and increase the stability of earnings, domestic banks need to increase their share of the mortgage market. Starting in August 2004, banks have begun to do so, competing directly with the HFF for first mortgages (Box 5). However, as the HFF enjoys a public guarantee, it is not clear whether banks will be able to sustain this

Box 5. Mortgage Market Developments in Iceland[1]

In 2004, the publicly-guaranteed Housing Financing Fund (HFF) reformed its mortgage financing and increased its lending limits, in part in response to the entry of commercial banks into the mortgage market. As a result, mortgage lending increased sharply and real mortgage rates declined substantially. New possibilities to refinance and withdraw equity have contributed to the demand pressures in the economy, with spill-over effects on the housing market, residential construction, and household debt.



1/ Deflated by CPI.
Source: Statistics Iceland.



Source: Central Bank of Iceland.

Few countries provide public support through the mortgage system to the extent that is done in Iceland today, with interest rate subsidies for single-family housing generally focused on social needs. The recent developments in the Icelandic mortgage market might constitute a golden opportunity for reform of the HFF, aimed at maintaining the benefits of the current system while also allowing for banks to remain profitably in the mortgage market.

[1] Selected issues paper, "Mortgage Market Developments in Iceland and the Role of the Housing Financing Fund."

activity on a profitable basis without taking on excessive risk on the funding side. Given the country's level of wealth and high rate of homeownership, staff questioned the need for a publicly backed retail mortgage finance institution such as the HFF. The authorities noted that, in addition to ensuring access to homeownership regardless of income or region of residence, the HFF served two other important functions. First, because Iceland is so small, having a single entity securing the funding allows for economies of scale that help ensure low-cost mortgage finance. Second, having a single institution issuing housing bonds has increased those bonds' international profile, ensuring a liquid market for domestic-currency-enominated bonds. Staff suggested, and the authorities agreed, that the HFF could be reformed in such a way that banks could profitably remain in the mortgage market, thereby increasing financial stability, while still retaining the positive features of the current system.

F. Other Issues

28. **Statistics Iceland officials and staff discussed the motivation for the change in the CPI methodology introduced in May.** Officials indicated that moving to a shorter moving average of interest rates was more consistent with the objective of capturing the spot user cost of housing. Initially, the longer moving average was used to avoid the possibility that interest rate volatility would induce excess volatility in the CPI. However, real mortgage rates have turned out to be less variable than expected, and the decision was made to shorten the averaging period. While agreeing with the theoretical motivation for the change, staff raised concerns about the timing and the lack of preannouncement. Officials agreed that these were important considerations and in the future such changes would be announced well in advance. Furthermore, they saw the merit of keeping such methodological changes to a minimum.

29. **Official development assistance (ODA) is targeted to increase from an expected 0.21 percent of GNP as of end-2005 to 0.35 percent in 2009.** The authorities noted that one of the greatest challenges with ODA was ensuring that it effectively alleviated poverty. To that end, they have increasingly been focusing on specific projects, and because it has worked well, plan to continue with this approach.

30. **A successful conclusion to the Doha round would be welcomed by the authorities.** It was noted that this would likely imply a reduction in agricultural subsidies and trade protection. Although agricultural subsidies were politically important in Iceland, the authorities expressed confidence that adjustment could be accommodated.

III. Staff Appraisal

31. **The authorities have consistently implemented policies that have supported strong economic growth, but the challenge now is to increase macroeconomic stability.** In particular, at the current point in the economic cycle, appropriate policy measures need to be put in place so that the unwinding of the imbalances in the current account, external debt, domestic demand and inflation following the completion of the current investment projects do not generate excessive volatility in real activity.

32. **Although fiscal policy has been tightened, a more restrictive stance than that contained in the 2005 budget is required.** While the increased flexibility of the economy —not least of which is the flexible exchange rate regime introduced in 2001—has enhanced its ability to quickly adjust, prudence is called for to avoid the potentially large negative impact of a disorderly unwinding of the imbalances. Since the drafting of the 2005 budget, the outlook for aggregate demand has been revised upward considerably and projected imbalances have widened. Consequently, fiscal policy should be tightened appropriately.

33. **The required fiscal tightening will need to rely on both expenditure and tax measures.** On the expenditure side, additional public investment projects, including some of those planned for the remainder of 2005, should be delayed until after the energy-intensive investment cycle peaks. On the tax side, although reducing income taxes stands to have longer-term benefits for labor supply, the impact is likely to unfold gradually and be modest, given Iceland's already commendably high labor market participation rate. It would, therefore, be prudent to postpone the tax cuts announced for 2006 and beyond until it is clear that excess demand in the economy has dissipated. If the tax cuts cannot be delayed, offsetting cuts in government expenditure, beyond those currently planned, should be identified and implemented. This may also be an opportune time to introduce or extend the application of user fees in health care and education. Additionally, proceeds from the privatization of Iceland Telecom should be fully used for debt reduction.

34. **Although public finances are on a sound footing from a medium-term perspective, the medium-term fiscal framework could usefully be strengthened.** The introduction of multiyear spending targets was a step in the right direction, but more can be done. Defining these targets in nominal terms at the general government level would be beneficial and the central and local governments should cooperate more to prevent slippages. Furthermore, the multiyear spending targets should be derived from a rules-based approach that ensures the simultaneous achievement of the government's medium-term target for public debt and a consistently countercyclical fiscal stance. This would enhance the prospects for achieving both strong and stable growth.

35. **Monetary policy has been responding appropriately to emerging demand and inflationary pressures.** Rising house prices have contributed significantly to inflation. However, they are indicative of the general overheating of the economy, and the policy response has hence been appropriate. While temporary factors have recently lowered measured CPI inflation, monetary policy should continue to focus on the underlying demand conditions that are the primary source of persistent inflation. The developments in the mortgage market, which have lowered the cost of long-term financing to households, have increased the challenge of stabilizing inflation. The central bank will need to be prepared to respond to changing economic circumstances, while recognizing that having to rely heavily on the exchange rate channel for the transmission of monetary policy, given the current overvaluation, will add further to external imbalances and the sharpness of the eventual unwinding.

36. **Because of the size of the economy, stabilizing inflation in Iceland is a more difficult task than in larger inflation-targeting countries and measures to help address this should be implemented.** Introducing a schedule for preannounced monetary policy

meetings that conclude with a public announcement of the central bank's decision regarding interest rates could help enhance inflation stability by more firmly anchoring inflation expectations. The inclusion in the *Monetary Bulletin* of a scenario based on an interest rate path that would return inflation to its target could also be helpful in this regard.

37. **Once the current investment cycle has been completed, further enhancements to the monetary policy framework could increase the stability in both inflation and real economic activity.** Although the indexation of mortgage loans in Iceland, among other reasons, makes it important to continue to target a measure of inflation that includes house prices, removing volatile components—such as energy or food, as has been done in other countries—could be considered.

38. **The risks to financial stability of the ongoing credit boom should be monitored closely and prudential measures implemented quickly if required.** Financial institutions have strong balance sheets. Given that asset prices are continuing to accelerate sharply, the development of more stringent stress tests is welcome and staff looks forward to the FME's prompt implementation. Furthermore, in light of the rapidly growing debt levels, a large portion of which is foreign-currency denominated corporate debt, the FME should accelerate the pace of developing and implementing interest rate and exchange rate stress tests. The importance of this is further highlighted by the sensistivity of the external debt positon to exchange rate movements, as illustrated in the external debt sustainability analysis.

39. **The entry of commercial banks into the mortgage market has been a positive development from a financial stability perspective, but reform of the HFF will be necessary to ensure that the banks' presence can be sustained.** If banks must compete directly with the HFF, which enjoys a funding advantage because of its state guarantee, it is not clear whether they can profitably sustain their mortgage-market lending. Consequently, expeditious reform of the HFF is necessary. The reform should be guided by broad principles that will retain the positive aspects of the current system, while allowing it to evolve in a manner that will strengthen the stability of the financial system.

40. To provide the opportunity for an early assessment of developments in current demand pressures and related imbalances, it is proposed to move the next Article IV consultation temporarily to the standard 12-month cycle.[8]

[8] Iceland was shifted from a 24- to a 12-month cycle also during the 2001–03 boom episode. In August 2003, in light of the positive assessment of the FSAP update and encouraging macroeconomic performance, Iceland was returned to a 24-month cycle.

Table 1. Iceland: Selected Economic Indicators, 2000-06

	2000	2001	2002	2003	2004	2005 Staff Forecast	2006 Staff Forecast
	(Percentage change unless otherwise noted)						
National Accounts (constant prices)							
Gross domestic product	5.7	2.6	-2.1	4.2	5.2	5.8	4.9
Total domestic demand	7.2	-3.7	-4.5	7.8	7.7	9.6	1.8
Private consumption	4.4	-3.5	-1.4	6.6	7.5	7.5	4.5
Public consumption	4.4	3.1	3.2	3.5	3.6	2.5	2.5
Gross fixed investment	15.3	-6.4	-20.9	17.0	12.8	22.2	-5.5
Export of goods and services	4.0	7.4	3.9	1.4	8.3	4.9	8.7
Imports of goods and services	8.0	-9.1	-2.7	10.4	14.3	14.1	0.9
Output gap 1/	4.2	2.5	-2.5	-0.6	1.5	3.0	3.6
Selected Indicators							
Fish catch (at constant prices)	1.3	7.7	3.2	-0.5	0.6	...	...
Unemployment rate 2/	1.3	1.4	2.5	3.4	3.1	2.3	1.7
Real disposable income per capita	2.1	1.1	0.4	0.2	3.7	...	...
Consumer price index	5.1	6.6	4.8	2.1	3.2	3.4	3.5
Nominal wage index	6.6	8.9	7.1	5.6	4.7	5.5	5.5
Nominal effective exchange rate 3/	-0.1	-16.7	3.0	6.4	2.1	...	...
Real effective exchange rate (CPI) 3/	2.9	-13.0	5.7	6.3	3.2	...	...
Terms of trade	-2.7	0.2	0.6	-4.2	-1.3	1.2	-3.8
Money and Credit							
Deposit money bank credit (end-period)	26.7	17.4	5.2	25.6	48.8	...	...
Domestic credit (end-period)	26.2	13.2	0.8	16.4	41.3	...	...
Broad money (end-period)	11.2	14.9	15.3	23.5	15.7	...	...
CBI policy rate (period average)	10.4	10.9	8.4	5.4	6.3	...	...
Public Finance (in percent of GDP)							
General government 4/							
Revenue	47.6	46.3	47.9	48.7	49.9	49.3	48.8
Expenditure	45.1	46.1	47.7	49.8	49.5	48.3	48.0
Balance	2.5	0.2	0.2	-1.0	0.4	1.0	0.8
Balance of Payments (in percent of GDP)							
Current account balance	-10.5	-4.6	1.4	-5.1	-8.5	-12.0	-11.4
Trade balance (goods)	-5.7	-0.8	1.8	-2.0	-4.3	-8.3	-6.4
Financial and capital account	11.4	2.6	0.0	2.1	15.7	12.0	11.4
o/w: reserve assets 5/	0.9	0.7	-0.7	-2.9	-1.7	-0.5	0.1
Net errors and omissions	-1.0	1.9	-1.4	3.0	-7.2	0.0	0.0
Gross external debt	104.3	121.8	135.1	159.1	220.2	204.5	194.3
Central bank gross reserves (in months of imports of goods and services) 6/	1.5	1.4	1.5	2.3	2.3	2.3	2.3

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/ Excluding imports from the construction of hydropower facility and smelters in 2003-04.

