

**FOR  
AGENDA**

SM/08/273  
Supplement 2

September 8, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Staff Report for the 2008 Article IV Consultation**

The attached supplement to the staff report for the 2008 Article IV consultation with Iceland (SM/08/273, 8/20/08) has been prepared on the basis of additional information and is tentatively scheduled for discussion on **Wednesday, September 10, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Iceland indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Ms. Brooks (ext. 39809) and Mr. Luzio (ext. 38327) in EUR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat forthwith; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

ICELAND

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

**Supplementary Information**

Prepared by the European Department

Approved by Poul Thomsen and Tessa van der Willigen

September 8, 2008

1. This supplement provides an update on economic and policy developments in recent weeks. The thrust of the staff appraisal remains unchanged.
2. **The risk premiums of the three largest Icelandic banks have eased following the banks' interim Q2-2008 results.**
  - Buoyed by considerable gains on foreign exchange positions and inflation-linked assets, bank profits in the second quarter of 2008 were broadly in line with expectations. In all three banks, loan impairments on loans increased, albeit from very low levels, pointing to a deterioration in asset quality.
  - The four largest banks passed the Financial Supervisory Agency's (FME) regular stress tests.<sup>1</sup> The FME indicated that the main banks can withstand considerable financial shocks, but need to focus on maintaining strong capital and even increase it to reflect rapidly changing financial conditions.
  - Subsequently, the CDS spreads of the three main commercial banks eased by over 200 basis points (bps) in early August 2008 (Figure 1). However, they remain notably above those of similarly rated banks. The sovereign spread has declined to around 250 bps after reaching over 300 bps in July.
3. **Domestic price inflation continued to rise, mostly due to the past króna depreciation.**
  - CPI inflation edged up 0.9 percent in August 2008 to reach 14.5 percent in 12 months. Core inflation maintained an upward trend, increasing to 12.9 percent over a year ago, compared to 11.7 percent in July. The impact of the recent króna

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<sup>1</sup> Please see the Chapter II of the FSSA for a detailed explanation of the FME's stress tests.

depreciation continued to filter through to domestic prices, in line with staff's estimates.

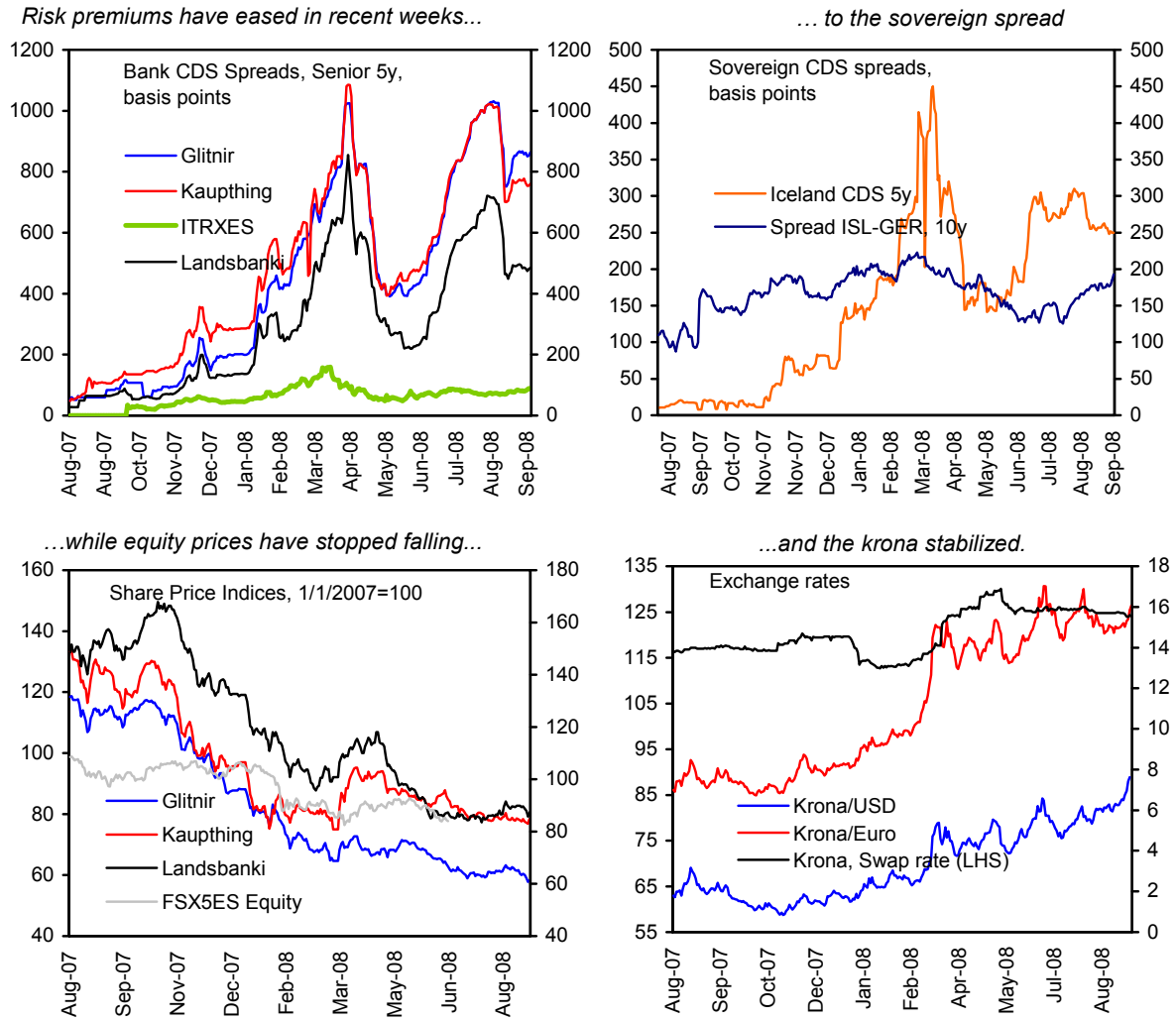
- Wages rose 0.7 percent in July 2008, bringing the annual increase to 9.1 percent, largely due to the impact of previously-settled collective agreements in the public sector. Real wages continued to contract, denting households' purchasing power.
- The króna stabilized in August 2008 after reaching record lows in late June.

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

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

- The preliminary current account deficit in Q2-2008 was more than twice as large compared to the same period a year ago and to Q1-2008, mainly due to a higher income account deficit. The IIP position also deteriorated. These developments are broadly in line with staff's baseline forecast.
- After a significant deterioration of 28 percent in Q1-2008 (mostly due to krona depreciation), the net external debt position stabilized in Q2-2008 at Kr. 4.1 billion (about 287 percent of projected GDP in 2008). This development presents an upside risk to the staff's projection of 244 percent of GDP by year-end, which assumes an improvement in the debt position reflecting banks' plans to consolidate their balance sheets.
- The country's foreign currency reserves increased by USD 850 million last month and stood at around USD 3.7 billion as of end-August.

Figure 1. Iceland: Recent Financial Market Developments



Source: Bloomberg, Datastream