

SUR/08/95

September 11, 2008

**The Acting Chair's Summing Up
Iceland—2008 Article IV Consultation
Executive Board Meeting 08/79
September 10, 2008**

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

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

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

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

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

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

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

It is expected that the next Article IV consultation with Iceland will be held on the standard 12-month cycle.