Table 2. Iceland: Summary Operations of the General Government, 1999-2006

(in percent of GDP)

	1999	2000	2001	2002	2003	Prel. 2004	Proj. 2005 MoF	Proj. 2005 IMF	Proj. 2006 IMF
Total revenue	47.9	47.6	46.3	47.9	48.7	49.9	48.3	49.3	48.8
Current revenue	45.8	45.6	44.3	45.8	46.7	47.9	46.3	47.2	46.7
of which:									
Direct taxes	19.0	19.5	20.2	20.6	21.2	21.8	20.8	21.2	20.7
Indirect taxes	20.5	19.8	17.5	17.9	18.7	19.3	19.2	19.7	19.9
Interest income	1.4	1.5	2.0	2.5	1.7	1.8	1.5	1.5	1.4
Capital revenue	2.1	2.0	2.0	2.1	2.1	2.0	2.0	2.1	2.0
Total expenditure	45.5	45.1	46.1	47.7	49.8	49.5	47.4	48.3	48.0
Current expenditure	39.7	39.9	40.5	42.8	45.1	44.1	42.7	43.5	43.5
of which:									
Interest expenditure	3.7	3.4	3.9	3.4	3.6	3.3	3.1	3.2	2.7
Capital expenditure	5.7	5.2	5.7	4.9	4.7	5.4	4.7	4.8	4.5
Primary balance	6.1	5.9	4.0	3.6	2.6	3.7	4.1	4.2	3.5
Overall balance	2.4	2.5	0.2	0.2	-1.0	0.4	0.9	1.0	0.8
Debt position									
General government gross debt	44.6	42.1	47.9	44.5	42.3	37.0	33.7	33.1	30.2
General government net debt	24.2	24.0	26.9	23.8	24.2	22.9	21.9	21.0	18.9
Cyclically adjusted 1/									
Primary revenue	46.4	45.9	44.3	45.4	47.1	48.2	...	47.7	47.3
Primary expenditure	42.6	43.4	43.1	43.2	45.6	45.8	...	45.6	45.8
Primary balance	3.7	2.4	1.2	2.3	1.5	2.3	...	2.1	1.5
							...		
Total revenue	47.8	47.5	46.3	47.9	48.8	50.0	...	49.3	48.7
Total expenditure	46.4	47.0	47.0	46.5	49.2	49.1	...	48.8	48.6
Overall balance	1.4	0.5	-0.8	1.4	-0.4	0.9	...	0.4	0.1
Memorandum items:									
Real expenditure change 2/	6.8	4.8	4.3	1.7	8.9	2.5	...	3.7	3.7
Output gap 3/	2.0	4.2	2.5	-2.5	-0.6	1.5	...	3.0	3.6

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

1/ In percent of potential GDP.

2/ Change in percent.

3/ Actual output less potential in percent of potential.

Table 3. Iceland: Financial Soundness Indicators, 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Capital adequacy									
Risk-based capital adequacy ratio (CAR) 1/ 4/	10.4	10.4	9.8	11.4	12.2	12.29	12.84		
CAR excluding subordinated loans	8.7	8.0	6.6	8.1	9.1	9.24	9.52		
Tier 1 capital ratio	9.9	9.3	8.1	9.1	9.7	9.69	10.38		
Asset quality									
Credit institutions									
Total lending (in ISK billion) 2/	385.7	475.8	601.5	704.3	740.2	920.4	1,303.0	1,439.5	Feb
thereof foreign currency loans (in percent)	34.4	36.5	41.6	44.3	39.6	48.9	50.9	52.1	Feb
Sectoral credit concentration									
Real estate loans (as percent of total loans)	6.3	6.8	6.6	5.8	5.3	...	...	...	
Loans to fisheries (as percent of total loans)	27.7	24.8	22.9	21.2	17.1	13.4	10.9	10.2	Feb
thereof foreign currency loans (in percent)	83.3	83.9	86.5	86.8	87.0	90.1	90.3	90.7	Feb
Loans to households (as percent of total loans) 3/	27.9	27.3	27.5	25.5	26.3	20.1	23.5	24.0	Feb
thereof foreign currency loans (in percent)	1.8	4.8	8.1	10.4	8.6	4.1	7.0	5.6	Feb
Loans to businesses (as percent of total loans)	64.8	65.7	65.2	64.2	62.6	61.9	59.1	57.0	Feb
thereof foreign currency loans (in percent)	49.8	50.6	55.6	54.7	49.4	56.9	57.1	57.8	Feb
Loans to retail and services (as percent of total loans)	24.8	28.6	29.4	30.0	32.7	35.5	37.7	36.6	Feb
thereof foreign currency loans (in percent)	19.5	29.5	37.0	36.1	33.7	49.9	51.6	52.9	Feb
Loans to manufacturing et. al. (as percent of total loans)	12.3	12.2	12.9	13.0	12.7	12.3	10.0	9.8	Feb
thereof foreign currency loans (in percent)	35.5	32.4	43.0	45.3	39.2	42.1	43.4	43.6	Feb
Foreign sector (as percent of total loans)	...	...	...	3.6	6.2	12.3	14.6	16.7	Feb
thereof foreign currency loans (in percent)	...	...	...	99.4	78.6	91.2	96.1	96.1	Feb
Non-performing loans (NPL) as percent of total loans 1/ 5/	1.4	1.6	1.5	2.0	2.6	2.1	0.9		
Total provisions as percent of average loans 1/	1.0	0.9	0.8	1.2	1.2	1.40	0.81		
Leverage ratio (equity as percent of total assets) 1/	7.3	6.9	6.2	6.5	7.2	7.09	7.08		
Borrowing entities									
Debt-equity ratios									
All listed companies (except financial companies)	1.93	2.13	2.32	2.27	1.72	1.80	1.93		
Fisheries companies	1.77	1.94	2.57	2.57	2.00	2.00	2.00		
Manufacturing companies	1.66	1.28	1.52	1.40	1.40	1.60	1.61		
IT companies	2.93	2.31	1.80	1.43	1.10	1.00	1.28		
Retail, services, and construction companies	2.30	2.77	1.94	1.99	1.52	1.40	2.37		
Corporate profitability (EBITDA/turnover)									
All listed companies (except financial companies)	8.2	7.3	7.8	10.2	11.9	11.10	12.10		
Fisheries companies	17.8	14.7	17.4	27.1	24.0	21.30	18.10		
Manufacturing companies	9.3	7.5	12.5	13.4	12.9	11.00	18.10		
IT companies	6.1	8.7	9.0	10.2	27.2	23.40	20.20		
Retail, services, and construction companies	4.7	5.6	7.9	5.6	7.5	10.50	27.50		
Household indebtedness (debt/disposable income) 6/	146.1	157.3	165.4	176.8	182.4	172.92	175.69		
Management soundness 1/									
Expense ratios									
Operating expenses as percent of net operational revenue	67.9	61.8	65.7	66.7	59.4	55.03	45.14		
Staff costs as percent of net operational revenue	35.6	31.9	32.9	33.8	30.9	29.39	23.92		
Earnings and profitability 1/ 4/									
Return on assets	0.9	1.2	0.7	0.8	1.1	1.3	1.8		
Return on equity	13.8	18.6	10.7	13.5	18.1	22.1	30.9		
Interest margin (as percent of total revenue)	56.3	53.1	54.5	63.8	51.4	44.2	40.7		
Fees and commissions (as percent total revenue)	23.5	23.7	31.0	32.6	26.2	25.0	21.3		
Value adjustments of other financial operations (as percent of total revenue)	14.7	12.4	-1.24	-5.80	12.1	22.7	24.7		
Dividends from shares and other holdings	3.6	7.9	5.9	4.0	2.7	3.2	3.9		
Other income (as percent of total revenue) (as percent of total revenue)	1.9	2.9	9.8	5.3	7.6	4.9	9.3		

Table 3. (continued) Iceland: Financial Soundness Indicators

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Liquidity									
Central bank credit to banks (end of period, in ISK billion)	22.8	36.0	46.9	68.7	73.7	25.0	37.5		
Deposits to M3 ratio	0.97	0.97	0.98	0.98	0.98	1.00	0.98		
Loans-to-deposits ratio	1.46	1.53	2.07	2.09	1.91	1.94	2.42		
Liquidity ratio (cash and short-term assets/ demand and short-term liabilities)	...	...	1.2	1.2	1.2	1.2	1.3		
Measures of secondary market liquidity:									
Interbank FX market turnover (Kr. Billions)	401.8	468.0	768.0	1218.0	834.4	1185.6	949.9		
Interbank domestic market turnover (Kr. Billions)	447.7	502.9	524.28	426.1	420.8	578.9	1073.3		
Market-based indicators:									
Stock market index (ICEX-15; y-o-y change)	9.8	47.4	-19.31	-11.25	16.7	56.4	58.9		
Residential housing prices (y-o-y increase)	7.8	22.2	13.3	3.1	7.5	9.1	23.3	32.2	Feb
Commercial property prices (y-o-y increase) (between yearly averages)	19.8	25.2	19.5	-7.1	-12.1	14.8	8.9		
Market capitalization at year-end/GDP	39.9	57.6	59.5	57.0	68.2	81.3	126.2		
Turnover rate (trading/market capitalization) (12 month trading)	17.3	32.4	50.0	32.4	60.8	84.0	0.7		
Credit ratings									
Moody's short-term	P2	P2	P1-P2	P1-P2	P1-P2	P1	P1	P1	Apr
Moody's long-term	A3	A3	A2-A3	A2-A3	A2-A3	A1-A3	A1-A3	A1-A2	Apr
Fitch short-term	...	...	...	F1	F1	F1	F1	F1	Apr
Fitch long-term	...	...	...	A	A	A	A	A	Apr
Sovereign yield spreads (spread between yields on Icelandic and foreign trade-weighted 3-month T-bills)	3.4	5.7	6.3	7.9	3.1	2.8	5.3	6.4	March

Sources: Financial Supervisory Authority and Central Bank of Iceland.

1/ Commercial banks and six largest savings banks. Fisheries Investment Fund and Industrial Loan Fund included 1996-1997. FBA include 1998-1999. Kauphting Inc. included from year 1996. Figures for Islandsbanki include both the banking and insurance part of the corporation.

2/ Inflation adjusted accounting principles were discontinued in year 2002. Results for year 2002 and onwards are therefore in nominal terms but were in real terms before year 2002.

3/ Deposit money banks, adjusted for FBA and Commercial Loan Fund. Kaupthing bank Inc. included from year 2002 and Glitnir included from May 2003.

Figures from year 2003 onwards for sectoral breakdown of lendings is not comparable with the past because of new loan classification.

4/ Item “miscellaneous” also includes individuals’ private business operations. Changed with new loan classification in year 2003. See note above.

5/ Loans for which special provisions have been posted less specific provisions, and other loans which have been interest frozen. Appropriated assets not included.

6/ New loan classification results in a break for this series in the year 2003.

Table 4. Iceland. Medium-Term Scenario, 2003-10
(Percentage change, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP	4.2	5.2	5.8	4.9	3.1	2.6	3.1	2.8
Real domestic demand	7.8	7.7	9.6	1.8	-4.4	-1.2	1.3	1.8
Private consumption	6.6	7.5	7.5	4.5	0.5	0.7	1.2	1.7
Public consumption	3.5	3.6	2.5	2.5	2.5	2.5	2.5	2.5
Fixed investment	17.0	12.8	22.2	-5.5	-23.4	-12.0	0.0	1.0
Change in stocks 1/	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 1/	-3.5	-2.7	-4.3	3.0	7.7	3.7	1.9	1.2
Exports	1.4	8.3	4.9	8.7	10.1	9.1	4.7	3.0
Imports	10.4	14.3	14.1	0.9	-7.8	0.6	0.6	0.6
Current account 2/	-5.1	-8.5	-12.0	-11.4	-7.2	-6.1	-5.9	-5.5
Inflation								
Consumer Prices	2.1	3.2	3.4	3.5	3.5	3.0	2.5	2.5
Labor market								
Employment	-0.5	2.7	2.8	2.0	0.3	0.5	0.7	2.0
Average unemployment rate	3.4	3.1	2.3	1.7	2.0	2.3	2.5	2.5
Public finance								
General government balance 2/	-1.0	0.4	1.0	0.8	-1.2	0.3	-0.3	-0.7
General government structural balance 2/	-0.4	0.9	0.4	0.1	-0.8	1.7	1.3	0.5
General government gross debt 2/	42.3	37.0	33.1	30.2	30.1	28.6	27.6	26.9
Output gap 3/	-0.6	1.5	3.0	3.6	0.7	-0.7	-0.7	0.0

Sources: CBI; and IMF staff estimates.

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

Table 5. Iceland: Balance of Payments, 1999-2004

	1999	2000	2001	2002	2003	2004
			(In millions of kroner)			
Current Account	-42,833	-69,288	-33,729	10,754	-40,330	-73,071
Balance on Goods	-22,382	-37,480	-5,936	14,082	-15,900	-36,548
Merchandise exports f.o.b.	144,928	149,272	196,582	204,303	182,580	202,373
Merchandise imports f.o.b.	-167,310	-186,752	-202,518	-190,221	-198,480	-238,921
Balance on Services	-6,934	-11,637	-1,549	-328	-9,263	-14,615
Exports of services, total	67,238	80,248	102,830	101,561	105,534	113,730
Imports of services, total	-74,172	-91,885	-104,379	-101,889	-114,797	-128,345
Balance on Income	-12,792	-19,409	-25,285	-4,170	-14,001	-20,728
Receipts	9,328	11,603	16,914	27,163	28,419	41,922
Expenditures	-22,120	-31,012	-42,199	-31,333	-42,420	-62,650
Current transfer, net	-725	-762	-959	1,170	-1,166	-1,180
Capital and Financial Account	56,289	75,671	19,306	16	16,485	135,221
Capital transfer, net	-57	-222	362	-122	-402	-234
Financial Account	56,346	75,893	18,944	138	16,887	135,455
Direct investment, net	-4,094	-17,534	-16,449	-21,230	-3,942	-160,452
Abroad	-8,918	-30,966	-33,737	-29,570	-28,373	-182,085
In Iceland	4,824	13,432	17,288	8,340	24,431	21,633
Portfolio investment, net	41,658	43,152	61,522	21,986	228,000	507,488
Assets	-32,392	-50,369	-5,643	-30,017	-45,320	-75,688
Liabilities	74,050	93,521	67,165	52,003	273,320	583,176
Other investment, net	23,962	44,574	-30,948	5,046	-183,770	-197,351
Reserve assets	-5,346	5,794	4,819	-5,664	-23,401	-14,230
Net errors and omissions	-13,456	-6,383	14,423	-10,770	23,845	-62,150
			(In percent of GDP)			
Current Account	-7.0	-10.5	-4.6	1.4	-5.1	-8.5
Balance on Goods	-3.7	-5.7	-0.8	1.8	-2.0	-4.3
Merchandise exports f.o.b.	23.8	22.6	26.5	26.7	22.9	23.6
Merchandise imports f.o.b.	-27.5	-28.3	-27.3	-24.8	-24.9	-27.8
Balance on Services	-1.1	-1.8	-0.2	0.0	-1.2	-1.7
Exports of services, total	11.1	12.1	13.9	13.3	13.2	13.2
Imports of services, total	-12.2	-13.9	-14.1	-13.3	-14.4	-14.9
Balance on Income	-2.1	-2.9	-3.4	-0.5	-1.8	-2.4
Receipts	1.5	1.8	2.3	3.5	3.6	4.9
Expenditures	-3.6	-4.7	-5.7	-4.1	-5.3	-7.3
Current transfer, net	-0.1	-0.1	-0.1	0.2	-0.1	-0.1
Capital and Financial Account	9.3	11.4	2.6	0.0	2.1	15.7
Capital transfer, net	0.0	0.0	0.0	0.0	-0.1	0.0
Financial Account	9.3	11.5	2.6	0.0	2.1	15.8
Direct investment, net	-0.7	-2.7	-2.2	-2.8	-0.5	-18.7
Abroad	-1.5	-4.7	-4.6	-3.9	-3.6	-21.2
In Iceland	0.8	2.0	2.3	1.1	3.1	2.5
Portfolio investment, net	6.8	6.5	8.3	2.9	28.6	59.1
Assets	-5.3	-7.6	-0.8	-3.9	-5.7	-8.8
Liabilities	12.2	14.1	9.1	6.8	34.3	67.9
Other investment, net	3.9	6.7	-4.2	0.7	-23.0	-23.0
Reserve assets	-0.9	0.9	0.7	-0.7	-2.9	-1.7
Net errors and omissions	-2.2	-1.0	1.9	-1.4	3.0	-7.2

Sources: Central Bank of Iceland.

ICELAND: FUND RELATIONS
(As of May 31, 2005)

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

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	117.60	100.00
Fund holdings of currency	99.02	84.20
Reserve Position	18.58	15.80
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	16.41	100.00
Holdings	0.03	0.18

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements: None

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges/Interest	0.21	0.41	0.41	0.41	0.41
Total	0.21	0.41	0.41	0.41	0.41

VII. Implementation of HIPC Initiative: Not Applicable

VIII. 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 sanction against Iraq (see EBD/90/242, 7/13/90).

IX. Last Article IV Consultation:

Discussion for the 2003 Article IV Consultation were held in Reykjavik during May 21–June 2, 2003.The Staff Report (Country Report No. 03/266) was considered by the Executive Board on August 22, 2003. Article IV consultations with Iceland are currently held on the 24–month cycle.

X. Technical Assistance: None

XI. ROSC: Data module assessment took place in February 2005. The draft report has been sent to the authorities for comments.

XII. Resident Representative: None

ICELAND: SUSTAINABILITY EXERCISE

Public Debt Sustainability

The staff's baseline scenario predicts a decline in the gross public debt-to-GDP ratio from 37 percent in 2004 to 27 percent in 2010, suggesting that risks to *medium-term debt sustainability* are limited (Table A1). When the historical average values of real GDP growth, the real interest rate, and primary balance are used throughout the projection period (scenario A1), the gross debt ratio falls to only 15 percent by 2010. Keeping the primary balance unchanged over the projection period (A2) lowers the debt ratio almost as much, to 16 percent by 2010. The most significant "bound test" is the shock to real GDP growth in 2005 and 2006 (B2), which increases the gross debt ratio to 57 percent by 2010. A 10 percent of GDP increase in other debt-creating inflows in 2005 (B6) raises the debt ratio to 38 percent by 2010 while a one time real depreciation of 30 percent in 2005 (B5) raises it to 35 percent. Meanwhile, shocks to the real interest rate (B1) and to the primary balance (B3) have little impact on debt dynamics compared with the baseline scenario.

External Debt Sustainability

Significant current account deficit, driven by the investment projects, coupled with expansion of Icelandic firms and commercial banks abroad, resulted in a sharp increase of the external debt (from 159 percent of GDP in 2003 to 220 percent in 2004). However, in net terms the level of external dent has risen only by 24 percent reaching 122 percent of GDP in 2004. As Table A2 indicates, in the baseline scenario external debt is projected to decrease and stabilize around 200 percent of GDP. The alternative scenarios and bound tests indicate that while Iceland is resilient to a variety of shocks, movements in exchange rate could drive the gross external debt to above 300 percent of GDP.

Table A1. Iceland: Public Sector Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004	10-Year Historical Average	10-Year Standard Deviation	2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing primary balance 10/**
Public sector debt 1/	42.1	47.9	44.5	42.3	37.0			**33.1**	**30.2**	**30.1**	**28.6**	**27.6**	**26.9**	**0.8**
o/w foreign-currency denominated	23.1	29.2	25.4	22.2	19.4			17.4	15.9	15.8	15.0	14.5	14.1	
Change in public sector debt	-2.6	5.8	-3.4	-2.2	-5.2			-3.9	-2.9	-0.1	-1.5	-1.1	-0.6	
Identified debt-creating flows (4+7+12)	-2.7	-0.1	-9.7	-5.2	-6.5			-4.0	-2.9	-0.1	-1.5	-1.1	-0.6	
Primary deficit	-5.9	-4.0	-3.6	-2.6	-3.7			-4.2	-3.5	-1.4	-2.7	-1.9	-1.4	
Revenue and grants	47.6	46.3	47.9	48.7	49.9			49.3	48.8	47.6	46.9	46.1	45.6	
Primary (noninterest) expenditure	41.7	42.3	44.3	46.2	46.2			45.1	45.3	46.2	44.2	44.2	44.2	
Automatic debt dynamics 2/	3.4	4.1	-4.6	-1.1	-2.7			0.2	0.6	1.3	1.2	0.8	0.8	
Contribution from interest rate/growth differential 3/	-0.1	-0.7	1.8	1.9	0.3			0.2	0.6	1.3	1.2	0.8	0.8	
Of which contribution from real interest rate	2.2	0.3	0.8	3.7	2.3			2.2	2.1	2.2	2.0	1.7	1.5	
Of which contribution from real GDP growth	-2.3	-1.0	1.0	-1.8	-2.0			-2.0	-1.5	-0.9	-0.7	-0.9	-0.7	
Contribution from exchange rate depreciation 4/	3.5	4.7	-6.4	-3.0	-3.0			...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	-0.1	-1.5	-1.5	-0.1			-0.1	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.1	-0.1	-1.5	-1.5	-0.1			-0.1	0.0	0.0	0.0	0.0	0.0	
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	
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	
Residual, including asset changes (2-3) 5/	0.1	5.9	6.3	3.0	1.3			0.1	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	88.3	103.4	92.8	86.7	74.2			67.2	62.0	63.3	61.1	59.8	59.1	
Gross financing need 6/	-1.0	2.3	3.0	5.1	2.6			4.1	3.3	4.4	2.5	2.9	2.4	
in billions of U.S. dollars	-0.1	0.2	0.3	0.5	0.3			0.6	0.5	0.7	0.4	0.5	0.4	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	5.7	2.6	-2.1	4.2	5.2	3.6	2.6	5.8	4.9	3.1	2.6	3.1	2.8	3.7
Average nominal interest rate on public debt (in percent) 7/	8.3	10.3	7.3	8.5	8.4	8.1	0.9	9.4	8.8	9.1	8.2	8.2	8.2	8.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.5	1.1	1.7	8.7	6.0	4.5	2.3	6.6	6.9	7.6	6.8	6.3	5.8	6.7
Nominal appreciation (increase in US dollar value of local currency, in percent)	-14.3	-17.7	27.8	13.5	16.3	2.0	14.2	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.8	9.2	5.7	-0.2	2.4	3.6	2.6	2.8	1.9	1.5	1.4	1.9	2.4	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	5.6	4.1	2.7	8.5	5.3	4.5	3.1	3.2	5.3	5.2	-1.7	3.1	2.8	3.0
Primary deficit	-5.9	-4.0	-3.6	-2.6	-3.7	-3.8	1.4	-4.2	-3.5	-1.4	-2.7	-1.9	-1.4	-2.5
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 8/								**33.1**	**29.6**	**26.0**	**22.4**	**18.8**	**15.1**	**0.1**
A2. No policy change (constant primary balance) in 2005-09								**33.1**	**29.4**	**26.5**	**23.4**	**19.9**	**16.3**	**0.5**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**33.1**	**30.9**	**31.3**	**29.8**	**28.8**	**28.2**	**0.8**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**33.1**	**35.5**	**42.9**	**47.2**	**51.9**	**57.2**	**1.7**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**33.1**	**32.8**	**33.3**	**31.9**	**31.0**	**30.4**	**0.9**
B4. Combination of B1-B3 using one standard deviation shocks								**33.1**	**32.6**	**32.1**	**30.7**	**29.7**	**29.2**	**0.8**
B5. One time 30 percent real depreciation in 2005 9/								**33.1**	**37.5**	**37.7**	**36.5**	**35.7**	**35.3**	**1.0**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**33.1**	**40.2**	**40.5**	**39.5**	**38.8**	**38.5**	**1.1**

1/ Gross general government debt.
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/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table A2. Iceland: External Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						Debt-stabilizing non-interest current account 6/
External debt	104.3	121.8	135.1	159.1	220.2			**202.7**	**193.2**	**196.7**	**200.3**	**203.1**	**204.4**	**2.7**
Change in external debt	19.0	17.5	13.3	24.1	61.1			-17.5	-9.5	3.5	3.7	2.7	1.3	
Identified external debt-creating flows (4+8+9)	18.4	15.2	-10.2	-15.5	-9.5			10.0	4.0	2.5	2.0	1.2	1.4	
Current account deficit, excluding interest payments	6.1	-1.0	-5.9	1.1	4.4			5.6	4.1	-1.3	-3.2	-4.2	-4.8	
Deficit in balance of goods and services	7.4	1.0	-1.8	3.2	6.0			10.3	8.7	3.4	1.5	0.5	-0.1	
Exports	34.7	40.4	39.9	36.1	36.8			34.8	33.3	34.7	35.5	35.2	34.6	
Imports	42.2	41.4	38.1	39.3	42.8			45.1	42.1	38.1	37.0	35.7	34.5	
Net non-debt creating capital inflows (negative)	7.7	-0.5	2.8	5.8	5.9			8.3	1.5	1.2	0.8	1.3	1.4	
Automatic debt dynamics 1/	4.5	16.8	-7.1	-22.4	-19.9			-3.9	-1.5	2.6	4.4	4.0	4.8	
Contribution from nominal interest rate	4.3	5.6	4.5	3.9	4.1			6.4	7.3	8.4	9.4	10.1	10.3	
Contribution from real GDP growth	-4.9	-3.0	2.3	-4.6	-7.0			-10.3	-8.8	-5.9	-5.0	-6.1	-5.5	
Contribution from price and exchange rate changes 2/	5.1	14.2	-13.8	-21.7	-17.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.5	2.3	23.5	39.5	70.6			-27.5	-13.6	1.0	1.7	1.6	-0.1	
External debt-to-exports ratio (in percent)	300.3	301.2	338.4	440.5	598.3			583.1	579.4	567.1	564.1	577.5	590.7	
Gross external financing need (in billions of US dollars) 4/	3.3	3.5	3.3	5.4	7.7			10.7	12.2	12.2	12.6	13.2	13.9	
in percent of GDP	39.7	45.6	39.0	51.8	63.0			70.8	72.1	69.7	70.2	70.8	71.2	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	5.7	2.6	-2.1	4.2	5.2	3.6	2.6	5.8	4.9	3.1	2.6	3.1	2.8	3.7
GDP deflator in US dollars (change in percent)	-5.6	-12.0	12.8	19.2	11.9	3.9	9.7	16.4	6.6	0.3	0.4	0.9	1.7	4.4
Nominal external interest rate (in percent)	5.1	4.8	4.1	3.6	3.0	4.8	1.0	3.6	4.0	4.5	4.9	5.2	5.3	4.6
Growth of exports (US dollar terms, in percent)	-0.7	5.2	9.1	12.4	19.9	7.3	6.1	16.3	7.2	7.6	5.5	3.0	2.9	7.1
Growth of imports (US dollar terms, in percent)	6.0	-11.2	1.6	28.0	28.2	11.2	13.0	29.8	4.4	-6.3	-0.1	0.4	1.0	4.9
Current account balance, excluding interest payments	-6.1	1.0	5.9	-1.1	-4.4	-0.4	4.0	-5.6	-4.1	1.3	3.2	4.2	4.8	0.6
Net non-debt creating capital inflows	-7.7	0.5	-2.8	-5.8	-5.9	-3.3	2.6	-8.3	-1.5	-1.2	-0.8	-1.3	-1.4	-2.4
								II. Stress Tests for External Debt Ratio						Debt-stabilizing non-interest current account 6/
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**202.7**	**200.0**	**200.1**	**200.9**	**202.3**	**203.8**	**-2.1**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**202.7**	**198.1**	**206.0**	**209.9**	**212.7**	**214.1**	**2.8**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**202.7**	**205.8**	**219.9**	**224.4**	**227.9**	**230.0**	**3.1**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**202.7**	**242.6**	**294.0**	**301.1**	**307.3**	**311.6**	**4.1**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**202.7**	**197.6**	**210.9**	**214.8**	**217.7**	**219.1**	**2.8**
B5. Combination of B1-B4 using one standard deviation shocks								**202.7**	**230.5**	**264.5**	**269.4**	**273.0**	**274.8**	**3.6**
B6. One time 30 percent nominal depreciation in 2005								**202.7**	**286.7**	**292.6**	**299.7**	**305.8**	**310.2**	**4.1**

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

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, ε = nominal appreciation (increase in dollar value of domestic currency), and α = 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/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Table A3. Iceland: Net Investment Position
(in percent of GDP)

	1999	2000	2001	2002	2003	2004
Assets	40.1	47.6	56.9	51.6	88.8	130.4
Direct investment abroad	5.4	8.5	11.7	11.4	15.4	28.1
Portfolio investment abroad	22.6	28.0	27.4	20.8	32.9	40.1
Other investment abroad	6.2	5.9	12.9	14.5	33.3	54.6
Reserve assers	5.9	5.2	4.9	4.9	7.3	7.6
Liabilities	89.8	115.8	136.7	129.1	157.9	210.7
Direct investment into Iceland	5.7	6.3	9.6	8.4	10.6	12.8
Portfolio investment into Iceland	37.2	52.6	63.6	64.0	97.3	151.6
Other investment into Iceland	46.9	56.9	63.5	56.7	49.9	46.3
Net investment position	-49.7	-68.2	-79.8	-77.5	-69.0	-80.4
Direct investment abroad	-0.3	2.2	2.2	3.0	4.8	15.2
Portfolio investment abroad	-14.6	-24.6	-36.2	-43.1	-64.4	-111.5
Other investment abroad	-40.7	-51.0	-50.6	-42.2	-16.7	8.3
Reserve assers	5.9	5.2	4.9	4.9	7.3	7.6

Source: CBI

ICELAND—STATISTICAL ISSUES

Iceland's economic database is comprehensive and sufficient for effective surveillance. Iceland has subscribed to the Special Data Dissemination Standard (SDDS). A Statistics Department (STA) mission conducted the data module of the Report on the Observance of Standards and Codes (ROSC) during February 1–15, 2005.

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

Iceland is in observance of the SDDS since June 30, 2004, meeting the specifications for coverage, periodicity, and timeliness, but uses a flexibility option on the timeliness and periodicity for the production index and the producer price index (PPI). Iceland generally meets the requirements regarding advance release calendars. However, there are some delays in the dissemination of data on central government operations and central government debt, and the advance release dates posted for these data categories are tentative dates. Also, summary methodology statements in a number of data categories are neither provided nor posted on the Dissemination Standard Bulletin Board of the IMF.

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.

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

Iceland's balance of payments data deviate from the IMF's Balance of Payments Manual, fifth edition *(BMP5)* in certain respects. In particular, the CBI follows the methodology applied by the European Central Bank (ECB) for the calculation of income payable by collective investment institutions (e.g., mutual funds). Unlike the *BMP5*, the ECB's methodology includes portfolio investors' shares of retained earnings in the balance of payments statement.

Some other departures from *BPM5* are: a) income on external debt and foreign direct investments is compiled on a due-for-payment basis, including that between affiliated enterprises; b) debt between affiliated banks is not identified; c) banking sector loans are not classified separately from currency, and deposits; d) foreign direct investments are valued at book value; e) external debt is valued at face value; f) financial derivatives held by banks are not available as on-balance sheet item; g) domestic currency deposits held with banks by nonbank nonresidents are not recorded as part of external debt.

It should be noted that balance of payments statistics focus mainly on traditional sectors while certain other sectors are becoming more important (e.g., statistics of international trade in services).

Monetary Statistics

The concepts and definitions broadly conform to the guidelines of the *Monetary and Financial Statistics Manual (MFSM)*. Departing from the *MFSM*, monetary aggregates include deposits of the foreign sector and the central government; and the currency-linked and indexed bonds held by nonresidents are classified as domestic instead of foreign liabilities. Classification and sectorization are mostly in line with the *MFSM*, except that, in the accounts of other depository corporations (that is, commercial and savings banks), financial derivatives are off balance sheet and positions of nonfinancial public corporations are indistinguishably included as part of government; and, in the accounts of the CBI, fixed assets are off balance sheet and IMF accounts are included under other items net instead of as foreign liabilities. The basis for recording follows the *MFSM*, except that several banks report loans net of provisions and securities for investment are not at market value.

Iceland: Table of Common Indicators Required for Surveillance

(As of July 22, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	Jun 2005	Jul 2005	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar 2005	4/6/2005	M	M	M
Reserve/Base Money	Feb 2005	3/17/2005	M	M	M
Broad Money	2/28/05	3/17/2005	M	M	M
Central Bank Balance Sheet	3/31/05	4/6/2005	M	M	M
Consolidated Balance Sheet of the Banking System	Feb 2005	3/21/2005	M	M	M
Interest Rates[2]	4/15/05	4/20/2005	D	D	D
Consumer Price Index	Jun 2005	7/20/2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	2/3/2005	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Feb 2005	4/7/2005	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]					
External Current Account Balance	Q4, 2004	3/4/2005	Q	Q	Q
Exports and Imports of Goods and Services	May 2005	7/20/2005	M	M	M
GDP/GNP	Q4, 2004	3/14/2005	Q	Q	Q
Gross External Debt	Q4, 2004	3/7/2005	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign and domestic financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

INTERNATIONAL MONETARY FUND

ICELAND

Staff Report for the 2005 Article IV Consultation

Supplementary Information

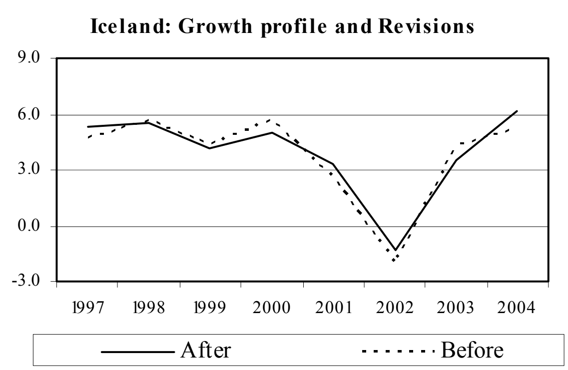
Prepared by Staff Representatives for the 2005 Consultation with Iceland

Approved by Alessandro Leipold and Martin Fetherston

September 26, 2005

1. This supplement provides an update to the staff's medium-term outlook for Iceland based on revisions to historical National Accounts data and outturns since the staff report was finalized. The new information does not change the thrust of the staff appraisal, though the stronger momentum of growth heightens the risks and strengthens the case for a more restrictive fiscal stance.[1]

2. In mid-September, Statistics Iceland released **revisions to quarterly National Accounts data** extending back to 1997 that reflect the application of chain linking. The revisions suggest that the trough of the 2001–02 downturn was milder, with the pace of the subsequent recovery being slower in 2003, but faster in 2004 (annual growth in 2004 was revised up by 1 percentage point). Reported year-over-year GDP growth for the second quarter of 2005, at 6.8 percent, is slightly faster than was expected. Taken together, the revisions to GDP and its second quarter growth rate suggest that there is more momentum in the economy than assessed at the time the staff report was finalized. Additional support for this view is evident in September's year-over-year CPI inflation rate of 4.8 percent, above both expectations and the 4 percent upper limit of the central bank's tolerance range.



3. Given the greater momentum in the economy, **the staff outlook for growth and inflation** in 2005 has been revised upward and the current account deficit is now forecast to

[1] Attached are updated staff report tables and the background section of the PIN reflecting the latest available data and the new projections.

be 13 percent of GDP. For 2006, however, staff expects a more pronounced slowing in growth because monetary policy is likely to tighten more than previously expected with inflation now outside the tolerance range. In fact, markets are expecting the policy rate to increase by 50 basis points, to 10 percent, when the quarterly *Monetary Bulletin* is released on September 29, with most analysts looking for additional tightening to follow. Based on the outlook for faster growth in nominal private consumption and wages, higher than previously expected revenues will lead to slightly larger fiscal surpluses in 2005 and 2006. However, on a structural basis, the fiscal balance is now forecast to be in deficit over these two years as opposed to the very small surpluses forecast previously.

4. The updated outlook, with a larger current account deficit, higher short-term nominal interest rates and, consequently, the potential for more appreciation of the currency in the near-term, implies that the risk of a sharp slowing in activity further out may now be higher.

Table 1. Iceland: Selected Economic Indicators, 2000-06

	2000	2001	2002	2003	2004	2005 Staff Forecast	2006 Staff Forecast
	(Percentage change unless otherwise noted)						
National Accounts (constant prices)							
Gross domestic product	5.0	3.3	-1.3	3.6	6.2	5.9	4.5
Total domestic demand	6.6	-2.8	-3.6	7.0	8.4	11.2	1.6
Private consumption	4.1	-3.2	-1.8	5.8	6.9	9.9	4.5
Public consumption	4.4	3.1	5.0	1.5	2.8	3.1	2.5
Gross fixed investment	14.6	-4.9	-19.6	20.5	21.0	22.2	-5.5
Export of goods and services	4.3	7.4	3.9	1.4	8.3	4.9	8.6
Imports of goods and services	8.5	-9.1	-2.6	10.7	14.2	18.0	1.0
Output gap 1/	3.0	2.2	-2.3	-1.2	1.0	3.2	3.7
Selected Indicators							
Fish catch (at constant prices)	1.3	7.7	3.2	-0.5	0.6	...	...
Unemployment rate 2/	1.3	1.4	2.5	3.4	3.1	2.3	1.7
Real disposable income per capita	1.9	0.5	2.0	-0.3	4.3	...	...
Consumer price index	5.1	6.6	4.8	2.1	3.2	4.1	3.7
Nominal wage index	6.6	8.9	7.1	5.6	4.7	5.5	5.5
Nominal effective exchange rate 3/	-0.1	-16.7	3.0	6.4	2.1	...	...
Real effective exchange rate (CPI) 3/	2.9	-13.0	5.7	6.3	3.2	...	...
Terms of trade	-2.4	0.3	0.6	-4.1	-1.3	-2.7	-4.5
Money and Credit							
Deposit money bank credit (end-period)	26.7	17.4	5.2	25.6	48.8	...	...
Domestic credit (end-period)	26.2	13.2	0.8	16.4	41.3	...	...
Broad money (end-period)	11.2	14.9	15.3	23.5	15.7	...	...
CBI policy rate (period average)	10.4	10.9	8.4	5.4	6.3	...	...
Public Finance (in percent of GDP)							
General government 4/							
Revenue	47.0	45.7	46.9	47.9	48.5	47.9	47.4
Expenditure	44.5	45.6	46.8	48.9	48.0	46.5	46.2
Balance	2.5	0.2	0.2	-1.0	0.4	1.4	1.2
Balance of Payments (in percent of GDP)							
Current account balance	-10.4	-4.5	1.4	-5.0	-8.4	-13.0	-12.0
Trade balance (goods)	-5.6	-0.8	1.8	-2.0	-4.1	-9.0	-7.1
Financial and capital account	11.3	2.6	0.0	2.0	15.3	13.0	12.0
o/w: reserve assets 5/	0.9	0.6	-0.7	-2.9	-1.6	-1.4	0.1
Net errors and omissions	-1.0	1.9	-1.4	2.9	-7.0	0.0	0.0
Gross external debt	103.0	120.3	132.3	156.4	213.7	197.0	187.0
Central bank gross reserves (in months of imports of goods and services) 6/	1.5	1.4	1.5	2.3	2.3	2.2	2.2

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/ Excluding imports from the construction of hydropower facility and smelters in 2003-04.

Table 2. Iceland: Summary Operations of the General Government, 1999-2006

(in percent of GDP)

	1999	2000	2001	2002	2003	Prel. 2004	Proj. 2005 MoF	Proj. 2005 IMF	Proj. 2006 IMF
Total revenue	47.3	47.0	45.7	46.9	47.9	48.5	47.4	47.9	47.4
Current revenue	45.3	45.0	43.8	44.9	45.9	46.5	45.4	45.9	45.5
of which:									
Direct taxes	18.8	19.2	19.9	20.1	20.8	21.2	20.5	20.3	19.8
Indirect taxes	20.2	19.6	17.3	17.5	18.3	18.7	18.8	19.5	19.8
Interest income	1.4	1.5	1.9	2.5	1.6	1.8	1.5	1.5	1.4
Capital revenue	2.0	2.0	1.9	2.1	2.0	2.0	2.0	2.0	1.9
Total expenditure	45.0	44.5	45.6	46.8	48.9	48.0	46.5	46.5	46.2
Current expenditure	39.3	39.4	40.0	42.0	44.3	42.8	41.9	41.9	41.9
of which:									
Interest expenditure	3.7	3.4	3.8	3.3	3.6	3.2	3.1	3.1	2.6
Capital expenditure	5.7	5.1	5.6	4.8	4.6	5.2	4.6	4.6	4.3
Primary balance	6.1	5.9	4.0	3.5	2.5	3.6	4.0	4.5	3.8
Overall balance	2.4	2.5	0.2	0.2	-1.0	0.4	0.9	1.4	1.2
Debt position									
General government gross debt	44.1	41.5	47.3	43.5	41.6	35.9	33.7	31.4	28.2
General government net debt	23.9	23.7	26.6	23.3	23.8	22.3	21.9	19.8	17.3
Cyclically adjusted 1/									
Primary revenue	45.9	45.4	43.7	44.5	46.3	46.7	...	46.3	45.9
Primary expenditure	41.9	42.4	42.7	42.4	44.8	45.3	...	44.8	45.2
Primary balance	4.0	3.0	1.1	2.1	1.5	1.4	...	1.5	0.7
							...		
Total revenue	47.3	46.9	45.7	46.9	47.9	48.5	...	47.8	47.3
Total expenditure	45.7	45.9	46.5	45.7	48.3	48.5	...	48.0	47.9
Overall balance	1.7	1.1	-0.9	1.2	-0.4	-0.1	...	-0.2	-0.6
Memorandum items:									
Real expenditure change 2/	6.6	4.0	5.7	1.3	8.4	4.2	...	2.6	3.8
Output gap 3/	1.5	3.0	2.2	-2.3	-1.2	1.0	...	3.2	3.7

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

1/ In percent of potential GDP.

2/ Change in percent.

3/ Actual output less potential in percent of potential.

Table 3. Iceland: Financial Soundness Indicators, 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Capital adequacy									
Risk-based capital adequacy ratio (CAR) 1/ 4/	10.4	10.4	9.8	11.4	12.2	12.29	12.84		
CAR excluding subordinated loans	8.7	8.0	6.6	8.1	9.1	9.24	9.52		
Tier 1 capital ratio	9.9	9.3	8.1	9.1	9.7	9.69	10.38		
Asset quality									
Credit institutions									
Total lending (in ISK billion) 2/	385.7	475.8	601.5	704.3	740.2	920.4	1,303.0	1,439.5	Feb
thereof foreign currency loans (in percent)	34.4	36.5	41.6	44.3	39.6	48.9	50.9	52.1	Feb
Sectoral credit concentration									
Real estate loans (as percent of total loans)	6.3	6.8	6.6	5.8	5.3	...	...	...	
Loans to fisheries (as percent of total loans)	27.7	24.8	22.9	21.2	17.1	13.4	10.9	10.2	Feb
thereof foreign currency loans (in percent)	83.3	83.9	86.5	86.8	87.0	90.1	90.3	90.7	Feb
Loans to households (as percent of total loans) 3/	27.9	27.3	27.5	25.5	26.3	20.1	23.5	24.0	Feb
thereof foreign currency loans (in percent)	1.8	4.8	8.1	10.4	8.6	4.1	7.0	5.6	Feb
Loans to businesses (as percent of total loans)	64.8	65.7	65.2	64.2	62.6	61.9	59.1	57.0	Feb
thereof foreign currency loans (in percent)	49.8	50.6	55.6	54.7	49.4	56.9	57.1	57.8	Feb
Loans to retail and services (as percent of total loans)	24.8	28.6	29.4	30.0	32.7	35.5	37.7	36.6	Feb
thereof foreign currency loans (in percent)	19.5	29.5	37.0	36.1	33.7	49.9	51.6	52.9	Feb
Loans to manufacturing et. al. (as percent of total loans)	12.3	12.2	12.9	13.0	12.7	12.3	10.0	9.8	Feb
thereof foreign currency loans (in percent)	35.5	32.4	43.0	45.3	39.2	42.1	43.4	43.6	Feb
Foreign sector (as percent of total loans)	...	...	...	3.6	6.2	12.3	14.6	16.7	Feb
thereof foreign currency loans (in percent)	...	...	...	99.4	78.6	91.2	96.1	96.1	Feb
Non-performing loans (NPL) as percent of total loans 1/ 5/	1.4	1.6	1.5	2.0	2.6	2.1	0.9		
Total provisions as percent of average loans 1/	1.0	0.9	0.8	1.2	1.2	1.40	0.81		
Leverage ratio (equity as percent of total assets) 1/	7.3	6.9	6.2	6.5	7.2	7.09	7.08		
Borrowing entities									
Debt-equity ratios									
All listed companies (except financial companies)	1.93	2.13	2.32	2.27	1.72	1.80	1.93		
Fisheries companies	1.77	1.94	2.57	2.57	2.00	2.00	2.00		
Manufacturing companies	1.66	1.28	1.52	1.40	1.40	1.60	1.61		
IT companies	2.93	2.31	1.80	1.43	1.10	1.00	1.28		
Retail, services, and construction companies	2.30	2.77	1.94	1.99	1.52	1.40	2.37		
Corporate profitability (EBITDA/turnover)									
All listed companies (except financial companies)	8.2	7.3	7.8	10.2	11.9	11.10	12.10		
Fisheries companies	17.8	14.7	17.4	27.1	24.0	21.30	18.10		
Manufacturing companies	9.3	7.5	12.5	13.4	12.9	11.00	18.10		
IT companies	6.1	8.7	9.0	10.2	27.2	23.40	20.20		
Retail, services, and construction companies	4.7	5.6	7.9	5.6	7.5	10.50	27.50		
Household indebtedness (debt/disposable income) 6/	146.1	157.3	165.4	176.8	182.4	172.92	175.69		
Management soundness 1/									
Expense ratios									
Operating expenses as percent of net operational revenue	67.9	61.8	65.7	66.7	59.4	55.03	45.14		
Staff costs as percent of net operational revenue	35.6	31.9	32.9	33.8	30.9	29.39	23.92		
Earnings and profitability 1/ 4/									
Return on assets	0.9	1.2	0.7	0.8	1.1	1.3	1.8		
Return on equity	13.8	18.6	10.7	13.5	18.1	22.1	30.9		
Interest margin (as percent of total revenue)	56.3	53.1	54.5	63.8	51.4	44.2	40.7		
Fees and commissions (as percent total revenue)	23.5	23.7	31.0	32.6	26.2	25.0	21.3		
Value adjustments of other financial operations (as percent of total revenue)	14.7	12.4	-1.24	-5.80	12.1	22.7	24.7		
Dividends from shares and other holdings	3.6	7.9	5.9	4.0	2.7	3.2	3.9		
Other income (as percent of total revenue)	1.9	2.9	9.8	5.3	7.6	4.9	9.3		
(as percent of total revenue)									

Table 3. Iceland: Financial Soundness Indicators (concluded)

	1998	1999	2000	2001	2002	2003	2004	2005	as of
Liquidity									
Central bank credit to banks (end of period, in ISK billion)	22.8	36.0	46.9	68.7	73.7	25.0	37.5		
Deposits to M3 ratio	0.97	0.97	0.98	0.98	0.98	1.00	0.98		
Loans-to-deposits ratio	1.46	1.53	2.07	2.09	1.91	1.94	2.42		
Liquidity ratio (cash and short-term assets/ demand and short-term liabilities)	...	...	1.2	1.2	1.2	1.2	1.3		
Measures of secondary market liquidity:									
Interbank FX market turnover (Kr. Billions)	401.8	468.0	768.0	1218.0	834.4	1185.6	949.9		
Interbank domestic market turnover (Kr. Billions)	447.7	502.9	524.28	426.1	420.8	578.9	1073.3		
Market-based indicators:									
Stock market index (ICEX-15; y-o-y change)	9.8	47.4	-19.31	-11.25	16.7	56.4	58.9		
Residential housing prices (y-o-y increase)	7.8	22.2	13.3	3.1	7.5	9.1	23.3	32.2	Feb
Commercial property prices (y-o-y increase) (between yearly averages)	19.8	25.2	19.5	-7.1	-12.1	14.8	8.9		
Market capitalization at year-end/GDP	39.9	57.6	59.5	57.0	68.2	81.3	126.2		
Turnover rate (trading/market capitalization) (12 month trading)	17.3	32.4	50.0	32.4	60.8	84.0	0.7		
Credit ratings									
Moody's short-term	P2	P2	P1-P2	P1-P2	P1-P2	P1	P1	P1	Apr
Moody's long-term	A3	A3	A2-A3	A2-A3	A2-A3	A1-A3	A1-A3	A1-A2	Apr
Fitch short-term	...	...	...	F1	F1	F1	F1	F1	Apr
Fitch long-term	...	...	...	A	A	A	A	A	Apr
Sovereign yield spreads (spread between yields on Icelandic and foreign trade-weighted 3-month T-bills)	3.4	5.7	6.3	7.9	3.1	2.8	5.3	6.4	March

Sources: Financial Supervisory Authority and Central Bank of Iceland.

1/ Commercial banks and six largest savings banks. Fisheries Investment Fund and Industrial Loan Fund included 1996-1997. FBA include 1998-1999. Kauphting Inc. included from year 1996. Figures for Islandsbanki include both the banking and insurance part of the corporation.

2/ Inflation adjusted accounting principles were discontinued in year 2002. Results for year 2002 and onwards are therefore in nominal terms but were in real terms before year 2002.

3/ Deposit money banks, adjusted for FBA and Commercial Loan Fund. Kaupthing bank Inc. included from year 2002 and Glitnir included from May 2003.

Figures from year 2003 onwards for sectoral breakdown of lendings is not comparable with the past because of new loan classification.

4/ Item "miscellaneous" also includes individuals' private business operations. Changed with new loan classification in year 2003. See note above.

5/ Loans for which special provisions have been posted less specific provisions, and other loans which have been interest frozen. Appropriated assets not included.

6/ New loan classification results in a break for this series in the year 2003.

Table 4. Iceland. Medium-term Scenario, 2003-10
(Percentage change, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP	3.6	6.2	5.9	4.5	2.4	2.3	3.1	2.8
Real domestic demand	7.0	8.4	11.2	1.6	-4.6	-1.2	1.3	1.8
Private consumption	5.8	6.9	9.9	4.5	0.5	0.7	1.2	1.7
Public consumption	1.5	2.8	3.1	2.5	2.5	2.5	2.5	2.5
Fixed investment	20.5	21.0	22.2	-5.5	-23.4	-12.0	0.0	1.0
Change in stocks 1/	-0.3	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Net exports 1/	-3.3	-2.4	-5.7	2.7	7.3	3.5	1.8	1.1
Exports	1.4	8.3	4.9	8.6	10.0	9.1	4.7	3.0
Imports	10.7	14.2	18.0	1.0	-7.6	0.6	0.6	0.6
Current account 2/	-5.0	-8.4	-13.0	-12.0	-7.7	-6.4	-6.4	-6.7
Inflation								
Consumer Prices	2.1	3.2	4.1	3.7	3.5	3.0	2.5	2.5
Labor market								
Employment	-0.5	1.3	2.8	2.0	0.3	0.5	0.7	2.0
Average unemployment rate	3.4	3.1	2.3	1.7	2.0	2.3	2.5	2.5
Public finance								
General government balance 2/	-1.0	0.4	1.4	1.2	-0.7	0.0	-0.6	-1.0
General government structural balance 2	-0.4	-0.1	-0.2	-0.6	-0.9	0.5	-0.1	-1.0
General government gross debt 2/	41.6	35.9	31.4	28.2	27.7	26.6	25.9	25.6
Output gap 3/	-1.2	1.0	3.2	3.7	0.5	-1.0	-0.9	0.0

Sources: CBI; and IMF staff estimates.

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

Table 5. Iceland: Balance of Payments, 1999-2004

	1999	2000	2001	2002	2003	2004
			(In millions of krona)			
Current Account	-42,833	-69,288	-33,729	10,754	-40,330	-73,929
Balance on Goods	-22,382	-37,480	-5,936	14,082	-15,900	-36,548
Merchandise exports f.o.b.	144,928	149,272	196,582	204,303	182,580	202,373
Merchandise imports f.o.b.	-167,310	-186,752	-202,518	-190,221	-198,480	-238,921
Balance on Services	-6,934	-11,637	-1,549	-328	-9,263	-14,615
Exports of services, total	67,238	80,248	102,830	101,561	105,534	113,730
Imports of services, total	-74,172	-91,885	-104,379	-101,889	-114,797	-128,345
Balance on Income	-12,792	-19,409	-25,285	-4,170	-14,001	-21,586
Receipts	9,328	11,603	16,914	27,163	28,419	41,197
Expenditures	-22,120	-31,012	-42,199	-31,333	-42,420	-62,783
Current transfer, net	-725	-762	-959	1,170	-1,166	-1,180
Capital and Financial Account	56,289	75,671	19,306	16	16,485	135,629
Capital transfer, net	-57	-222	362	-122	-402	-234
Financial Account	56,346	75,893	18,944	138	16,887	135,863
Direct investment, net	-4,094	-17,534	-16,449	-21,230	-3,942	-165,374
Abroad	-8,918	-30,966	-33,737	-29,570	-28,373	-192,970
In Iceland	4,824	13,432	17,288	8,340	24,431	27,596
Portfolio investment, net	41,658	43,152	61,522	21,986	228,000	507,488
Assets	-32,392	-50,369	-5,643	-30,017	-45,320	-75,688
Liabilities	74,050	93,521	67,165	52,003	273,320	583,176
Other investment, net	23,962	44,574	-30,948	5,046	-183,770	-192,021
Reserve assets	-5,346	5,794	4,819	-5,664	-23,401	-14,230
Net errors and omissions	-13,456	-6,383	14,423	-10,770	23,845	-61,700
			(In percent of GDP)			
Current Account	-7.0	-10.4	-4.5	1.4	-5.0	-8.4
Balance on Goods	-3.6	-5.6	-0.8	1.8	-2.0	-4.1
Merchandise exports f.o.b.	23.6	22.3	26.2	26.1	22.5	22.9
Merchandise imports f.o.b.	-27.2	-27.9	-27.0	-24.3	-24.5	-27.0
Balance on Services	-1.1	-1.7	-0.2	0.0	-1.1	-1.7
Exports of services, total	10.9	12.0	13.7	13.0	13.0	12.9
Imports of services, total	-12.1	-13.7	-13.9	-13.0	-14.2	-14.5
Balance on Income	-2.1	-2.9	-3.4	-0.5	-1.7	-2.4
Receipts	1.5	1.7	2.3	3.5	3.5	4.7
Expenditures	-3.6	-4.6	-5.6	-4.0	-5.2	-7.1
Current transfer, net	-0.1	-0.1	-0.1	0.1	-0.1	-0.1
Capital and Financial Account	9.2	11.3	2.6	0.0	2.0	15.3
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	9.2	11.3	2.5	0.0	2.1	15.4
Direct investment, net	-0.7	-2.6	-2.2	-2.7	-0.5	-18.7
Abroad	-1.4	-4.6	-4.5	-3.8	-3.5	-21.8
In Iceland	0.8	2.0	2.3	1.1	3.0	3.1
Portfolio investment, net	6.8	6.4	8.2	2.8	28.1	57.3
Assets	-5.3	-7.5	-0.8	-3.8	-5.6	-8.6
Liabilities	12.0	14.0	9.0	6.6	33.7	65.9
Other investment, net	3.9	6.7	-4.1	0.6	-22.7	-21.7
Reserve assets	-0.9	0.9	0.6	-0.7	-2.9	-1.6
Net errors and omissions	-2.2	-1.0	1.9	-1.4	2.9	-7.0

Sources: Central Bank of Iceland.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

IMF Executive Board Concludes 2005 Article IV Consultation with Iceland

On October 3, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Iceland.[1]

Background

An extended period of structural reforms, privatizations, and fiscal consolidation as well as large investment projects in the aluminum-smelting sector have resulted in high average GDP growth in Iceland over the last decade. At the same time, in large part because of the magnitude of investment projects relative to the size of the economy, the volatility in output growth and inflation has been notably above that in other industrial countries.

Following a recession in 2002, growth has been accelerating, fueled by new investment projects in the energy and aluminum-smelting sector. With GDP growth of 3.6 percent in 2003 followed by growth of 6.2 percent in 2004, the available slack in the economy was quickly absorbed. Consequently, inflation recently breached the 4 percent upper bound of the tolerance range, prompting a report from the central bank to the government outlining the underlying factors and prospects for returning inflation to target. Domestic demand pressures, particularly in the housing market were cited as the key factors. With private consumption and investment being the key drivers of growth, the current account has deteriorated sharply, reaching a deficit of 8.5 percent of GDP in 2004. Domestic demand has been supported by rapid credit expansion that the banks have funded largely through external borrowing, increasing net external debt by 24 percentage points to122 percent of GDP in 2004.

[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.

Monetary policy has been responding to the growing demand pressures, and since May 2004 the policy rate has risen by 420 basis points to 9.5 percent. However, with increased competition in the mortgage market lowering long-term mortgage rates and increasing the availability of credit to households, monetary policy has been working largely through the exchange-rate channel. The fiscal stance has tightened, as the general government balance moved from a deficit of 1.0 percent of GDP in 2003 to an estimated surplus of 0.4 percent of GDP in 2004.

GDP is forecast to grow by 6 percent in 2005. Strong domestic demand is expected to be the key driver as project-related investment peaks, and consumption spending is further stimulated by mortgage market developments and labor income tax cuts. The current account deficit is projected to peak at 13 percent of GDP in 2005. Inflationary pressures are expected to persist and markets anticipate further increases in interest rates. Some additional fiscal tightening is expected in 2005, as the general government surplus is forecast to rise to almost 1.5 percent of GDP. However, the multi-year spending targets in the 2005 budget and planned labor income tax cuts imply no additional tightening in 2006.

Growth is forecast to moderate to less than 5 percent in 2006 and rebalance toward the external sector. However, the expected improvement in the trade balance will be partly offset by a further deterioration in the income balance and the current account is projected to improve only modestly. Once the new export capacity associated with the investment projects comes on line and investment returns to a more normal level in 2007, the current account deficit is anticipated to fall to just under 8 percent of GDP and improve gradually beyond that point.

Executive Board Assessment

The Executive Directors commended Iceland's recent economic performance on the back of stability-oriented polices and structural reforms undertaken over the last decade. These included central bank independence, the introduction of inflation targeting and a floating exchange rate regime, strengthening of financial supervision, privatization, and export diversification. Directors also noted that more recently the ongoing major investment projects, while central to export diversification, have contributed to economic volatility and macroeconomic imbalances. Consequently, the key challenge for policy is to enhance macroeconomic stability by ensuring an orderly unwinding of the current imbalances and limiting their reemergence in the future.

Directors stressed that the main policy task in the near-term is to contain the current pressures in private consumption, the housing market, the current account, and inflation. They considered that both monetary and fiscal policy would need to contribute to this end. Directors recognized that, in the absence of appropriate fiscal tightening, too heavy a reliance on monetary policy would increase the likelihood of further exchange rate appreciation that would, in turn, widen the external imbalances and induce more borrowing from abroad.

With strong public finances and low and declining public debt, Directors agreed that medium-term fiscal sustainability is not at risk. However, they emphasized that further tightening of the fiscal stance is needed to contain imbalances and their associated risks. Directors noted that the tightening could be achieved by some combination of delaying planned tax cuts, postponing additional public investment projects, and reducing growth in public consumption expenditure.

While welcoming the introduction of multi-year spending targets, Directors called for a further strengthening of the medium-term fiscal framework. In particular, the introduction of a rules-based, multi-year framework would help ensure a counter-cyclical fiscal stance without jeopardizing medium-term targets for public debt. Directors also noted that the introduction of nominal rather than real expenditure targets would contribute to the credibility of budgetary policies, with nominal targets being more transparent and enforceable.

Directors commended the proactive and vigilant monetary policy stance of the Central Bank of Iceland, including the most recent tightening, announced on September 29. They stressed that, in an environment with strong growth in domestic demand and rising inflation, this policy stance was appropriate. At the same time, Directors noted that the expansion of credit that followed the entry of commercial banks into the mortgage market has increased the difficulty of the central bank's inflation stabilization task. Some Directors noted that further increases in policy rates might be warranted. More generally, Directors considered that these circumstances reinforced the need for strong fiscal adjustment.

Directors welcomed the successful implementation of the inflation-targeting monetary policy framework, noting that it has served Iceland well. Most felt that it could be further improved, taking steps to enhance the communication of monetary policy to the public. Several Directors suggested that once the current cycle is over, modifications to the framework, such as removing volatile components from the targeted inflation index, should be considered.

Directors pointed to the risks to financial stability of the ongoing credit boom and emphasized that close monitoring of the financial sector is critical. Despite the strong balance sheets of financial institutions, risks reside in accelerating asset prices, highly leveraged corporations, and rapidly expanding credit, a portion of which is financed by borrowing in foreign currency. They encouraged the Financial Supervisory Authority to implement quickly their plans for more stringent stress tests and—given the large and growing portion of foreign-currency-denominated debt—to expand their scope to include interest rate and exchange rate risks.

Directors noted that the increased presence of commercial banks in the mortgage market has diversified their asset base and increased financial stability. At the same time, Directors expressed concern that banks would find it difficult to fund their mortgage portfolios profitably in the medium term if they had to compete at the retail level with the Housing Financing Fund, a publicly guaranteed mortgage institution. They also noted that increased competition in mortgage lending has led to a surge in housing prices and private consumption that has fueled inflation. Directors called for a reform of the Housing Financing Fund in a manner that would both strengthen the stability of the financial sector and retain the positive features of the current system.

Directors commended the authorities' progress in the privatization of Iceland Telecom and welcomed intentions to use a significant portion of the proceeds for retiring public debt.

Directors welcomed the targeted increase in Official Development Assistance (ODA). They also welcomed the authorities' efforts to reduce agricultural subsidies in the context of the Doha round, and encouraged them to take further trade liberalization measures towards opening Iceland's market to developing country imports.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Iceland: Selected Economic Indicators

	2001	2002	2003	2004	2005 1/
Real Economy (change in percent)					
Real GDP	3.3	-1.3	3.6	6.2	5.9
Domestic demand	-2.8	-3.6	7.0	8.4	11.2
CPI	6.6	4.8	2.1	3.2	4.1
Unemployment rate (in percent of labor force)	1.4	2.5	3.4	3.1	2.3
Gross domestic investment (in percent of GDP)	-4.9	-19.6	20.5	21.0	22.2
General Government Finances (in percent of GDP)					
Financial balance 2/	0.2	0.2	-1.0	0.4	1.4
Structural overall balance	-0.8	1.3	-0.4	-0.1	-0.2
Gross debt	47.3	43.5	41.6	35.9	31.4
Moneyt and Credit (change in percent)					
Deposit money bank credit (end of period)	17.4	5.2	25.6	48.8	...
Domestic credit (end of period)	13.2	0.8	16.4	41.3	...
Broad money (end of period)	14.9	15.3	23.5	15.7	...
CBI policy rate (period average, in percent)	10.9	8.4	5.4	6.3	...
Balance of Payments (in percent of GDP)					
Trade balance	-0.8	1.8	-2.0	-4.1	-9.0
Current account balance	-4.5	1.4	-5.0	-8.4	-13.0
Financial and capital account balance	2.6	0.0	2.0	15.3	13.0
Gross external debt	120.3	132.3	156.4	213.7	197.0
Reserves 3/	1.4	1.5	2.3	2.3	2.2
Fund position (as of August 31, 2005)					
Holdings of currency (in percent of quota)					84.2
Holdings of SDRs (in percent of allocation)					0.0
Quota (in millions of SDRs)					117.6
Exchange Rate					
Exchange rate regime		Floating Exchange Rate			
Present rate (September 21, 2005) 4/			110.4		
Nominal effective rate (change in percent)	-16.7	3.0	6.4	2.1	...
Real effective (change in percent)	-13.0	5.7	6.3	3.2	...

Sources: Statistics Iceland, Central Bank of Iceland, Ministry of Finance, and IMF staff estimates.
1/ Projections.
2/ National accounts basis.
3/ In months of imports of goods and services.
4/ Trade weighted index of the exchange rate as kronur per unit of foreign currency (12/31/1991=100).

Statement by Jon A. Solheim, Executive Director for Iceland and Bjorn Gunmar Ólafsson, Advisor to Executive Director October 3, 2005

The Icelandic authorities would like to express their appreciation to the Article IV mission for the constructive discussions in Reykjavik this summer and the well balanced Staff Report. The topics for the Selected Issues Papers were appropriate and the government especially welcomes the analyses of the housing market and the possible impact of tax cuts. The authorities are in broad agreement with the main conclusions, although some divergences in views remain, in particular on the potential impact of the upcoming income tax cuts and their timing in the business cycle. The authorities would like to thank the mission that conducted the ROSC Data exercise in February for their valuable input and careful assessment that will enhance the quality of Iceland's data.

Over the last decade Iceland has experienced one of the highest economic growth rates among industrialized countries, or an average rate of 3.8% per year. Growth for 2006 is expected to be significantly higher. This impressive growth can be attributed to a combination of structural reforms, fiscal consolidation, diversification of the export base and large investment projects in the aluminum-smelter sector. Important structural changes include the floating of the currency, adoption of inflation targeting in 2001, privatization of banks and improvements in the financial sector regulatory framework. Icelandic businesses are increasingly investing abroad and have rapidly expanded their activities in several countries. Real disposable income has also increased significantly in recent years.

While economic growth has been robust macroeconomic imbalances have emerged. The current account deficit is high, but is expected to peak at over 12% of GDP in 2005. Half of the deficit is due to the large investment projects. These ongoing large investment projects have had a direct effect on investment spending and income which has stimulated consumption and put upward pressure on inflation and the exchange rate. In addition, mortgage credit conditions eased considerably after the commercial banks entered the housing loan market and started to compete with the state Housing Financing Fund (HHF) in August 2004. This represented an unexpected change which had profound implications for credit growth. Consumption has been significantly spurred by a confluence of factors underpinning optimism. A wealth effect associated with a surge in housing prices has stimulated credit growth. The relatively high real exchange rate has led to a rise in imports of consumer goods. Finally, the high income growth has added to optimism.

Fiscal Policy

The general government balance has been mostly in surplus for the last eight years. The government has pursued a policy of fiscal consolidation and has focused on debt reduction and closing the funding gap on pension obligations in the public sector. The pension system is close to being fully funded. In light of concerns that the economy might be overheating, staff has encouraged the fiscal authorities to tighten their stance. The fiscal authorities believe that additional tightening is forthcoming already in 2005. The surplus will be much larger than expected as tax receipts are running well above the budgeted amount while expenditures have been tightly controlled. At this juncture, the budget surplus for 2005 is anticipated to be 2% of GDP, but the budget proposal 2005 envisaged a surplus of 1.25% of GDP.

In July the state telecommunication company was privatized and more than half of the receipts will be used to reduce the external debt of the central government. In 2001 the foreign debt of the Republic was 28% of GDP. This ratio has been improving rapidly and is expected to be 9% of GDP at the end of the year. The strong position of the Treasury is especially appropriate as Iceland has a comparatively young population and the gross debt ratio is expected to reach 20% at the end of the year.

The government adopted multiyear spending targets in 2003 whereby government consumption may not grow by more than 2% in real terms each fiscal year. Staff has recommended that in order to increase transparency, the multiyear spending targets should be specified in nominal terms at the general government level. The authorities agreed that there were positive aspects to this change, but they have noted that the indexing culture is still relatively strong in Iceland and the general public is very literate in this sense due to the high inflation period in the 1970's and 1980's.

Monetary Policy

The CPI published on September 12 showed an increase of 4.8% from September last year, but most of the increase is due to the surge in housing prices. Inflation has been above the Central Bank's target of 2.5% from April 2004 and exceeded the upper tolerance limit twice in 2005. This development obliged the monetary authorities to submit a public report to the government explaining why inflation breached the 4% upper limit and the prospects of returning to the target. The main inflationary pressures come from strong domestic demand driven by the housing market boom in addition to those originating in the investments projects. Most of the rise in the CPI is explained by the housing component of the index. Inflation excluding housing prices remained low at 1.4% in September, after being close to zero during the summer. Goods prices in general have been on the decline, reflecting the strong krona. This has prompted calls for the removal of the owner occupied housing component from the index. The authorities, however, consider the housing component an important measure of domestic inflationary pressures and a leading indicator of more general inflationary trends later on. Hence, the monetary authorities fully agree with staff that the housing component should remain in headline CPI.

The Central Bank has responded firmly to deteriorating inflation prospects. Since May 2004 the policy rate has been raised from 5.3% to 10.25%, most recently when the Central Bank issued its *Monetary Bulletin* on September 29. This policy action has been reflected, *inter alia,* in a 10% appreciation of the krona over the last year. High interest rates have also encouraged foreigners to issue bonds in Icelandic krona in the international markets starting in late August. This has led to a further appreciation of the exchange rate in the most recent weeks.

The inflation forecast presented in the latest *Monetary Bulletin* shows a deteriorating outlook in the absence of further monetary restraint. It was on that basis that the Central Bank raised its instrument rate by 0.75 percentage points. In announcing that decision, the Central Bank said that by taking such a large step now, it would hopefully succeed in convincing households, businesses and the financial markets that it is absolutely serious in keeping inflation as close as possible to the target over the next two years and further ahead, even if this temporarily hits certain sectors hard. Leaving inflation to its own devices and allowing it to take root would be even more costly, since the process of unwinding such a development would require more painful measures.

Staff has suggested the introduction of a pre-announced schedule for monetary policy meetings that would be concluded with a public statement of the Central Bank's decision regarding interest rates. Staff believes that this would enhance transparency and the public profile of monetary policy. The authorities note this suggestion, but would like to emphasize that the Board of Governors of the Central Bank conducts regular monetary policy meetings, although they do not follow a publicly announced schedule. It is also necessary to stress that there are *de facto* four monetary policy decision dates per year, i.e. the publication dates of the quarterly *Monetary Bulletin* which contains the Central Bank's inflation forecast. Each *Monetary Bulletin* starts with a policy statement explaining, *inter alia,* the rationale behind the decision of the Board of Governors either to change interest rates or leave them unchanged. Thus, it is equivalent to a public declaration at the conclusion of a pre-announced monetary policy meeting. These dates are seen by the markets as monetary policy decision dates, as confirmed in comments by analysts and commentators and the development of expectations in the period preceding the publication of the *Monetary Bulletin.*

Structural Policies and Imbalances

Significant structural reforms have been implemented during the last decade that has liberalized the economy. The banking sector was fully privatized in early 2003 and the privatization of the state telecommunication company was finalized this summer. The HFF now faces competition from the commercial banks in the mortgage market. The authorities view these developments as positive and concur with staff that reforms of the HFF are warranted. A working group has been established to assess the appropriate changes for the institution.

Staff believes that the balance of risks is on the upside, especially due to the easing of credit conditions that have fueled consumption. Staff further believes that the monetary policy has borne most of the burden in addressing the imbalances. The Government, on the other hand, stresses that its current stance has also been adequately restrictive. In line with the government's medium-term strategy public investment projects for 2004 – 2006 have been postponed until the end of the investment period and public consumption growth restrained to 2% per year. Moreover, the bulk of the tax cuts will not be implemented until 2007-2010, when the economy is expected to slow down. Most of the proceeds from the privatization of the telecommunication company will not come into play in the economy until 2007. The Government believes that these steps should be sufficient on its part to address the rising imbalances in the economy. Furthermore, the authorities view the external imbalance as temporary and highly investment driven. Once the investment projects wind down the deficit should also contract. The intertemporal allocation of consumption is also known to be highly correlated with changes in both the exchange rate and incomes. A reduction in the foreign exchange value of the krona and contracting domestic activities have been associated with a rapid unwinding of the current account deficit.

The authorities note the staff assessment that the rapid expansion in external liabilities and domestic credit can create difficulties and intensify vulnerabilities that could amplify the downturn once investment slows down. The authorities would like to stress that the external position can, to a certain extent, be explained by demographics and should be also viewed in context of the strong financial position of the government, increasing assets of the households and a well funded pension system. The wealth of the pension system now exceeds the GDP. Most of the debt rests with the private sector which has been increasing its gross debt, but at the same time this has been accompanied by a significant increase in assets.

The financial sector has grown significantly in the last decade. The banks have increasingly been investing abroad and actively taken part in mergers and acquisitions. As a result, the banking system is much more diversified and its income base has broadened. About half of the banks income is now derived from abroad and this ratio is estimated to increase in the coming years. The total assets of the Icelandic banks have approximately risen seven fold in 4 ½ years time. The banks are well funded as the external financial environment has been benign. The banks are believed to have taken advantage of the circumstances and structured their debt accordingly. The financial sector is constantly under prudent scrutiny and the financial supervisory authority has strengthened its activities in recent years.

The main features of the Icelandic economy have been flexibility and resilience, which have been identified by the rating agencies in the past. In recent years the foundation of the economy has been strengthened significantly due to the structural reforms that have been undertaken. The authorities, therefore, believe that the economy is even more resilient than in the previous boom and that the economy will come out of this business cycle without serious disturbance. The ability of households and firms to participate in the macroeconomic adjustment should not be neglected.

In February the authorities undertook a Data ROSC exercise and the reports have been sent to the authorities, which are about to finalize their response. The whole exercise has been constructive for the authorities. It is believed that the ROSC Data Module and the DQAF reports were well balanced and gave a good overview of the current status. The authorities will approve the publication of the ROSC work and their responses on the IMF's website.